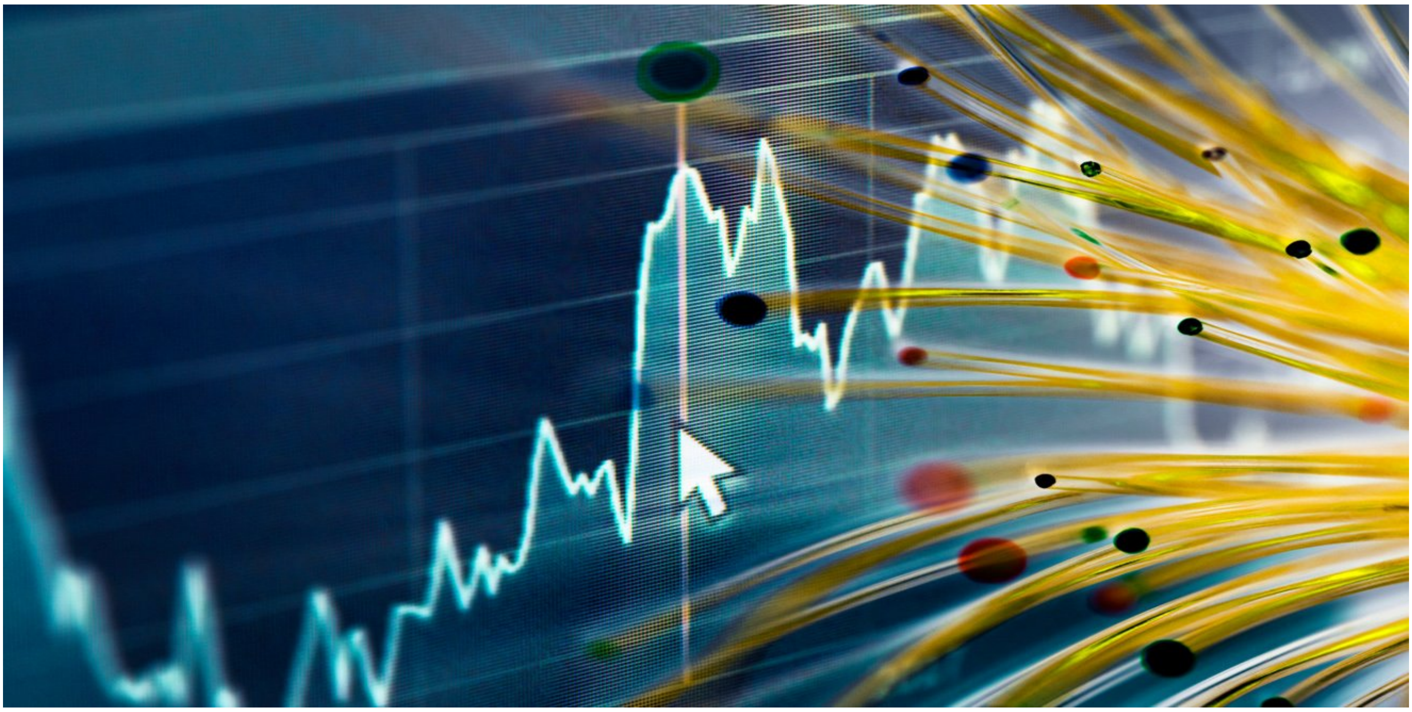


Financial Services Dispersion Creates Opportunity

April 7, 2021

On the surface, financial services may look like a sleepy sector dominated by well-established institutions and networks. But for fundamental, active investors trying to uncover opportunities for sustainable value creation, financial services is anything but boring.

In addition to having a vast total addressable market (TAM), financial services is defined by rapid innovation across a complex ecosystem of sub-industries with a wide dispersion of growth rates. This dispersion occurs on multiple levels, each of which offers the opportunity to discover compelling themes and companies to watch. Gaps in growth rates are often particularly wide when comparing developed and emerging markets, incumbent players and disruptors, or companies with best-in-class digital capabilities versus digital laggards.

All of this is precisely why we find financial services to be such a compelling opportunity set for us as active investors.

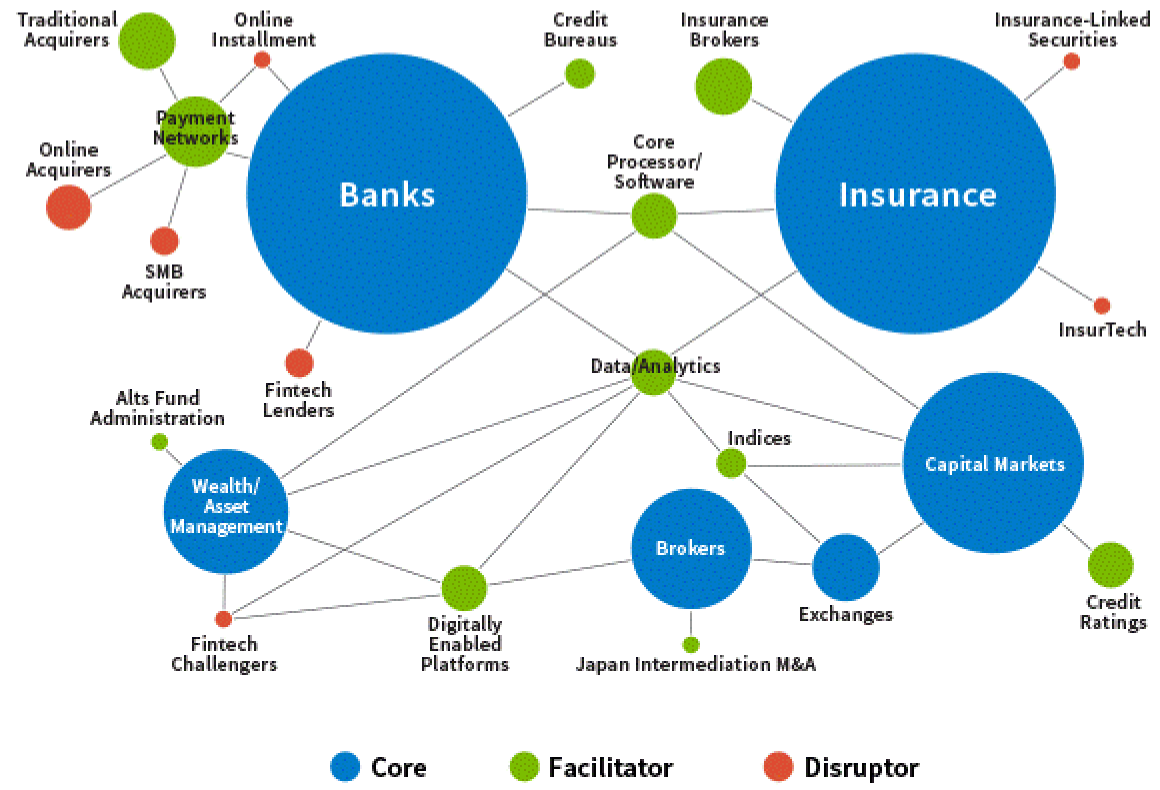
Interconnectedness Drives Growth and Dispersion

Viewing financial services as an ecosystem allows us to examine connections among the various players. Understanding these relationships is critical to assessing how the pools of profitability are growing and shifting—in some cases at a very rapid pace.

In particular, we find it helpful to view financial services companies in three different categories: **core** (established businesses with the largest market share); **facilitators** (businesses helping drive better decisions, growth, and efficiency for businesses in either of the other categories); and **disruptors** (newer businesses offering lower costs or other advantages over core businesses, such as better customer acquisition, execution, products, or services).

The chart below shows the approximate size of each sub-industry (based on revenue pool). The “messiness” of this graphic helps illustrate just how interconnected the sub-industries all are.

Financial Services: Core, Facilitators, and Disruptors



Source: William Blair analysis, as of March 2021.

To put the growth dispersion across sub-industries in perspective, it helps to keep in mind some of the key structural drivers influencing the sector as a whole: acceleration of digitalization; prevalence of low interest rates, which have now spread into emerging markets; and China's size and growth, which is the largest driver of expansion in the sector.

Beyond these structural drivers, it is also interesting to note how innovations in data and technology don't just facilitate growth, but also create efficiencies that are reshaping current profit pools and enabling new business models. Across all aspects of the ecosystem, technology is being used to offer solutions to bad products or ease consumer pain points, and data is being used to generate predictive insights that lead to faster, more reliable lending and underwriting decisions.

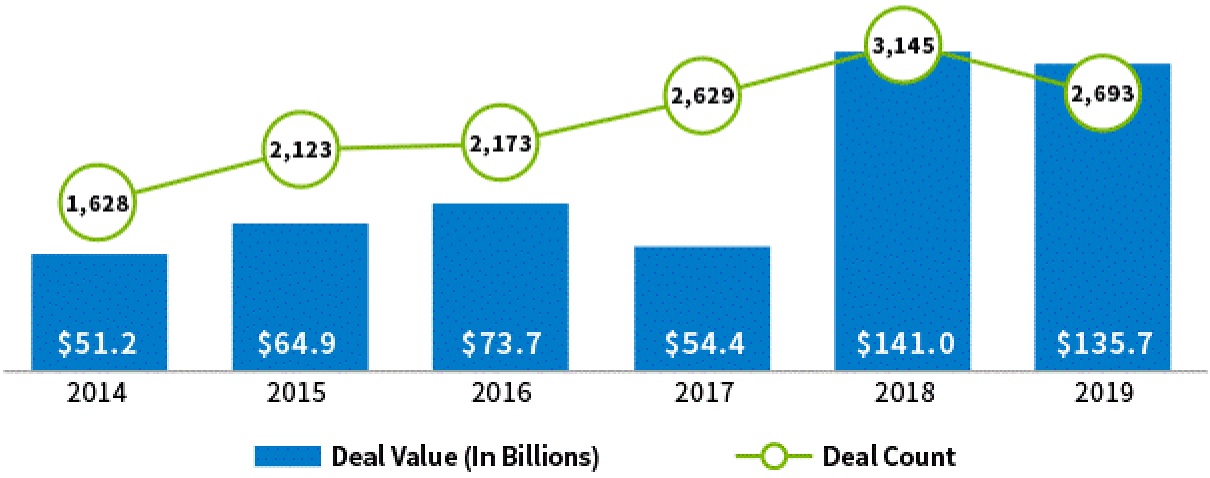
Private Investments Shape Public Opportunity Set

A major driver of innovation and disruption in financials is the massive amount of private investment activity in fintech. In 2018 and 2019 combined, there was more than $275 billion of private investment activity in fintech, exceeding the total from the preceding four-year period, according to KPMG and PitchBook.

These investments are fueling disruptive business models such as robo-advisors in wealth management and data-driven insurance technology (insurtech) platforms. Cybersecurity, blockchain and cryptocurrency, and payments are other verticals that are seeing huge inflows of private capital.

Within fintech, the role of corporate investors and their venture arms is more pronounced across the global landscape than in many other sectors due to fintech's unique properties and the business opportunities within legacy financial services. As a result, to truly understand the public investment opportunity set in financials, you must closely monitor private investment trends.

Fintech Private-Market Investment Activity, 2014-2019



Source: "Pulse of FinTech 2019," KPMG International (data provided by PitchBook), Includes venture capital, private equity, and M&A.

Banks and Payments

Within the core of the banking industry, digitalization is the most important driver of returns and growth dispersion. Banks have been forced to become digital-first service businesses, resulting in a divergence of banks with best-in-class capabilities in terms of customer acquisition and delivery versus digital laggards.

The importance of digitalization has accelerated as a result of the COVID-19 pandemic and the consequent need for immediate digital solutions. Other structural drivers in banking include increased penetration in select emerging markets and specialist lending.

Facilitators in the banking industry focus on helping core players lower costs and provide better underwriting and distribution. It is interesting to note that these adjacent facilitators aren't stealing part of the revenue pool; rather they are driving better decisions, growth, and efficiency for core businesses.

In our view, payments is the most attractive segment within the broader financial industry and has the highest growth rates of any part of the financial services ecosystem. The space includes many disruptive players, particularly in areas such as buy now pay later.

Within payments, the highest-growth areas are small and midsize merchants, international markets, and e-commerce, which is driving demand for value-added solutions related to fraud prevention, online acceptance rates, and omnichannel capabilities.

Other exciting themes include real-time payments, frictionless/contactless payments, and sizable opportunity in B2B payments. Our blog series on payments offers more insight into why we find this opportunity set to be so attractive.

Insurance

Growth for core insurance businesses is fairly compelling, especially in emerging markets. We are seeing potential for accelerating demand in life and health insurance post-pandemic, similar to what we saw after the SARS epidemic. Emerging new categories provide some interesting opportunities, such as cyber/data breach insurance and pet insurance, both of which are growing markets. Similar to what we are seeing in the banking industry, facilitators in the insurance space are generally capital light and enable better distribution, efficiency, and underwriting outcomes.

When it comes to growth themes and innovation, digitalization and data drive everything. This is playing out in multiple ways, including AI and predictive models, telematics, wellness and dynamic underwriting, and better risk selection.

Much of the disruption is coming from insurtech players; these companies are challenging the home and rental insurance base with a differentiated model, which often includes a social element. Insurtech is small at this point, but a key area to watch in the future.

Asset Management

In asset management, there is a large growth opportunity as a result of wealth creation across emerging Asia, consistent with what we are seeing in most parts of the financials ecosystem. Other important structural drivers include increasing allocations to alternatives in a low-yield environment, a shift toward passive strategies as investors focus on costs, and the growing importance of ESG, particularly in emerging markets. More recently, trading activity has skyrocketed with people spending more time at home during the pandemic.

Robo-advisors are another area of focus. On the surface, these platforms may seem like a threat to incumbent wealth managers, but we were surprised to observe that Vanguard and Schwab are the two largest robo-advisors. Looking at emerging markets outside Asia, Brazil appears to be one of the markets most prone to disruption in asset management, and we see that charge being led by digitally enabled platforms such as XP.

Capital Markets

Exchanges are an interesting growth area within capital markets, but not all exchanges are created the same. Core cash equity business in developed markets tends to grow in the low single digits through the market cycle, whereas exchanges with strong and leading positions in proprietary data services or derivatives clearing may offer more opportunity.

Merger and acquisition (M&A) activity also has been a big driver in the exchange space. We expect this to continue and for the focus to remain on scale, post-trade, and high-growth businesses.

Other structural drivers include low interest rates pushing activity toward equities and the proliferation of financial data. Use of alternative data on the buy-side continues to grow, and we see electronification of trading by asset class continue to drive fixed income and foreign exchange volume.

Emerging Markets Opportunities and Trends

While increased penetration in emerging markets is a major growth driver across the financial services ecosystem, it is important to remember that within emerging markets every country is unique. So it is essential to do a market-by-market analysis that looks at the regulatory, technology, and competitive dynamics in each country.

We think that the growth opportunity is particularly intriguing in countries with relatively low banking penetration levels, which includes much of southeast Asia, particularly in Indonesia, the Philippines, Malaysia, and India, which is a battleground worth keeping a close eye on.

China has been a leader in tech-enabled payments, with companies like Alipay and Tenpay finding ways to create their own super apps and build lending platforms based on the data they gather from users.

Alipay and Tenpay both use closed-loop payment systems, but outside of China, most payments run on systems that rely on networks such as Visa and MasterCard, as well as issuing banks and merchant acquirers.

Many wonder whether the China closed-loop model can be exported to India and other markets. Even if this does happen, we believe the threat that it poses to the incumbent networks is largely overstated, at least in the near to medium term. The current platforms are highly efficient, giving consumers little incentive to switch.

Threats to Structural Growth Drivers

The acceleration of digitalization globally, innovative models that are expanding and maturing in China, and untapped opportunities in emerging markets all provide interesting prospects for future growth in financial services. But there are certainly risks and potential inhibitors to the growth themes we identified above.

At this stage, the biggest risk to disruptors is higher interest rates. If rates and inflation rose quickly, the competitive landscape could meaningfully shift toward core/incumbent businesses and drive consolidation among disruptive players.

Regulatory changes, political interference, and capital requirements are other risks that we are closely monitoring. Caution is warranted when considering high-growth, capital-intensive businesses, especially given near-term concerns about the ability to collect on loans.

Conversely, we believe that capital-light businesses with high operating leverage and strong free cash flow are attractive and better poised for sustainable value creation. The more capital-light, digitalized, and tech-enabled those businesses are, the more interesting they become to us as fundamental, active investors.

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