

Evolution or Revolution? The Impact of Fintech on Working Capital

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Prepared for:



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EXECUTIVE SUMMARY

Evolution or Revolution? The Impact of Fintech on Working Capital, commissioned by C2FO and produced by Aite Group, discusses the value financial technology (fintech) innovation brings to working capital evolution.

Key takeaways from the study include the following:

- The 2008 credit crunch can be thought of as an asteroid that hit the earth, making dinosaurs extinct and allowing species that lived in small niches to survive and flourish thanks to their capacity to adapt to changed environmental conditions.
- Fintech firms are nimble companies that have taken advantage of the crisis, while banks have been going through a severe existential change. Emerging fintech firms have the ability to change and positively disrupt existing models.
- Fintech solutions support working capital optimization by fostering collaboration between buyers and suppliers. Problems emerge when trying to reach out to the thousands of lower-tier suppliers (i.e., the suppliers' suppliers). This "long tail" is probably the most interesting because companies here are craving money, but they have no idea how to participate in the program. Fintech providers can handle the middle of the tail.
- Savvy banks are looking at technology entrants as an opportunity rather than a threat and are increasingly becoming aware that investments into these new technologies must go beyond pouring in money, as the real investments are in education, awareness creation, and really understanding what corporations want.
- Companies must look with confidence at banks that partner with fintech firms that create transparency through new paradigms and new systems. These are solid alliances that connect those that have the money with those that are looking for money.

INTRODUCTION

We are living in an age in which technology is revolutionizing the way we operate within our personal lives and across industries. Increasingly, it's changing the way the financial services industry operates, marking clear trends within fintech companies and specific innovations. At a recent roundtable in London, Enrico Camerinelli, senior analyst at Aite Group, joined a panel of working capital experts, including Mark Tweedie, U.K. corporate banking head at Citi Institutional Client Group; Charles-Henri Royon, VP EMEA at Tradeshift; Sandy Kemper, Founder and CEO of C2FO; and Mark Thomas, director of client operations, EMEA at C2FO, to discuss fintech's effects on working capital.

METHODOLOGY

The paper summarizes the roundtable discussion, integrating post-roundtable in-person interviews with the participants.

GROWTH OF FINTECH

Fintech isn't just about the tiny startups, although they represent today's focus of interest. It's about how technology is changing the wider financial system.

The credit crunch can be thought of as an asteroid that hit the earth, making dinosaurs extinct and allowing species that lived in small niches to survive and flourish thanks to their capacity to adapt to changed environmental conditions. So fintech companies are nimble companies that have taken advantage of the crisis, while banks have been going through a severe existential change.

After "cleaning house," banks are now making some very clear decisions about where they want to be geographically, what they want to do functionally, and which client-base they want to serve. Banks understand technology's relevance as a business-change enabler and are approaching the fintech space along different avenues, nurturing, acquiring, and fostering the emergence of third-party technology providers. Banks have especially increased their attention to technology solutions for regulatory compliance (i.e., regtech), understandably because the national and international regulators, such as the Federal Communications Commission (FCC), Financial Conduct Authority (FCA), and the Basel Committee, have put banks under severe scrutiny and change in order to ensure enough capital value, better liquidity, and better leverage. The investments that the biggest institutional banks have to put in place are in adherence and compliance due to the regulatory changes.

While these factors are pushing banks to react and take action, financial institutions are learning how to proactively take advantage and build business opportunities from nascent demand (i.e., "pull" factors): emerging markets' quantum leaps in terms of technology through unconventional and traditional mechanisms, increasing emergence in the consumer technology and institutional space, and capital looking for a home. This last point is extremely important and critical for banks that want to shape their mid-to-long-term IT strategies. On one side, financial institutions have to deal with an anemic economy that generated negative interest rates, uncertainty regarding central banks' actions, and investors that seek for yield and security of principal. On the other side, tremendous amounts of venture capital and private equity are looking for investment opportunities.

This is where technology comes into play, as it uses very little capital to get extraordinary things done. Large IT firms, bank IT departments, startups, and smaller companies are all constituents of an ecosystem of parties with extreme needs on the demand side and huge amounts of capital looking for a home on the supply side. While this huge amount of money is ready to be deployed in the market, there's also a massive blockage because of the lack of streamlined processes. Banks need to completely reinvent the market in this space. It's about how to distribute liquidity in a grid of streamlined processes.

Companies are always in search of ways to cut costs and remove inefficiencies, and investments in technology have traditionally been a safe bet to streamline processes by replacing manual operations with smoother automation. Things have evolved in today's world of apps deployed on a common platform to solve myriad consumer needs, and IT is an enabler of new business models, not just a cost cutter. From the corporate perspective, business-to-business (B2B)

transactions and B2B problems tend to be expensive to fix, and money flowing into financial large-scale B2B problem-solving companies represents a significant opportunity for all parties involved. B2B processes involve buyers, suppliers, and intermediaries, and operational inefficiencies in any part of the chain generate working capital inefficiencies for all.

KEY AREAS IN WHICH FINTECH IS ALREADY HAVING AN IMPACT: WORKING CAPITAL

According to market estimates, US\$40 trillion is currently sitting in businesses' books of receivables on any given day. There is a lack of connection between those who have cash and those who need cash, mainly due to the untapped liquidity of those who have it. This is very true in import-export trade and B2B transactions.

Traditionally, intermediaries have tried to fill that void but had challenges, despite the best intentions, until now. The application of technology—as it relates to working capital—has the potential to improve visibility between trading partners to the point that the supplier's accounts receivable is the buyer's accounts payable. Such visibility has a de-risking effect, diminishing the role of the intermediary in the provision of working capital and allowing those with capital to connect directly with those who need capital more efficiently.

Emerging fintech firms have the ability to change and positively disrupt existing models. Working capital optimization is therefore an excellent opportunity for nimble fintech companies to firmly address the small-and-midsize-business market (i.e., companies that are typically on the lower side of credit rating and maybe aren't even rated at all). The credit risk becomes extremely high, and forward-looking fintech players are finding ways to mitigate this risk by extracting more data and turning it into information for better risk profiling and predictive management. Innovative fintech firms measure their clients' (e.g., buyers' or suppliers') operational performance (e.g., on-time deliveries, quality products, on-time payments) to establish a reliable risk profile of these companies. Fintech companies in the peer-to-peer lending space capture transactional history to determine cash inflow projections, cash outflows, procurement forecasts, even credit underwriting. By gathering structured and unstructured data, they are able to build a risk profile and lend money to borrowers.

Corporate decision-makers use technology not only to automate tasks and reduce inefficiencies, as previously discussed, but also to build information that supports decisions. The corporate treasurer is among the most information-hungry corporate parties. The treasurer's role is dramatically changing: Formerly pure operations (only looking at how much is in the bank today and tomorrow), the treasurer is now accountable for the company's working capital results. The access to payables, receivables, and inventory data allows the corporate treasurer to start evaluating which suppliers, customers, and logistics partners are strategic. Treasurers can then talk with the organization's procurement, sales, and logistics functions, gauging how much each of these functions impacts the company's prized assets and the group's risk management profile. Treasurers are the principle decision-makers over anything that touches their company's financial ecosystem.

THE BANK'S PERSPECTIVE

The banks are in a very prominent place in helping their clients optimize working capital through supply chain finance (SCF) schemes. Banks are in the front line when it comes to providing massive balance sheets to give free cash-flow-beneficial solutions to multinational corporations or even government departments. Clients looking for gross margin increases and profitability improvement in a negative-rates scenario are going to look to use cash to improve their earnings before interest, taxes, depreciation, and amortization (EBITDA). Banks also have a big role to play in oversight and third-party intervention: It's a bank's role to support clients in nimble and quick onboarding, pointing to fintech players as the natural solution.

While the strategy of disintermediation is shared by many startup fintech firms as a potent way of sidelining the banks that traditionally provided these working capital services, good market practices show instead that there are several adjacencies and very clear areas of opportunity for both. Savvy banks are looking at technology entrants as an opportunity rather than a threat. Still, a good number of people at banks want to categorize this as a pro and con or competition, but forward-looking banks see fintech companies rather as a "frenemy." These banks look at fintech partners as opportunities for new ways to deploy their capital, while fintech firms look at these partnerships as opportunities to help suppliers and clients with the banks' deep balance sheets.

Market dynamics present us with banks that are building out a tech sector within the fintech world: Some are forming consortia, and the vast majority are creating innovator labs, investing and injecting equity. Banks are renowned for being very good at going from big to bigger, so they are changing this attitude by bringing the outsiders in and partnering with peers and emergent players in the industry. Banks let the innovators do what they do well, being very agile and quick to develop, while the banks themselves industrialize and take care of control, structure, access, and distribution. Forward-looking banks are increasingly becoming aware that investments into these new technologies must go beyond pouring in money, as the real investments are in education, awareness creation, and really understanding what corporations want. By having more information, they can reduce the level of risk.

Fintech solutions support working capital optimization by fostering collaboration between buyers and suppliers. Connecting with key "tier-one" suppliers (usually the first 200 to 300) is rather feasible. Problems emerge when trying to reach out to the thousands of lower-tier suppliers (i.e., the suppliers' suppliers), considering that most of the big buyers in the world have 40,000 to 50,000 suppliers. This long tail is probably the most interesting because companies here are craving money, but they have no idea how to participate in the program.

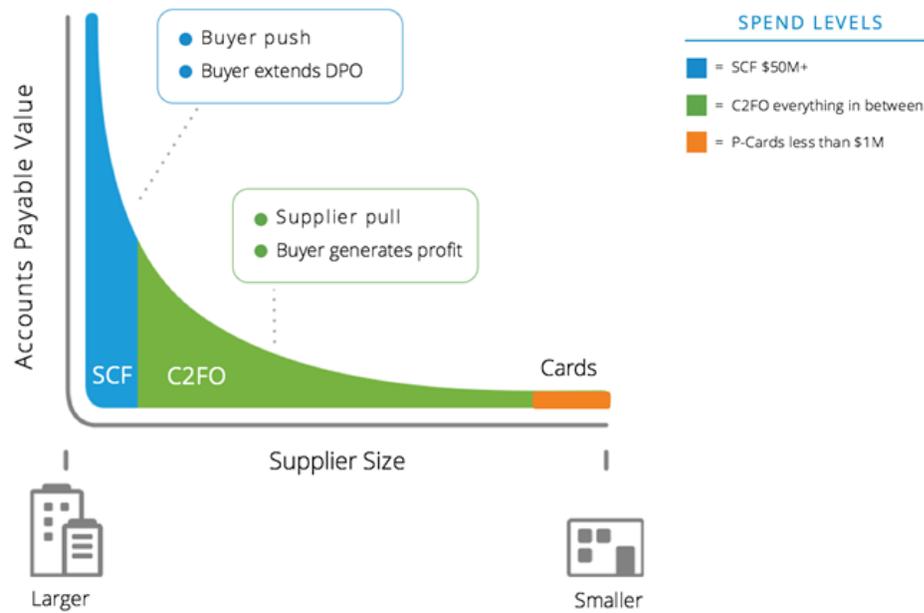
These suppliers are the "left overs" of SCF programs, and the whole idea is to facilitate the collaboration between these suppliers and the buying companies to make sure that the former have enough access to collaboration schemes. These are areas within financial services where the banks and certainly the systemic banks—the globally important systemic banks that have higher capital rates—will not naturally wish to play.

Fintech providers can handle the middle of the tail, however (Figure 1). That's one of the reasons that banks establish a collaboration with them to provide end-to-end payables solutions. Citi, for instance, has established a collaboration with C2FO, a working capital market that allows buyers

and suppliers to collaborate on early cash flow at a rate that's profitable for both. The platform is ideal for handling the suppliers typically left out of SCF and P-Card programs. All along the curve, suppliers have varying needs at different times. Large suppliers are often looking for quarter-end balance sheet improvements, while small and midsize suppliers may have a variety of cash needs that vary seasonally.

Figure 1: Fintech Firms' Scope Includes Long Tail of Suppliers

HOW DOES FINTECH FIT WITH BANKS' EARLY PAY PROGRAMS?
THEY COMPLEMENT EACH OTHER PERFECTLY



Source: C2FO

Suppliers face the same challenges that large buyers do with their suppliers: everyone needs their cash flow quicker. Having steady cash flow and being able to pay suppliers promptly grows a company's capacity to distribute and sell products. Examples come from Elizabeth Arden and HanesBrands, which use C2FO to accelerate cash flow as needed from numerous large customers.

THE FUTURE OF FINTECH FIRMS: EVOLUTION OR REVOLUTION?

Despite the possible benefits, the uptick of fintech has not been fast in many of the corporations. The main reason is the combination of the companies' inefficiencies and silo positions. The companies that are structured like this are very inefficient, and this is a massive barrier to adoption. Large organizations are not incented to drive for change or to find incremental value. Although treasurers are well-informed, they are not motivated to act, as their companies do not want to make waves.

Their tactic is to preserve the status quo. Furthermore, the market is facing an industry-wide gold rush, particularly fueled by venture capital, to invest in frontier startups leveraging new technologies. The nimbleness and flexibility of fintech startups, touted as an advantage, also make them vulnerable to acquisitions. Some people are even saying that fintech is in a bubble. Banks—as previously seen—are deeply embedded in fintech today: capital markets infrastructure, payment providers, data administrators, market data intelligence, and algorithmic providers. The fintech sector is, however, a secular force that is going to continue, supported by the trends of governments' regulatory frameworks and incubator framework. It is still an open market for initial public offerings, mergers and acquisitions, and equity capital markets in private activity, and an environment that is going to create opportunity for new entrants.

Companies know that banks instinctively play defense when they have clients, revenue, and reputations to protect. So companies become very cautious when they watch financial institutions seeking fintech opportunities. The proliferation of capital for startups, especially in the consumer lending environment, brings the inherent risk to generate income and revenue against bad assets, based on false hope that technology alone creates value. Greed takes hold of first movers that act almost as pioneers, thinking the winner will take it all.

On the contrary, those that will survive in this industry are those that are going to create the strongest alliances. Only the fittest will survive in a population that is fighting and competing. There will be solutions doomed to die because no one will use them. But they create the necessary competitive environment and the phenomenon of expectation transfer: Somebody might build a new solution but miss the target, not because of a wrong solution but because they were targeting the wrong market. Somebody can then pick up that idea and turn it into something profitable. You want to have more participating companies, but you don't want to invest in companies based on the hype and their good marketing. That may be where the bubble will burst.

Companies must look with confidence at banks that partner with fintech firms that create transparency through new paradigms and new systems. These are solid alliances that connect those that have the money with those that are looking for money. Collaboration and solid partnerships are the specific mechanisms to create business flexibility and competitive advantage. The revolution started by fintech companies entering the market has created new business environment conditions that will allow only the fittest to survive and evolve. The ones who prefer the old status quo and eat-or-be-eaten mentality are doomed to extinction.

There's no evolution without a revolution.

CONCLUSION

Fintech players:

- Fintech players must mitigate this risk of long-tail suppliers by extracting more data and turning it into information for better risk profiling and predictive management.
- Instead of adopting a strategy of disintermediation to sideline banks providing working capital services, fintech companies must find adjacencies and clear areas of opportunity for both.

Corporate users:

- Corporate decision-makers must use technology not only to automate tasks and reduce inefficiencies but also to build information that supports decisions.
- Treasurers must become the principal decision-makers over anything that touches their companies' financial ecosystems.

Banks:

- Financial institutions must proactively take advantage and build business opportunities from nascent demand.
- Banks must let the innovators do what they do well, being very agile and quick to develop, while the banks themselves industrialize and take care of control, structure, access, and distribution.
- Banks should build out a tech sector within the fintech world, forming consortia, creating innovator labs, or investing and injecting equity.

ABOUT AITE GROUP

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