LOMBARD ODIER
INVESTMENT MANAGERS

Investment Viewpoint

Global FinTech: positioning for 2022

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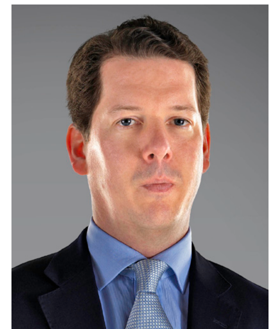
January 2022

Key points

- In 2021, trends in the FinTech space accelerated and earnings were extremely robust. Valuations for loss-making, hyper-growth companies became more extreme before sheer saturation dampened sentiment.
- We expect blockchain to be adopted more broadly in 2022, as well as the acceleration of embedded finance in non-financial platforms, and further development of open banking.
- Amid these ever-changing market conditions, we remain loyal to our investment principles of selecting profitable, quality compounders with a pure focus on FinTech and expectations embedded in their valuations.



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2021: expectations to reality

This time last year, we formulated several expectations in our white paper "FinTech positioning for a re-opening in 2021." They were:

- The pandemic would accelerate many of the secular FinTech growth trends and help to increase the digitalisation of the broader economy.
- Growth would continue to be heavily favoured. Over the course of 2020, lower interest rates, in combination with a scarcity of companies growing their earnings, had led to a sharp re-rating of growth stocks. However, valuations in the space, especially for the hyper-growth-oriented business models, had reached extreme levels.
- This extreme environment called for very selective stock picking among companies attracting high growth expectations. Within our FinTech strategy, we avoided most of the revenue-growth-at-any-price stocks and preferred high-quality compounders.
- With Democrats taking control of both the US Congress and the Senate, and pledging additional economic stimulus, we thought this would likely lead to higher inflation and an end to the environment of low interest rates that had been with us for the past decades.
- Covid-19 vaccination drives would be key in 2021. With positive vaccine development towards the end of 2020, stimulus could be lowered again, allowing investors to differentiate between the underlying quality of companies once more.

The accelerating trends were indeed evident across the FinTech space, where digitalisation progressed from being a nice-to-have to a must-have for financial services companies. This resulted in some of the biggest sales and earnings growth in history for FinTechs, with strong earnings beats in every reporting quarter of the year. The enabling technology segment of our universe benefited particularly strongly from this trend, with digital transformation companies Epam and Endava,[1] for example, growing over by 50% versus the 'normal' 20% historic sales growth.

While the extreme valuations for loss making, hyper-growth companies didn't matter at the beginning of the year, sentiment completely changed towards the end. This was not triggered by higher interest rates, but by a more general saturation after tonnes of special purpose acquisition companies (SPAC) and IPOs came to market at far too high valuations and often with shaky fundamentals. New valuation measures like enterprise value-to-revenue-to-growth or fantasy total addressable/available markets (TAMs) reminded us of the extreme optimism from the dot.com era. Although market preferences changed very frequently during the year, we stuck to our investment process, selecting companies with that are pure FinTech businesses and are profitable, quality compounders with a strong emphasis on embedded expectations in their valuations.

While only feared at the start of 2021 and, according to many, only transitory in the middle of the year, inflation remained stubbornly high towards the end of the year, caused by labour shortages, supply chain issues and high commodity costs feeding through the entire economy. This was clearly reflected in sector returns throughout the year, with energy being the standout performer by far.

Unfortunately, it also became evident that the vaccination campaigns only resulted in a temporarily re-opening trade. Towards the end of the year, new covid variants forced governments, especially in Europe, to shut down large parts of the economy again. This resulted in the economically sensitive digital payments segment of our universe and portfolio flipping from being a tailwind to the biggest detractor of performance. This happened despite ongoing solid results and extremely attractive valuations.

Key developments in 2021

Two trends highlighted acute risks in the FinTech space during 2021. In the retail space, the gamification of financial markets saw large communities of new investors gather on platforms like Reddit in order to squeeze hedge funds out of favoured short positions. The best example of this new gaming experience was the heavily shorted, nearly bankrupt retailer Gamestop,[2] which shot up 1,600% in January 2021 on the back of coordinated retail investor support. In the cryptocurrency space, where we have no direct exposure, we observed similar irrational behaviour. Encouraged by tweets from celebrities, the community jumped from one crypto coin to another, resulting in the 'joke' Dogecoin reaching a market capitalisation of USD 85 billion in May 2021. In both instances, regulators were completely behind the curve and allowed this to happen without any consequences.

On the institutional side, we witnessed a similar trend as SPACs became the mainstream method for companies to go public. Traditional initial public offerings (IPOs) – with proper investor education objectively describing business models, opportunities, risks, historical financial statements and with regulatory stamps and independent research – were bypassed. SPACs, or blank cheque companies, became the preferred route to stock exchanges. They enabled firms to raise vast amounts of money based on the sponsor's reputation in order to find appropriate targets at the right price, with very limited and only subjective information from the SPAC itself. Of course, this all ended in tears with most SPACs ultimately trading below their issue prices, making SPAC management teams and the selling companies the only winners. Here again, regulators were far behind the curve.

Towards the end of the year, optimism suddenly turned into risk-off behaviour, as seen in the payment space amid the extreme fear of disruption. While companies were rewarded for earnings beats in the first half of the year, driven by the acceleration of digital trends,

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[2] Roy Charles Amara (7 April 1925 – 31 December 2007) was an American researcher, scientist, futurist and president of the Institute for the Future. Hi is best known for coining Amara's law on the effect of technology. He held a BS in Management, an MS in the Arts and Sciences, and a PhD in Systems Engineering, and also worked at the Stanford Research Institute.

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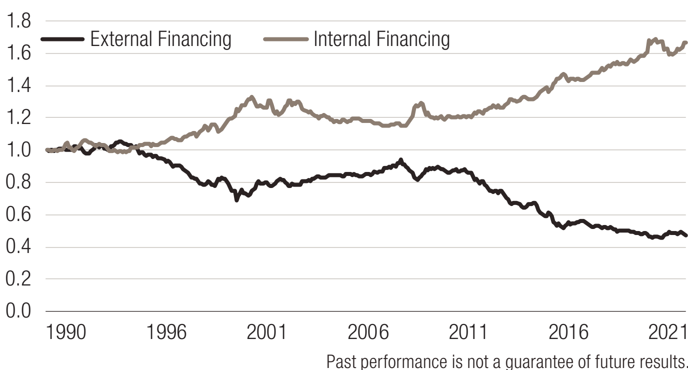
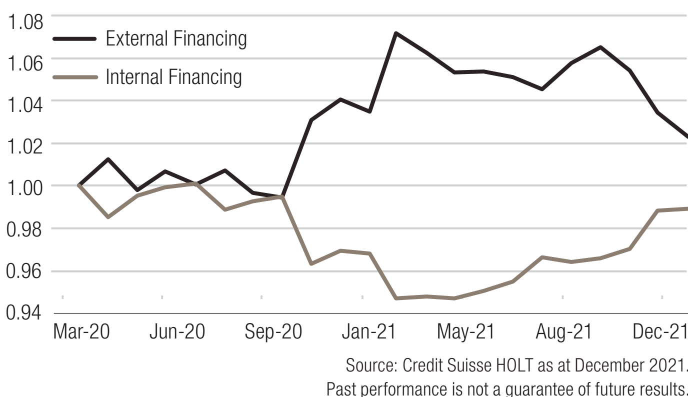
after the third quarter we observed a glass-half-empty approach towards solid but decelerating earnings beats. Disruption fears were the main culprit and a reason to take profits. Driven by extremely low interest rates and abundant access to capital, many companies, both private and public, are swollen with liquidity, resulting in record capital formations. Investors have been obsessed by these new kids on the block that only focus on, and were rewarded for, subscriber and revenue growth. Instead of properly questioning the sustainability and underlying quality of these new, externally financed business models, it was the legacy (or FinTech 1.0) companies with proven business models, solid track records and internally financed growth that were heavily de-rated as the new arrivals completely took over – which we describe in detail in our digital payments white paper. Although the jury is still out on the ultimate survival rate of the new entrants, figure 1 shows that last year's outperformance of externally financed business models was an exception to the norm and, longer-term, we believe the place to be is in companies such as Visa, Endava, Intuit or Accenture, which exhibit internally financed growth and are holdings in our portfolio.

FIG 1. PERFORMANCE OF COMPANIES WITH INTERNALLY AND EXTERNALLY FINANCED BUSINESS MODELS FROM 1990-2021
Cumulative Excess Returns



Past performance is not a guarantee of future results.

DURING THE COVID-19 PANDEMIC
Cumulative Excess Returns



Source: Credit Suisse HOLT as at December 2021.
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The ultimate combination of this obsession with overvalued loss making, externally financed hyper revenue growth companies, given regulators remain behind the curve, is detailed in our white paper on the rise of buy now, pay later (BNPL) companies.

Finally, China's regulatory crackdown on the technology sector in July was an important moment. Although we had little exposure, it has impacted big tech companies across the world. Eventually, it could even be that the Chinese crackdown on the power of big tech will show up in history books as being the first move, followed by action in the West, to rein in the power of big tech companies that have become increasingly powerful year after year.

Our 2022 views

With many of our peers in the FinTech space struggling in 2021 after moving up the risk curve, we remained loyal to our original promise: selecting high quality, profitable compounders with pure FinTech businesses that benefit from structural trends in the space, and which are trading at reasonable valuations. Furthermore, with markets rapidly changing from month to month, a disciplined portfolio construction process with the following characteristics remains key:

- Building a balanced portfolio across both the Financial and Technology sectors to hedge for interest-rate moves
- Combining the stability of established FinTech companies, the predictable growth of enabling technology providers and the high growth of up-and-coming FinTech enterprises
- Being globally diversified across the best possible combination of quality, growth and valuation
- Limiting single-stock risk by sizing of individual positions.

We are sticking to our cyclical upside bias for the next year, as well our exposure to the digital payment space, which is approximately 30% of the portfolio. In this way, we have positioned the portfolio to deal with possible changes in interest rates that could result from inflation pressures and general economic activity. Furthermore, we think the decline of the legacy payment providers has been greatly exaggerated and the likes of Visa, Mastercard, Global Payments and Fiserv will continue to defend their moats, embrace the latest technological trends such blockchain, artificial intelligence, cloud computing or new financial offerings such as BNPL or cryptocurrencies.

The trends we expect to be top of mind in 2022 are as follows:

- Broader adoption of blockchain technology, which we have explored in our tokenisation white paper
- Acceleration of embedded finance or the seamless integration of financial services into non-financial platforms
- Open banking, which will enable third-party developers to build applications and services around financial institutions

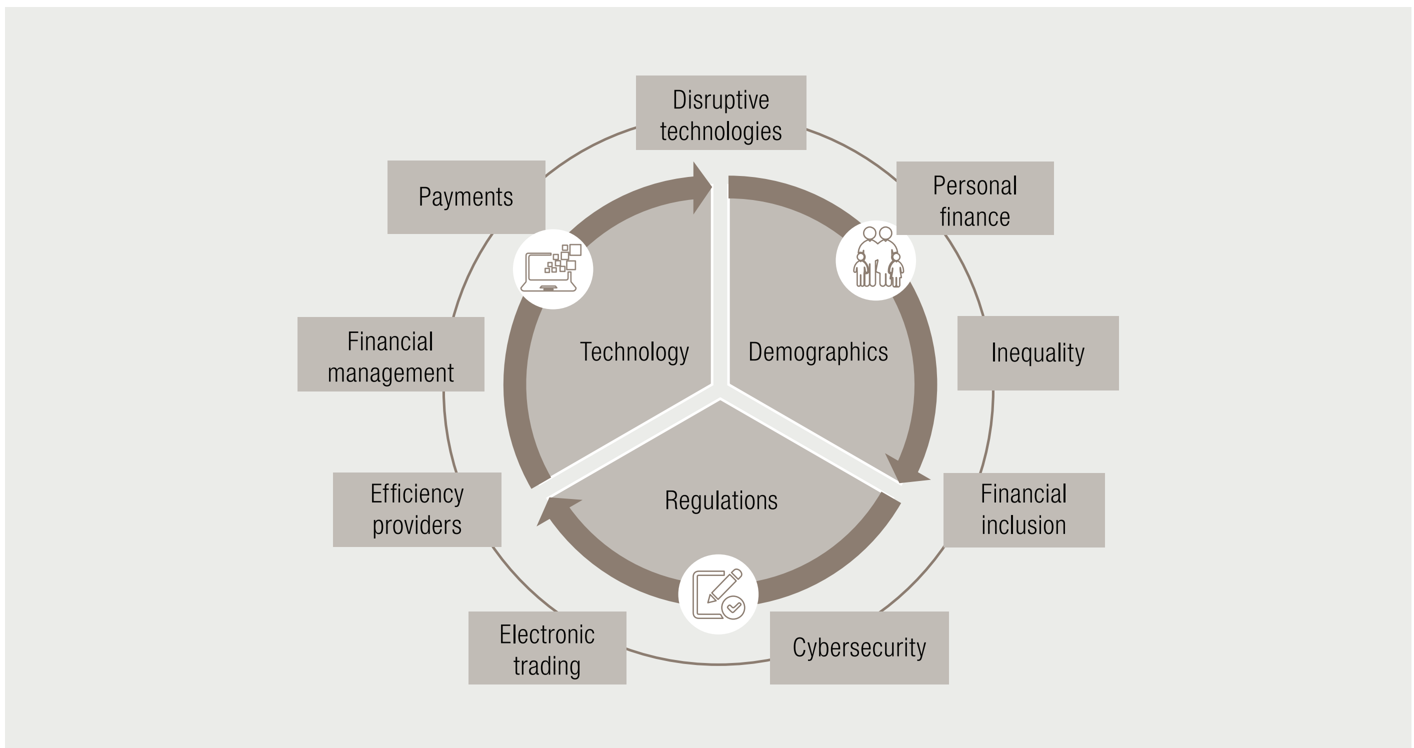
Furthermore, we expect regulators to start catching up with the latest trends to create a more level playing field. In terms of market preference, we expect the rotation into quality to continue into the new year. However, after the heavy sell-off in loss making, hyper-growth stocks, it is inevitable that there will be some strong, short-term reversals.

Portfolio positioning

Trends investing boils down to being able to monetise behavioural inefficiencies in the market, where the impact and pace of change is underestimated in the long run. This change results from three distinct drivers: technology, socio-demographics, and policy and regulation. Eventually, all trends can be traced back to these three drivers or a combination thereof. From an investment perspective, however, not all of these drivers of change can be equally monetised. Socio-demographics, for example, is slow moving and very transparent for everyone to incorporate in their models and predictions. Policy and regulatory-driven changes can be very impactful, but predictability is lacking and we tend to see more reactive rather than anticipatory price movements.

Finally, technological change provides the trained professional with ways to exploit behavioural biases resulting from a tendency by the market to overestimate technological change in the short term but underestimate its long-term impact. This is often referred to as Amara's law.[3] Within FinTech, we can think of ageing, urbanisation, the rising middle class and financial inclusion as socio-demographically-driven change. Inequality, regulatory equality between incumbents and start-ups, cyber security requirements and data protection are examples of policy-driven change. Finally, distributed ledger technology, payment infrastructure, and artificial intelligence and big data integrations are examples of technology-driven change that impacts the FinTech space substantially. We have summarised this in figure 2.

FIG 2. DRIVERS OF CHANGE AND RESULTING FINTECH TRENDS



Source: LOIM as at December 2021. For illustrative purposes only.

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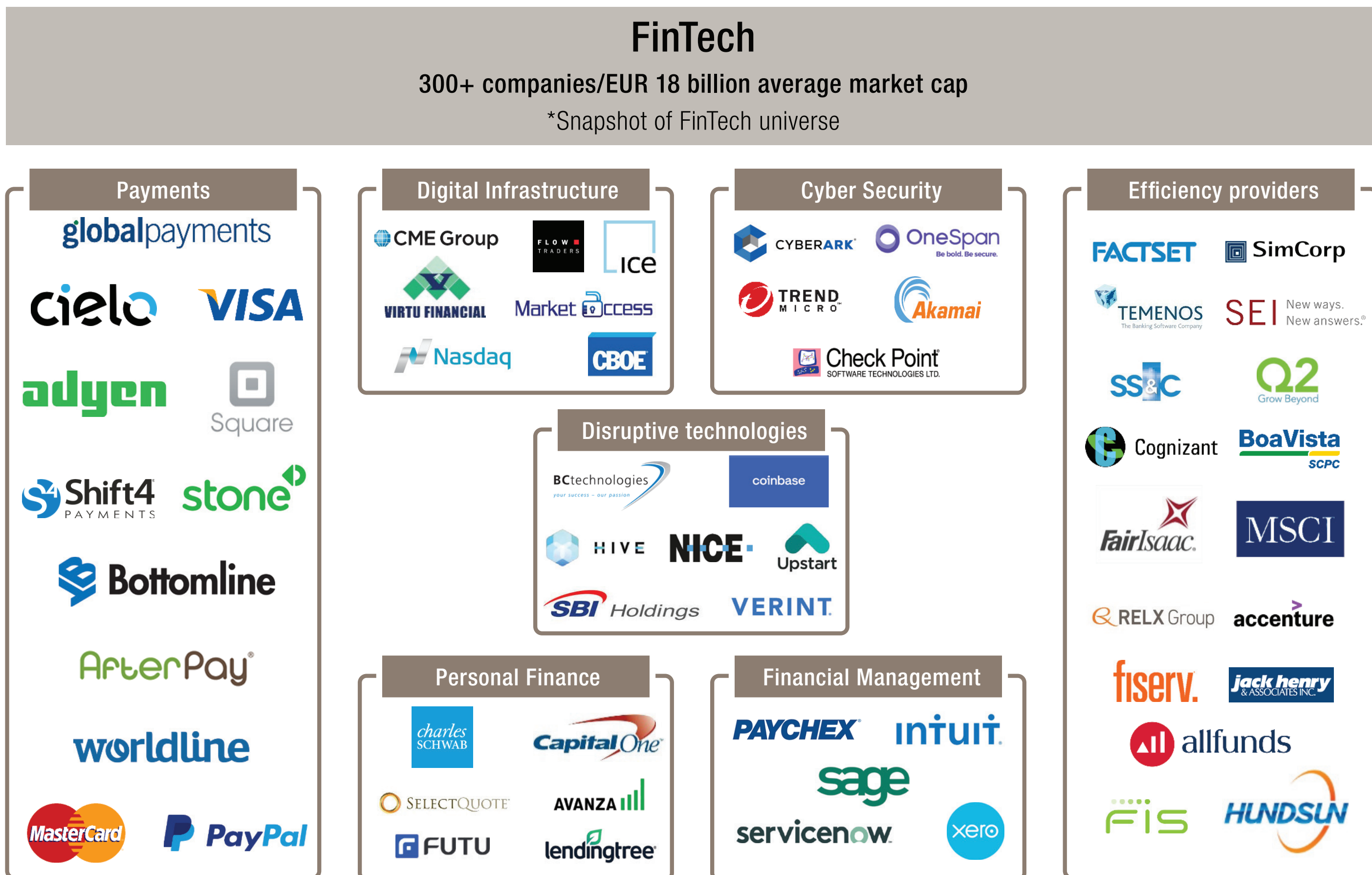
FIG 3. LOMBARD ODIER'S FINTECH UNIVERSE: AN OVERVIEW



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For our Global FinTech strategy, we have identified more than 300 companies that we expect to benefit from the digitalisation of the financial sector. A snapshot of this universe is listed in figure 3. We apply a quality overlay on top of this universe to select companies with profitable business models most purely exposed to FinTech, and with strong financial track records. Without exception, all members of our proprietary FinTech universe will benefit from increased digitalisation.

Within the quality framework of our investment process, we have constructed a balanced high-conviction portfolio of 40-60 companies, comprising those participating in secular growth as well as those benefiting from a re-opening. All stocks in our top 4% of holdings are digital-payments companies. Within this industry, we have a contrarian view and do not invest in consensus names such as Adyen, Block (old Square) or PayPal,[4] but instead focus on undervalued compounders such as Fiserv, Global Payments and Fleetcor. The contrast with the underlying fundamental data is growing by the month. If the market doesn't do its job, we think this is an area where M&A activity could become a trigger for recognising their value.

Companies in the enabling technology sector and established FinTechs comprise around 90% of the portfolio (equally distributed), with up-and-coming FinTechs limited to the remaining 10% of the portfolio due to their elevated valuations and higher risk profiles. Longer term, we expect this category to comprise about a quarter of our portfolio, but for now we prefer the stability and predictability of established and enabling FinTech companies.

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