Valuations are Down, but Don't Count Fintechs Out Yet

How industry players can weather a challenging market — and prepare for a rebound.

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After several years of record-high valuations, the fintech market is stabilizing and valuations are coming back down to earth. These valuations have practical implications for companies trying to attract investors or looking to be acquired in an M&A deal. To capitalize on opportunities during the uptick in M&A activity forecasted for later this year, fintechs need to focus on strengthening their business models and improving profitability to stay competitive.

As fintechs shift their priorities away from fundraising in the current economic environment, they should take the opportunity to focus on fundamentals by reinforcing the goals of their high-priority projects and strengthening their financial position through a variety of resilience-building tactics. Doing so will demonstrate their value to buyers ahead of a market rebound. Fintechs that have invested in building a profitable and strong foundation will be better prepared to take advantage of a more favorable market.

IN TIMES OF UNCERTAINTY, FOCUS ON FUNDAMENTALS

Due to increases in interest rates, the impact of recent business failures, and increased negative regulatory scrutiny, fintechs are not experiencing the deal-making frenzy they did a few years ago. Buyers have become much more selective, and investors will likely remain cautious into the last quarter of 2023. As valuations decline and the economic environment remains uncertain, investors and strategic buyers are re-evaluating fintech companies' profitability and runway. We are seeing investment decline with fewer, but larger, deals period over period.

Given the current climate, fintech companies should focus on building resiliency, which tactically can look like prioritizing mission-critical projects and postponing non-essential initiatives. Reassessing headcount is also an important component of adapting to the market. Many fintechs have already taken steps to rightsize their business ahead of a feared downturn, resulting in widespread layoffs across the industry that took place at the tail end of 2022.

Finally, another tactic to preserve the business during times of somber valuations is consolidation through deals, which many fintechs are likely to pursue. Although financing costs are significantly higher, lower target prices may provide a great opportunity for fintechs looking to acquire – to scale more quickly, lower customer acquisition costs, and potentially exploit revenue synergies through complimentary technology for a lower valuation. For those being acquired, consolidation provides a safe option to keep the business operational.

Focusing on fundamentals in the near term will help struggling fintechs stand out to buyers ahead of a potential "acquisition stampede" when the market rebounds.
Many fintechs are or will be looking for an exit strategy, and since IPO windows are just now starting to open back up, these businesses would be wise to start preparing now by:

- Improving their profit margins
- Exploring cost optimization strategies over harsh cost-cutting; and
- Continuing to refine their workforce strategies.

Companies should also keep in mind that reducing cash burn will make them more attractive to potential buyers. To improve their positioning, fintechs should take a holistic look across the enterprise and accurately value their assets – as well as their operational overhead up against their revenue projections – to establish healthy financials ahead of eyeing any deals.

UNCOVERING M&A OPPORTUNITIES IN A CHALLENGING ECONOMIC ENVIRONMENT

Though M&A activity in the fintech space has tapered off over the last few quarters, smaller deals are closing. In particular, fintechs involved with payment tech and credit card management platforms have maintained popularity even as valuations have fallen. Neobanks provide a front-end interface for customers that offers a better, more user-friendly experience than traditional bank software or applications, but neobanks often require a back-end bank partner. In these scenarios, these neobanks typically act as a partner to traditional banks to give customers the enhanced digital services and experience they've come to expect from traditional banking in a technologically streamlined model. The neobanks involved in these deals benefit by getting access to the financial institution's security infrastructure, while the back-end bank partner is able to improve the customer experience and expand its customer base to the neobank's market via increased deposits and loan activity.

Banks are also often acquiring fintechs to solidify good partnerships, obtain access to emerging technology, and fuel embedded finance. For this reason, banks acquiring fintech companies have made a significant impact on M&A activity in the current environment. M&A activity is expected to remain consistent, particularly for fintechs that can offer more advanced technical tools. Fintechs with a strong online presence or with advanced familiarity with artificial intelligence may be even more attractive for banks or acquirers looking to improve customer conversion or expand their customers' capabilities. Fintech acquisitions can enable banks to improve and strengthen their technology for digital banking, online payments, and other financial services, as well as diversify their capabilities beyond lending.

On the other hand, while it has become fairly common for banks to acquire fintechs, a small but growing trend of fintechs acquiring banks has emerged — particularly as market volatility has reduced the price of bank assets. Acquiring a bank gives fintech companies more control of the financing supply chain, which in turn attracts investors looking for companies that have better control of back-office operations and expenses.

An example of this scenario would be **SoFi's acquisition of Golden Pacific Bancorp** in 2022. SoFi saw the benefit of acquiring a banking charter through acquisition, versus de novo application. For more recognized fintechs, this strategy may prove beneficial but may cause performance to track more closely with the national banking sector.

BECOMING A FUTURE-FOCUSED FINTECH

Dealmaking activity is likely to pick back up towards the end of 2023. However, when the market does open back up, it is unlikely to be as hot as it was a few years ago. Valuations probably won't return to the sky-high numbers recorded in 2021. As investors and buyers remain selective, a competitive environment will ensue – meaning fintechs who start preparing now can make the most of potential opportunities on the horizon.

Ultimately, financial services companies being digitally integrated will continue to evolve and grow in importance, which signals ongoing opportunity for fintechs. Going forward, companies with access to specialized and focused insight into the industry and/or specific sub-segments will be better able to position themselves for growth and improved valuations. With banks increasingly interested in embedded finance and weaving technology into their business models and offerings, we know that highly robust digital functionalities and innovative tools will always be cornerstones of an attractive and successful fintech company — provided it can adapt as markets shift.

While the economic future is still uncertain, fintechs may benefit from working with a competent, knowledgeable third party to solidify their resiliency strategies and best position themselves for success.

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