WiNG

Rediscovering The Fundamentals Of Lending

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What's going on with lending startups? Two of the highest profile "success stories"—Lending Club and Ondeck—are starting to look less successful by the day. High default rates, misleading statements to investors, and low returns to capital providers have some wondering about the sustainability of these businesses.

Lending is an ancient business model—borrowing was invented early in the economic development of our species. Yet we appear to have forgotten many of the fundamental elements of a profitable lending business in recent years.

Risk/Return

The core of any lending business is the risk/return of the underlying transaction. A lender is providing capital to a borrower with the promise to be paid back at a point in the future. The difference between fees-plus-interest and lost principle is the potential profit pool for the lender and its capital providers. This profit pool is divided between the originator and the providers of capital. The cost of capital is determined by the risk perceived by the capital provider in the transaction.

Herein lies an important fundamental of lending: increased risk reduces profit in two compounding ways**.** First, it increases charge off rates, and reduces the potential profit pool for the lender and capital provider. Second, it increases the risk perceived by the capital provider and therefore increases the rate they will expect on their capital.

Let's look at an example: The LC Advisors Broad Based Consumer Credit Fund saw its returns from LendingClub loans decline from 8% in 2012 to under 2% in 2016. These returns are likely unattractive given the level of risk inherent in LendingClub's loan portfolio. For comparison, OnDeck has a 5.4% cost of capital. To offer investors attractive returns, LendingClub will likely

need to either increase its rates to customers by approximately 3.5%, or reduce its charge-off rates by roughly the same amount by increasing underwriting standards. Both of these actions would impact origination growth.

Key insights for entrepreneurs:

- **Find transactions with attractive risk adjusted returns.** The larger the spread between risk and return, the more profitable the business.
- **These transactions are often in new or emerging areas**. Competition drives the spread between risk and return to zero. Mature markets, such as consumer lending in the US, have more often than not appropriately priced risk already.
- **Find an underwriting edge.** Competition is the enemy of profitability. If you are lending to the same customers as competitors, with the same underwriting data, it is unlikely you will earn outsized returns for yourself or your investors. You must have an edge.

Customer Acquisition Costs

Customer acquisition requires educating potential customers about your product and convincing them to use your solution instead of an alternative. This can be easy if customers desperately need your product and have few alternatives. It can be very difficult if customers feel less urgency in their need, or if they have many seemingly comparable alternatives.

Lending products are typically commodities. Two lenders providing the same amount of capital for the same duration with the same terms are offering the same product. Qualitative factors such as “customer experience” are sometimes a factor, but are typically secondary.

Competitive lending markets are less profitable markets. In unsecured consumer lending, for example, there are many products competing for attention. LendingClub has spent significantly on sales and marketing to enter this market. For example, in 2015 the company spent $171.5m on these areas, which represents 46% of transaction fees generated that year!

Key insights for entrepreneurs:

- **Find new markets where there is less competition.** It is difficult to build a profitable business in mature, crowded markets. New geographies, customer segments, and transactions

are opportunities to break away from the crowd.

- **Build a new product, rather than tweaking an existing one.** The best way to beat competition is to avoid it. Building a product around a compelling use case that hasn't been served by incumbents is a good way to reduce the attractiveness of alternatives.
- **Target higher LTV customers than competitors.** What matters is not absolute customer acquisition costs, but customer acquisition costs relative to LTV.

Lifetime Value

Not all customers are created equal. Customers that cost less to serve, borrow more per transaction, or borrow more frequently are more valuable.

Repeat usage is a major driver of lifetime value in lending businesses. Some lending products, such as invoice factoring and lines of credit, are built around repeat usage. Others, such as term loans, are not.

Key insights for entrepreneurs:

- **Build your product around repeat usage.** Products built around repeat usage have many more opportunities to recoup acquisition costs and drive up LTV. Trade finance and lines of credit are examples.
- **Find underserved larger borrowers.** Larger customers are typically higher LTV, but may also be targeted by incumbents. However, these customers sometimes slip through the cracks. For example, in some geographies banks are unexcited about working with businesses with less than $5m in annual revenue.
- **Increase the spread between gross revenue and cost of capital.** Find underserved customers that have a high willingness to pay relative to the risk of the underlying transaction.

Conclusion

If you're an entrepreneur considering building a new lending business, ask yourself three questions:

1. Have I found a new lending use case with an inherently attractive risk/return profile?
2. Will my product be pulled out of my hands by customers due to a lack of high-quality alternatives?

3. Does my product drive high LTV through repeat usage?

Be intellectually honest with yourself when answering these questions. You want to find situations where there is meaningful differentiation on each of the points above. Think 10x improvement rather than 10%. Don't settle for less!

Footnotes:

[1] See, for example, https://www.wsj.com/articles/defaults-slash-returns-for-online-loan-investors-1487327408 (https://www.wsj.com/articles/defaults-slash-returns-for-online-loan-investors-1487327408)

[2] https://www.wsj.com/articles/defaults-slash-returns-for-online-loan-investors-1487327408 (https://www.wsj.com/articles/defaults-slash-returns-for-online-loan-investors-1487327408)

[3] LendingClub also earns servicing and management fees, which will be recognized over the life of a loan. These revenue streams are much smaller than transaction fees the company earns when a new loan is originated. It is also true that the company has some level of repeat usage, increasing customer lifetime value above revenue earned on the first loan taken out by a new customer.

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