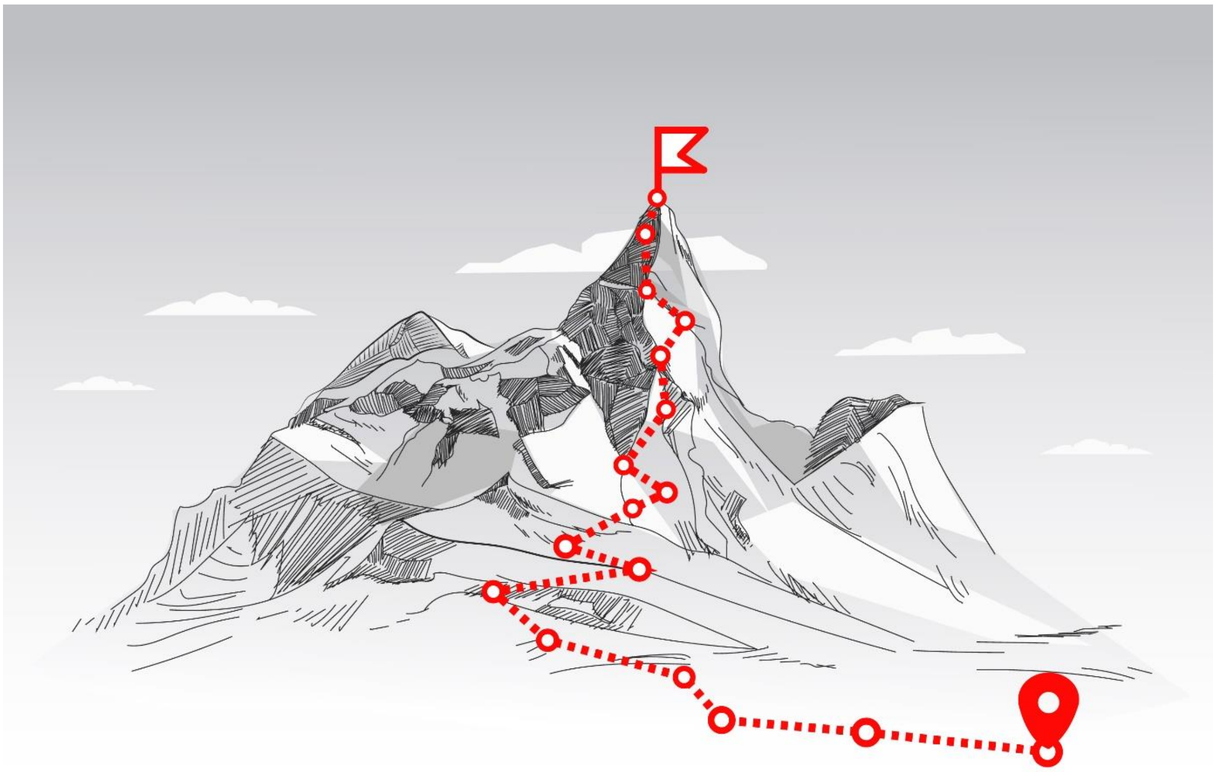
The Blue Finance

The Blue Finance Paper

on

Strategy: The «Moneymoon» is over – Time for Value-based Fintech Strategy



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0 SUMMARY

In this The Blue Finance Paper we provide a sound approach to fintech strategy by applying The Blue Finance's systematically philosophical analysis to the sector.

Our thesis is straightforward: To be successful, Fintech must deliver a real value added perceived in the eyes of *users*, i.e. humans.

We would call the last 10 years the "**Fintech Moneymoon**". There was a lot of euphoria, a huge potential for rationalization and a lot of venture money to be spent on "disrupting" (a term lately used for every change in an existing process) new business models. But many prominently acclaimed models disappeared because of lack of paying customers. The potential clients did simply not recognize a value added.

Already before the outbreak of the global corona pandemic it was evident that Fintech was to stand the test of time. Our call therefore: Now that the venture capital driven "Fintech Moneymoon" is over, let's get to work and apply a sound approach to Fintech. Financial services companies need a sound[1] Fintech strategy! The industry needs to accept that Fintech is a tool to improve people's lives and that the old adage of the client always being the king is also true in Fintech. Those companies that don't obey this imperative are set to disappear. Fintech needs to add value in the eyes of its customers in order to also deliver value for Fintech companies and their shareholders. The Blue Finance provides a value-based approach to getting a grip on Fintech.

1 WHAT ARE WE TALKING ABOUT?

Strategy needs to start with the question: "What are we talking about? What is Fintech?" There are numerous definitions of the term "Fintech". We would keep it simple and go with this definition: "Fintech is every technology applied to support the financial sector in delivering its services." The financial sector is defined as the industry that serves people in the storage, transfer and management of wealth.

The Origin

Strategic thinking is philosophical thinking. When we apply some philosophical thinking (as The Blue Finance's proprietary consulting method "VALURADIX" does), we first ask ourselves the question: "What's the origin of it all?". We kind of take a mole's *radical* view from the roots of a system (radix, lat. for "root").

Every process or system has a source (a root) and an ultimate purpose (or fruit). The Blue Finance applies the analogy of a tree to make things more figurative.

At the beginning of every process in finance and the economy per se lies a **need**, a desire or wish of a human being or a group of human beings (such as a company or the government). The sole purpose of the finance industry is to serve

[1] Merriam-Webster: sound (adjective); solid, firm, stable, secure, reliable, thorough, free from error, fallacy or miscomprehension; exhibiting or based on thorough knowledge and experience.

these needs by supplying services to entities that satisfy the needs of these human beings, the ultimate clients. Generally, these entities can be called "the real economy". So, finance caters the Real Economy. The following graph depicts this genuine source-purpose-relationship with the different subsystems (steps) and peripheral systems supporting or interfering with the core process.

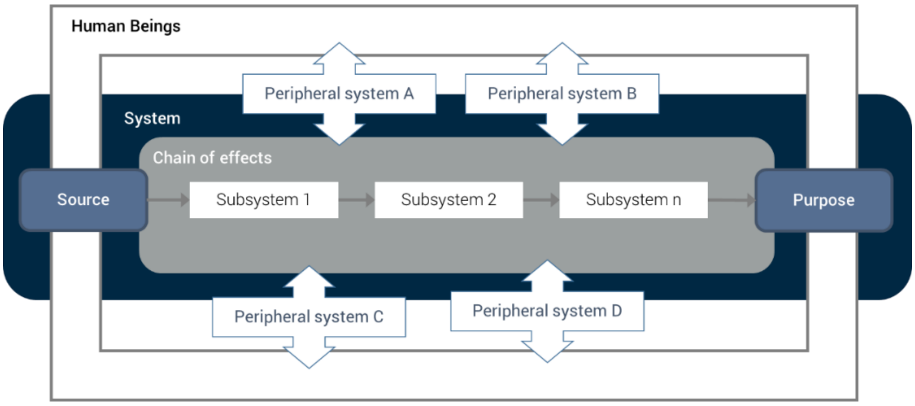

Figure 1: The Blue Finance's Process Decomposition

The clients want services delivered at a very high standard of quality at a price as low as possible. The industry's aim, on the other hand, is to cater these needs for as many clients as possible, for a price as high as possible and with minimized costs.

Why Fintech? – The Purpose

It is a very humbling and instructive exercise to really step aside, and not only to step aside, but literally fly up to the moon to assess a system with maximum distance and in its whole breadth. We then ask ourselves: "Why fintech? What are the fruits of it all?" The purpose of fintech is quite straightforward. Technology in the financial sector ought to serve the purpose of contributing a real value added to the overall purpose of the industry. From an economic standpoint that means to either improve the conceived service for the client, to increase output or to lower the necessary input.

Effectiveness, efficiency and value creation measured as utility are the three main purposes of the application of technology. Of course, this is a generic definition, as it applies also to other industries, as well. Just as a recap: Effectiveness measures the result relative to the goal ("is the purpose accomplished?"), efficiency sets the result into relation to the input ("is the purpose accomplished with minimal input?") and value being the difference in the utility (mostly measured with money, i.e., the willingness to pay) before and after an action.

Having applied the top-down "moon view" with the mole's "process decomposition" we end with a comprehensive insight into a subject of investigation – we can see the whole tree.

As we will see, there's the outside view that has to be matched with the company's inside view. In this paper we separate the customers' outside view from the company's inside view in order to get closer to a decision framework. Let's get to work with the company's perspective.

1.1 Company's Perspective

The company's view is ultimately the Shareholders' perspective. With the advent of corporate social responsibility (CSR) and ESG investing the purpose of a company's existence has been subject to debate. Of course, The Blue Finance does have a clear stance on that, but in order to not complicate things beyond the necessary, we will assume in this paper that the best proxy for a company's success is its company **value**. The value of an enterprise is (still) most suitably approximated with a plain vanilla discounted cash flow (DCF) calculation. To assess the *change* in value, The Blue Finance applies the "Economic Value Added"-concept (EVA) going back to Alfred Rappaport's "Shareholder Value Network" and business consultancy Stern Stewart.

The following graph shows the schematic derivation of the economic value added. The Blue Finance is happy to explain it in further detail, but for the purpose of this paper lets the 4 levers stand for themselves.

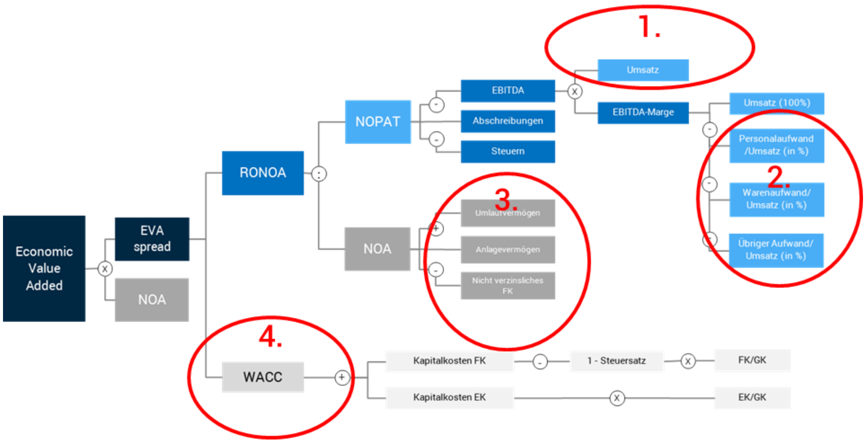

Figure 2: Economic Value Added-Framework

The concept basically tells you that a company has 4 **value lever groups** for increasing company value:

1. Sales
2. Costs
3. Working capital
4. Capital costs

If we define strategy as a means of coping with current and future challenges, these 4 levers are the "points of attack" for a comprehensive and effective fintech strategy. Of course, this is not rocket science at all. On the contrary: at least two of them (cost and sales) are very straightforward. As a manager, you want

- to increase sales,
- keeps costs low,
- use as little working capital as possible and
- be fortunate enough to have low capital costs.

Experience shows, though, that management oftentimes lacks a clear framework and radar when establishing a strategy. As far as fintech and digitization is concerned, we recommend applying the just mentioned corporate finance approach with a little less accounting-prone angle. Business Consultancy McKinsey & Company has identified 5 generic levers of how digitization in general can add value. It can

1. create **New Business Models**
2. contribute to **Cost Reduction**
3. lead to an **Enhanced Customer Experience**
4. introduce New sources of **Revenues**, and
5. enhance **Decision making**

These levers are to a large part interrelated. New business models will hopefully lead to new sources of revenues and an enhanced customer experience.

Fintech Value Matrix

When formulating a fintech strategy, these 5 levers can serve as entry points for the systematic formulation of measures to increase company value. All of them in one way or another relate to one of the four value lever groups. McKinsey's levers can be merged with corporate finance's value levers groups to get a "Fintech Value Matrix". The Fintech Value Matrix can serve management as a cockpit for its fintech initiatives. The following table shows its structure and examples of concrete measures.

Lever Groups	↓ COSTS (INPUT)	↑ REVENUES (OUTPUT)	INTELLIGENCE
	Focus: Procedures, Processes, Aim: Industrialization, Revenues		Focus: Strategy Aim: «outsmart» competition
Levers	▪ Costs ▪ Capital Costs ▪ Working Capital	▪ New Business Modell ▪ Customer Experience ▪ New Revenue Sources	▪ Decision Making
Measures			
1	Digitization of process Y	Update of user interface XY	Analysis of user data X
2	Replacement of application X with Y	ESG-matchmaker	Cross-section survey of Y
…	…	…	…

Table 1: Example of Fintech Value Matrix

It is set up in three main categories for value generation: Cost, Revenues and Intelligence. Costs and revenues are mostly about the further improvement of processes and procedures in order to reduce input and increase output. Both also cater the industrialization of the industry. The overarching category of Intelligence helps the company and its clients make better decisions. By better, we mean value enhancing. It therefore serves the strategic component of the framework. The Fintech Value Matrix provides management with a clear structure for a company's fintech efforts. It is crucial that fintech strategy does not consist of isolated measures across the value chain, but that it is an ensemble of thoughtfully and strategically aligned and implemented actions.

1.2 Clients' Perspective

When looking at the Fintech Value Matrix it becomes obvious, that especially the revenues lever group substantially depends on the clients' behavior. As obvious as it may seem: In order to increase sales and be given the economic right to exist, fintech must do the following:

1. solve **problems** conceived as such by paying clients, and/or
2. deliver **value** added conceived as such by paying clients.

That's it. The magic word here is: paying clients. By clients this paper means the industry or the industry's clients. Every business textbook reminds its readers that clients come first. So, one would assume that this reminder is void. But it is not. As experience shows, dazzled by the prospects of technology some fintech ventures seemingly forgot about paying clients.

It cannot be emphasized enough how important the clients' perspective is for a successful fintech strategy.

2 Sound Fintech Strategy

What's keeping managers up at night is the fact, that there is 1. no future without digital processes (i.e., *you don't have a choice*) and 2. you can hardly implement the strategy in one comprehensive leap forward. So there has to be a thought through strategy with a staggered approach that builds the basis for a multi-year tactical implementation of different measures. The curse is that, as you go along, circumstances are constantly changing. Technology, as well as customers' needs are moving targets. Management needs to closely monitor what tune is being played in the market and keep your digitization platoon agile. It's the climbing of a mountain with constantly changing weather, seasons, trails and ground. The fintech value matrix helps you keeping the course and not missing the forest for the trees.

So, how is a sound fintech strategy elaborated?

Self-image. Management needs to have a strategic plan of what a company achieves to stand for in the digitization age. First mover? Early follower? Or an early adapter? These are entirely different stances toward digitization, and they depend on the current IT-framework it operates in. Companies with many legacy systems still operating meet different circumstances than young startup ventures built on new technology.

The **vision of the future** of a company drives the technology it applies. Technology itself should not be the synonym for the future, because it does not in itself bear a value proposition. Create your vision first, then choose the right technology to support it. If a company decides to «go digital" the decision has to be **embedded** into a broader review of the business strategy and adapted to the context. Digitization as an isolated measure is not a promising strategy.

The fintech value matrix is the starting point of the strategic **planning** of the implementation of fintech initiatives. Combined with a timeline it provides the strategic fintech plan. Based on that, the CFO-department should be able to come up with a plan on how to finance the transition into the digital age. There should be a specific "fintech **finance plan**" at hand.

The **people** currently leading the process have to be heavily involved in the design of new processes or services. Most of the time there is a reason the current process is designed the way it is carried out. Inside knowledge from day-to-day operation should be combined which an external view of best practice. The ability of outsiders to ask seemingly “dumb” questions is essential and enlightening. Take employees along as the process is being redesigned and digitized. Make them a valuable source of knowledge and success for the entire project. Don’t let consultants alone do this work. A digital strategy has to come and needs to be driven from the inside. That of course needs time to shift the minds of opinion leaders. But take that time – and therefore start now. You will most probably be fine being on early follower.

Train staff to be **fintech-savvy**. By igniting interest for the digital transformation, the company plugs their knowledge and ideas, and at the same time gains their buy-in for the project. Show them, what their role will be in the future. For them, it is important to not be laid off. Make them clear, that processes are not digitized through right away, that there will remain manual tasks to be done and – challenge and chance alike – new roles will be created, too.

Finally, don’t stop halfway through. Digitization strategies have to be thought through without any blinders blocking the view for the whole. Think end (client) to front first, then front to end. Client facing processes ought to be designed or redesigned backwards from the customer experience or product use to the origin of production inside the company. Don’t let your current processes and organization influence your thinking in the first place. Make concessions only where needed.

3 CHANCE FAVORS THE PREPARED MIND

Fintech has been a buzzword in the finance industry for many years. Now that the Covid-19-pandemic has accelerated digitization in many aspects of our lives, also fintech’s day of truth is around the corner. The abundantly accessible venture money has let to many well-intentioned fintech initiatives and a fragmented fintech landscape.

Now that the «moneymoon» is over, established financial services firms need to get their act together to come up with sustainable fintech strategies. The time of trial and error is fading. Internally, digitization is the key to enhanced efficiency. Benign financial markets might have dampened the need to do so. But it’s just a matter of time until circumstances turn more hostile and increase pressure for rationalization.

In client-facing processes, incumbents are really being challenged by new entrants targeting a younger, more tech-savvy clientele. At the same time, investors can not be satisfied with fancy business plans and visions of the future. The future is here and fintech is a source of return. This calls for systematic, serene action.

The next years will bring further consolidation in the financial sector. Among a breath of further wisdom, legendary investor Charlie Munger coined the saying “Opportunity comes to the prepared mind.” Munger seemingly cited Louis Pasteur’s famous adage “Chance favors the prepared mind.”

So, prepare yourself and don’t hesitate to learn from others.