WELLS FARGO

The Rise of Fintech

And the frontier of finance

Data provided by PitchBook

The Opportunities and Risks of a More Connected World

"The future is already here" is a widely attributed quote. Different people have said it, in different contexts and in different years. It's a timeless quote, ironically, because it captures our surprise at how quickly things can change without our noticing. The most recognizable context for the quote revolves around technology, and more surprises seem to pop up every year.

In conjunction with PitchBook, a private markets data provider, Wells Fargo is releasing a three-part series on the opportunities and risks of today's technology sector. The topic for this report is fintech. Technology's impact on the financial industry is still in its early stages, and while many new platforms are already familiar to us, many more applications are on the way. PayPal's formation in the late 1990s marked fintech's unofficial start, and dozens of mainstream applications—from phone-based money transfer apps to direct lending platforms—have gained quick popularity in recent years. They also represent the tip of the iceberg in terms of fintech's potential. Because those technologies are still in their infancy, this report will focus on venture capital activity, which is often about five to ten years ahead of the curve. The payments & processing sector was Silicon Valley's first attempt at digitizing finance. The startup and VC communities succeeded so well that it's worth paying attention to what today's fintech startups are focusing on.

Another report will focus on hardware products, including the Internet of Things and the underlying software that powers them. A third topic, cyber security, will throw cold water on the others. Our money and privacy are valuable commodities that are increasingly vulnerable to attacks. While technological advances make our lives easier in many ways, they also come with potential costs.

This series, guided by our industry experts, is geared toward a corporate audience. PitchBook Data has provided numbers that help contextualize these trends as they play out in the venture capital, private equity and M&A markets. Deals and investments happen every day, but as any dealmaker knows, every transaction has a thesis behind it. When many similar transactions begin to happen across entire industries, it often means something bigger is going on.

Wells Fargo's Technology Banking team works with a large number of technology companies to help them grow. We've worked with a multitude of fintech companies to deliver a range solutions, from authenticating identity to new payment types to helping customers consolidate their receivables. For more insights on fintech and the future of finance, please visit us at welcome.wf.com/tech-banking.

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Introduction

The fintech industry got its start with the payment processing business 10 years ago, when venture funding was relatively modest and focused almost solely on the movement of money. Today, the fintech industry spans across several segments and technologies including popular investor hubs such as insurtech, wealthtech, regtech, and alternative lending platforms, leaving payment processing a minority.

The fintech market is unique among tech sectors, especially at the early stage. Many tech-enabled segments focus on disruption, or in many cases, creating new markets. Disrupting a market as large as financial services requires different strategies than what one commonly sees in segments such as social media or Software as a Service (SaaS). And, importantly, it requires a longer return timeline. Most tech segments revolve around three- to five-year return timelines. In fintech, however, such a quick turnaround might be unrealistic, considering the regulatory hurdles in place, as well as the size of industry incumbents.

3-5 year VC return timelines are unhelpful for fintech startups, which need more time to develop before exiting.

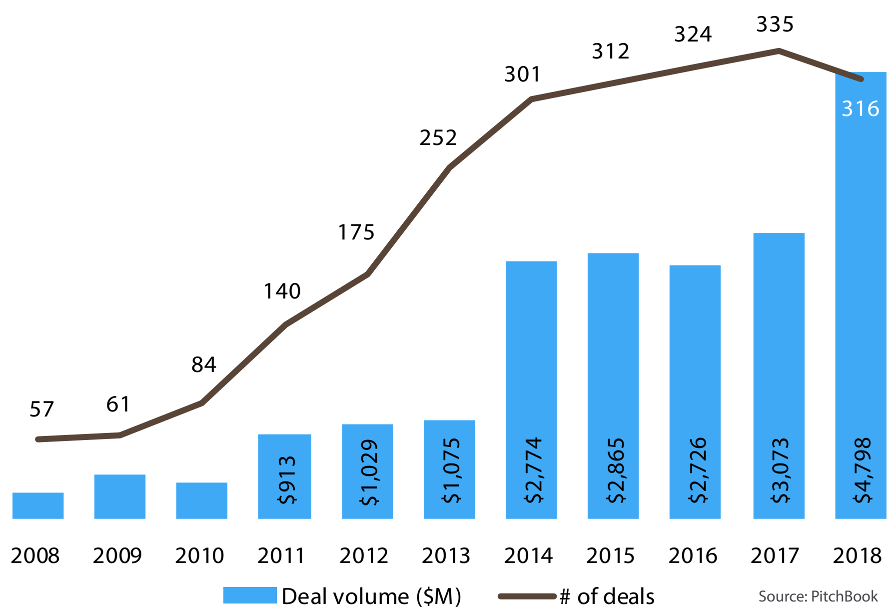
The vast majority of fintech companies can be characterized as startups, many of which are venture-backed. Any industry that relies heavily on venture capital (VC) must take exits into account. While most tech sectors take full advantage of the IPO market, fintech is again unique. The preferred exit route for fintech startups has historically been through mergers and acquisitions (M&A), specifically from institutional buyers. Fintechs can be a way to fill a product or service gap for both retail and investment banks. While established corporate competition is considered adversarial in most industries, the relationship between fintech companies and larger banks is considered more symbiotic. A collaborative approach builds on the longstanding tradition of banks sourcing innovation from third-party financial technology vendors that specialize in banking, including payment services. For banks, fintechs are connectors to the latest technologies and nimble execution that can heighten responsiveness to customer demands and speed to market. For fintechs, banks bring deep customer relationships, trust, security, and compliance along with scale efficiency and banking infrastructure connectivity. Delivering services through banks can provide fintechs with a critical growth platform.

This report will focus on select institutional categories within fintech. The three main segments discussed include direct lending platforms, wealth management platforms and insurance, each of which is dominated by large incumbents.

Fintech's initial promise

Fintech's initial promise was rooted in payment processing. The highest profile startup in the space was PayPal, which emerged in the dot-com boom. The internet, then in its infancy, lacked a secure payment solution for online purchases. PayPal went public in 2002 and saw its shares immediately rise 55 percent, one of the few success stories in the aftermath of the dot-com crash. Months after going public,

Payments and processing VC investments by year



the company agreed to be acquired by eBay, which owned PayPal for almost 12 years.

PayPal's early history is noteworthy in the broader context of the fintech market. Considering how few dot-com era startups survived the crash, PayPal's popularity with both public investors and strategic acquirers was unique. As the first incumbent player in online payment processing, PayPal was a confirmation to both Wall Street and Silicon Valley of the importance of securing payments in online commerce. PayPal's initial success as a business model helped create the payment processing market we know today, where late-stage startups such as Stripe and Square are industry leaders.

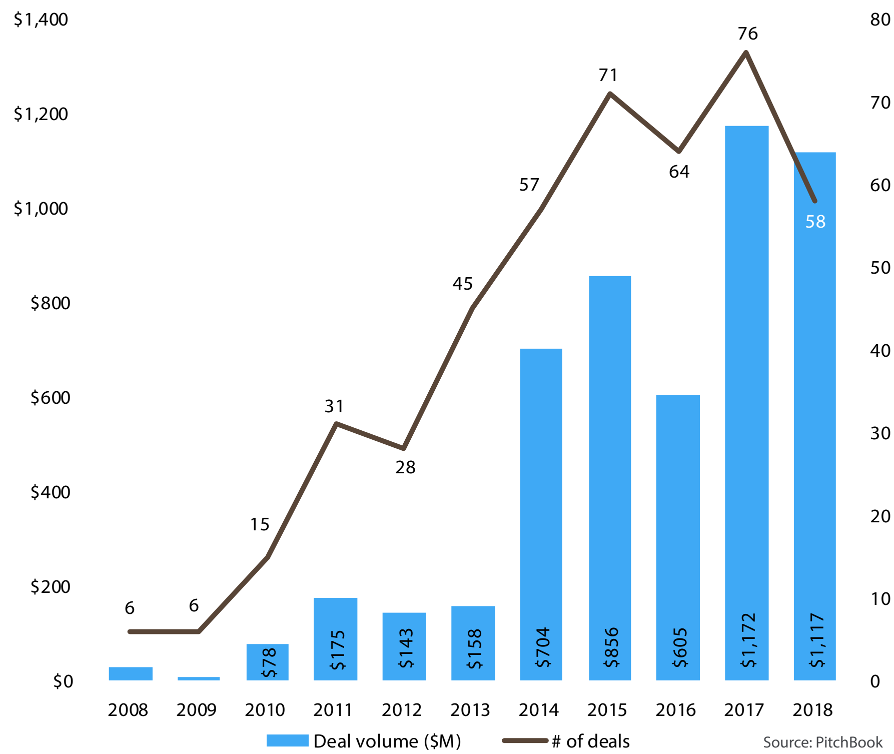
The market has grown much bigger in recent years. 2018 recorded another $4.8 billion of capital invested in the payment processing segment, nearly 20 years after PayPal was formed. Several fintech segments now boast billion-dollar-plus years for venture funding, and the payment processing space now represents a minority of total VC financing.

Payments & processing now represents a minority of overall VC activity within fintech.

From payments to transfers

A compliment to the payment processing sector, money transfer companies allow individuals and businesses to seamlessly send and receive money.

Money transfer VC investments by year



2018 came close to the record-setting year in 2017 in terms of total value. The segment saw a dip in volume, however, as recent investments have been earmarked for larger, late-stage rounds for established players. The downtrend in volume is a recent phenomenon, but today's figures compare well to the industry's infancy only 10 years ago. Money transfer startups collected less than $10 million as recently as 2009, when smart phones were just beginning to infiltrate the market. By 2014, total VC invested cleared $700 million for the first time; by 2017, more than $1 billion was invested on an annual basis, a hurdle that was cleared for the second time in 2018.

Fintech gets personal

Personal finance startups have begun to proliferate, providing consumers tools and services to help them manage their spending and saving habits. These companies serve the same general market as retail banks. The personal finance vertical has enjoyed strong years of funding since 2014, the first-year total funding leapt above the $1 billion mark. The $1.9 billion recorded that year quickly swelled to $4 billion in 2015, before finally peaking at $4.9 billion in 2018. The number of personal finance startups has boomed, in

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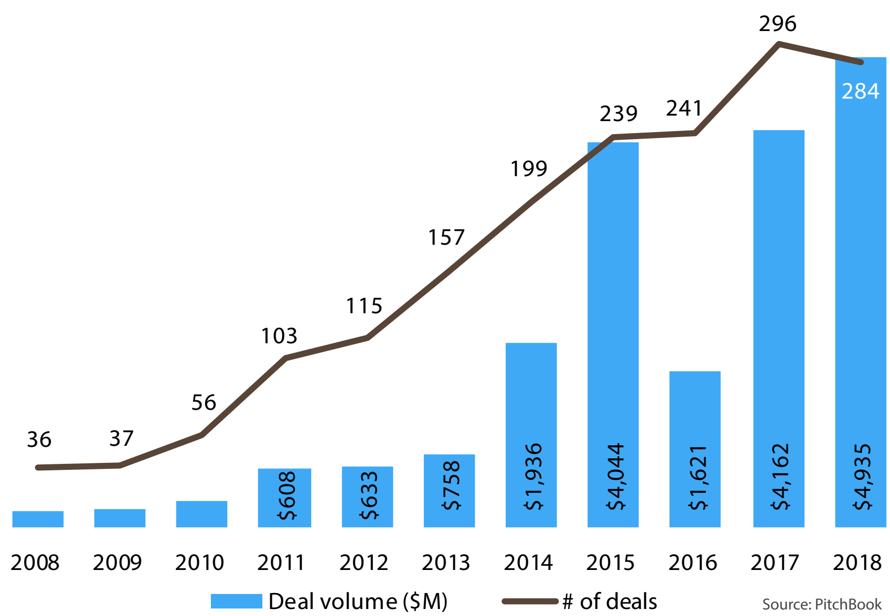
part due to the size of the market itself. Most success stories can be traced back to high-quality systems aimed at automating routine tasks and transactions, such as expense breakdown, autopay features and better overdraft protection tools. Silicon Valley's focus on cutting-edge technology led to a large portion of the financial services industry being effectively overlooked. The amount of attention now paid to personal finance—in the form of institutional capital—suggests that this corner of the market will continue to grow in size over the medium-term, and potentially add societal value if done effectively.

Personal finance VC investments by year



Lenders go alt

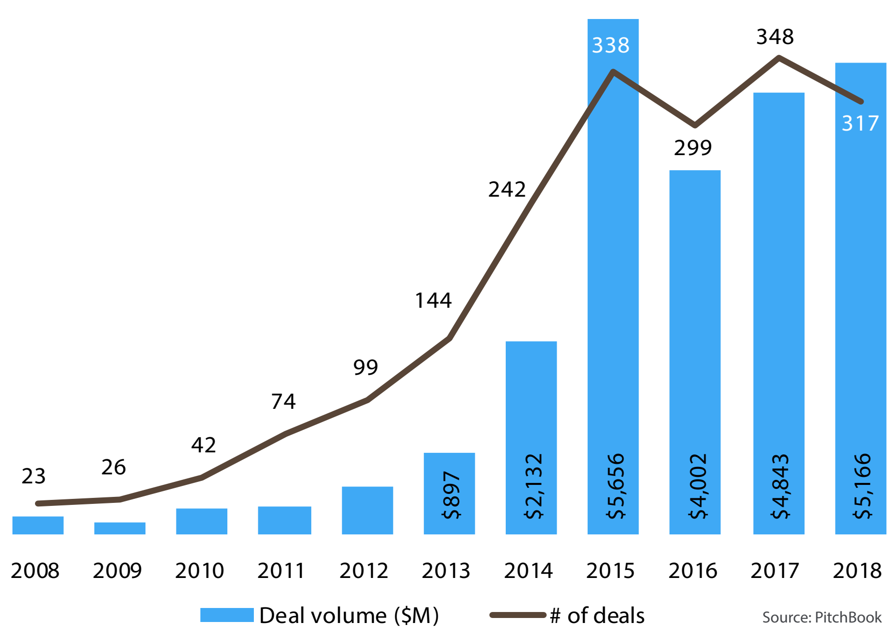
Similar to personal finance, alternative lending platforms also have garnered attention. Now one of the largest verticals within fintech, alternative lenders have been funded with at least $2 billion on an annual basis since 2014.

The alternative lending segment's utility will continue for the foreseeable future. Alternative lenders provide capital to borrowers who otherwise cannot secure it through traditional lenders. Institutional banks are often hamstrung trying to offer credit at the lower end of the market, where small lines of credit are often cost prohibitive.

The road to wealthtech

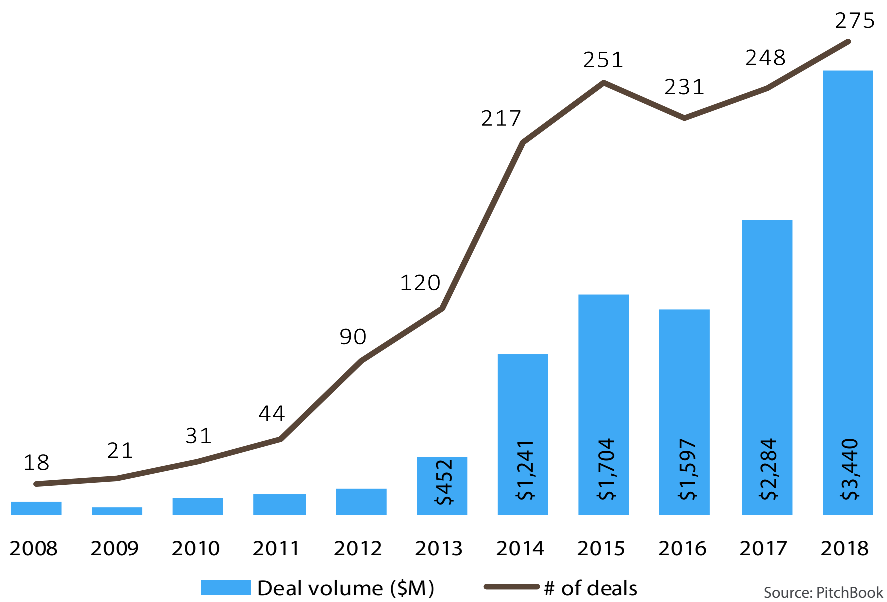
The wealthtech corner of the fintech market began as an alternative investment platform for wealth management. Features included full-service brokerage accounts, robo-advisors and digital marketplaces for certain asset classes. Over time, however, many wealth management platforms began to add more traditional banking features, including checking accounts and other ways that tied back to legacy bank products. Particularly in this segment, fintech

Alternative Lending VC investments by year



players are looking to leverage existing technologies with the aim of becoming the primary financial partner for their customers. This is an important battleground for all participants. While these startups are often not looking to become licensed banks, their success rates within wealthtech are creating a potential inflection point for the broader retail banking industry. More so than other fintech verticals, wealthtech has gained significant user acceptance in recent years while continuing to broaden their product suites and technological reach within a massive market.

Wealthtech VC investments by year



Source: PitchBook

VC insurance agents

Insurance costs command a large share of corporate budgets. Compared to standard financial services products, most companies routinely spend upward of four or five times that amount on insurance and risk mitigation products. Insurtech, a relatively novel branch of the fintech market, leverages emerging technologies to administer the creation and distribution of insurance-related products.

The market got its start as a series of insurance platforms offering features to help agents find new clients. Today's insurtech carriers have the ability to become full-stack insurance providers, though it isn't necessarily clear what end effect those platforms would have.

Insurance is a low-margin business, which often discourages newcomers and, until recently, most of Silicon Valley. Insurtech providers have an opportunity to claim market share, but the industry they're seeking to disrupt, especially on the consumer side, is price-sensitive. Cost-conscious insurance shoppers are almost exclusively focused on price, and some platforms have the ability to drive them down through underwriting automation. For other startups, the more promising stakes in the market are niche demographics that have been underserved by the traditional apparatus. Part-time car drivers, gig economy workers and a wide swath of small business owners, for example, may find better options from insurtech providers who can successfully apply predictive analytics to their unique circumstances.

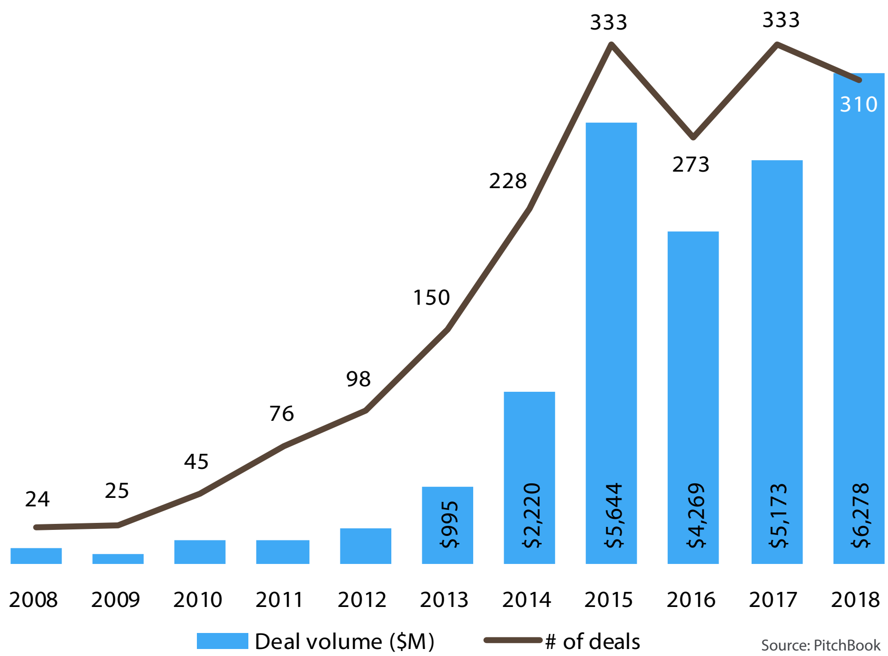
The insurtech market is more likely to find success targeting the M&A market, where fully established insurance providers can buy the underlying technology and apply it at scale. The number of insurtech startups receiving VC financing has ballooned since 2015, when more than $5 billion in capital was funneled into 333 startups. Last year's 310 financings continued a four-year stretch of volume eclipsing at least 270 annual financings.

The compliance opportunity

One of the largest opportunities within fintech, and one with potentially significant societal value, involves regtech. Targeting the large, mostly mundane industry of compliance, regtech provides more agile systems to sift through compliance data, prevent fraud, streamline audits and monitor employee activity. The market came into its own following the financial crisis, with only a few startups receiving financing in the immediate aftermath. More financings have followed as the niche industry has developed, but the regtech market remains one of the lesser-financed segments of fintech overall.

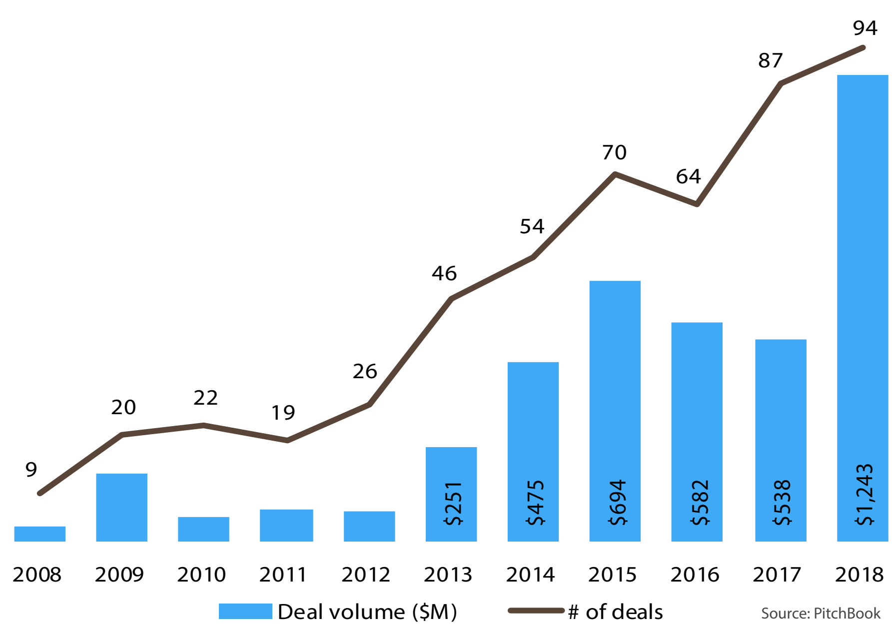
It remains to be seen how the broader regulatory market will react to those new technologies. One potential hurdle is exits. Large investment banks and asset managers have built their own bespoke systems over the years, particularly in the aftermath of the crisis, with an internal price tag that runs in the hundreds of billions of dollars. Each bank's system is unique and nontransferable, and while established players in the financial markets would welcome improvements to their systems, the would-be M&A candidates would need to suit specific needs to one specific buyer. While regtech startups may provide significant value to the market, institutional incumbents have been largely content to invest a large percentage of their revenues to develop their own systems in-house, potentially negating an important exit ramp for newcomers. More likely, the most successful startups tackling fraud prevention, data tracking and reconciliation will become sustainable IPO candidates down the road.

Insurtech VC investments by year



Source: PitchBook

Regtech VC investments by year



Source: PitchBook

Summary

While established corporate competition is considered adversarial in most industries, the relationship between fintech and large banks is considered more symbiotic. Startups help bring innovation to the sector; banks provide brand recognition, millions of long-term customer relationships and large pools of capital.

Silicon Valley's focus on cutting edge technology and creating new markets wholecloth has led to a large portion of the financial services industry to be effectively overlooked. That perception is changing rapidly in segments like wealth management, insurance and regulatory compliance.

Fintech's beginnings can be traced back to PayPal, which was Silicon Valley's first foray into traditional finance. PayPal, one of the few dot-com era startups to survive the crash, demonstrated the potential inherent in financial technology, not only to consumers but perhaps more importantly to entrepreneurs and venture capitalists.

As new segments within fintech gain momentum, their path to growth is, in some cases, leading them to mimic traditional banking services. For example, many wealthtech platforms have added checking accounts as a way to become the primary financial partner of their clients.

Likewise, the insurtech segment is growing rapidly, despite the insurance industry's reputation for low margins. Today's insurtech carriers have the ability to become full-stack insurance providers, a development few saw coming a decade ago.

From an investment standpoint, while many of these segments are popular and promising, exits pose a question mark. Most fintech startups won't become IPO candidates. Instead, they are much more likely to become M&A targets over time.

However, the finance industry, particularly banking, has a penchant for developing solutions in-house and acquire as needed. Investment banks developed bespoke regulatory systems in the aftermath of the crisis, for instance. The health of the broader fintech model will rely on startups paying close attention to the needs of the industry incumbents and their customers alike.

John Huber, Senior Vice President, Wells Fargo Corporate Banking

John Huber is a Senior Vice President for Wells Fargo's Technology Banking Group (San Francisco) where he manages client organizations on a national basis for growth-stage, innovation-based companies. He has a strong interest and expertise around all aspects of payments and consumer- and commerce-enabling technologies. John is a long-time board member for AAMA and served on Northwestern University's Regional Leadership Council. He received his BA from Northwestern University and his MBA from the University of Chicago.

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