

FINTECH ONE-ON-ONE PODCAST 381-ADAL FLORES

Welcome to the Fintech One-on-One Podcast, Episode No. 381. This is your host, Peter Renton, Chairman and Co-Founder of Fintech Nexus.

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Before we get started, I want to tell you about Fintech Nexus LatAm happening in Miami on December 13th and 14th. Latin America continues to be the hottest fintech region on the planet. In our 2022 event, we'll feature all the leading players. So join the LatAm fintech community this year where you'll meet the people who matter, learn from the experts, and get business done. Register at fintechnexus.com/latam and use the discount code "podcast" for 15% off.

Peter Renton: Today on the show, I'm delighted to welcome Adal Flores. He is the CEO and Founder of Kueski. Now, Kueski is a Mexican fintech - they've been around for many years. We've been following the journey of Kueski and think they're just a super interesting company getting some serious scale. So I wanted to get Adal on and they've really been scaling their BNPL offering so we talk about that in some depth.

They've had a lending product for many, many years which we go in-depth on that as well. We talk about how they manage risk, which is - I think some really interesting tidbits there - that Adal shares about how they do things that are very different to how people do it in the US. We talk about the cash-based informal economy in Mexico and what it's going to take to kind of bring people into the formal economy, and Adal has many thoughts on that. And he also talks about his vision for the company. It was a fascinating interview, hope you enjoy the show.

Welcome to the podcast, Adal!

Adal Flores: Thank you, Peter. Thank you for having me.

Peter: My pleasure. So, let's get started by giving the listeners a little bit of background about yourself. Love to hear some of the highlights before you started Kueski.

Adal: I was born and raised in Mexico, specifically in Guadalajara, Mexico. I was in industrial engineering so I studied industrial engineering in undergrad, you know, really interested in what's happening in Asia specifically, so I started learning Chinese Mandarin on, I think it was year 2003 I believe.

Peter: Wow!

Adal: Yeah. And then went to live in China to study my bachelor's in Mandarin, which I was halfway there. I came back to Mexico but interested in what's happening in Asia, obviously. I did some studies in Brazil. I spent a lot of time in San Francisco, so I was keen and kind of like understanding global trends especially. I think financial services was interesting for me, generally speaking.

Before Kueski I was working for a company called Ooyala, which is a technology company that got acquired by Telstra. I was in-charge of opening the Mexican operations for Ooyala Mexico so it was pretty much its own startup. That was when I bumped into the idea of Kueski, like I was experiencing first hand how difficult it is to get access to financial services in general, in Mexico, but more specifically getting access to a loan or credit card. I think this was what motivated me to create better access to credit in Mexico.

Peter: Maybe you could tell us a little bit more and tease that story out a little bit. Is there something that you saw - like did something happen to you, or what was the impetus? It's one thing to say, now look, there's a lot of under-banked people in Mexico. It's another thing to go and create a company to help solve that. What was the impetus there?

Adal: Just several things that happened to me and people very close to me. So for example, on my end, I wanted to get access to kind of like a credit card, and it was very difficult to. I got rejected multiple times, and then when I finally was able to get a credit card, the credit limit was actually very, very low. It was in some aspects, not helpful, right? No matter if I'd been on time for years, I couldn't get my credit limit to increase. So I think that was one aspect. And then my Dad - he's told us for years how painful it was for him to...he wanted to get access to a credit card for *his* business, and he got rejected. It was a profitable business, well run, and he couldn't even get access to a credit card. My Co-Founder was the same thing. And then I would say, generally in Mexico for example, going to a bank is just a very painful experience.

Coming from the background from Ooyala - Ooyala was using, you know, machine learning and data science to predict user behavior and increase engagements for consumers that were consuming videos, essentially. And the original insights that we have for Kueski in Mexico was that the financial industry is actually really, really, really new in Mexico. The one that we know right now. So essentially, the banks were private and then they were governmental-owned. And I think it was very close to the 1970s and 1980s, there was a foreign currency issue that prompted the government to essentially take over the banks and make them governmental-controlled. And then in the early 1990s, the banks were privatized again so, you know, the government said, "It doesn't make sense for us to control the banks. Let's just make them private."

And then you have the 1994 tequila crisis which essentially destroyed the financial industry in Mexico. We had to have the bailouts - the banking bailouts in the mid-1990s - and then the first credit bureau was created in Mexico in 1996. If you take one step back and think like the new industry, the one that we're seeing right now that's touching the consumers in Mexico, it is less than 30 years old. And there's this kind of vicious cycle that's happening in Mexico which is if you do not have access to credit, you know, you don't have the credit history. But then if you don't have a credit history, you cannot get access to credit, so there's kind of like this vicious cycle.

Peter: Right.

Adal: And we thought like there's so much after that telco reform that was made in Mexico, I think it was ten to 14 years ago. You know, the access to Internet data was...we were one of the most expensive countries in terms of OECD in terms of mobile Internet. And then we became one of the most competitive countries, so access to the Internet just went off and grew significantly in Mexico.

There's so much information you can get from consumers. And our insight was - it's a new industry and there's lack of this access to credit. If we could use machine learning and data science to score people with non-traditional data sources, then we could give them access to credit. Then that would probably be a really interesting product to build. So far, it's doing well. More than 60% or 70% of our consumers in Kueski have mentioned they have either created their credit history for the first time in their lives, or they have actually improved their credit history because they're using Kueski. So, that's kind of like how we got started with the company.

Peter: Right, right. So I know you started in credit. You started a company - was it 2013? How has the company evolved from your early days?

Adal: We founded the company late in 2012, but we started the operations in 2013. That's when we got started. We started with the original product which is essentially a lending product. A direct to consumer personal loan, essentially. Our goal was first to kind of build the capabilities, you know, start building the model, start getting the data sets. And building all the capabilities first to, you know, getting access to the debt funding, the ability to go and build a team that's helping us with collections - like everything - the marketing capabilities, everything. And that worked perfectly well.

And then we got into a new insight a few years ago, just before the pandemic. And the new insight was that um...if you see Mexico compared to other countries in the world, I think we're one of the top five most unbanked countries in the world. And it's interesting because you can compare this to other countries, either in Latin America, the Americas, and Europe, or even Sub-Saharan Africa, and we're trailing behind. We're not getting significant people getting access to a bank. We were trying to understand why was that happening? And we came to the conclusion, (this was the second thesis,) there's a lot of people that are working in the informal economy. They earn their money in cash and they pay everything in cash. They (for one reason) do not want to pay taxes, and they stay away from the banking industry.

When we read and speak about what's happening in lack of access to banking in Mexico, some people say "Oh, it's because of the offer that banking institutions are giving to consumers, it's not attractive." You know, our thesis is actually the opposite. The demand for banking services is actually constrained. The Mexican market by its own characteristics, is constrained, and we felt that there are a lot of people that are in the informal economy and they are unbanked. They prefer to be unbanked. But we believe that being, you know, in cash is actually expensive. It's expensive to move cash. It's expensive to do cash in/cash out. It's risky to have cash. And we thought, let's try to think about the way in which we can enable people that are currently living in cash economies to start transacting online and get access to e-commerce even without having a bank account.

If we can help them build a credit history and give them access to credit, we can start incentivizing them to get access to more financial services and convince them that it's better to be part of a formal economy. And it's better to be part of the banking system, right? So that's when we launched Kueski Pay. Kueski Pay is our buy now, pay later solution. And essentially the way it works, anyone in Mexico (as long as they're more than 18 years old because that's when they are considered to be adults,) anyone can actually go and buy online or offline using Kueski Pay. They're not required to have a bank account, they're not required to do a down payment. And with this in mind, we think we can connect dozens of millions of consumers that are, you know, living in Mexico with millions of merchants that are trying to reach out to these consumers, either online or offline. That's how we have evolved. So this was a couple of years ago, and this has just grown off the roof.

There was a study made by Morgan Stanley in which it says that Kueski Pay is present in, I think, like 9% of, you know, 150 top e-commerce merchants in Mexico which compares Kueski to, very similar to the penetration of established companies in the BNPL space in the United States. So our business has grown significantly. And then most recently, we've been doing a service, we're trying to launch a few products, and we're testing several products that we can start to continue offering to our consumers. So, the general vision of what we want to achieve is: we want to become the financial operating system of Mexicans. And we want to facilitate, the mission is to facilitate the financial lives of people in Mexico.

Peter: Right, right. So, it's interesting what you said there because you talk about cash and the cash economy. You know, there's a lot of momentum obviously behind people wanting to just stay in that economy. But then when you were talking, I just realized that you can't really participate in the Internet economy, right, everything is cash.

It's really hard to buy something online, to do online transactions. So it sounds like what you're providing is a little opening for them. They don't have to go to a bank and fill out a 10-page application and sit there and be humiliated, they can just tiptoe their way in. You know I've read some articles too, that BNPL in Mexico is really growing fast right now. What do you think is behind that? Because obviously there's still a lot of people who prefer cash, so what's behind the growth of BNPL in Mexico?

Adal: I would say there's a couple of things. The most self-serving would be, you know, there's lack of access to credit in Mexico, there's just a huge bump in e-commerce in Mexico, and there's no fundamental, like you know what, even from the market perspective. Imagine this, if you take all of the countries in the world, which is like very close to 200 countries, and you take their GDP, multiply it times the percentage of people that are unbanked in those countries, you take all of those...by the way, we call this Economic Financial Inclusion Opportunity Index. So we see which countries have the most, you know, the biggest opportunity. First place is China. Second place is the United States. Third place is Mexico. Fourth place is Brazil. Fifth place is India, and then sixth place is Indonesia. There's just so much opportunity.

It's an extremely, extremely exciting market. It's also a very, very difficult market. Some people realize that the fact why Mexico is unbanked, where's there's such a lack of access to credit, is not because people haven't thought about it - I'll just give access to credit and banking products to the population -

It's because it's a very difficult market to give access to. I would also say that the reason why there's a lot of BNPL growth in Mexico was because of all the easy capital that was available in the last couple of years, you know, after the pandemic. So, the pandemic actually shook up the world and the US government, and the Feds were decreasing the cost of capital, making it easy for people (and that was a good call). But then suddenly you have all of these "pandemic stocks" and the technology world just actually leapt off, and there was a lot of money in the investor community. BNPL used to be one of those companies where many of the public companies, BNPL public companies were getting very high revenue multiples and valuation, and I think investors got excited about the model which I think is exciting.

It's very, very difficult, by the way, and our thesis is that BNPL, at least in Mexico, is more of a feature of a whole ecosystem as opposed to a standalone product or a standalone company. We got excited, and there was a lot of money. I think that's what's happening and we're seeing this in the markets and it's a tough model. We are 150% high conviction. This is a really interesting model, and Mexico is a tough market. Just to summarize, Peter, I would say it's a combination of two things. It's the market opportunity that's there, and it's just how much access to capital was available in pursuing high revenue multiple companies in business, including buy now, pay later.

Peter: Okay. I want to delve into a little bit of the details here. Firstly, the majority population is in the cash economy. How do you manage risk when that is a reality? How are you underwriting these people?

Adal: I think that's at the core of what we do. So, what happens in the traditional banking industry in Mexico is that the way banks are scoring people, it's more common using the mentality of the last century. Which is basically you have a paper application, you go to a physical banking branch, you have a physical, you know, paper in which you do the application, and then traditional banks typically what they do is they get 10 to 15 data points. They use very traditional, simple statistical models to score people. One of the main data sources that they use is: do they have a bank account with us or not? If they do, it's easier for them to get access to credit, and if they don't, then it's difficult for them to give them access to credit. And then what happens is they have this legacy infrastructure that makes them update their credit models every six months.

It's a very, in some aspects, simple from the data perspective, very complicated from the process perspective, access to building the models. That's why, essentially in Mexico, I think like 80% of the people in Mexico do not have access to a credit card in Mexico, you know, that's the number. So, what we do is we take that process upside down and the way we do that is we say, let's try to get as much data sources as we can from customers and let's just try to analyze everything. Thousands of things and data sources in different ways you see users and we've seen things like, for example, the way people type, if somebody types extremely fast, they tend to be fraud. If they type slow, they're not fraud, but they probably have a lower credit capacity. If they type fast but not extremely fast, they tend to be phenomenal customers.

Peter: (laughs) Right.

Adal: And then things like if they're applying from their computers and if they use their tab rather than the mouse, they are better customers. People using a tab are better customers than people using a mouse, if you don't want to go from one question to another. And then Gmail users are better than Hotmail users, so we started getting this type of new interesting things. It was difficult to get access to data and we brought in literally... the first people that were actually building the credit models were PhD in Particle Physics.

Part of the research group that actually finalized the detection, the full understanding of the Boson Higgs particle. For years, we didn't have any people that knew credit in our company, this was just essentially data science. They were building very sophisticated models, very robust data sets. I think we calculate that we probably have a larger data set than the credit bureau in Mexico. So a very robust data set, but very agile ways for us to score people using machine learning and data science.

And then the interesting thing is that there have been points of time in which if something is happening in the macro environment which makes us think that the credit profile of customers is changing by any reason. One example was COVID, you know, there were suddenly millions of people that were losing their jobs every week or so, we can update those models. We have a very fast feedback loop because our loans, all of the products that we're giving to customers are...the feedback loop is from a few weeks to a few months, so every single day we know who's paying us (and who's not), and we can update the model every single day if we wanted to.

So, we ended up seeing that, for example, in the pandemic, while banks were actually tightening their credit standards or their approval rates if I can say it this way, we, at one point, we were so good at understanding what's happening in the environment that we had the higher approval rates, and our loss rates were below...lower than what happened before the pandemic.

Peter: Hmm. Interesting.

Adal: I think we have, you know, somewhere between more than 60/70 people full time, building the credit technology, the credit fraud and underwriting technology of the company.

Peter: Right, right. And so, obviously, you had many years of doing consumer loans before you got into BNPL. I imagine that really helped, but now, you're obviously adding huge numbers of BNPL clients. Is that helping to fuel the other sides of your business now?

Adal: We see ourselves as an ecosystem of products. We admire companies like Apple or Disney, and we try to see the analogy of what we're trying to build at Kueski. So, you know, if you see products in Apple, your AirPods are connected to your iPhone, and then your notes are connected to your computer, and then you have iCloud and then you have Apple Music. There's so much interconnection within the ecosystem, and the user experience is just so easy, and it's so convenient. I think that's why Apple is (essentially) the most valuable or the second most valuable company in the world.

We take the same analogy. Every single time that we have a new product, it needs to make the ecosystem stronger. It needs to deliver a better value proposition to the customer. I think that's essentially what we do, right? You know, people that essentially get access to a lending product, they can certainly go and shop with thousands of merchants. And by the way, the merchants are paying us an MDR so we can give them access to better deals and rates, and then the other way around as well. Somebody uses a buy now, pay later product, any reason that they need access to liquidity, you know, we know them, and they can get access to easier and more convenient liquidity from Kueski. So we think a lot about that aspect.

Peter: So then, are you operating online and offline with the BNPL product?

Adal: We do, yes, that is correct. Like right now, most of our merchants are online, but we are doing a small pilot with a few stores. With 1 or 2% of our merchants, we're doing a small pilot with physical stores offline, and I think we are somewhere between 700 to 1,000 physical stores. It's a very small pilot, and there's a lot of things that we're learning. Once we're ready, I think we can go and start offering this to essentially more than 100,000 physical stores.

Peter: Okay. So, you've talked about the growth of BNPL in the US, in Europe, in Australia. I mean, Australia was really one of the birthplace (my native country) and it's become so big there that it's part of how people pay. It's as ubiquitous as credit cards in many ways. But I'm curious about when looking at Australia and the US, Europe, I mean, what have you learned from those places that you've incorporated into your offering in Mexico?

Adal: The jobs to be done by BNPL companies in countries like Australia, United Kingdom, the United States or some countries in Europe is, in some aspects, so different from the jobs to be done in Mexico.

Peter: Right.

Adal: And by the way, these BNPL companies, they're getting so much traction - there's several reasons why. One of the reasons is a lot of the millennials, essentially what happened in the 2008 crisis, they saw people getting burned with credit and they didn't want them to get access to credit cards. There's this trend around some millennials not getting exposed to credit cards coming from the 2008 crisis, so there's a psychological aspect to that. And then there's also this convenience in access to credit. So, if you think about what's happening in these companies in all parts of the world: people have a debit card, they have a credit card and they can pay for something online. But either they do not want to use their balance in their debit card, or they do not want to use their credit limits. They don't want to decrease their credit limits. So what they do is they go and they say, "let's just use a BNPL solution," right?

And it's easy, it's convenient, it lets you pay sometimes with no interest in four installments. In some aspects it's a better rational decision because why do you need to pay now to your credit card if you can pay in a couple of months with this BNPL solution? So it's more rational if you know how to

manage your finances, obviously. So that's why that's happening in those parts of the world. Now, in Mexico, the problem is much more exciting. Because what happens in Mexico is it's not only a convenient way for people to pay, it's a better rational decision because it's lower cost of capital. Because there's no interest rate, (at least our product has no interest in the first two and four installments,) but at the same time it becomes a payment solution. Most of the people in Mexico, so 60% of people in Mexico don't have a bank account. 80% of the people in Mexico do not have a credit card. Like 78% of the merchants in Mexico do not have a POS terminal that accepts a credit card or a debit card.

So essentially what we are doing, what we believe we're doing, is we're connecting the economy. We're enabling people to buy online even if they don't have a credit card, debit card, a bank account or a credit history. And the other aspect, *the vision*, is that we can connect thousands or hundreds of thousands of merchants that can accept payments. And eventually the vision is that they only need the mobile app with a QR code in which customers can scan and they can go away and buy if they don't have cash or a credit card or whatever and they don't need to pay for that. Right, it's just the mobile app that they need to download. It's multiple times more challenging, but it's multiple times more interesting.

Peter: Right, right. A couple more questions before we wrap. I'd love to get a sense of how the regulators view this and maybe also, you know, comment on CoDi, the digital payment solution that the government really wanted to get going. It hasn't had a lot of traction - is that a negative or a positive? So it's a two-part question. You know, government regulators and the lack of kind of the success of CoDi, is that a good thing or a bad thing for you guys?

Adal: Regulators, I believe, are honest, very hardworking people that are trying to make Mexico a better place and a safer place in financial services. I think they are genuinely trying to improve it and that's why we saw the, for example, the Fintech Law, right? The Fintech Law in Mexico was approved a few years ago. I think it was necessary because there was this gray line between the way people were getting access to people's deposits and wallets and things like that.

By the way, there's different regulators. We have the Condusef which is the equivalent of Mexico's CFPB then we have the CNVB which is essentially the one that is in charge of anti-money laundering and things like that, and then we have the Bank of Mexico. I think that the general perception of all regulators in Mexico is we need access to credit, we need access to financial services in Mexico. It's hurting Mexicans, and it's hurting the government, the fact that there's such a lack of access to financial services.

As long as there's honest, professional, well-established institutions that are trying to reach out and really trying to improve people's lives in financial services, they want to support them. You see in the United States, for example, you know, there's always something changing, some regulation is changing. In Mexico, in the last ten years, except for the Fintech Law which I believe was a positive, you know, it's been very stable, very predictive. And the reason why they do that is because they want more established, professional institutions.

Now, to your question about CoDi - unfortunately, it hasn't taken off the way, you know, it's taken off with UPI in India or the Pix in Brazil. I would say that the reason why this happened is because the regulators, when they were pushing CoDi, their original thesis was that they felt that it was expensive for small merchants to accept payments through, you know, digital payments essentially because they would be charged a merchant, an interchange fee, and that could potentially be prohibitive for them. Especially the smaller merchants which are just essentially, you know, living on a daily basis from a financial perspective, cash flow perspective.

And their thesis was that if they could actually enable them a payment system, you know, that would not cost the merchants, they would be willing to support CoDi because they would increase sales. It would not cost them anything, and then we would have this kind of a positive feedback loop and network effect in which everybody, you know, more merchants would promote CoDi and then more consumers would be using CoDi, and there's this feedback loop. I think that what happens in CoDi is that coming back to the informal economy, the people do not want to use banking services.

Peter: Right.

Adal: It's more consumer not demanding banking services because they're working in an informal economy. They are concerned that if they use a banking service (it's either a consumer or a merchant,) they're going to get tracked from the tax perspective and they're very, very afraid of that. In India for example, there was this demonetization issue that also helped the adoption of UPI. In Mexico there's probably, I think there could be some interesting things about that, about CoDi, that needs to be done. There's something else that needs to be made to support the growth of CoDi. Otherwise, it's going to be tougher for consumers and merchants to adopt it.

Peter: Right, right, okay. Give us a sense of what scale you guys are at now, like how many customers do you have? How many employees? That sort of thing.

Adal: So we've had more than 1.4 million customers. We have more than 700 employees. We're going to soon be disclosing revenue numbers. But in the startups in Mexico, I would say probably top five in terms of most revenue run rates.

Peter: Okay, so let's end on your vision for how this is going to play out, you know, in the long term where Kueski can be sort of the center of helping bring people from the informal economy into the more formal economy. What's your vision there?

Adal: We're inverting the equation. So suppose I'm saying to the consumer, "Hey, give me money (that's the bank account initially,) and I'll give you access to financial services". Our proposal is: we'll give you access to financial services and there's a bunch of stuff we can offer them. We're starting with loans, you know, or credit because that's very well rated in Mexico, but there's a bunch of stuff that we want to do. You know there's credit, there's insurance, there's savings, wealth management, investments, there's a bunch of stuff, there's commerce. So we want to give them access to several of these products first, and then gradually convince them to be part of the banking system, the formal economy.

We want to educate them that it is better to pay taxes. And if they pay taxes and they get access to all of these financial services, they're going to be in a better shape. They're going to get more customers, and it opens them the world. Part of things that we're going to be offering to this ecosystem of products, some of them we're going to be offering them ourselves, (because we believe we can give them access to those products,) but we also believe that we can become a platform so that other companies can also give access to those financial services. You know, coming back to my admiration from what's happening in the technology world in China, I like what AliPay and what WeChat are doing in China and I think if we do something like that in Mexico, that would be phenomenal.

Peter: Okay. Well, best of luck with that, Adal. Really, really interesting story. Thank you so much for coming on the show today.

Adal: Thank you for having me here.

Peter: As Adal said, many times actually, the opportunity in Mexico is huge, they say it's one of the biggest opportunities on the planet, and that's because the informal economy is so entrenched. We were chatting after we stopped recording and were talking about how the older generation are the ones that are very resistant to change, and sort of really don't want the Mexican IRS involved in their lives whatsoever, but the younger generation have...they get the benefit of being in the financial system and that's what it's going to come down to.

The benefit of having everything done in the formal financial system has got to outweigh the benefit of going cash-based in the informal system, and that's really what they're selling. And as I said, Adal is building this whole ecosystem so people are not just getting a loan, they're not just getting a way to pay, but they're getting an entire ecosystem made available to you which simply is not available in the informal economy, and will never be because cash is so different and it's got it's own unique challenges along the way.

Anyway on that note, I will sign off. I very much appreciate you listening and I'll catch you next time. Bye.

(music)