The
Future Project
A King & Wood Mallesons Series

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Digital Financial Services

Digital innovation and FinTech in Southeast Asia is the "new normal" for financial services distribution and customer engagement, but accessing it requires a specialist M&A toolkit

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In the second instalment of this three part series, King & Wood Mallesons Partner and Head of Corporate for South and Southeast Asia, Jake Robson and Special Counsel Nick Davies discuss the challenges of market entry and traditional investment structures in digital financial services in Southeast Asia and how to overcome them in order to successfully develop or expand a market presence in this sector.

Part 2:

The limitations of organic growth: Why traditional venture capital funded FinTech companies are often unable to address some of the key challenges for developing digital financial services in Southeast Asia

Southeast Asian FinTechs attract a disproportionately low amount of investment relative to the market opportunity

Since the global financial crisis, FinTech has evolved into a mainstream investment category attracting US$33.9 billion in total annual venture capital invested in 2019 on a global basis according to CB Insights' 2019 annual report. Southeast Asia contains approximately 8.5% of the world's population and is populated by an increasingly digitally savvy and affluent, yet underbanked, population. Yet, the amount of FinTech venture capital funding flowing to the region has been disproportionately low compared to the rest of the world - US$ 993 million in 2019, or less than 3% of global FinTech venture capital funding according to the same study.

As discussed in the first part of this series, late stage venture capital funding rounds in Southeast Asia have largely been concentrated on a relatively small number of companies such as Grab,

Go-Jek and Tokopedia, which are also in the process of developing digital financial services platforms. Southeast Asian FinTech companies that have been targeting the region for a number of years seem to be less attractive targets for investment compared to their bigger but less experienced new competitors in the FinTech sector.

Regardless of funding, Southeast Asian FinTechs often fall into a "linear growth trap"

The traditional model for venture capital funded companies is to grow organically and rapidly. In the case of FinTech companies targeting Southeast Asia, this necessitates obtaining financial services licenses and rapidly building a strong presence in multiple markets in the region, which, as noted on the first part of this series, is costly and time consuming.

Rapid organic growth in multiple countries simultaneously is a difficult strategy to execute, but it is by no means impossible to achieve. Yet in our experience, many venture capital funded FinTech companies in Southeast Asia with regional aspirations end up focussing almost all of their time and resources in developing a functional business almost exclusively for one or two launch countries.

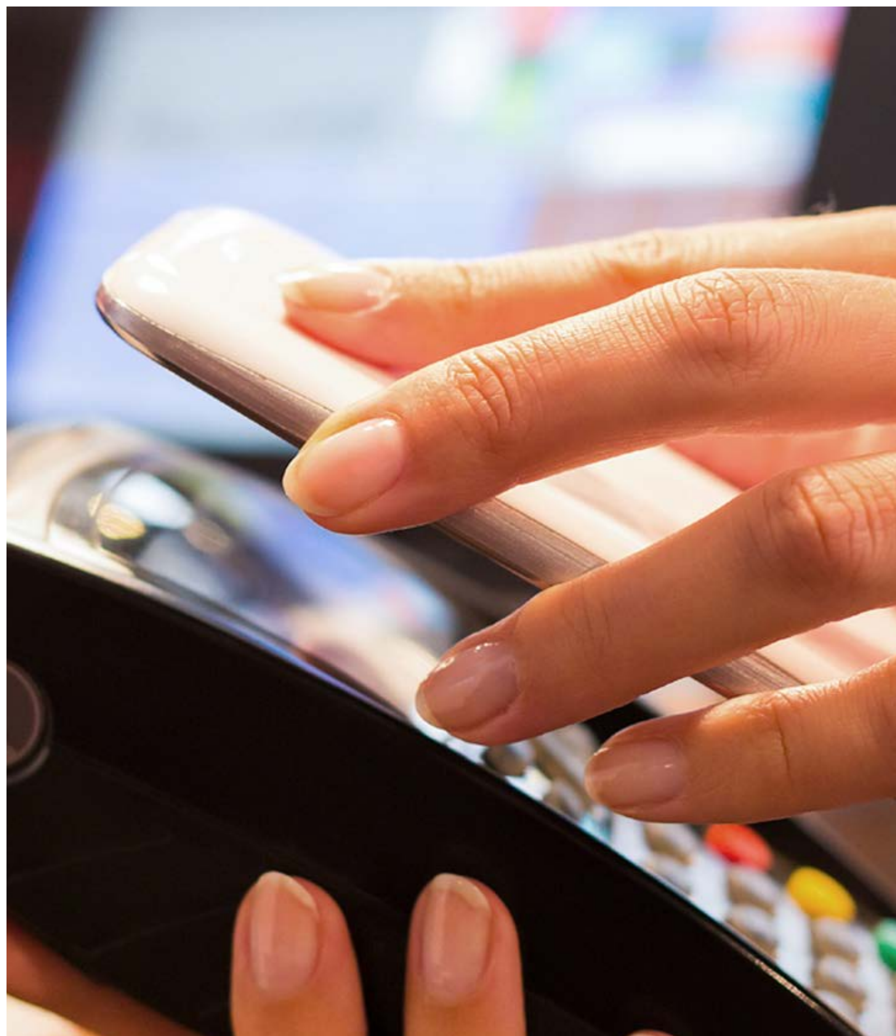
The focus in these launch countries becomes on overcoming barriers to entry and developing the product and a user base. Embarking on regional expansion becomes an increasingly distant third priority and a "linear growth trap" arises which effectively constrains a FinTech's ability to expand either organically or rapidly outside of its launch countries. This helps explain why:

- "pure play FinTechs" remain relatively small and fragmented in their financial services offering and geographic coverage in the region;
- investor funding of FinTech business development has been flowing into consumer digital platforms present in multiple countries rather than "pure play FinTechs" that have a more limited geographic presence;
- many FinTechs find themselves as targets for acquisition from larger incumbent players or growing digital platforms at a much earlier stage in the venture capital funding cycle and at a time when financial returns to investors from an exit are still relatively low; and
- out of 61 FinTech unicorns in the world at present, there is currently only one in Southeast Asia – OVO (and in spite of its significant financial backing, OVO remains almost entirely focussed on the Indonesian market).

Barriers to entry that contribute to the Southeast Asian FinTech "linear growth trap":

We outline below some of the underlying barriers to entry that inhibit FinTechs' organic growth in Southeast Asia and prevents them from executing their regional expansion plans.

These factors contribute to the fragmented digital financial services market in Southeast Asia. As will be discussed further in part 3 of this series, they also present unique circumstances in which carefully crafted M&A deals such as business or technology collaborations between market participants pursued through a joint venture or strategic commercial partnership can unblock a FinTech company's pathway to regional growth.



Meaningful and broad innovation in financial services

- **Challenge for FinTechs:** The FinTech product or service should be innovative – opening up access to financial services in the case of products aimed at consumers or business customers, or bringing significant time or process improvements for FinTechs aimed at financial institutions.
- **The problem in Southeast Asia:** Companies in Southeast Asia with FinTech products targeting a narrow market segment (for instance, only payments or lending) have found their ability to grow beyond a Series A or Series B funding round is constrained as their product and customer base in confined to one or two countries and transitioning this to other countries will take significant time and is in the face of significant competition.

Trust and customer acquisition

- **Challenge for FinTechs:** The customer must be ready to switch and put their trust in a start-up or new entrant for their financial services requirements.

- **The problem in Southeast Asia:** Arguably, customer disillusionment with incumbent financial services providers in the U.S. and Europe following the global financial crisis has been a major driver for FinTech companies in those regions. However, in Southeast Asia, customers have generally not had the same negative experiences with the incumbents and the reputation of financial institutions remains relatively strong and untarnished by financial and regulatory scandals. Thus, attracting and retaining customers – even in the FinTech company's core markets, poses a significant challenge.

Useful data pools

- **Challenge for FinTechs:** One of the biggest commercial advantages for FinTechs is the ability to utilise or monetise the huge volume of high-resolution data that they can collect about their users from smartphone enabled apps.

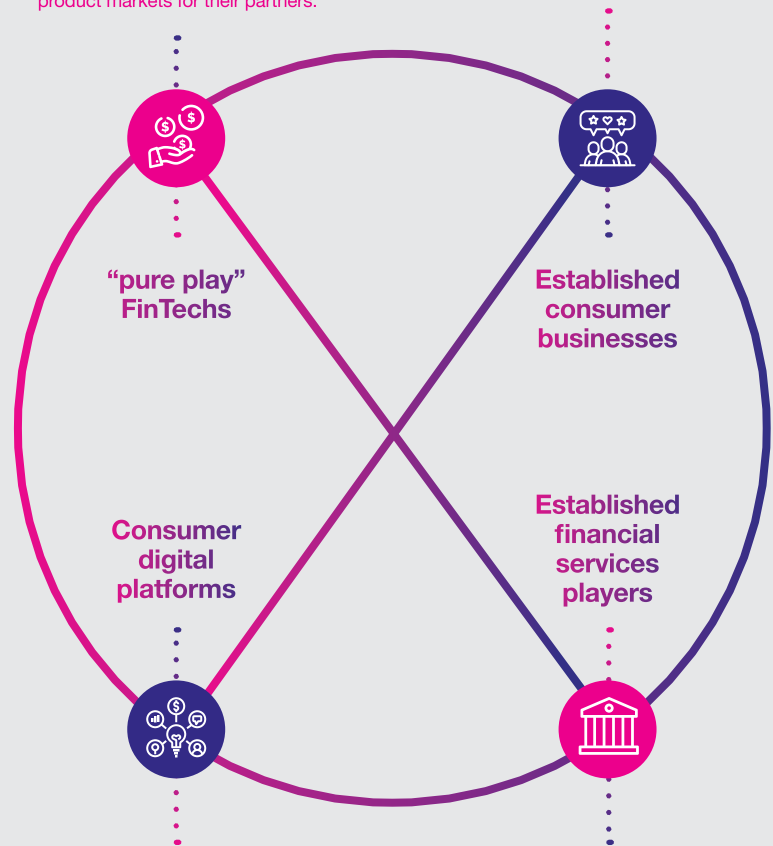
- **The problem in Southeast Asia:** On their own, the datasets are of limited use in a financial services context, unless they are combined with other complementary datasets. Key datasets such as credit reference agency data is patchy in Southeast Asia. Without regional data collaboration or sharing agreements with other commercial partners, including financial institutions and ecommerce platforms, FinTechs find it challenging to, for instance, accurately credit score loans, or underwrite insurance in other jurisdictions in the region.

The fragmented digital financial services market in southeast asia where collaboration stategies can be more effective than consolidation

The following categories of FinTech and financial services market participants exist in Southeast Asia. Each have their own inherent weaknesses for developing a regional business model and this drives either consolidation opportunities through M&A, or as will be discussed in part 3 of this series, effective business or technology collaborations various categories of participants present in different countries in the region.

These are often independent early stage companies with venture capital or corporate venture capital backing. They usually lack the customer base and the financial means to achieve scale across the multiple jurisdictions in Southeast Asia. If they cannot raise sufficient capital, they are at risk of being acquired by the other market participants. However, collaboration with the other participants could help extend their reach whilst opening up access to new customer segments and product markets for their partners.

These include telcos and retailers. Whilst they have large customer bases and access to data, which could be deployed for distributing financial services, they have little or no expertise in running financial services businesses and their data points or data analytics need development to be useful from a financial services perspective. Collaboration with other market participants is likely to be necessary but is not always within their institutional DNA.

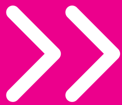


These include e-commerce, gaming, and ride-hailing platforms. Whilst they have large customer bases, they rarely have a long track record of operations or local presence in all of their markets in the region and do not yet have the relevant financial services expertise. Developing this internally is proving to be time consuming and personnel with sufficient experience are in short supply, leading to a temptation to acquire talent by buying out "pure play" FinTechs. This is a highly risky strategy, as creating a regulatory compliant financial services business which sits within their other core business is problematic because operational and capital requirements of the financial services business will start to impact on the conduct of their core businesses. Arguably the same benefits of integration with a FinTech could be achieved through a long-lasting JV to develop an ancillary financial services business.

These include banks, insurers and wealth managers, most of whom are trying to distribute their products using digital channels. However, these financial institutions struggle to adapt their legacy IT systems to match their internal digitisation agendas and to expand their digital offerings into new product categories. Whilst they have sophisticated data models for their existing customer base, they lack the means of collecting, analysing and utilising high resolution customer data that would achieve these objectives. Some have acknowledged that they have to reinvent themselves or form digital-only sub-brands, sometimes in collaboration with other market participants. Others believe that their digital offerings are sufficient to compete with the next generation of financial services providers. In reality all require commercial partnerships or collaborations with either back-office or consumer facing FinTech companies.

Regulatory bias

- **Challenge for FinTechs:** In an increasing number of countries in Southeast Asia, we see governments trying to promote FinTech innovation by introducing regulatory clarity through specific regulations. These specific regulations can, however, have the often unintended result of preventing FinTechs from engaging in mainstream financial services activities.
- **The problem in Southeast Asia:** Rather than being able to compete as an alternative to traditional financial institutions (which is a strong narrative driving growth in the U.S. and Western Europe), FinTechs in Southeast Asia increasingly find themselves subject to an alternative regulatory regime, in which their activities or transaction volumes are more restricted. This puts them at a natural disadvantage compared to the incumbent financial institutions that they are sometimes trying to compete with, requiring collaboration with incumbents rather than competition.



We have touched on the principal difficulties for venture capital funded FinTech companies to enter and expand in Southeast Asia. We also have outlined how various forms of business or technology collaborations pursued through a joint venture or strategic commercial partnership can be alternatives to traditional M&A transactions.

In the third part of this series:

We will explore in greater detail **how to try reconcile the various commercial tensions that present themselves in such structures** and how to help maximise the benefits of a FinTech growth strategy that combines strategic collaboration or joint venture transactions with organic growth and traditional M&A transactions.

Please click here to subscribe to receive the third instalment in this series.

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