Venture capital as a path to innovation in payments

As rapid technology development, regulatory change and the proliferation of non-bank entrants continue to transform the payments marketplace, market share positions and competitive dynamics are shifting rapidly. If today's leaders are to grow their market share and earnings, substantial, continuous innovation will be crucial. The industry is rich in examples of new entrants altering existing business models and shifting market leadership. A handful of mobile point-of-sale (POS) companies have quickly expanded the reach of POS devices to thousands of small merchants, putting data analysis, fraud management and loyalty at the forefront of defining the customer experience.

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Financial institutions that include innovation as an integral part of strategy are six times more likely to meet their financial objectives, according to a May 2012 McKinsey Global Survey of 2,297 executives from a range of industries and regions. Eighty-six percent of executives also agreed that innovation is crucial to their organization's long-term growth. Yet many financial institutions struggle to find the resources and commitment to compete with the diversity of innovative ideas emerging from start-ups and non-bank attackers like retailers and mobile operators.

McKinsey's survey further found that, while generally agreeing that innovation is fundamental to their organization's long-term strategy, 54 percent of executives believe that financial institutions face greater obstacles than other industries do in their efforts to innovate. They cite regulatory hurdles, lack of focus and an insufficient infrastructure as impediments. One innovation executive at a leading global financial institution complained of a lack of talent available to generate and execute new ideas; another said that new initiatives at his institution must pass through a cumbersome product development "obstacle course." Even for financial institutions committed to innovation, sourcing new ideas is not that simple, since, as one executive put it, "There are so many more ideas coming from outside than inside."

One option for financial institutions struggling to bring innovative ideas to market is to take on an investor role. Investing venture capital in new payments technologies, business models and adjacent players – while not without its challenges – is a way to make an end-run around typical obstacles and enter the innovation flow quickly.

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Why venture?

Financial institutions that take the venture investing route are typically driven by one or more of the following rationales:

- *Exclusive, continuous insight*. Venture investing often allows financial institutions to better understand the potential trade-offs involved in innovative ideas and to discover strategic options that are unavailable from traditional sources. "Even with external advisors and well-informed internal strategy teams, the depth and breadth of insight brought to the table cannot be matched with what we gain by attending portfolio company board meetings," said one participant in McKinsey's executive interviews.

- *A seat at the table*. Venture capabilities enable incumbent players to detect and act upon changing dynamics as they are happening. "Instead of seeing the shifts and reacting to them, we hope to be defining the movements," a survey respondent stated. Jay Reinemann, the head of BBVA's venture group, told the *New York Times* in September 2012, "We are in one of the most regulated and risk-averse industries in the world, so innovation doesn't come naturally to us. We want to avoid the video-rental model. We want to evolve alongside our consumers."

- *Enablement of offensive strategies*. Venture investing can open up new strategic options that would otherwise be unavailable through partnerships or alliances. For example, in seeking to enter an already crowded credit card market dominated by local players, a top-tier global financial institution found that its equity investment in a leading lifestyle and couponing platform provided access to millions of targeted potential customers. "Although we would like to believe we always have something to offer through partnerships, at times that is not the case. Equity opens up a door otherwise closed to us," noted an executive at the financial institution.

- *Expanded options*. Merger integration is inherently cumbersome, and synergy difficult to achieve. Unlike an acquisition, venture investing makes technology experimentation less risky and can give an organization room to adapt and prepare for future business integration. "Despite being dead-on target, after two major acquisitions, more than $150 million, and two years, we still were just in the process of bringing our mobile financial solution fully to market," lamented a respondent.

- *Maintaining focus on innovation.* Internal incubation efforts and innovation teams often suffer from the fluctuating commitment and administrative hurdles common to organizations whose cultures and metrics are geared toward short-term returns rather than longer-term experimentation with new ideas, products and business models. Creating a venture unit to test and develop innovative ideas is one way to avoid the complications of finding the time, funding and resources within the core business while still running everyday operations. One major Asian financial institution significantly enhanced its agility by creating an independent entity with its own reporting structure and objectives for experimentation and venture investment. Alternatively, a venture approach and logic can be applied to internal teams and ideas as if they were independent start-ups.

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- *Going where customers go.* As customers' shift to digital technology and online interaction, the nature of financial products and services they demand will evolve. With the growing capabilities of advanced analytics to make sense of a diversity of data sources (e.g., financial transactions, shopping patterns, geo-location data), keeping abreast of customers' behavior and purchase decisions will become increasingly important. Venture investing is about more than simply offering new technology to appear innovative; it is about gaining access to new business models and technologies through third parties and harnessing those capabilities to offer new value propositions to customers. (For example, American Express invested in a digital coupon company.)

Making the leap

To determine whether venture investing fits into its overall innovation strategy, financial institutions should consider some fundamental questions: *What is our overall strategic aspiration? How does innovation (e.g., in products or business models) fit into that aspiration? Are we on track to fulfill that aspiration, or is there a gap between our aspirations and capabilities that venture investing might help us fill?*

If the gap between a financial institution's current capabilities and its desired state is deep and wide, then venture capital investing – coupled with the abilities to experiment and to capture and act on proprietary insight – is a promising way to bridge that gap.

Even if venture investing seems interesting in theory, several practical questions need to be addressed:

- *Does our innovation strategy have a clear mechanism for engaging with external networks?* McKinsey research suggests that successful innovation strategies rely on both internal and external idea generation. Venture investing can provide smaller players with financial resources and opportunities to scale, thereby paving the way for collective idea generation between the two parties.

Leading corporate venture units

Citi Ventures: Global corporate venturing arm chartered to collaborate with internal and external partners to conceive, partner, launch and scale new ventures that have the potential to disrupt and transform the financial services industry, drive client success and generate new value.

Sample portfolio companies: *Jumio, payment and online ID verification company; DDWang, location-based offers platform; ShopKick, customer loyalty management.*

Amex Ventures: American Express corporate venture fund charged with identifying and developing innovative technologies that will help accelerate the company's digital transformation, including loyalty and rewards programs, mobile and online payments platforms, security, fraud detection and data analysis.

Sample portfolio companies: *Fancy, social fashion and style platform; SavingStar, mobile couponing; Radius Intelligence, system of record for small and medium-sized enterprises.*

BBVA Ventures: The corporate venture arm of BBVA Group. Its mandate is to partner with and invest in teams with innovative ideas that could change or disrupt the world of finance.

Sample portfolio companies: *Social Point, social game development and distribution; Radius Intelligence, system of record for SMEs; SumUp, mobile POS.*

Ping An Ventures: Corporate venture arm of Ping An Insurance Group, the world´s second-largest insurance group by market value, with a broad focus on financial services, consumer products, healthcare, automobiles and tech, media and telecom.

Sample portfolio companies: *Not publicly available.*

Visa Ventures: Established in 2011, Visa Ventures is a non-dedicated venture unit complementing Visa´s corporate development and innovation activities.

Sample portfolio companies: *Square, mobile POS and customer loyalty; SecureKey, PaaS for authentication, payment and identity.*

Notable payments start-ups, 2012-13

Square	trialpay	boku	Braintree
JUMIO	SavingStar	sumup	iZettle
CLINKLE	peerTransfer	DWOLLA	SAFETYPAY

- *Is the external ecosystem robust enough to serve as a source of new inspiration?* Without a healthy deal flow, venture investing is not possible. Sufficient deal flow is still concentrated in a relatively small, though growing, number of geographies. Emerging ecosystems ripe for venture investment can be found in Brazil, Singapore and East Africa; established opportunities are abundant in the United States, China, Israel and Western Europe. Some institutions in regions where start-up activity is weak are maintaining a remote presence in more vibrant markets such as Silicon Valley.

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- *Are elements of our core business under threat?* Disruptions across the payments and overall financial services landscape are becoming increasingly likely, as is the potential threat to leading players. For example, over the past five years, more than 40 percent of venture activity in financial technology in the U.S. has occurred in the payments space. With so much money pouring into innovation, many incumbent institutions feel threatened. As one industry executive suggested when asked about the value of venture investing versus waiting and acquiring, "Investments in and of themselves are a tool not only to educate us about what the future will look like, but also to help us realize that, well beyond the confines of our venture unit, we may not have the tools to deliver on a myriad of other core daily challenges." In other words, venture investing is one more tool in the effort to evaluate the health of a payments player's core business.

Getting into the flow

Financial institutions that choose to venture need a clear strategy, just as they would for any other business venture. Particular issues to address include how the new unit will engage with external networks, the specific rationales for investment, and the value proposition for portfolio companies. Prudent venture investments usually take the following steps:

Take time to understand the marketplace and how current trends fit with your innovation strategy. Financial institutions seeking to invest need a broad view of emerging trends, and then must determine how (and whether) those trends fit into their innovation strategy. Adjacent opportunities will surface that, while not tied to an institution's core business, may be worth considering for the insights they provide into emerging trends or access to new customers. American Express, for example, has invested in a company called "Rent the Runway," which allows consumers to rent designer clothing for special occasions. Such investments can enable financial institutions to continue to reach their customers in an increasingly diverse digital marketplace. "The payments industry is undergoing a fundamental change as the very nature of commerce is redefined," said Harshul Sanghi, managing director at American Express.

Rather than trying to find "the next big thing," develop a diversified innovation portfolio. Venture investing is risky by nature; many ventures will fail, and others will bring lackluster returns. Financial institutions seeking to invest must set realistic expectations and manage their venture investment portfolios as they do their overall innovation portfolios; both should be similarly diversified in terms of risk profiles and the timeline for expected return. Portfolio companies should run the gamut from young, risky start-ups to relatively stable and established concerns (with a minimum of two years' track record), and from short-term investments with immediate benefits to longer-term investments with less certain returns. Without "quick wins" – investments that can be immediately integrated into the core business or begin generating value right away – institutions may lose support for the more disruptive ideas that take longer to bring returns.

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Some of the companies in the portfolio will provide insight and experimentation opportunities, while others will be almost ready to scale to the investor's business. Venture candidates that can readily scale across the investing institution's entire enterprise are rare, so financial institutions should not hold their breath for global, one-size-fits-all solutions to invest in. Instead, they should look for core markets with a healthy deal flow that will help them to gain a foothold in that particular market.

Define communication channels and processes during strategy development. Gaining value from venture activities depends largely on the investing institution's ability to establish formal mechanisms for gathering insight and keeping executives and staff informed at all levels. In particular, a process for communication – including a formal planning and review process – between the venture unit and senior management should be established, as venture employees often struggle to explain their activities and goals to senior managers who are used to rigidly defined processes and time frames. Good communication ensures that the investment portfolio informs strategy review and development. For example, the investment team could participate in the annual strategic planning process, a member of the investment committee could serve on the corporate strategy team and the strategy team could have input into product development roadmaps.

Prepare to enter the innovation flow. Portfolio companies will expect much more than money from investing firms. For example, they will be excited to work with financial institutions that provide technical expertise, access to customers or support in navigating regulatory questions. To manage expectations on all sides, the investing organization should establish clear guidelines as to what they will and will not do for their portfolio companies. Mechanisms that facilitate experimentation (e.g., a lower bar for offering portfolio companies' services to a small portion – less than 1 percent – of the investing company's customers) will generate value quickly for the investor and investee alike. Moreover, it is critical that financial institutions remove obstacles that could inhibit future opportunities to engage with the start-up ecosystem.

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As disruption becomes the new norm in payments, it will become increasingly difficult to predict how market shares will swing and who the long-term winners in the payments industry will be. Venture investing will not be for everyone, but for those who have set an ambitious vision for future growth and cannot meet it by internal means alone, venture investing could become a critical component of the broader innovation agenda.

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