Fintech Trends Equity

Latin American fintech: Thriving in a fast-changing environment

- Latin America has a large and growing population of new internet users
- The region's fintech ecosystem is growing quickly, particularly in Brazil
- The Covid-19 crisis has been more of a catalyst than a trend-breaker

Fintech is disrupting financial services across the globe. Yet, when it comes to finding the most attractive fintech investment opportunities, it is best to stray off the beaten track. From this perspective, Latin American countries stand out as being particularly exciting. In these countries, fintech is not just disrupting incumbent service providers, but is responsible for technological leapfrogging and boosting financial inclusion.

When WhatsApp unveiled where it would debut its long-awaited payment services last June, many expected it to be India. Instead, the Facebook-owned app said Brazil was its place of choice for launching its service that allows users to link their debit and credit cards to their WhatsApp account.[1] Past the initial surprise however, the move seemed logical. WhatsApp has been facing regulatory hurdles in India for several years now and Brazil is its second-largest market after India, with 120 million users.

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In the end, things did not turn out quite as WhatsApp expected. A few days after the app's announcement, Brazil's central bank suspended the rollout in its current form, arguing this could undermine 'competition, efficiency and data privacy'. The following month, the central bank pressed ahead and unveiled more details regarding its own payment

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system, Pix, that will be launched in November and allow instant transactions. This is sorely needed, as under the current system, payments in Brazil sometimes take numerous days to process.

These recent developments involving WhatsApp, Brazilian regulators and, to a lesser extent, the country's incumbent banking system, illustrate the powerful forces currently reshaping the country's financial industry. The digitalization of financial services is transforming people's daily lives across the globe. But it is especially impactful in emerging countries, where dozens of millions of new internet users get connected each year, fueling demand for faster and more efficient digital finance tools and services.

Beyond India and China: Latin America

China and India, for instance, have developed bustling local fintech ecosystems, which are world-class in terms of technological sophistication and an ever-increasing user base. However, as WhatsApp's recent twists and turns in Brazil illustrate, these two demographic giants are only part of the story. Latin America also stands out as one of the world's most promising regions for fintech – not just for diversified tech giants venturing into the industry, such as Facebook, Google, or Apple, but also for a myriad of local niche and not-so-niche players.

'Latin America is home to a population of roughly 450 million mobile phone users, which is expected to reach 484 million by 2025'

The region is home to a population of roughly 450 million mobile phone users, which is expected to reach 484 million by 2025. Of these 450 million users, nearly 80% access the internet via their phone – a proportion that is forecasted to reach 87% by 2025.[2] Yet, despite what these forecasts suggest, most of these countries remain relatively underpenetrated. Brazil for example, by far Latin America's most populated country, has an internet penetration rate of close to 70%, compared to roughly 87% in Western Europe and the US.[3]

Altogether, current figures represent enough users for fintech businesses to establish themselves in these countries and thrive. But they represent great potential for colossal growth going forward, as millions of younger internet users will join their connected Latin American cohorts. Ultimately, better telecommunication infrastructures and increasing internet access will be responsible for driving step function growth across the entire region for fintech.

Rather than gradually moving from coins and banknotes, to ATMs and checks, to credit cards and electronic payments over the span of several decades, new internet users will typically go straight from cash to digital wallets, as many of them will get a smartphone before they even open a bank account. This radical switch from physical cash to digital payments is a good example of leapfrogging, where users are skipping the typical steps seen in developed markets and instead, are quickly making exponential progress through technology. Transformations can go faster since many of these countries do not have the legacy technology that needs to be disrupted, making it a very fertile ground for fintech.

For instance, Brazil's central bank recently pointed out that since regulations were introduced in 2018 to encourage competition in the credit market, it has authorized no less than 30 new lenders to operate in the country. Consequently, innovative financial products and services are being brought to a market that was historically dominated by a few legacy players. Of these 30 new players, 24 are direct credit companies, while the other six are peer-to-peer lending companies.[4]

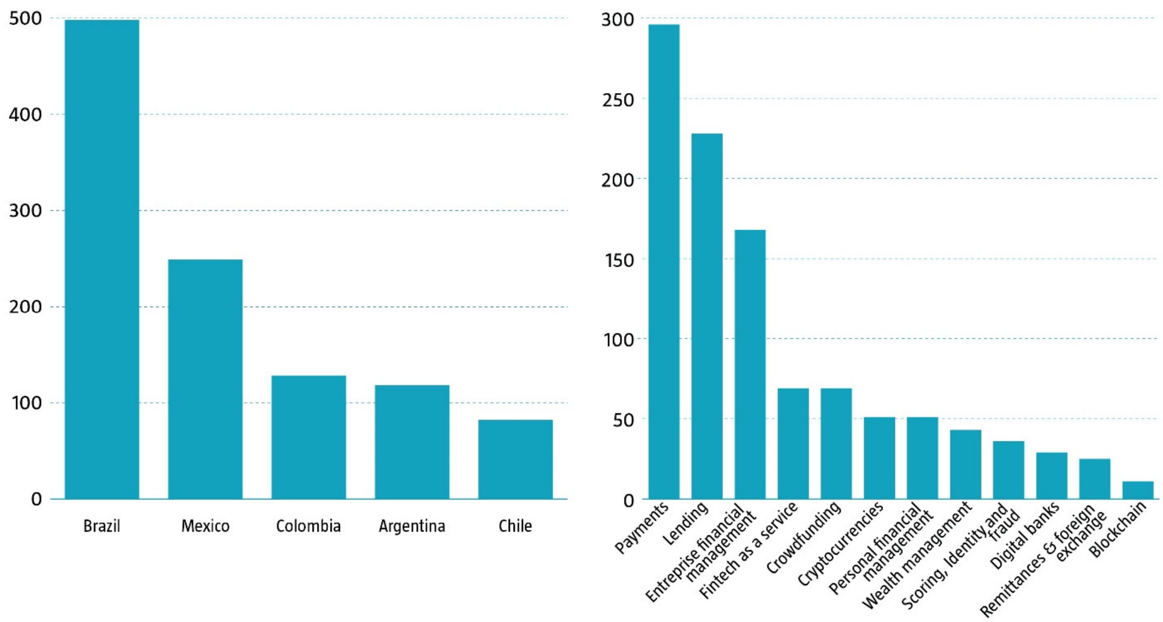
But, the Latin American fintech growth story is not just limited to Brazil. Several other countries in the region, such as Mexico, Colombia and Argentina, have a large and fast-growing population of new internet users hungry for quicker and

[2] Source: GSMA, 2019, "The mobile economy – Latin America".
[3] International Telecommunication Union (ITU), The World Bank, data as of 2018.
[4] See the dedicated press release dated 2 July 2020 on the central bank's website in English.

more efficient financial services. These markets generally passed the 50% internet penetration rate mark in the first half of the past decade and have now reached sufficient traction for local tech and fintech ecosystems to emerge and prosper.

For instance, Uruguay's dLocal, a cross-border payment processor specifically targeting emerging market businesses, or Mexico's Softbank-backed Clip that enables small businesses to accept contactless payments with all types of credit or debit cards, are just two of the many local innovators currently shaking up the financial services industry in these countries. These local fintech service providers are challenging incumbents and exploring new or underserved markets.

Figure 1 | Overview of the Latin American fintech sector (number of fintech firms)



Source: KoreFusion, 2020 LATAM Fintech Report", summer 2020.

From agribusiness crowdfunding projects, to advanced financial reporting and compliance software, to domestic and cross-border remittances – the potential playing field for Latin American fintech ventures is wide open. This means countless business opportunities for those players able to seize them. Over the years, hundreds of Latin American fintech firms have managed to achieve sufficient scale to start generating meaningful revenues. This means they are able to raise venture capital, or, in some cases, even go public.

From this perspective, they are following patterns already seen in other developing countries. For instance, in China the local fintech industry started gaining momentum in the early 2000s, and since then, the market capitalization of these firms has grown exponentially. Brazil has so far proven to be a leader in Latin America in this regard. Its public capital markets have made it possible for several fast-growing fintech ventures to go public and list on both international and local exchanges.

The recent success and popularity of Latin American fintech companies is also clearly visible in venture capital (VC) flows in the region. VC investments in Latin America have been doubling every year since 2016, reaching USD 4.6 billion in 2019 – of which USD 2.5 billion were invested in Brazil. Throughout that period, fintech remained by far the most coveted sector, luring 31% of all venture capital invested across Latin America in 2019.[5]

Admittedly, a large percentage of these increased flows have been concentrated in a few select companies, that have reached more mature stages in their development. What is more, they are from a small group of institutional investors largely located outside of the region itself. This raises the question of how sustainable this type of capital really is.

[5] Source: LAVCA, Association for Private Capital Investment in Latin America, May 2020, "LAVCA's Annual Review of Tech Investment in Latin America".

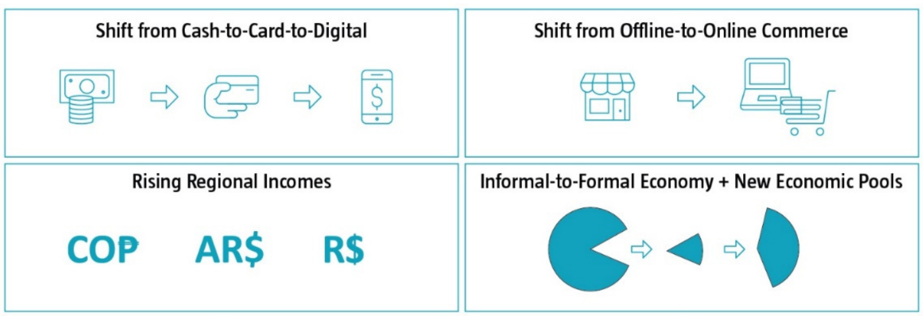
Some of these flows could be considered 'fly-in-fly-out'. They are perhaps more opportunistic and not really committed to long-term development of the region. There are still gaps in VC funding, primarily in the mid-stages. But this is changing rapidly as VC ecosystems across the region are becoming increasingly institutionalized and robust.

Four powerful forces driving fintech

Today, smartphones and laptops are rapidly replacing more traditional ways of doing business across Latin America. This, and the steady increase in internet connections expected in the region over the coming years, creates huge opportunities for companies to introduce new business models or tap into new and underserved segments of the market, particularly among younger generations.

Beyond rising levels of connectivity, several other powerful forces are at play as well, including (i) rising incomes at the regional level; (ii) a broad transition from the informal economy to the formal economy; (iii) a gradual shift from offline commerce to e-commerce and (iv) a related shift from cash to card to digital payments. These four drivers have helped bring the sector past a certain inflection point, ensuring accelerated growth going forward.

Figure 2 | Four Powerful Forces Driving Fintech



Source: Robeco

Rising regional incomes

Rising incomes across Latin American countries will 'lift all boats' in the financial sector. Yet some players, in particular fintech companies, will be able to benefit more than others. By providing cheaper or more agile and innovative financial services to relatively underbanked populations gradually getting online, fintech firms are often better positioned than slower incumbent banking institutions to capture growth opportunities offered by rising incomes.

Informal to formal

The slow but broad transition from the informal to the formal economy is expected to provide tailwinds to the fintech sector. According to the most recent IMF estimates,[6] the informal economy in Latin America and the Caribbean has steadily been decreasing over the past three decades, but still represented 40% of the region's GDP on average from 2010 to 2014 – a rate even higher than Sub-Saharan Africa's 38% over the same period.

As the formal economy gradually overrides the informal one – increasingly helped by the rise of e-commerce and new payment methods across the region – and as economic transactions get registered in the financial system, it is likely that fintech players will enjoy greater opportunities to offer a wide range of services. Additionally, efficiencies created through technology have the potential to form new industries and "revenue pools" that were not previously considered possible.

A shift in payment methods

The accelerating shift from cash to card payments and from card to digital payments is not just about a move from informal to formal transactions. Within the formal economy too, payments are experiencing profound changes, as

[6] Source: International Monetary Fund (IMF), 2017, "Regional economic outlook. Sub-Saharan Africa", World economic and financial surveys.

countries see their internet-connected populations grow. What is more, younger generations, who are typically more inclined to buy online and less inclined to use cash, are becoming more influential in the overall mix.

Mobile wallets appear to be taking hold much faster than previously expected. This has been possible because of the historic imbalance between the relatively small proportion of banked adults and the rising overall number of internet users. In recent months, the Covid-19 pandemic has only boosted the adoption of mobile wallets.

Rise of e-commerce

The broad-based shift from offline retail to e-commerce as younger cohorts come of age and access the internet, is also boosting demand for fintech services, including merchant acquiring, payment gateways, and SME lending. While e-commerce is not new to the region, improved technology in payments and logistical infrastructures and increased consumer trust in online purchases, has helped boost this transition in sales.

Recent estimates by UNCTAD,[7] the United Nations' body dealing with trade, investment, and development issues, reveal developing and transitional economies accounted for about half of the top 20 economies with respect to B2C e-commerce sales in 2018. Mexico and Brazil were on this list, with online shoppers representing roughly a third of internet users in both countries.

Diverse fintech ecosystems

While the broader forces mentioned above appear to be at work across Latin American countries, local circumstances can vary considerably and certain countries have more 'advanced' fintech ecosystems than others. In Latin America, Brazil is arguably the most exciting market in the region for fintech investments, as it boasts the largest population (and consequently the largest addressable market) and has some of the most progressive companies in terms of technology and ability to generate substantial revenues.

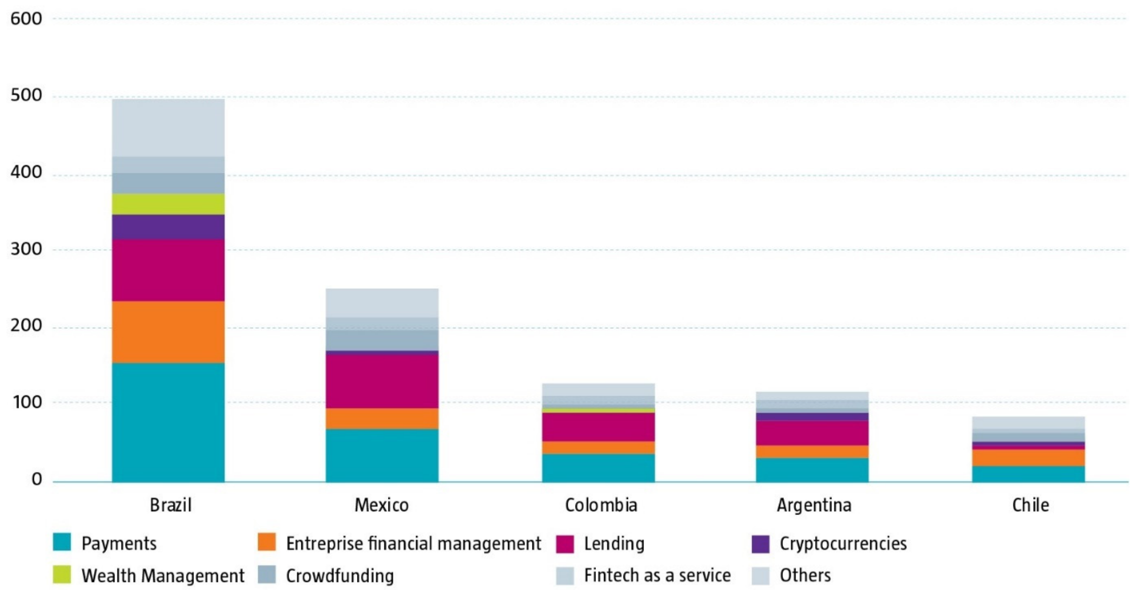
'Local circumstances can vary considerably and certain countries have more advanced fintech ecosystems than others'

It is also Latin America's pioneer when it comes to financial regulation. Over the past few years, Brazilian authorities have introduced various regulations to encourage innovation and competition in the financial services industry, particularly in the areas of payment, peer-to-peer lending, crowdfunding and personal finance.

In fact, the country's oligopolistic, inefficient incumbent banking system, long known for charging high fees and interest rates for relatively poor services, is being seriously disrupted by more agile and efficient financial technology services. Local payment providers (see Figure 3) in particular are thriving, but new opportunities are also emerging in lending and enterprise financial management, which includes services such as payroll management or expense management.

[7] UNCTAD,"UNCTAD estimates of global e-commerce 2018", UNCTAD Technical Notes on ICT for Development, n.15.

Figure 3 | Number of fintech players per sub-industry



Source: KoreFusion, "2020 LATAM Fintech Report", summer 2020

More than half a dozen local core 'pure-play' listed fintech companies currently exist in Brazil (including PagSeguro, StoneCo, XP Investimentos, Banco Inter, Cielo, and Brasil Bolsa Balcao). Collectively, they represent a combined market capitalization of roughly USD 75 billion.[8] More companies are expected to join this group and list on public markets over the next 12 to 24 months. Meanwhile, other countries, such as Mexico or Colombia, are maturing fast, but still lack a listed ecosystem of fintech firms.

Mexico follows Brazil as the second largest Latin American fintech ecosystem. Its geographic proximity to the US has attracted mainly US VC capital into select deals. However, the local VC ecosystem is not as robust as that of Brazil. VC investments in Mexico reached USD 649 million last year – a fourth of what was invested in Brazil in the meantime. Argentina should be mentioned as well as it has some very talented entrepreneurs and some of the largest tech companies in the region. These often test solutions in their home market before taking them northwards to the much larger Brazilian market.

Box : Will the Covid-19 Pandemic be a Catalyst?

The fintech industry has not been unaffected by the Covid-19 pandemic. The crisis has curtailed demand for some fintech services and has also dampened investors' appetite for the sector. For instance, according to CB Insights, venture capital-backed fintech activity dropped to USD 6.1 billion across 404 deals in the first quarter of 2020, making it the worst quarter in three years in terms of funding. Funding rebounded by 17% in the second quarter, to USD 9.3 billion, but the quarterly number of deals continued its steady decline, that started at the end of 2019.

Despite this turbulence, some of the longer-term expected consequences of the pandemic and the subsequent lockdown measures, are an acceleration of digital consumption, representing strong tailwinds for the industry. This is the case not only for developed countries, but also for less developed ones. For instance, a recent consumer survey by BCG,[9] showed that the strong and broad-based acceleration of e-commerce seen in key emerging markets since the imposition of lockdown measures, continued in May even after several lockdown measures were lifted. Figure 4 illustrates this.

[8] As of September 2020.
[9] Bharadwaj,A. Witschi, P., Sanghi, K., Azevedo, D., Kurbay, A., Koslow, L., Chen, C. and Niavas, S., June 2020, "Edition 2: COVID-19 and the Emerging-Market Consumer – The Power of Resilience", BCG.

Figure 4 | Strong acceleration of e-commerce in key developing markets

Source: BCG. June 2020.

More generally, a recent International Monetary Fund (IMF) paper[10] revealed some countries, such as Ghana, Kenya and Myanmar, have encouraged the use of fintech during the lockdowns, by introducing measures to lower costs and by increasing monetary limits on digital transactions.

The paper also reported anecdotal evidence that suggests fintech is being used to mitigate the impact of Covid-19. For instance, by helping deploy fiscal measures quickly and efficiently to intended beneficiaries, even if this includes the unbanked. In other countries, such as China, fintech lenders are using real-time data and online processes to be able to address the needs more quickly of SMEs affected by the crisis.

All of these developments are likely to have a long-term impact on the way citizens and consumers interact with their local governments – as well as their goods and services providers. This will likely accelerate the broader digitalization trend that has been in place since the early 2000s, and will probably speed up the shift to digital financial services in these countries.

In this vein, China and the 2003 SARS outbreak provide interesting insights. SARS triggered what would become a definitive shift in behaviors. Due to the pandemic, consumers had to stay at home and turn to e-commerce sites they had previously not trusted for goods/services they would have otherwise sought offline. Meanwhile, Chinese retailers definitively adopted e-commerce as people were reluctant to go back to traditional shops.[11] There is evidence that suggests the SARS outbreak in the early 2000s accelerated fintech and e-commerce in China – and we are seeing similar effects on a global scale today due to the Covid-19 pandemic.

Conclusion

Latin America is developing at a rapid rate as a region, with an upsurge in local fintech innovation. Venture capital investments in Latin America have been doubling every year since 2016 and fintech has been by far the most coveted

[10] Ratna Sahay, Ulric Eriksson von Allmen, Amina Lahreche, Purva Khera, Sumiko Ogawa, Majid Bazarbash, and Kim Beaton, 2020, "The promise of fintech: Financial inclusion in the post Covid-19 era", IMF departmental paper.
[11] Xiao, Y. and Chorzempa, M., May 2020, "How digital payments can help countries cope with Covid-19, other pandemics: Lessons from China", World Economic Forum article.

sector. Meanwhile, Brazil enjoys the largest and most mature fintech ecosystem in the region and is also the most progressive in terms of financial regulation to facilitate and encourage this change.

The incumbent oligopolistic and relatively inefficient banking system, long known for charging high interest rates, is being seriously disrupted by more agile and efficient financial technology service providers. Local payment providers, in particular, are thriving – but new opportunities are also emerging in lending and other areas.

The Covid-19 crisis has put the fintech sector under stress in some cases, curtailing demand for several fintech services and dampening investors' appetite for the sector. However, it is expected that the pandemic will create strong tailwinds for the industry in the long term. Prospects remain bright for the Latin American fintech sector and the growth potential of several businesses operating in the region is significant. Investors should therefore keep watching developments closely in the years to come.

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The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub-Funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website www.robecosam.com.