J. STERN & CO.

The Value of Long-Term investing

Insight

INNOVATION, DISRUPTION AND OPPORTUNITY: GLOBAL FINTECH GETS PERSONAL

How quickly does an innovation go from novelty to habit? Two years ago, we had not even heard of Revolut. This summer we paid for everything with it during our travels. We thought nothing of loading up the prepaid card with its easy to use app, and then paying using its contactless card technology. We no longer had the hassle of taking wads of banknotes on holiday and being left with change that goes into a wallet at home, unlikely to be used again. We could make same day transfers from different accounts that would take our bank three days or longer. Most importantly, we no longer were charged the superfluous foreign currency transactions fees and uncompetitive foreign exchange rates by our bank. We are certainly not early adopters (Revolut has four million users already) but if you do not have a Revolut card and you are a travel frequently, then it comes highly recommended (we even have a referral code if you would like!). In a short space of time, Revolut and others have changed how consumers make foreign exchange transactions and disrupted major revenue streams for legacy banks. It is just one example of how "fintech" has gone mainstream and is now an actual investment category.

From a consumer standpoint, much of the innovation in the payments sector has come from industry leaders Mastercard and Visa as they have shifted the payments ecosystem away from cash and onto card and other digital means. Their contactless technology for low ticket payments has sped up the checkout process in stores, reduced the need for coins and change and improved the security and compliance of transaction. It has been a key driver for the strong share price performance of both companies and is a key reason why we regard them as technology companies.

One flagship use of the contactless technology is travelling on the London Underground, with the easy tap in and out through the station barriers. Some of us have noticed the bright coral coloured card by Monzo over the last year, as the predominately younger userbase tap in and out of the barriers. Long gone are the days when a Platinum Visa or a black American Express card were the status symbol. Now the latest cards, hot coral Monzo card, the sleek black Revolut Metal card or even the Apple card have overtaken them in terms of prestige.

J. Stern & Co
4 Carlton Gardens
London SW1Y 5AA
United Kingdom

Tel: +44 20 3478 1800
Fax: +44 20 3478 1799
info@jsternco.com
www.jsternco.com

Monzo, like Revolut and Starling, has emerged over the last couple of years as a digital only bank account with an easy to use interface and ability to budget in real time. As it has grown it has expanded its offerings and functionality with more than two million customers. It has taken significant share in disintermediating legacy banks because millennials and digital natives no longer have the desire to visit a branch, they do not understand why it should take days to make a transfer and they are not prepared to pay exorbitant and often hidden fees for the privilege of accessing their own money.

At J. Stern & Co. we continually meet with and occasionally invest in both private and public fintech companies that are bringing highly innovative solutions to age-old problems. Common among all of them is their extensive use of data and the sophistication of their computer programs and algorithms as they disrupt the status quo. We are clearly just at the beginning of a significant and far reaching change in attitudes towards greater use of technology and these new business models. Fintech is also one of the most popular "unicorn" categories, with companies including Stripe, Robinhood, SoFi, Plaid and Zenefits, all expecting to go public at large valuations in the next few years.

Part of the reason why these fintech companies are growing so quickly is that millennials have a different attitude towards money than prior generations. Their attitudes have been shaped by the financial crisis in 2008 and high levels of student debt. Surveys have shown that almost two thirds of millennials do not own a credit card. Given that millennials are over 30% of the entire global population and will be the largest cohort of earners in the coming years, it is notable that they do not own credit cards. As such, they do not allow credit card debt to compound and are more responsible budgeters.

Linked towards this responsible spending is a trend that we have closely observed in Australia, the "buy now pay later" sector with millions choosing to transact in this way. This model is now expanding rapidly across the United States and into Europe. Essentially, companies provide interest free credit on low priced items and users repay it back in set instalments. It has flipped the credit card model on its head. Instead of users paying interest on the balance, it is interest free financing and debt no longer spirals. It allows users to budget in advance what payments come out of their predominantly debit accounts at set periods without nasty shocks.

For these "buy now pay later" companies to earn revenue, the merchant pays a higher fee for acceptance, but the merchant sees benefits from increased transactions and greater conversion. It has changed the model where the merchant pays for the customer to receive credit. These businesses have seen a groundswell in terms of users, merchant acceptance and, crucially, transactions with very low default rates. With more sophisticated risk technology and systems in place, these businesses try to better identify credit risk and defaults. This "buy now pay later" model has the potential to become prevalent across the United States and Europe, similar to how Airbnb and Uber grew from being innovators for millennials into the mainstream.

This innovation also brings regulatory scrutiny. The "buy now pay later" companies have already had investigations by the Australian authorities and will likely face further questions both in Australia and from other jurisdictions as they expand.

We fully expect regulation of digital companies to evolve as stakeholders gain experience and regulators work to create frameworks and policies. In fintech it is critical to protect customers and guard against irresponsible lending. But at the same time, we must guard against the unintended consequences of increased regulatory burdens, which can raise the barriers to entry for new competitors, make it harder for start-ups who need to allocate resources to compliance that could be invested in other areas, entrench incumbents and stifle innovation.

Europe has been a pioneer in regulation to protect data and privacy. Important new regulations in payments is coming to Europe soon. SCA (Strong Customer Authentication) requires an additional layer of safety and security for online transactions. It will involve a two-factor authorisation, for example biometric identification, or a SMS with confirmation codes at the point of checkout. These additional security checks should help to lower the risk of frauds, but it could also mean further time spent at the online checkout with the possibility of many more uncompleted purchases. The goal of companies like Mastercard and Visa is to make the payment transaction as seamless as possible, but regulators also have a duty to protect citizens. It will be fine balance to accommodate both as innovation should not be hindered.

The biggest disruption in payments is yet to come. Facebook has taking a leadership role in the Libra association which aims to create a new global currency and financial infrastructure.

We believe that Facebook has seen the success of Tencent in China and its WeChat app. In particular, the WeChat payments service diversifies away from the traditional advertising business model. The payments service allows users to link their bank debit card to the app. WeChat then allows payments to be sent between users and to pay in store and online. Even just outside our office in St. James's, London, shops take WeChat and Alipay to accommodate Chinese tourists. WeChat payments has had significant user adoption and we believe that Facebook has seen the opportunity and is working on offering a similar service to its userbase.

Cryptocurrencies have been a hot topic over the last few years as the price of Bitcoin and other cryptocurrencies have fluctuated wildly. The Libra cryptocurrency is run by a consortium of major digital companies led by Facebook and including Booking Holdings and Uber. It is backed by fintech leaders like Mastercard and Visa, but noticeably not by banks. It is a "stable coin," intended to be backed by a basket of developed market currencies and US treasury securities to avoid some of this volatility.

Libra has enormous potential but is also tremendously disruptive to the global monetary system and the central banks that govern its money supply and regulate its flows. Part of the attraction of cryptocurrencies is that they are not controlled by governments and central banks. However, Libra has the potential to undermine the central banks especially in emerging markets. Libra could provide a digital version of the stronger currencies available in developed markets and could result in emerging market central banks unable to set their own monetary policy but be forced to adhere closer to the policies of the US Federal Reserve or the European Central Bank. That is why despite the involvement of Mastercard and Visa we have already seen the backlash from governments and central banks and expect the proposal to face significant challenges before it is implemented.

Ultimately, we look for exponential opportunity in all the investments we make. We expect global fintech and payments to be a key area of investment over the next decade as it has a compelling combination of innovation, enormous addressable markets and a legacy sector ripe for disruption. Today there are more questions than answers, and while it may be some time before we use Libra to pay for our holidays, the opportunity for innovation, disruption and value creation is clear.

Giles Tulloch
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