Banking on Emerging Markets

Throughout emerging markets, advances in technology are enabling the creation of digital banking solutions that better address evolving consumer preferences and enable billions of the unbanked to access the financial system. While many businesses offering these solutions have enjoyed a strong recovery thus far in 2023, we believe they still offer a long-term fundamental opportunity that remains underappreciated by much of the market and that valuations are attractive relative to our growth outlook.

AUGUST 2023

Across emerging markets, traditional banking institutions, as well as financial technology companies, are vying for the business of enormous swaths of the population whose needs are unserved or underserved.

Competition to meet these demands has increased over the past decade as advances in technology have begun transforming the financial landscape. A range of banking models, offering a variety of products and services, has uprooted age-old businesses, lowering costs and enabling access to populations often excluded from traditional banking systems.

In Brazil, for instance, the combination of an inefficient, concentrated banking system and staggering numbers of underserved presented an enormous opportunity for the country's largest fintech company, Nubank.[1] When the company first set up shop in 2013, it was an unlikely contender to take on powerful banking oligarchies that controlled decades-old financial institutions, charging high fees and offering poor service with outdated technology. But the spread of broadband and smartphones gave the startup the needed firepower to do battle with the old titans. Nubank gained ground by offering no-fee credit cards and apps that made it easier for customers to apply for loans, pay bills, and request credit line increases.

By March 2021, two months after going public, Nubank, far exceeded the size of most other fintechs in Brazil, becoming one of the largest digital banks in the world.[2] In the first quarter of 2023, Nubank reached 79 million active users, up from 59 million users a year earlier.[3]

The Opportunity

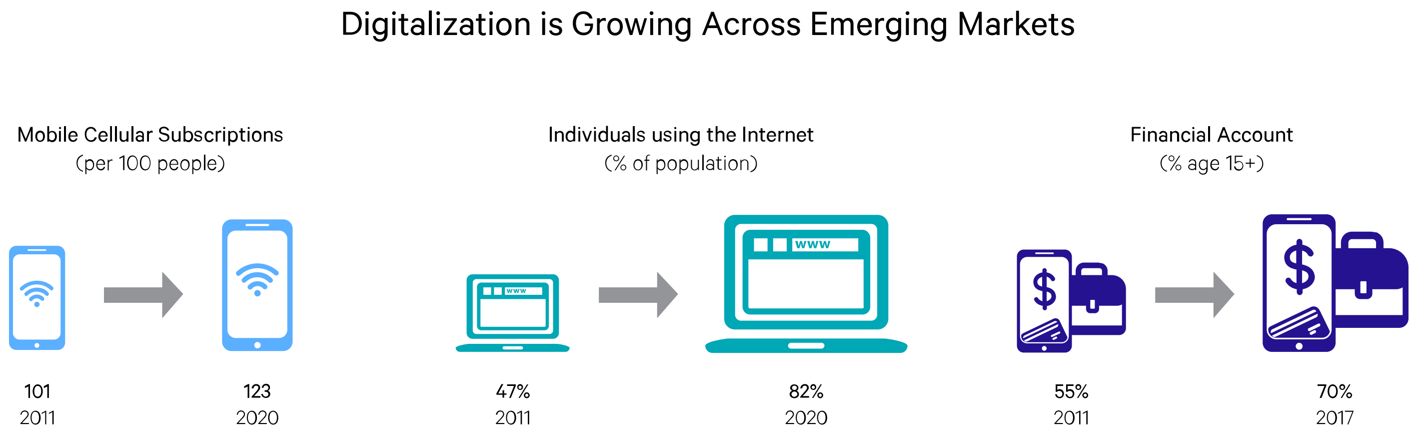
The digitalization of financial services in emerging markets is opening the way to greater, cheaper, and more convenient access to banking services. We believe this is one of the most exciting investment opportunities we've seen in recent years. Financials and fintech-related companies operating in emerging markets are owned in all public equity strategies at Sands Capital. We believe they have long runways for growth as they convert new consumers and merchants who had previously not been in the banking system. These customers tend to be younger, and their demographic cohort is expanding faster than some of the older, more established institutional clients of the financial services sector.

However, the businesses that are leading this fintech transformation are by no means uniform. Fintech success will vary by country and region as businesses are challenged to adapt to differences in regulations, macroeconomic conditions, existing banking structures, and consumer preferences. In our view, such a crowded and diverse landscape makes active management all the more critical in seeking to identify models and patterns that characterize the most promising businesses. Only through a deep understanding of the nuances of each investment case can we hope to pinpoint the select fintechs that are best suited to lead the next wave of growth in their respective markets.

While we have chosen to focus this article on opportunities in emerging markets, we believe our findings also apply to investment cases on developed market fintechs. In fact, there are many insights that fintechs operating in the United States and Europe can learn from experiences in emerging markets where populations have been much faster to adopt

EXHIBIT 1

DIGITALIZATION IS GROWING ACROSS EMERGING MARKETS



Source: World Bank https://data.worldbank.org/indicator/IT.CEL.SETS.P2?end=2020&start=2009

digital banking alternatives. For instance, Sea, the Singapore-based gaming and ecommerce giant, has demonstrated how powerful network effects can be spun into a financial services platform in societies that transact business primarily through mobile phones. Sea has become a meaningful holding in many of our portfolios since we first added it to our Emerging Markets Growth strategy when the company went public in 2017.

The enormity of the opportunity is clear from the limited availability of banking services across emerging markets. Nearly 1.5 billion adults globally—about one-third of the world's adult population—remain unbanked. Nearly all of them live in emerging markets.[4] Even those with access to the banking system still use inflexible, expensive, informal services.[5] On top of that, emerging markets boast a younger demographic and there are more digitally savvy millennials and Gen Zers, who we believe are looking for more modern banking solutions. Against this backdrop, it is not surprising that Sea's mobile-first strategy has been so successful.

While many of the traditional banks in emerging markets are formidable businesses and investment opportunities, in our view, the demand for more modern banking options that work from mobile devices has created an enormous opportunity for fintechs that use innovative, digitally native business models to address the daily financial needs of emerging market customers. Many have been able to seize the momentum, using technology to—in some cases—upend traditional banking models and challenge established financial institutions, bringing more efficient and easier-to-use options to consumers.

While models vary, digitalization has enabled some fintechs to more adroitly drive a new wave of financial penetration. They are rebuilding large parts of the financial services system, using cloud-native architectures that enable online and mobile-first business models. They have used technology and mobile communications to extend the reach of services and deliver more advanced and convenient banking services to a massive existing and potential user base. And, the use of data intelligence allows for better risk decisions, which can further improve accessibility, affordability, product innovation, and personalization.

Seizing the Opportunity

This push to capture the business of the emerging market consumer has not been without hurdles. Digital banks have had to contend with in-country banking regulations, consumer distrust of new models, and greater process complexity. All these issues have delayed the digital transformation of financial services, relative to other verticals in emerging markets.

To date, we have seen that the development of fintech models is much more dependent on regulatory considerations than in some other sectors. Central bank regulations, for instance, can quickly quash the nascent operations of a startup. We saw the implications that a changing regulatory environment can have on even the most established fintechs, when in 2020 Ant Group's initial public offering was halted by Chinese authorities concerned with the lack of regulations surrounding its financial products.[6]

However, central banks can be supportive, or at least neutral, toward fintechs. In Brazil, the central bank has helped cultivate and support a generation of fintech disruptors that are now competitive with the incumbents. The Reserve Bank of India has positioned itself as a neutral agent between fintechs and incumbents and encouraged fintechs to establish partnerships with traditional banks.

Despite the challenges, the digitalization of financial services is accelerating globally. To succeed, these fintechs will need to continue to find innovative ways to monetize and maintain their massive user bases. To stand up to the incumbents, they will need a highly skilled management team that can execute at a very high level and that is nimble enough to adjust to evolving regulatory frameworks, astute enough to identify local preferences and service gaps, and savvy enough to compete against well-established financial institutions.

As we have seen in other industries, the inherent business model advantages of this new class of financial services companies—proprietary data, distribution power, scalable cost structures— suggest the leaders will take a fundamentally higher market share, with better economics, than other businesses in many parts of the existing financial services system.

We believe active management is critical to identifying the potential leaders in this field. Only through deep knowledge of individual businesses and their regulatory environments as well as geographic and regional customer preferences can we hope to isolate those businesses that can support their often very high valuations.

Going Where the Growth Is

Based on our expansive global research in private and public markets, we see significant opportunities among several fintech business models that are gaining traction. Among them are start-ups that are challenging inefficient incumbents; fintech acting as digital distribution platforms for traditional financial institutions; legacy financial services companies that are digitalizing their own businesses; and commerce platforms that have embedded proprietary financial services into their offerings.

Creating from scratch: Nubank is an example of the full-stack/vertically integrated model in which businesses manufacture their own products as well as distribute them through digital channels.

While Nubank benefited from the digitalization trend and opportunities in the massive underbanked and underserved populations, the idiosyncrasies of Brazil's traditional banking structure led to the development of its distinct business model.

A concentrated incumbent banking system in Brazil meant Nubank had to become a product manufacturer and compete directly, unlike fintechs in other markets that have formed a distribution partnership in more fragmented financial systems.

Nubank's first foray into Brazilian finance came with the launch of credit cards, which were already widely used. It has since expanded to become a financial services hub for many Brazilian consumers and is in the early stages of expanding this into Mexico. While Nubank's credit cards are the product most widely used in Brazil, the company is scaling and launching additional services, including personal lending, insurance, and investing. Longer-term, we think Nubank has the opportunity to become the primary driver and beneficiary of the digital transformation of financial services across Latin America for consumers and small and medium enterprises. This is a large market opportunity; so, we believe Nubank could become a significant global financial institution if it executes on its opportunity in Latin America.

Going digital: Throughout emerging markets, we have seen legacy financial institutions transforming into digital businesses. These fintechs started as traditional banks but have invested in their technology. India's Bajaj Finance is one example of a traditional lender that has effectively combined its existing customer base, brand trust, and expertise in product manufacturing and distribution with new digital capabilities to continue to drive growth and maintain its competitive position.

In the first quarter of 2023, the company completed the final roll-out of its consumer-facing app and web platform that includes end-to-end journeys for lending, investment, and insurance products. After launch, in the first quarter of 2023, its fintech app achieved 53 million downloads underscoring the larger growth opportunity, as the issuance of EMI cards, credit cards, flexi loans, and insurance policies all exceeded the company's annual targets.

The company's digital payment platform taps into India's broader Unified Payments Interface (UPI), an instant payments system developed by the National Payments Corporation of India that allows users to transfer money between bank accounts using a smartphone. Bajaj Pay allows users to make purchases through online retailers, transfer money to friends and family, pay bills, and pay for goods in physical stores. Bajaj Finance's digital payment platform highlights how the company has effectively transformed itself to retain its customer base and stave off competitors that offer comparable digital payment services. The company had 13 million UPI accounts and 600,000 merchant acceptance points, as of the fourth quarter of its 2023 fiscal year, which ended March 31, 2023.[7] Management is continuing to invest in the digital payment channel, which is helping the company reduce its reliance on more expensive customer acquisition methods like its in-store consumer durables financing.

Commerce platforms embedding financial services: Fintechs need not be standalone businesses. In fact, MercadoLibre and Sea launched their fintech businesses out of necessity. Both had thriving commerce businesses in cash-based regions where rampant fraud and a lack of trust in traditional banking systems made cash the preferred medium of exchange. For their commerce businesses to succeed, they had to create electronic payments systems that would be accessible to the large population of unbanked and underbanked. Both followed the lead of U.S. ecommerce pioneers that made online shopping possible for customers without credit cards. These businesses created synergies by adding payment and credit products to their ecosystems. A virtuous circle was created. As consumers gained access to credit, they were able to increase consumption. Similarly, merchants were able to increase inventory using credit. Rather than losing revenue to an outside credit card processor, payments systems created a default, high-trust medium of exchange that could be monetized within the platform. The model of layering on services to the ecommerce platform increased ecommerce spending and the ways in which that spending could be monetized.

In 2002, MercadoLibre launched Mercado Pago to process online payments. Since then, this payments business has spawned numerous systems that support buy-now/pay-later programs as well as consumer and merchant loans. Its payments business is still in its early phase and the company is working to expand next-generation services, such as cardless payments, credit, asset management, and insurance. We expect that use rates should improve as the features develop.

Sea followed a similar path in setting up its fintech business, Sea Money. As noted above, we initially bought Sea for our Emerging Markets Growth strategy at its 2017 public offering and have since purchased it in many of our portfolios.[8] The company, now a leading emerging markets internet company, used its early success in its gaming business, Garena, to fund its ecommerce (Shopee) and digital payments (Sea Money) platforms.

Sea faced many of the same challenges as MercadoLibre as it sought to create a fast and convenient payments system for more than 600 million people throughout the region who don't have access to traditional banking services, let alone more modern digital payments systems. While Sea Money's value currently lies in payments for Shopee, it has expanded to include online and offline payments, digital lending through SPayLater, and distribution of other financial services, including insurance and wealth management. Going forward we expect the majority of Sea's value will come from digital lending. By the end of the second quarter of 2022 (Sea stopped disclosing this number after this date) SeaMoney had 52.7 quarterly active users with the trailing 12-month cumulative total payment volumes of $20.4 billion.[9]

The Southeast Asian digital payments market is expected to reach $1 trillion by 2025, accounting for half of all payments in the region.[10] Against this backdrop, we believe SeaMoney has the potential to be a significant business on its own. Sea's familiarity with Southeast Asian markets, strong execution, and technology capability fueled Sea's success in ecommerce. The powerful Shopee ecosystem along with understanding of consumer behavior should allow SeaMoney to create value for the underserved Southeast Asian population.

Over time, we expect the network effects to take hold and the financial applications to sprawl in line with the buyers and sellers of the ecommerce platform. In both models, we expect that the original ecommerce business will strengthen while the financial offshoots should provide numerous new potential runways for growth, while continuing to bolster the core ecommerce business.

Building an interconnected digital ecosystem: Kaspi began as a traditional commercial bank in 2002. However, its path to super-app status has hardly been conventional. The bank, which currently extends services to almost 13 million customers in the central Asian republic, didn't launch its first digital product until 2012. However, over the past decade, it has curated three main business segments, which are payments, lending and ecommerce.[11]

Products in these business lines, along with messenger and map services, are contained in Kaspi's super app, which creates a powerful network effect, connecting buyers and sellers in a virtuous circle of scale begets scale. More consumers attract more merchants, which in turn attract more consumers. As Kaspi acquires more consumers and merchants, the company can easily offer its users more products across its interconnected platform. For example, Kaspi's payment business enables growth in ecommerce, while the company's loans can be used on its payment and ecommerce networks.

Kaspi's super app boasts an impressive user base, with approximately 65 percent of Kazakhstan's adult population as monthly active users.[12] In addition, 65 percent of monthly super app users logged into the app daily in the fourth quarter of 2022, according to Kaspi's 2022 annual report.[13] The high ratio of daily to monthly super app users highlights its popularity and convenience.

Kaspi's super app provides a seamless user experience for both merchants and consumers, and growth in each business unit helps support growth in the other business lines. The company continues to expand its product offerings to attract and retain users. For example, Kaspi, recently added grocery delivery and travel services. As of the first quarter of 2023,, its ecommerce marketplace connected consumers with goods from over 500,000 merchants.

Kaspi provides robust logistics services that empower businesses to overcome the challenges posed by Kazakhstan's vast geography—it is the world's ninth largest country in terms of land area. [14]Kaspi delivery accounted for 94 percent of total Kazakhstani ecommerce orders in 2022.[15] This reliable and efficient service ensures that products reach customers promptly, with 46 percent of orders delivered within 48 hours.

Kaspi's Postomat service, similar to Amazon lockers, is another solution that reduces the operating expenses associated with last-mile delivery. With 3,348 lockers spread across 86 cities in Kazakhstan, this service accounted for 31 percent of ecommerce deliveries, providing customers with a convenient pickup option.

The company also boasts an impressive lending operation, representing more than 40 percent of all consumer loans in Kazakhstan.[16] Meanwhile, the company's payments platform has 12 million active consumers transacting two times per day on average with 500,000 merchants offering 3 million SKUs or stock=keeping units.[17]

Kaspi also built its own payment network (akin to Visa) that handles more than 90 percent of its own transactions, which helps reduce costs for customers and attract more users to the platform.

Given the low penetration rates in the mobile shopping sphere, we see a long runway for growth.[18] We find that once network-effect businesses, such as Kaspi and many of the other preferred fintech companies, reach scale they are often able to defy the traditional laws of mean reversion for much longer than a non-platform business, because the value of the network grows as each user is added, while the cost of acquiring each additional user declines.

Finding the Future

We believe these leading technology franchises in emerging markets are must-own businesses for global growth investors. In our view, select fintechs in emerging markets could seize the incremental digital transformation opportunities in their respective regions to create even greater opportunities than their developed-market peers. As discussed, many have ambitions beyond purely financial services, and we believe those that succeed in repurposing their underlying technology stack or their direct relationship with their customers will be more likely to profoundly transform the customer experience, expand their ecosystems, and create the enduring businesses of the future. These fintechs, of varying models, are opening the way to the financial system of the future in which consumers and businesses increasingly demand convenience, speed, selection, and safety. Moving forward, we expect that companies will place an even greater emphasis on convenience, which will be met by increased efforts to develop platforms that enable consumers to enjoy more seamless experiences to shop, bank, and communicate.

As the ecosystem continues to evolve, we expect positive outcomes for those businesses that offer more variety at lower prices and in the most convenient way. Convenience and low cost are sometimes opposing forces, but companies that can offer both should have a competitive advantage.

Along with convenience and cost, we expect personalization will also be critical to the fintech of tomorrow. As companies succeed in getting everything online, the banking experience, with so much choice, can become overwhelming. We see this as an opportunity for banking companies to move toward more personalization and even individual curation.

Finally, as we look back at the past decade, we can see that technological advances and a robust funding environment have enabled many fintechs to gain significant scale and generate massive value as private companies before going public. Our ability to conduct deep research across public and private markets gives us an understanding of existing market structures and the at-scale incumbent players that will influence the path of the innovators.

In studying the development of the fintech sector in emerging markets, we have often derived insights from U.S. fintech pioneers. However, driven by rapid adoption and acceptance, many emerging market countries have leapfrogged multiple generations of development seen in U.S. or European fintech markets and have replaced legacy products and services directly with innovative solutions. China and Kazakhstan, for instance, have quickly moved from being overwhelmingly cash-based societies to ones in which more than 75 percent of transactions are taking place digitally via mobile devices and QR codes.

Because incumbent emerging market banks have not been meeting the needs of potential customers, digital adoption levels have soared in line with this innovation, outpacing those in the United States or Europe, where consumers are not as challenged to get access to banking services. Overall, we have seen a much greater acceptance of integrated mobile financial platforms through which consumers can make payments, receive loans, invest, and purchase insurance on their smartphone.

While Western consumers may take longer to reach the same acceptance of fully integrated digital platforms that have flourished in emerging markets, from them we are able to envision a range of digital banking options that could evolve if successfully adapted to the preferences of the U.S. and European consumer.

Ultimately, we believe this understanding and our ability to share learnings across strategies will position us to stay ahead of this rapidly evolving space in an effort to capture the greatest potential wealth creation for our clients.

1 NuBank is held in Sands Capital portfolios

2 PitchBook, December 9, 2021

3 https://api.mziq.com/mzfilemanager/v2/d/59a081d2-0d63-4bb5-b786-4c07ae26bc74/a34aa2b7-08c4-5e29-eb21-04ad29b942e6?origin=1 (page 11)

4 https://www.worldbank.org/en/news/feature/2022/07/21/covid-19-boosted-the-adoption-of-digital-financial-services#:~:text=Globally%2C%20some%201.4%20billion%20adults,go%2C%20much%20more%20is%20needed

5 https://globalfindex.worldbank.org/

6 https://www.bloomberg.com/news/articles/2020-11-04/here-s-everything-you-need-to-know-about-ant-s-pulled-ipo

7 https://cms-assets.bajajfinserv.in/is/content/bajajfinance/ip-q4-fy23pdf?scl=1&fmt=pdf, p.17

8 We first invested in Sea for our Emerging Markets Growth (EMG) strategy on December 18, 2017. See the Emerging Markets Quarterly Report for purchase dates for all holdings.

9 https://www.sea.com/investor/home

10 Sea Fourth Quarter and Full Year 2021 Results. https://www.sea.com/investor/quarterlyresults

11 https://ir.kaspi.kz/financial-information/

12 Monthly active users from Kaspi annual report: https://ir.kaspi.kz/media/2022_Annual_Report.pdf (page 51) Kazakhstan population data sourced from the World Bank: https://data.worldbank.org/indicator/SP.POP.TOTL?locations=KZ

13 Kaspi 2022 annual report: https://ir.kaspi.kz/media/2022_Annual_Report.pdf

14 Statista: https://www.statista.com/statistics/262955/largest-countries-in-the-world/

15 Kaspi 2022 annual report: https://ir.kaspi.kz/media/2022_Annual_Report.pdf (page 39)

16 Sands Capital research based on Kaspi data. https://ir.kaspi.kz/media/1Q_2023_Presentation.pdf. Kazakhstan's nationwide consumer loan is sourced from the central bank's Consumer Loan from Second Tier Bank to Individuals report. https://nationalbank.kz/en/news/loans-to-economy-from-second-tier-banks/rubrics/1840

17 https://ir.kaspi.kz/media/1Q_2023_Presentation.pdf

18 Based on Euromonitor, ecommerce penetration was nine percent of total retail sales for 2022.

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Unless otherwise noted, the companies identified represent a subset of current holdings in Sands Capital portfolios and were selected on an objective basis to illustrate examples of the range of financial technology businesses across public and private markets that have created new drivers of growth through the creation of full-stack and vertical businesses and payment systems. They were selected to reflect fintech holdings with varied business models across multiple emerging-market geographies and regulatory environments.

Nubank, Kaspi, Sea, MercadoLibre, and Bajaj Finance represent fintech holdings across portfolios. As of 06/30/2023, Bajaj Finance was held in Emerging Markets Growth, International Growth, and Emerging Markets ex China. Kaspi was held in Emerging Markets Growth, Emerging Markets Discovery, and Emerging Market Growth ex China. MercadoLibre was held in the Emerging Markets Growth, Global Growth, Technology Innovators, International Growth and Emerging Markets ex China strategies. Nubank, owned by Nu Holdings, was held in the Emerging Markets Growth, Technology Innovators, Emerging Markets Discovery, and Emerging Markets ex China strategies, as well as in a private fund advised by Sands Capital Ventures, LLC. Sea was held in the Emerging Markets Growth, Global Growth, Select Growth, Technology Innovators, International Growth, Emerging Markets Discovery, and Emerging Markets ex China strategies. Block was held in Select Growth, Global Growth, and Technology Innovators. Visa was held in Select Growth, Global Growth, Global Leaders, Select Leaders and Technology Innovators.

PayPal, Ant Financial, eBay, and Intuit are not currently held in any Sands Capital strategy and are referenced for illustrative purposes only.

This article is part of a larger series on digitalization and features businesses and related companies that were selected to illustrate current underlying macroeconomic and sectoral trends. The series uses rotation whereby businesses featured are selected to highlight different trends across sectors and geographies.

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