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Why are frontier challenger banks outperforming their developed market peers?

Accelerated by the pandemic, the tale of challenger banks ('challengers') across the world has been diverging. In frontier markets[1], Tinkoff (Russia) and Kaspi (Kazakhstan) are reporting record figures, with the later recently listing at a valuation of $6.5bn on the LSE. In contrast, developed market challengers are coming under increasing pressure: Monzo (UK) was forced to accept new funding at a 40% lower valuation, Revolut (UK) has made mass redundancies, and N26 (Germany) shut its UK operations - effective April 2020. In this article, we highlight some of the reasons for this divergence and build a case for frontier challengers being structurally superior to their developed market counterparts.

Frontier challengers are solving fundamental societal issues

Based on a study by Alexandre Lazarow (2020), 63% of frontier start-ups are creating new industries, i.e. their users are not switching from an incumbent business[2]. This is particularly true in financial services, where frontier challengers are filling acute gaps in the financial system left by traditional banking institutions - of the 2 billion unbanked adults globally, virtually all are in developing countries[3]. Brazilian challenger, Nubank, founded in 2013 and currently valued at $10bn, has successfully targeted the under-banked population of >60m in Brazil, >36m in Mexico and >16m in Argentina. In comparison, 98% of the UK population hold an account they can use for day-to-day payments and transactions[4]. In Uzbekistan, less than 8% of the 33m population has ever received a formal loan. In the UK, over 80% of the population has held at least one credit or loan product in the last 12-months – this percentage rises further if we consider those who have ever used such a product.

The banking industry in South Africa was historically dominated by Standard, FNB, Nedbank and Absa. In 2000, Capitec entered the market aiming to reach the unbanked and under-banked, particularly in rural areas. The number of active clients rose quickly, with the figure now above 14m – the largest in South Africa. They are now tackling SME lending by acquiring Mercantile Bank: a digitally-led business bank built on the same fundamentals as their core retail bank offering.

Frontier challengers are providing an innovative – and highly localised - solution to meet the base needs of a large addressable market. This compares to developed market challengers for whom the most significant hurdle is persuading an arguably overbanked/overleveraged populous to switch from deeply embedded high street banks - many of which have an increasingly robust digital presence, and a clear edge in core activities such as lending. There is also the looming threat of new entrants by the tech giants - Apple, Amazon, Facebook, etc. - and other fintech players - SoFi, Transferwise, etc.

Frontier challengers are leveraging new digital infrastructure

The unprecedented development of digital infrastructure in frontier markets presents ripe opportunities for challengers. These markets have effectively skipped the offline era many developed markets experienced – with the associated baggage and dated infrastructure – starting instead from the digital age. According to Hootsuite's 2020 report, smartphone penetration is as follows: Eastern Europe (>78%), Russia (>66%), Central Asia (54%), Western Africa (36%), South America (>72%). This digital foundation has fuelled the rise of some of the world's most advanced – and profitable – banks.

__1.__ Please see the appendix for Sturgeon's definition of frontier markets. __2.__ This compares to developed markets where only 33% of start-ups are creating new industries with the remainder 'disrupting' incumbent industries. __3.__ Global Findex database – World Bank (2017) __4.__ FCA Financial lives of consumers across the UK (2017)

Frontier challengers are leveraging new digital infrastructure (continued)

Frontier markets also have young and increasingly tech-savvy populations without preconceived ideas of how things 'should be'. According to a new report[5], Vietnam and Indonesia are now more attractive than the US as an expansion target for developed market challengers due to their high propensity to adopt new technologies. According to Statista, in 2017, 298m people in Africa had a bank account (24% of the population). They estimate that by 2022, this will have grown to 456m, primarily due to the rapid increase in mobile phone usage.

Given high banking penetration in developed markets, the cost of tempting customers away from incumbents is exceptionally high. However, in frontier markets customer acquisition costs can be near zero: Nubank claims up to 80% of its customers are acquired organically (unpaid) in Brazil, and Tinkoff claim approximately 85% of new Russian users are organic.

Although rapidly improving, frontier challengers do still face legacy inefficiencies, for example, Russian legislation still requires Tinkoff to incorporate a face-to-face meeting whilst onboarding clients. Despite this inconvenience, their popularity and profitability are - in part - a testament to the value they offer customers via a world-class interface built on recently established digital infrastructure. Developed market challengers may have a near-seamless onboarding process, but they have struggled to add customer value such that they can generate a profit.

Frontier challengers focus on core profitability

Many are now questioning the viability of the developed market challenger banking model having previously attributed losses to raising and investing vast amounts of capital to spend on growth. Monzo announced in their latest report (year ending 29 Feb 2020) that annual losses more than doubled. The latest reports from Starling (Nov '19) and Revolut (Dec '19) show annual losses of £52m and £107.4m, respectively. We suggest this is not a demand problem, rather a fundamental flaw in their VC/PE-fuelled business model.

Frontier challengers focus on sustainable growth because they lack a deep pool of funding. With a balanced growth strategy, they can grow in controlled spurts, choosing to accelerate and invest in growth when required. Profitability is usually reached more quickly, or they preserve the option to modulate growth and head back to a sustainable business if needed. Tinkoff did not choose the self-funding model; it was simply not an option given the weak funding market in Russia. As a result, they had to focus on organic growth and core profitability from day 1 – net income has been positive since their third quarter of operation. As a result, frontier challengers have built a much stronger 'primary' relationship with users, which has proved a more fruitful foundation for expansion and diversification. In stark contrast to its developed market peers, approximately 80% of Tinkoff's income is interest-related, while the remainder is fee-based (services, referrals and interchange fees, etc.) – the business model is flipped in developed markets. Tinkoff is now one of the most profitable banks in the world, and regularly reports returns on equity above 50%. The story is similar to Kaspi, who recently reported a 40% net income margin (1H2020).

The low level of income generated by developed market challengers is partially explained by their core offering being cheap payments to boost the numbers of users - something that is only possible with the support of deep-pocketed external funders. This has resulted in a relatively large customer-base of principally inactive users, many of whom use their services as secondary accounts. To put this into context, the UK's largest 3 'challenger banks' (Monzo, Starling, Revolut) only held £4.8bn in deposits (including business accounts) - UK high street banks hold £1.9tn retail customer deposits alone[6].

5. *Finch Capital/MDI Ventures/dealroom.co: The Future of FinTech in Southeast Asia (2020).* ***6.*** *Bank of England sterling retail deposits from private sector (31 August 2020). Excludes small business deposits that challenger banks also target.*

Frontier challengers focus on core profitability (continued)

In short, developed market challengers offer a sub-set of banking services. To date, where they have tried to generate profit by providing core services such as lending, they have largely failed. Both Monzo and Starling began lending last year (Revolut is not a UK bank so cannot lend off its balance sheet) and lost money for loans provided. For instance, Starling recorded £2.1m in interest income from customers but has £2.2m in provisions for bad loans. A lack of customer knowledge is resulting in the development of risky loan books. Tinkoff knows their customers better and as a result, has weathered 3 economic crises and remained profitable throughout. Tinkoff generated a return on equity of 37.5% in Q1 2020 despite creating significant additional reserves to account for Covid-19. As their users' primary banking platform, frontier challengers are better able to utilise their broader range of data points to lend more profitability. Another headwind facing developed market challengers is the low interest rate environment. The Bank of England is now considering negative rates which would result in challenger banks paying to hold money with the central bank – yet another cost that cannot be offset by their relatively small loan books.

Focusing on aggressive growth targets over sustainability poses an additional risk for developed market challengers. In many of these companies, the employees act – in part - as financiers of the enterprise. Typically employees accept lower wages in exchange for stock options, with the hope they vest at higher future valuations. This mechanism works well when companies secure increasingly higher valuations. However, this mechanism breaks down if a company has a 'down round' (new funding at a lower valuation than the last). The more severe the down round, the more unlikely it is that employees will see the value of their options crystallised. As such, down rounds tend to be followed by senior managers and other key personnel leaving. Monzo's recent 40% down round in 2020 was a good example of a down round leading to key staff departures.

Frontier challengers are building ecosystems that are integral to their users' lives

Frontier challengers are building on their success by adding a complementary array of previously unavailable services which underpin a robust and sustainable network effect, with the growth and development of one service directly contributing to the growth and evolution of another. Kaspi has generated a market share of 41% in e-commerce, 35% in payments, and 31% in consumer finance. Tinkoff has recently also added a significant number of additional services including a 'Robinhood-style' investment platform which has seen >600k new users in 1H20 alone.

Even in areas with less smartphone coverage, frontier fintech ecosystems have thrived. Gojek began as a motorbike taxi-hailing app in Indonesia (2011). To bring customers into the system, Gojek had to offer a wider range of products than its developed market equivalents. The team realised that many of the customers were unbanked and so needed to pay for rides with cash (<52% of Indonesians had a smartphone). Gojek was an early online experience for many customers making the platform an ideal place to offer a range of services. To accept digital payments (and boost product adoption) the team developed the leading payment platform in Indonesia using drivers as an agent network to get cash into and out of the system (drivers act as human ATMs). They then added GoPay to make payments (pay bills) and accumulate savings. They then added food delivery (GoFood), commerce (GoMart), massages (GoMassage), shipping (GoSend) and airtime (GoPulsa). Gojek has become the largest income source in Indonesia.

Ecosystems as a new way of organising economic activity are growing across the emerging world, for example, a diversified ecosystem for trade, including banking and payments, has emerged from Alibaba's platforms for B2B and B2C commerce. Ping An, one of China's largest financial conglomerates, has reinvented itself as an ecosystem company, providing loans and investments, as well as insurance, across platforms for healthcare, housing, and more. Traditional banks are also building digital platforms as a way to integrate financial services into the everyday activities of consumers and SMEs e.g., HDFC Bank has broadened services for small farmers in India; DBS Marketplace enables consumers to search for cars, auto loans, and more in Singapore.

Frontier challengers have far more compelling valuations

The unicorn valuations of developed market challengers are increasingly being called into question. If you divide current UK challenger valuations by the number of customers, the value per user is £360 for Revolut and £300 for Monzo – down from £500 per user following a recent down round earlier this year. These are for loss-making companies, generating revenue per customer of approximately £24 (Revolut) and £20 (Monzo). We are yet to see a developed market challenger bank with a clear path to profitability which justifies these 'unicorn' valuations at which they continue to raise money.

In frontier markets, we see similar valuations for businesses that have proven profitability and a clear path of rapid growth for both their core banking services and their substantial 'super-app' ecosystem surrounding it. Like many frontier challengers, Tinkoff has a highly profitable core banking business which funds other new business lines, some of which are partially subsidised such as Tinkoff Black - a mobile app and debit card that has a similar resemblance to Monzo, Revolut, Chime, etc. However, rather than this loss-making element being core to the business model, it is merely one intermeshed and complementary element within Tinkoff which together drives the bottom line.

Some developed challengers will fair better than others, particularly those who have done a good job of adding genuine value to businesses – an area the high street has neglected. For example integration with accounting tools, ERP platforms, multiple accounts, etc. OakNorth has reached profitability by lending to SMEs, building a £3.5bn loan book since 2015 – their loans have an interest floor. Starling has been helped by playing a key role distributing government loans to those effected by Covid-19.

Immediately before Tinkoff went into the recent Covid-19 crisis, their valuation was $5bn on $550m of net income. Revolut is valued at $5.5bn, having lost approximately $140m over the last year with no obvious path to profitability. Even generously applying a discount for both the perceived cyclicality of lending (as central to the frontier challenger banking model) and a frontier market risk premium, they are still far more attractive investment targets. We believe the valuations and unit economics of developed market challengers will increasingly come under pressure, particularly if they decide to go public.

Although the success of frontier challengers is also built on many other factors, such as the quality of the management team and execution, it is difficult to entirely escape the conclusion that a bank with deeply embedded users and a profitable core is a better bet than one designed to lose money.

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Appendix: Sturgeon's definition of frontier markets

We reject traditional definitions of frontier markets based on metrics such as liquidity or GDP. Instead, we look globally for regional markets where we identify the following:

1. The rapid emergence of private enterprise from a low base
2. The high prevalence of positive secular trends
3. The existence of base digital infrastructure on which to build technology-enabled businesses
4. Opportunities to monetise efficiency gains through technology
5. Opportunities to implement 'tried and tested' business models
6. An absence of private capital funding innovation

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