Investment views

Challenging the challengers

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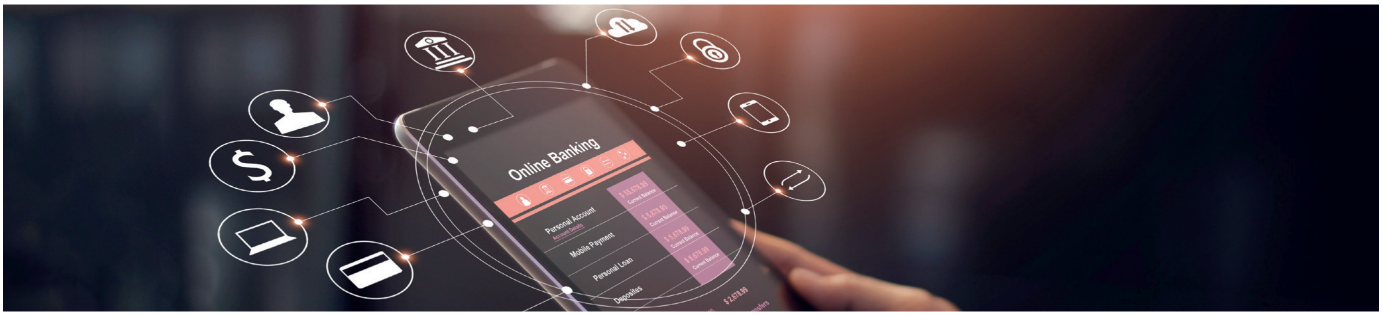

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Who are the challengers?

Revolut, Monzo, Starling and N26 are becoming household names across Europe. These businesses are part of a new wave of challenger banks that have disrupted retail banking services, divided critics and amassed millions of users. They have attracted global headlines in the last two years as they enjoy compound annual growth rates nearing 45%[1]. In a recent conversation with our financial analyst Willis Palermo, we explored three key issues for Europe's fintech fighters:

1. What does the emergence of challenger banks mean for established banks?
2. How are banks responding to the Covid-19 crisis?
3. Where do we stand on investing in challenger banks today?

The following is an edited transcript of the interview, which you can listen to in full by clicking here.

In with the new, out with the old?

A key ingredient of challenger banks' success has been their user-friendly mobile interfaces. Talk us through the user experience.

Download the online app on your phone, create your login details, send over a picture of your ID card and you are up and running with a bank account. Many of us have joined this new wave of quick and easy challenger banks that have sprung up to facilitate everyday payments and foreign exchange transactions. The ease and simplicity of joining these banks (see Figure 1) is particularly popular with younger generations. In the UK, Monzo boasts 68% of users aged between 18 and 34, while the same age group makes up more than 50% of Revolut and N26's customers.

Figure 1: A few clicks to a new account

A comparison of some of Europe's most visible challenger banks

	Revolut	Starling Bank	N26	monzo
Founded	July 2015	February 2015	February 2013	October 2015
Home country	UK	UK	Germany	UK
International presence	EEA, Australia, Canada Singapore, Switzerland, USA (expanding to 24 other countries worldwide)	USA (waiting list)	EEA, Switzerland, USA (Brazil coming soon)	USA (waiting list)
Cumulative app downloads (as of February 2020)	8,360,700	1,460,000	4,444,000	4,082,000
Time to open an account	A few minutes	5 minutes	8 minutes	Less than 10 minutes

Source: 'Fincog Benchmark on Challenger Banks Features and Profitability', Fintechnews.ch, October 2019.

[1] *https://medium.com/@amandajames19868/neo-bank-vs-challenger-bank-the-talk-of-the-town-53238a5dfe22*

“A key challenge for newcomers in this sector will be to convert a strong growth in numbers of users into profits.”

Willis Palermo | Financial Analyst

Since appearing on the market around 2015, challenger banks have enjoyed rapid growth. Which of the names are you keeping a close eye on?
The largest European fintech player in this sector remains Revolut. Emerging from a Canary Wharf fintech incubator in London in the summer of 2015, Revolut as of 2020 now has close to 10 million users and is valued at $5.5 billion (see Figure 2).

Another challenger bank we've taken a close look at is Germany-based N26. Founded in 2013, this platform counts more than 5 million users and is valued at $3.5 billion. Two competitors we are watching in the UK are Monzo, with 3.8 million users and valued at $1.5 billion, and Starling Bank, which has amassed some 1.3 million users and is valued at around $1 billion.

Outside of Europe, we're also watching Nubank. Tencent has invested in this well-funded Brazilian challenger bank, which now has over 20 million users[2] and is valued above $10 billion; and also Chime in the US, which recently reached a valuation of $6 billion.

The numbers are impressive given that their scale has been achieved in just a couple of years. Should established banks be concerned?

Overall, not particularly – we think the headlines continue to remain larger than the facts. This is particularly the case when we consider challenger banks from the perspective of our wealth management clients.

A key challenge for newcomers in this sector will be to convert a strong growth in numbers of users into profits. In particular, based on three facts:

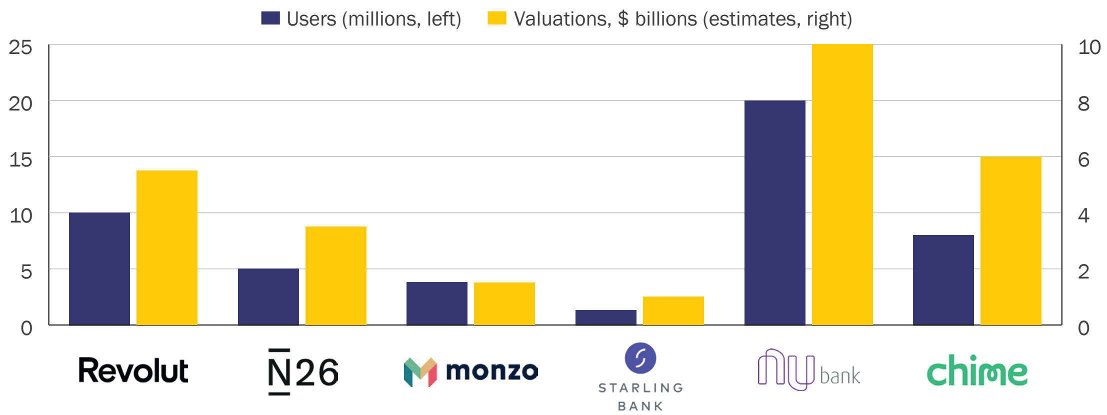
- Fees generated by card transactions are very small, hence require very large volumes.
- The more lucrative financial service products are often provided at a discount.
- Margins are all too often diluted through partnerships.

What additional factor has caught your eye when it comes to these new banks' ability to generate profits?
Customer loyalty remains an underlying concern – simply put, how many people use challenger banks as their primary account against an established institution like UBS, Credit Suisse or HSBC. In order to thrive, challenger banks need to convert customers into primary account holders. In developed markets like the UK, where one in five users now holds an account with a challenger bank, there are signs that this strategy is starting to have some success.

[2] https://www.contxto.com/en/brazil/fintech-nubank-has-20-million-customers/

Figure 2: Attracting attention

Challenger banks have amassed millions of users and reached $billion valuations in under a decade.



Source: Forbes, TechCrunch, February 2020, Fintechnews Switzerland, 18.01.2020, and Reuters, 25.02.2020.

“Established banks still have the edge when it comes to customer trust.”

Willis Palermo | Financial Analyst

A promising product from a revenue perspective is the premium subscription model offered by the likes of Revolut for €7.99 a month. This gives customers higher spending limits, insurance benefits and access to advanced features, such as disposable virtual cards.

Why are these extras so important?
These premium extras may sound like gimmicks but they help solidify customers’ loyalty, an essential part of increasing revenues, and, more importantly, ensure their recurring nature via subscription, which is a beautiful business model.

Would you say then that the simplicity of using challenger banks can work against them when it comes to retaining clients?
Absolutely. The challenge for new entrants is that when it comes to mobile payments, customers like to shop around and switch between payment providers. Customers expect to get these services for free, making loyalty an elusive concept.

Does trust also play a big part in customer loyalty?
Yes, challenger banks must resist the temptation to monetise their client data through sales to third parties – you only have to look at the Facebook data privacy scandal to see how damaging that can be. While both challenger and conventional banks hold large amounts of client data that could be monetised, they must remember data’s primary purpose within a bank is to:

- **assess the credit quality of customers;** and
- **maximize product placements.**

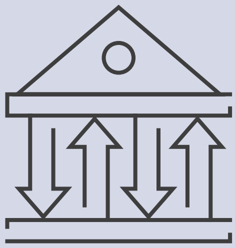
On this point, established banks still have the edge when it comes to customer trust. As challenger banks continue to grow their user base, they will come under increasing regulatory scrutiny for anti-money laundering and data privacy issues. This is something they will have to learn to live with – again, it will be another challenge for the newcomers as they try to become profitable.

Responding to the Covid-19 downturn

Any analysis in 2020 would not be complete without addressing the sector’s response to the Covid-19 crisis. What are your views?
Both newcomers and incumbents to the retail banking sector are seeing their margins compressed – it’s no secret that low or negative interest rates are hitting banks hard. Big banks still have an advantage when it comes to their cost of funding, which remains lower than for challenger banks. But the current crisis poses three risks for banks (see box ‘Covid-19 challenges for banks’).

Covid-19 challenges for banks

1. **The low-interest rate regime:** lower for longer means banks that have the lowest cost-to-income ratio will be in the best position to succeed. These trends are not new but have been accentuated by the downturn from the Covid-19 pandemic, as seen in the cutting of interest rates in the UK and the US.
2. **A decrease in volumes:** with people travelling less, there will be fewer foreign exchange fees; people will be consuming less and generating fewer transaction fees.
3. **Avoiding defaults:** for more established banks that offer loans and consumer finance, avoiding default on their debt will be a challenge in the current downturn. Many challenger banks that just offer deposit services, such as Revolut, will be less affected.



We saw Monzo face a valuation drop of nearly 40% in May 2020 based on its latest fundraising round[3]. How are challenger banks likely to respond to a new and more hostile business environment?
There is no single way to respond. As with most businesses during this crisis, they need to find ways to transform themselves, offering something customers can use or that is new. Importantly for challenger banks that lend, the quality of their loans will be key to determining who stays in business.

Monzo still needs to grow its user base, but will also need to focus on securing capital as it remains unprofitable. Meanwhile, as with other challenger banks, it should keep focused on capturing new consumer trends such as the shift from cash to cards and online shopping – the winner will be the one that can monetise these long-term trends.

So an ability to monetise services and products beyond deposit holding will be an important ingredient to the success of challenger banks going forward?
Yes, in banking there is very little differentiation. Customers generally select their mortgage or loan provider based on pricing. This is why challenger banks have introduced cheaper rates on services such as foreign exchange and lending. Overall, the strength of challenger banks resides in their sophisticated digital platforms and lower operating costs, thanks to modern and lean IT systems. Growing and monetising these platforms will be a key challenge going forward. A route to providing these services could be through developing partnerships between challenger and traditional banks. The two have different strengths and could benefit from a degree of collaboration.

Where we look

Index providers are servicing the growth in passive investment markets benefiting from a structural shift in investment preferences. Meanwhile, rating agencies enjoy a unique regulatory position within the markets they serve, giving them oligopolistic power in the way they price their services.

Finally, related to financials, we also like payment service providers that have captured market share and the long-term trend of customers moving from cash to card and online shopping.

An investor's perspective

Your analysis highlights some positive aspects of challenger banks, while remaining overall cautious on their development?
Yes. Looking from the perspective of our wealth management clients, the main obstacle to investing in challenger banks is that most remain unlisted. Beyond this technical point, our investment outlook remains clouded by a lack of long-term visibility and stability when it comes to three things:

- the definition of their business model;
- customer loyalty; and
- regulation.

That said, the new arrivals have brought disruption in the customer retail banking space, which will have to be closely monitored.

For now, the packaging is beautiful and customers feel empowered. But will challenger banks break through? For the reasons discussed above, it is fair to say we prefer to hold exposure to more established financial service providers in our clients' portfolios.
Yes, that's right. In particular we like to look at financial companies that have three characteristics:

- strong pricing power;
- an entrenched market position thanks to high barriers to entry; and
- recurring and predictable revenue thanks to long-term supportive market trends.

Three examples of this are the index businesses, rating agencies and payment businesses (see box 'Where we look').

You can find out more about the companies we select for our Mosaique discretionary and advisory services by contacting your client advisor at Rothschild & Co Wealth Management in Switzerland.

For further insights on our latest research and views, please visit www.rothschildandco.com/insights

[3] *https://www.ft.com/content/7dd0dd44-1614-475e-b272-c5dd4c206582*

Investment Insights

If you have enjoyed reading about challenger banks and wish to find out more, please do not hesitate to contact your client adviser.

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