YOULEND

Embedded finance: Buy or Build?

Introduction

Companies are increasingly embedding financial services into their core offerings. Embedded finance refers to the integration of financial services into customer experiences which are not fundamentally about financial services. The goal is to make it easier for users to access the services and products they need. An example in the B2C space is Uber integrating payments into their ride-hailing app; Another example in the B2B space is Jobber integrating payments into small business management software.

Prospective providers of embedded financing often consider whether it is best to build in-house ("Build") or to partner with an external provider ("Buy"). The Buy or Build decision varies from company to company and sector to sector. It is common for companies to Buy instead of Build when they are venturing outside their core and where they do not benefit from economies of scale. For example, companies often use AWS for server infrastructure and Salesforce for customer relationship management software.

In this paper we address some of the key considerations around the Buy or Build choice for a prospective provider of B2B embedded financing.

Providing merchants with a strong embedded finance offering requires much more than a nice front-end and a few tweaks on top of fundamentally challenged work processes and legacy technology. Payment service providers, and e-commerce platforms need to ensure that any potential embedded finance offering matches the quality of their core product to not dilute their standing with their merchants.

Why is embedded finance hot now?

The traditional perception of the bank manager and accountant being the most important financial relationships for merchants is changing.

Lack of transparency and low service levels by traditional financial institutions has eroded trust. Merchants are therefore turning to technology and payment companies they trust for financing.

78%

of merchants consider their payment service provider or ecommerce platform as their number 1 business partner ahead of their traditional banking relationship

2 out of 3

would consider applying for financial products through a technology company instead of a traditional financial institution

This increases to more than

8 out of 10

of those aged between **18 and 34** years indicating that the structural shift is even more pronounced amongst the younger generations

The golden opportunity

As payment service providers and ecommerce platforms become the number 1 business partner for merchants, they are faced with a **golden opportunity** to help their merchants through embedding additional financial services beyond payments into their user experience. Players such as Amazon, Shopify, eBay, PayPal, Square and Stripe all offer financing products embedded into their core ecommerce and payments experience.

The value of embedded finance

The high-street has moved online likewise has the battle for customers. Before it was all about the local bank branch, now the fight for customers happens digitally. Embedded finance can also generate growth for payment service providers and ecommerce platforms as it increases merchants' growth, reduces churn, lowers customer acquisition costs and creates an additional revenue stream.

Value drivers for payment service providers and ecommerce platforms:

Increases core sales

Merchants' sales grow when offered financing for inventory, advertising and other projects

10-20% increase in sales

Increases customer loyalty

Churn reduces through less switching and less defaulted merchants

50-75% reduction in churn

Attracts more merchants

Customer acquisition costs are lower the stronger and broader your product proposition

Significant variation by partner

Generates commission

Typically paid up front by the capital provider when merchants get funded

5-20% of total pre-loss revenue

→ **Payment service providers and ecommerce platforms tend to increase total life time value across entire portfolio by about 20-25%**

Buy or Build?

When deciding whether to partner with a provider or build an embedded financing solution, we see 7 key points to consider:

1. Time to market
2. Financing
3. Regulations
4. Costs
5. Control
6. Alignment of interest
7. Opportunity cost and resources

Time to market

Building an embedded financing solution in-house takes significant time. The main work involves legal and regulatory due diligence on desired jurisdictions and potentially licensing applications, sourcing capital, building a team, developing risk models, pricing strategy, and reporting, building a technology platform to support customer onboarding, servicing, and internal workflows. We estimate that an in-house solution takes 12-24 months to bring to market. This timeline can be extended if you do not already have the team and internal expertise required to develop a solution. Partnering, we estimate to take 0-3 months.

Buy | **Build**

Time to market →

0-3 months | **18+ months in the future**

The market is rapidly evolving, and it is vital to assess whether not having embedded financing sooner will affect your business adversely. If time to market is a crucial consideration, partnering will address this immediate need and enable a rapid go-live compared to an in-house build. Building in-house also comes with a more significant degree of execution risk and uncertainty regarding time to market compared to partnering with (buying from) a partner with a proven track record and launch experience.

Financing

Financing is capital intensive and demonstrates strong economies of scale. It takes on average 24 months to build a track record that enables external financing with covenant light structures and gradual reduction in the cost of capital. In addition, most internal builds rely on equity capital for initial fundings, resulting in downside risk from defaults. Partnering completely removes these challenges.

Further, payments and e-commerce companies generate a return on equity of 20% on average compared to a historic 5-6% average return on equity on traditional finance and core banking services. So again, this is an argument for deploying cash into building out the core proposition, compared to building out a embedded finance solution.

5-6% avg

Typical returns on capital for traditional finance and core banking services

20% avg

Typical return-on-equity hurdle for payments and ecommerce companies

Find the right data
Data advantages compound over time, but not all of this data is transferable to the models required for credit risk assessment. Before deciding to build, it is critical to establish which data points are needed and how to source them.

Partnering with a large embedded finance provider, you benefit from the partner's data pool and credit risk models, which have compounded in quality over time without putting your capital at risk. In addition, you benefit from lower financing fees for the end-merchant immediately versus waiting long periods for your dataset to mature to extract learnings.

Suppose you plan to partner and also want to deploy capital. In that case, it is essential to find a flexible organisation in accommodating your risk and exposure tolerances.

Regulations

Provisioning of financing and the associated money laundering challenges are traditionally highly regulated and often requires specific licenses and registration from local regulators and authorities. The licenses can come with:

→ **Capital requirements**
Ultimately reducing the licensed entity's return on equity

→ **Operational constraints**
Limiting the entity's technological and commercial agility. This compounds if you want to enter several markets at once to ensure global product-parity

An in-house build would have to factor in the regulatory obligations and requirements, while partnering would remove all or a large part of these considerations.

Costs

When building in-house, you bear all costs, including:

Initial scoping **Legal** **Tech resource to build**

Operational support resources **Management**

Market monitoring **Ongoing tech and software upgrades**

Partnering places most costs, including software-related development with the partner. **A clear advantage.** Also, the partner providing the embedded financing solution will be able to split R&D and infrastructure costs across multiple clients driving down unit costs through economies of scale. In the long run, the partner will have a resource (and thus product quality) advantage through better unit economics which will ensure that the product is market-leading and competitively priced.

Control

Building in-house, you have 100% control over the product.

You will not have to worry that a partner cannot meet your specific needs. If choosing a partner, you may get to a high level of control with some providers, but never to the same level as you would if building in-house.

Finding the right partner with a good cultural and strategic fit is important. So are clear service levels and ability to request new features easily, which should be front of mind if partnering. The more modular the partner's offering, the closer you can get to an in-house built look and feel. You can to a large degree "pick and choose" what to develop further in-house.

Aspects which are most important to control:

- **Onboarding experience**
- **Customer interaction**
- **Underwriting**
- **Pricing**
- **Collections**
- **Recoveries**
- **Renewal criteria**

Alignment of interest

We see two main objectives for providing embedded financing:

→ **1. Unlock value for payments and ecommerce companies' merchants**

→ **2. Potentially monetise a merchant portfolio further**

While these two objectives are not mutually exclusive, you need to consider what is most important. Do you want to focus on longer term benefits, through improved merchant performance as a result of merchants obtaining financing, or do you want to directly make money on providing financing? This may impact pricing and positioning towards your merchants.

→ **Merchants who obtain embedded financing tend to have higher sales and lower churn**

→ **A compelling & well-integrated offering will also reduce customer acquisition costs**

Another example where alignment of interest is essential is the enforcement situation where a merchant does not repay the financing. Here, there could be conflicting interests between you and the partner, mainly if the partner is providing the capital. In this situation, the partner is likely more eager to enforce against the merchant to minimise loss rates and defend their returns. At the same time, you might want to express more leniency from a brand and strategic perspective.

It is vital to make sure a potential partner is aligned with your interest and committed to delivering the product accordingly, with the flexibility to change your view during the partnership.

Opportunity of cost and resources

In a fast-moving world, time and experience are scarce resources. If a company chooses to build, there is likely another project or feature that they will not be able to do. Further, directing your core team away from the building and delivering the core product will likely present a substantial loss of momentum in the business in return for a speculative build of ancillary service. Partnering has the advantage of lowering opportunity costs and ensuring limited internal distraction.

If you choose to partner, make sure to establish a clear service level and gather a clear overview of resource and time required to integrate.

In an ideal world, look for a partner offering multiple integration layers, allowing you to go live with minimal effort to see if they are a good match and then integrate deeper subsequently once this is confirmed.

Conclusion

Commerce is changing fast; the high-street has moved online, and so has the battle for customers.

Payment service providers and e-commerce platforms have replaced the banks as the number 1 business partner for merchants. As a result, they are faced with a golden opportunity to help their merchants by embedding additional financial services into their user experience.

Building an embedded finance solution compared to partnering gives the payment service providers and e-commerce platforms full control over the product.

When launching an embedded financing offering, the payment service providers and e-commerce companies need to ensure that the new offering matches the quality of their core product. Rather than building in-house, partnering can be the optimal go-live solution with 7 key points to consider.

Access to fast and fair business finance accelerates growth and unlocks potential. Merchants are the drivers of economic growth and bring communities together across the world. That's why we at YouLend are excited to power embedded finance for the next generation of payments, e-commerce and technology companies.

Appendix

Sources

1. Source: https://blog.youlend.com/embedded-finance-whitepaper/
2. Source: Survey conducted by The Harris Poll in 2020
3. Source: Merchants that received funding through Shopify Capital on average experienced 36% higher sales in the following six months compared to their peers: https://www.shopify.co.uk/blog/capital-effect-on-business-growth#:~:text=We%20found%20that%20Shopify%20Capital,months%20compared%20to%20their%20peers