Manole Capital Management

FINTECH Trend: Being Nimble

February 2021

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On JP Morgan's recent conference call, CEO Jamie Dimon had some very interesting comments for the broader FINTECH community. He said he has told his management team to "be frightened." His message went on to say JP Morgan "should be scared shitless", about how FINTECH companies have been able to take advantage of traditional banks and financial service companies. He finished his blunt assessment by saying "We've just got to get quicker, better, faster…"

The FINTECH industry might be the "poster child" for innovation and the ability to adapt at a rapid pace. This mindset permiates throughout the ecosystem at the expense of traditional financial institutions and banks. In a world with so much rapid innovation, one's mindset needs to be open, coupled with a deep curiosity, and willingness to learn.

We strive to understand new developments and try our best not to be dismissive of ideas and innovation. When we find an investment with the potential to compound over long-term, one of the hardest things for us to do is remain patient. Of course, it comes down to valuation and risk versus return, but we try to remove all emotion from the decision. When one looks at a chart for an asset that has moved up and to the right for 5 or even 10 years, most do not think about how hard it was for a long-term investor to have held over that time period.

The power of compounding growth is truly an amazing thing. Like Albert Einstein once said, "Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it."

Visa's Acquisition of Plaid

Speaking of one of those nimble FINTECH companies, let's spend a little bit of time on one of our private positions. In our hedge fund, the ***Manole Fintech Fund,*** we can own private FINTECH companies.

We initiated a position in Plaid back in 2018, when its implied valuation was slightly more than $2 billion. In January of 2020, Visa announced its acquisition of Plaid for $5.3 billion. Who is Plaid? Well, we have longed described Plaid as a plumber, and we actually wrote a research note entitled "*The $2 billion Sexy Plumber."* There aren't too many plumbers worth over $5 billion, so we'll try to provide some additional perspective.

Plaid connects various FINTECH applications (i.e. apps) to over 11,000 financial institutions or funding sources. Stated a little differently, Plaid is a data network that helps to power various FINTECH apps. Maybe an example will help? When a Gen-Z'er wishes to fund a Robinhood brokerage account, Plaid connects back to their Bank of America account and helps to move the funds. It works with thousands of companies like Venmo (owned by PayPal), SoFi, Betterment and it allows millions of users to connect their favorite apps to their financial accounts. We call it a plumber because it provides the necessary plumbing between apps and the critical funding source, like a bank.

To say that Visa dominates debit would be an understatement. A recent document filed by the DoJ or Department of Justice stated that Visa possessed roughly 70% of the US debit market. Visa has key, long-term agreements and card relationships with many of the largest US banks, like JP Morgan, Wells Fargo, Bank of America, etc. This gives Visa the leading market share for processing debit transactions and volumes.

In November 2020, the US DoJ filed a lawsuit against Visa, attempting to block its acquisition of Plaid. The DoJ felt that Visa owning Plaid would increase its domination of the US debit market. Initially, Visa decided to litigate the case and tried to win its case against the DoJ. However, in January of 2021, Visa decided to terminate its acquisition of Plaid to bypass a legal battle. In its press release, Visa's Chairman and CEO Al Kelly stated: "We are confident we would have prevailed in court, as Plaid's capabilities are complementary to Visa's, not competitive," but Visa wanted "to simply move on" to avoid a lengthy and costly legal battle.

Going forward, there are multiple options Plaid can pursue. Even though Visa cannot purchase Plaid, because of that debit dominance, there might be signficant interest from other payment peers, like PayPal or Square or Fiserv's First Data. Another potential buyer, which is probably the most likely, is a SPAC or blank check company. The marketplace is flush with cash right now, with hundreds of companies looking to bring a company like Plaid to the public markets. These SPACs would be ideal partners for Plaid to partner with. Lastly, Plaid could decide to take itself public, just like Affirm just did. Affirm doubled in 1 to 2 days as a public company and Plaid would very likely receive the same warm public market reception.

Initially, we thought that Plaid would be considered "damanged goods," almost like a bride left at the altar. However, that couldn't be further from the truth. On one side of the equation (the glass half empty), we were considering marking our Plaid position back down to the pre-Visa deal price (an implied $2.3 billion valuation). On the other side of the equation (the glass half full), we could chose to leave the valuation at $5.3 billion, which was the price Visa was willing to pay for Plaid. Then, we decided to reach out to various private brokers and begin to understand what Plaid was trading for in the private market. This was eye opening.

With the excitement and buzz around private FINTECH companies right now, we believe Plaid's valuation would approach - if not materially exceed - that $5.3 billion valuation. In the private market, Plaid is currently trading at an implied valuation over $20 billion. That's 4x the price at which Visa was slated to buy it at a year ago.

BNPL or Buy Now, Pay Later

This holiday season, one of our biggest takeaway's is the explosion of BNPL (buy now, pay later) offers. Millions of US consumers have embraced this new way of paying, which evenly splits the cost of small to midsized purchases into four interest-free installments (over a week, month or quarter). Shoppers seem to be attracted to fixed payment schedules and a simplified checkout process. Are BNPL purchases taking market share from traditional credit card transactions? Are younger people simply more debt averse? Is this growth being fueled because the BNPL firms are essentially offering interest free loans, without requiring adequate background or financial checks?

There are three main companies that are providing BNPL – Affirm, Afterpay (Australian) and Klarna (Sweden). In terms of US accounts, Afterpay has 13 million, Klarna has 11 million and Affirm has 3.9 million. Afterpay (ticker APT.AX), has quadrupled since the beginning of last year and is worth over $33.7 billion. Affirm (ticker AFRM) doubled on its first day as a public company in January 2021 and now has a market capitalization of $26 billion. Klarna raised money last year, with an implied valuation of $10.7 billion.

We saw this sign recently at a POS and we decided to take a quick picture of it. When then asked our salesperson how many of the store's transactions were occurring on Afterpay. His answer? Roughly 10% to 15%, and all were younger shoppers.

For years, merchants have complained about the high cost of credit and debit card acceptance, commonly known as MDR (merchant discount rate). However, these BNPL companies earn the vast majority of their revenue from merchants, in terms of signficantly higher MDR's (in the 4% to 6% range).

If merchants believe that BNPL is driving sales that otherwise would not have occurred, they should be willing to pay these higher fees. At Express and Foot Looker, Klarna drove a +25% increase in the average order value for customers last month. Klarna and its BNPL process was the 3rd most popular way to pay at these retailers.

However, if BNPL doesn't increase business and purchase volumes, merchants will quickly cease to accept these high-cost transactions. Time will tell if these BNPL trends add value and take market share from traditional credit and debit transactions.

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