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Inclusive Fintech Funding in Times of Uncertainty

LESSONS LEARNED AND CHALLENGES AHEAD

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Acknowledgments

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Funding Challenges for Fintechs

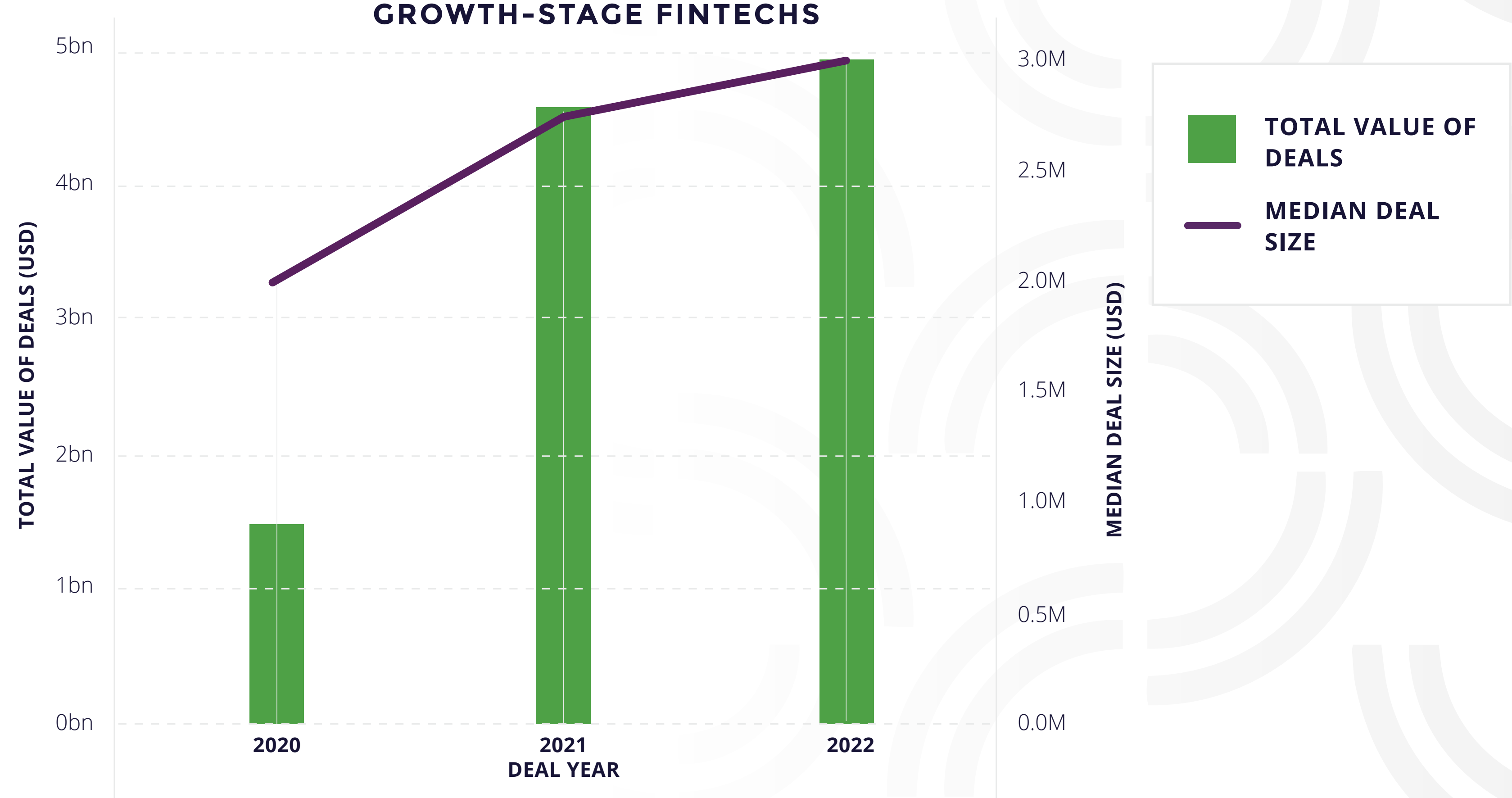
The surge in digital payments during the COVID pandemic has accelerated the digital transformation of the financial services industry across the world, leading to considerable growth over the past few years in the number and size of fintechs. For consumers, especially low-income people and underserved segments, digital technologies have the potential to offer better access to tailored and more affordable financial products.

But this sudden growth has also been accompanied by a highly complex set of global challenges, creating significant uncertainty and funding challenges for early- and growth-stage fintechs.

Macroeconomic headwinds are slowing global growth while interest rates are rising, placing strains on fintechs' customers. The war in Ukraine has decreased food supplies, especially in emerging markets, while COVID and trade wars have disrupted global supply chains, driving the largest price gains seen in decades. Central banks worldwide have responded by raising interest rates to rein in inflation and cool their economies. For low-income people, who typically have limited savings, no insurance, and unpredictable cash flows, rising prices directly impact the cost and quality of living, and consumption declines. For small businesses, the economic environment is particularly difficult because their cost of borrowing is increasing, even as customer spending is declining.

These three forces -- slowing economic growth, rising inflation, and climbing interest rates -- are straining fintech business models and putting a halt to the unexpectedly rapid growth in fintech funding seen in recent years. From 2020 to 2021, the total value of deals to early- and growth-stage fintechs in Sub-Saharan Africa, Middle East and North Africa, Latin America and Caribbean, and South Asia (India) grew more than threefold from USD $1.5 billion to $4.6 billion, according to data collected by Briter Bridges. The number of deals increased across all three regions, accompanied by an increase in median deal size from $2 million to $2.8 million (see Figure 1).

FIGURE 1. FUNDING TRENDS FOR EARLY- AND GROWTH-STAGE FINTECHS



Briter Bridges data for early- and growth-stage deals below Series C in Sub-Saharan Africa, Middle East and North Africa, Latin America and Caribbean, and South Asia (India) excluding mega-deals over $100M.

But the pace of gains slowed markedly in 2022 when the total value of deals increased by 6.5 percent from the prior year to reach $4.9 billion. The slowdown started to take hold in the fourth quarter of 2022, but due to the data lag on funding deals, the trend did not become fully evident until early 2023. The total value of deals closed in January and February 2023 was $0.4 billion, down 75 percent from the same period a year ago, strongly confirming the general trend of a significant pullback in funding to early- and growth-stage fintechs, which is expected to continue. Growth-stage fintechs - defined as Series A and B funding, excluding mega deals over $100 million - have seen the largest pullback, Briter Bridges data shows, signaling a significant challenge in raising the next big round of investment. In addition, the median deal size for growth-stage fintechs appears to be dropping from $20 million in Q1 2022 to $4.5 million in the first two months of 2023.

To better understand the funding decline in the context of a challenging macroeconomic environment is affecting the sector, the Center for Financial Inclusion (CFI) interviewed early-stage inclusive fintechs and investors, with an emphasis on learning what impact the funding uncertainties are having on their business models and the customers they serve.

HOW CFI CONDUCTED THE STUDY

CFI interviewed 12 fintechs that won the Inclusive Fintech 50 (IF50) competition between 2019 and 2022. They shared their perspectives on the current macroeconomic and funding landscape and their actions to navigate the uncertainties.

CFI managed the IF50 competition during that period, in which over 1,300 fintechs from more than 60 countries applied for the competition. The firms were relatively young, with over 40 percent in operation for less than two years and in the early stages of funding. Over 80 percent were either self-funded or seed-funded.

While we spoke to fintechs across a variety of countries for this report, the set of interviews is not representative of the entire fintech sector, nor the inclusive fintech sector. The majority of the interviewed fintechs offer business-to-business (B2B) and B2B-to-consumer (B2B2C) models to underserved communities, such as microentrepreneurs, small- and medium-sized enterprises (SMEs), women, low-income households, and smallholder farmers.

In addition, we spoke to six investors focusing on early-stage inclusive fintechs, providing an opportunity to hear about changes in their portfolio strategies and their perspectives on current and future funding trends.

How Fintechs Are Responding to Uncertain Times

With funding volumes declining, donors and impact investors are concerned that early-stage fintechs will move upmarket and away from serving financially underserved communities, which generally are considered a high-risk customer base and a low-profitability business model. Higher-income segments are purportedly easier to serve, potentially requiring lower operating costs. This concern was consistent in our conversations with impact investors working with inclusive fintechs in emerging markets. They explained that one of the risks they face within their portfolios is the possibility of fintechs deviating from inclusive missions in favor of serving lower-risk and higher-income customers for better profit margins.

However, the fintechs we spoke to remain true to their intentions of serving low-income and underserved segments. Fintechs explained that they remain focused on serving these customers because there continues to be a large unmet demand for financial products in these customer groups, driven by pain points that fintech products are well suited to solve. Moreover, despite the continuing challenges of the past few years, fintechs said they perceive their customers to be resilient.

Fintechs described two basic approaches to succeed in the current climate and remain competitive despite a challenging funding environment: enhancing operational efficiency and discovering more effective ways to cater to customers. They implement these approaches in several ways.

1. **Focus on business fundamentals.** The investors and fintechs emphasized a shift from a 'growth at all costs' mindset to a focus on fundamentals. Fintechs have been actively working to keep operational costs low, using tactics such as onboarding low-income customers more efficiently. By partnering with known and trusted institutions, fintechs can reduce customer acquisition costs and increase retention. For example:

    - Boost is a B2B commerce platform serving micro and small enterprsies (MSEs) in Sub-Saharan Africa. It has partnered with recognized fast-moving consumer goods (FMCG) companies such as Unilever to onboard new customers, reducing the need to invest in its field presence.

    - Cassbana is an inclusive fintech in Egypt that partners with wholesalers who help onboard MSME clients. As a result, wholesalers benefit from increased sales volume, which obviates the need for Cassbana to pay them additional commissions for customer onboarding.

Other fintechs are adjusting their internal cost structures. For example:

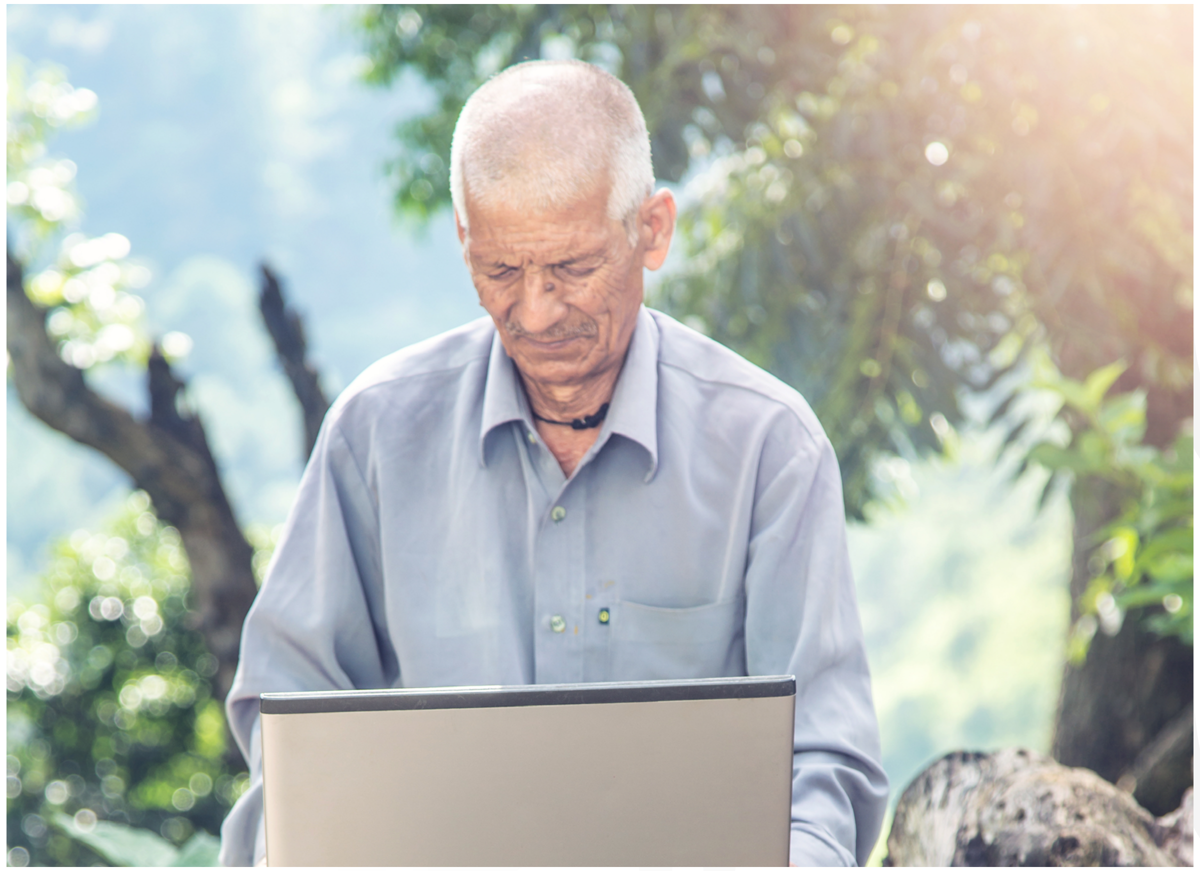
- Marketforce is a B2B fintech serving businesses in Kenya, Uganda, Rwanda, and Tanzania. It set customer retention targets and adjusted its staff incentive structure to reward sales on higher-margin goods.

- Bankaya is an inclusive business-to-consumer (B2C) fintech in Mexico. It switched from providing sales staff commissions based on account openings to a compensation scheme based on monetizing products.

2. **Focus on revenues and profits.** Fintechs interviewed said they have increased their focus on product-market fit and creating a path to sustainability and profitability. Bankaya's initial focus, for example, was customer acquisition. In 2021, the company started offering digital savings accounts to underbanked or unbanked customers who transact primarily in cash. But the digital savings accounts did not generate revenue. In 2022, it switched to monetization and launched additional products, including credit, payments, and remittances, to ensure an increase in revenues.

   Investors said the back-to-basics approach is necessary in the current environment. "In view of the recent fintech funding situation, fintechs that have moved beyond the hype and are focused on building strong fundamentals like product-market fit, sustainability, and a clear path to profitability are doing well now and will do so in the future," Efayomi Carr, Principal at the impact investor Madica, said.

3. **Strengthened customer focus.** As fintechs broaden their range of products and services, some strive to strengthen their connections with customers and extend their reach to a greater share of underserved



populations. For example, Lulalend, a B2B fintech in South Africa, began by offering digital credit to MSMEs. To qualify for a loan, Lulalend required a minimum operating history of 12 months and an annual turnover of at least 500,000 rand (approximately $26,000). Now, it has expanded into a neo-banking solution offering a wider suite of products, which enables it to reach smaller and younger businesses with more lenient terms. By making it easier for businesses to open a bank account and offering them cash flow analysis and savings products, Lulalend helps businesses establish a track record of cash flows, which allows it to accurately assess an SME's financial health and ability to repay a loan. Accordingly, Lulalend has relaxed its operating history and turnover requirements and cut its minimum loan size from 20,000 rand to 10,000 rand (approximately $1,040 to $520). These changes have made the company's products far more accessible to small businesses.

Several fintechs that serve SME clients said that understanding their customers' businesses and cash flows is crucial to ensuring they provide products and services that suit their needs and risk profiles. For example, ARTH, an inclusive fintech in India, recognized that the MSME segment in India is so large that it was better to concentrate on nine business sectors rather than the whole market. This shift allows ARTH to serve its customers better by tailoring the tenor of loans informed by the specialized knowledge it has gained of cash flows in the nine sectors it serves. ARTH is also pursuing a customer-deepening strategy by offering payments, insurance products, and credit to MSEs. It also aims to design an attractive and comprehensive bundle as a first product for new clients to avoid cross-selling costs later. Similarly, Cassbana focused deeply on microenterprises that provide FMCGs, like groceries, given the relatively consistent demand for those products.

Scott Onder, Chief Investment Officer at Mercy Corps Ventures, said measures like these are essential for fintechs to succeed: "A key element to a strong fintech is the way it distributes its products (e.g., bundling them with other products or incorporating them into existing products). In addition, it is crucial to ensure that education is woven into the user experience, encouraging the responsible use of those products, which will result in increased customer trust."

4. **Leverage technology and innovation.** Some of the fintechs that serve small businesses explained the importance of using technology, especially alternative data, to better understand their customers' needs and serve them more effectively. ARTH, for example, gains specialized insight into its customer base by partnering on a data-sharing platform with over 1,200 hyper-local business associations for distributors who share data on small business owners' cash flow and economic health. ARTH can then use this data to develop customer insights and create suitable products. "That's a big differentiator against many other fintechs in the market. And we intend to scale this model to the next level," ARTH said.

The Investors' Perspectives

The hectic funding period between 2021 and 2022 was characterized by short timelines for capital-raising activities, light due diligence, increased median ticket sizes, and high valuations based primarily on high growth targets for customer acquisition or market share. Today fintechs report that funders have become more cautious regarding the risks of investing in emerging markets; they are taking more time with due diligence and are stricter in their requirements.

The investors we interviewed acknowledged that it has been more difficult for fintechs to raise funding since the end of 2022 compared with the period between 2020 and 2021. There is less overall growth in funding, and company valuations are lower than several years ago, with some fintechs at risk of flat or lower valuations for future funding rounds.

Tamer Azer, Partner at Shorooq Partners, described the changed environment this way: "Capital is rational. At times, there was more capital than companies and their needs. Now, there are more companies, and the needs are greater than capital availability. Capital will make rational decisions, and the market will respond to the changing dynamics of supply and demand."

"Now, there are more companies, and the needs are greater than capital availability."

Tamer Azer, Shorooq Partners

The investors highlighted the importance of patient capital, recognizing a considerable time lag between the launch of a fintech and the time it starts to generate revenue.

Despite the more challenging environment and fintechs' perception of increased risk aversion, all investors said they continue to invest in inclusive early-stage fintechs. These inclusive early-stage fintech investors also noted that their due diligence criteria had not been impacted by the overall market conditions, in contrast to the reports from fintechs, which may have a more diversified investor base.

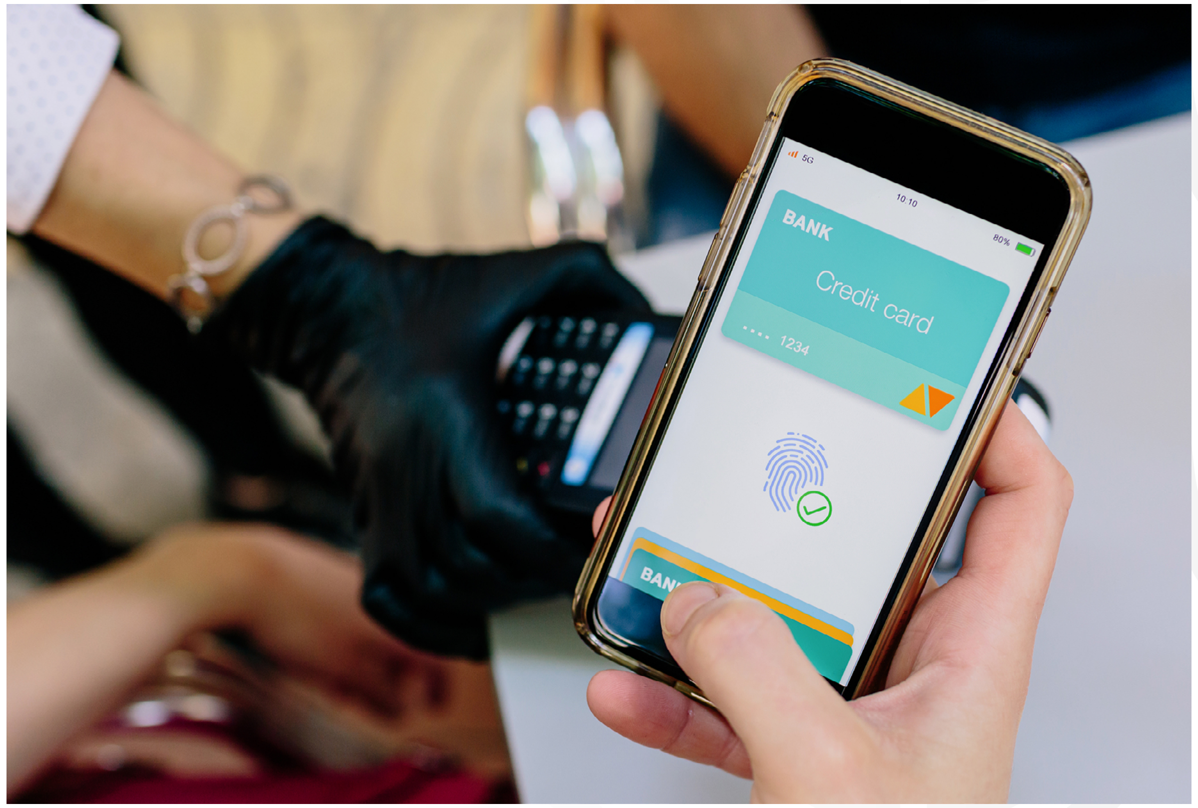
The Funding Outlook

Looking ahead, fintechs and investors expressed cautious optimism amidst the market shakeout. The continued interest among some investors to provide funding to early-stage fintechs indicates that they still believe in the innovative solutions offered by these companies to solve fundamental challenges around access to financial services for underserved communities. Investors said they remain excited about different opportunities, such as B2B models, financial solutions in offline markets, or solutions accessible in different local languages. However, the excitement around consumer lending models has waned, and funding for these fintechs is expected to shrink.

They expect the following trends to shape the market in the period ahead.

1. **Many early-stage fintechs will struggle to raise capital.** Fintech startups that raised funding during a time of abundant investment capital are expected to face greater challenges in raising another round of funding compared to fintechs that achieved growth and approached profitability with less reliance on funding support. Investors and fintechs stated that early-stage fintechs need to lower costs, raise smaller rounds through bridge financing, and accept flat or lower valuations.

   ARTH described capital raising as tough in today's market: "Post the pandemic, as the market opened up, it was a good environment for fintechs to raise funding rounds, and a number of fintechs did manage to receive a lot of capital. But unfortunately, this year is not so positive, and there seems to be an impending funding winter, including in India for fintech. As a woman solo founder of a mission-driven fintech, I have to work harder to raise funds this year."



2. **Investors and fintechs anticipate more failures in the short term.** They are aware of several fintechs struggling to raise the next round of capital and risk company closure. Fintechs and investors also expressed

concern that some foreign investors with less experience in emerging markets have recently become far more cautious about investing in these markets, and some have even started to retreat to products and markets that are considered safer.

3. **Investors will focus on businesses and geographies with longer track records.** Areas that have experienced incremental growth predating the funding boom are expected to be better positioned to attract capital and withstand the current macroeconomic instability. When analyzing funding market conditions, looking at total funding volumes and the funding growth velocity over time is important. In this regard, Latin America and India, each with proven track records, have already demonstrated greater funding stability. In contrast, countries and regions without a proven track record that attracted rapid growth between 2021 and 2022 will be most affected by the current slowdown.

4. **Fintechs will focus on building the core business and creating value for customers.** Capital is important to cover costs and keep the business afloat, but to continue to attract investment, fintechs must improve their core business models and prioritize positive unit economics over customer acquisition targets. Understanding the needs and challenges of low-income customers and designing low-cost, tailored products that address their concerns and create value in their financial lives is essential. Investors and fintechs said this approach would translate into higher customer retention and activity rates, favorable funding terms, and less overall reliance on investment.

5. **Experienced fintech founders are well positioned to thrive.** While fundraising currently poses some complex challenges, it is worth noting that the froth is out of the market, and the expectation is that experienced fintech founders will emerge even stronger when markets rebound. While the macroeconomic environment and external shocks like a pandemic are unpredictable, experienced fintechs have demonstrated that well-managed businesses can weather tough times by focusing on fundamentals, unit economics, and profitability. One impact investor explained that despite current challenges and difficult conditions, entrepreneurs and investors are more focused today on the core business: creating value for customers and becoming profitable.

6. **Opportunities will abound for impact investors with patient capital.** Despite the uncertain global backdrop, fintechs will continue to need capital. Thus, fintechs and investors must find the right alignment in navigating changed market conditions. Currently, the decline in funding and lower company valuations have shifted the balance of power toward investors. While acknowledging this, fintechs also have a better understanding today of the types of funding that work best for their business models. Some fintechs said they are weary of venture capital and commercial investment, which typically focus on rapid growth and three- to-five-year payback periods. They do not see an exclusive reliance on large-scale commercial capital as best suited to the business models of inclusive, early-stage fintechs and the customers they are trying to serve. In contrast, they said impact investors with patient capital, who understand the operating challenges of fintechs in developing countries, remain attractive partners. If commercial investment is included in the capital structure, fintechs emphasize the importance of blending it with returnable grants and impact investment to manage risks associated with serving underserved customers.

7. **Debt structures will change**. Although credit-focused fintechs must raise debt to fund their loan activities, foreign-currency debt is considered too risky to deploy in this dynamic global interest rate and foreign exchange environment. For example, Cassbana has obtained a US dollar debt facility with venture capital and local currency debt from domestic banks. However, it considers the foreign exchange rate risk associated with the US dollar debt too high to deploy that facility.

Conclusion

The current landscape of inclusive fintechs presents a mixed picture. Although challenging, the recent funding pullback may benefit the sector in the medium to longer term by forcing fintechs to operate more efficiently and sharpen their focus on refining their business models. This process could foster an ecosystem of healthier fintechs over time. It is particularly encouraging that inclusive fintechs remain true to their intentions of serving low-income, underserved people despite the difficult environment. In fact, many are doubling down on that commitment. They are striking partnerships and deploying technologies to better understand the needs of low-income customers and how to serve them more effectively.

At the same time, it is important to acknowledge that there will be further shakeouts and failures in this funding environment, especially among early-stage fintechs and within countries with higher perceived risk. As a result, there may be setbacks in innovation and inclusivity. Moreover, absent a clear understanding of how to measure impact, the case for impact investors is more complex when the link between the financial products provided by fintechs and financial inclusion is still primarily based on intentions. As the sector evolves, stakeholders must maintain a balanced perspective, leveraging the lessons from successes and failures to steer inclusive fintechs through these challenging times towards sustained growth and impact.

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