Buffett bets on all-digital banks, but the world still needs Goldman Sachs

Warren Buffett, until last year a devoted shareholder of big U.S. banks, has moved on to their challengers. Does that spell the end of his faith in the traditional financial sector?

This week, Berkshire Hathaway Inc. poured $500 million into Brazil's Nubank--the fintech company's largest single investment--giving it a valuation of $30 billion. Nubank is one of the world's biggest so-called neobanks, or all-digital lenders, with 40 million users in Latin America.

For decades, financial institutions were Buffett's bread and butter, with stakes in lenderslen, insurers and credit-card companies. That changed last year, when Berkshire dumped 84% of its holdings in Goldman Sachs Group Inc., initially picked up during the global financial crisis, and pared its stakes in Wells Fargo & Co. and JPMorgan Chase & Co. Berkshire's investment portfolio had just over 23.6% of its fair value concentrated in financial firms, including banks, at the end of 2020, down from 41% in 2019.

Berkshire watchers were shocked and worried as they tried to decipher Buffett's moves. He compared the coronavirus crisis to 2008, noting there were a lot of unknowns given large swathes of society were shut down.

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Now it's worth asking whether Buffett is going a step further with this Nubank stake--and whether this is a deliberate switch from the old and entrenched world of finance to the new, digital-only variety. Customers certainly don't need brick-and-mortar branches in the middle of a pandemic.

The reality may lie somewhere in the middle. Buffett's fintech bet is less a testament to his beliefs about the future of banking than a hunt for standout growth potential, driven by consumers. Berkshire already owns a stake of around 4% in another Brazilian payments firm, StoneCo Ltd., and India's Paytm. Buffett is looking for dislocations in the market, not just efficient money-churners with more or less diminishing to flat returns. After all, the benefits of technological disruption rarely show up in traditional lenders' bottom lines; they go to customers.

Virtual banks seem to have accomplished what incumbents have had a much harder time pulling off. Their ease of use and accessibility is a draw for consumers, while the cost of opening accounts is low. Operational expenses aren't as onerous because they don't need branches and physical assets. Firms that Buffett reduced stakes in have been trying to create their own consumer-focused digital units. But the transition from their normal functions to digital is slow and expensive. Goldman's Marcus has struggled with rising loan losses and executive turnover. JPMorgan pulled the plug on its version, called Finn, a year after launch and is planning a digital push into the U.K. instead.

It's true that Berkshire could have made its digital plays closer to home and in theoretically safer markets. In places like Europe and the U.S, however, the neobank space is relatively mature with limited investment upside, given all the venture capital money that's already crowded in. In the first quarter alone, 25 of the 42 digital-banking deals globally transpired in these two regions.

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Meanwhile, U.S. and European regulators are becoming more cautious (think Germany's Wirecard AG situation), and have been pushing big players toward full banking licenses. That's a good thing, but it can also create obstacles to growth. In addition, customer acquisition is more expensive as they have to spend larger amounts to compete with big incumbents, which are investing aggressively to defend their turf.

No wonder Buffet is looking elsewhere. Emerging markets like Latin America and Asia, where consumers have helped payments and digital money systems take off, present a long-term opportunity. Lenders in these regions are inefficient, expensive and relatively weaker — often saddled with bad loans. The number of unbanked people remains vast and, outside China, regulation isn't a huge hindrance yet. The future of fintech has already shown clear success and uptake. Ride-hailers and e-commerce businesses have become super-apps and are getting banking licenses.

Brazil's Nubank competes with the big lenders in terms of volumes. It had more than 57 million downloads, while annualized revenue between 2017 and 2020 grew over 100%, according to Goldman Sachs analysts. Its app-based, no-fee credit card for the urban middle class was key to that success. Yet digital banks aren't able to eliminate competition completely. Nubank itself relies on big lenders for credit lines, and turned to traditional banks to support its Mexican subsidiary in April. They still need their friends at JPMorgan and Goldman.

So while big banks appear to be on the defensive, they continue to hold the reins to large-scale credit, as costly as that is. Their digital friends, however, will have a much more lucrative path up. Buffett knows that.

Warren Buffett