Manole Capital Management
Commerce Club at Oxford Exchange
Tampa, FL
Phone: 813-728-3344
E-Mail: warren@manolecapital.com
Website: www.manolecapital.com

# Online Lending

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## How We Define "Fin Tech":

The word *Financial* refers to the finances or the financial situation of an entity or individual. It factors in any item pertaining to or related to money matters. It can also refer to the management of money, banking, investments and credit. As a sector or industry, *Financials* are often considered to be traditional banks, insurance companies, broker dealers or asset managers.

*Technology* can be defined in numerous ways. It is the practical application of science or knowledge to solve problems or invent useful tools. It is an activity that forms or changes culture. As a sector, *Technology* companies are classified into categories like software, hardware, services, online and consulting.

Our view of *Fin Tech* is fluid and somewhat unique. We are looking for any business that is utilizing technology to change an established process or its normal routine. This can range from altering workflows or simply changing from paper to a digital process. Within outsourcing, it could be moving from human to more computerized interactions. Any opportunity to disrupt the normal flow of money or business is the essence of *Fin Tech*. We realize this is quite broad, but we prefer not to be restrained by category classifications.

We have seen estimates that *Fin Tech* is only a $55 billion industry each year. We have also seen guestimates that *Fin Tech* approaches $1.3 trillion dollars annually. We are confident it is somewhere between these two figures. In our opinion, a business does not need to be a financial or even a technology company to be a *Fin Tech* investment. We prefer to deem it anything that simplifies or makes a transaction more efficient.

## Most Financials Are Opaque:

Financials are typically credit sensitive. They tend to be cyclical in nature, unpredictable and difficult to model. Most banks, insurance companies and broker dealers have complex and opaque balance sheets. Our preference, which can be challenging to spot in the financial sector, is to identify transaction-based businesses. These tend to be recurring revenue models that generate predictable and sustainable results. We strive to remain disciplined around transparency, low credit or balance sheet risk, and to find companies that specialize and differentiate themselves in commoditized businesses.

**One Example ~ Banks:**

In the US, there are 12,500 banks, credit unions and financial institutions. We would argue that traditional banking is a commodity business, with the commodity simply being the US dollar. In its simplest form, a bank earns the spread between its borrowing costs (i.e. a savings account) and its loan income (i.e. lending rate). This spread is often a function of interest rates, which tend to be driven by numerous macro factors. The Fed bases its Federal Funds rate on employment and inflation expectations.

In our opinion, when a bank is making long-term loans, too much risk and uncertainty exists. We prefer to understand how our companies generate their revenue and income. We model these businesses in excel and make various assumptions about future results. Opaque balance sheets, unpredictable trading results and untimely credit risks are not desired traits we look for.

**Our businesses are:**

- ✓ Market leaders with durable competitive advantages
- ✓ High barriers to entry with a "moat" around their franchise
- ✓ Pricing power and flexibility to withstand market volatility
- ✓ Recurring revenues and sustainable business models
- ✓ Strong balance sheets with predictable free cash flow
- ✓ A Board of Directors and management that properly allocates capital
- ✓ Management that is reliable, trustworthy and incentivized as owners

**Online Lending:**

There are numerous online lending marketplaces attempting to efficiently bypass the traditional banking model. Many consider this industry to be the ultimate *Fin Tech* sector, as they are bringing technological advances and change to an "old school" business.

Following the Financial Crisis, lending slowed. Banks were hoarding valuable cash on their balance sheets, either to be conservative or to adhere to newer, stricter regulatory rules. Online lending was perfectly positioned to capture market share from traditional players and the unsecured lending business was ripe for disruption. The Internet connected individuals seeking to borrow money with lenders anxious for yield. The process to apply for a loan was remarkably simple, even easier than applying for a credit card. Funds were made available in a matter of days, not weeks or even months. The flow of money was loose, as many online marketplaces were simply making it convenient and easy to borrow.

**Desperately Seeking Yield:**

With interest rates historically low, banks can bypass paying any interest to depositors and profitably lending it out to borrowers (earning the spread). Global growth remains sluggish and central banks continue to advocate loose monetary policies. This includes massive bond purchases and cutting interest rates. Negative yields are rampant and interest rates continue to decline. Recent estimates state that the global amount of debt securities with negative yields is $11 trillion.

At the same time, investors are frustrated with historically low yields and are desperately seeking investments that will generate any kind of positive return. In a world with miniscule bond yields and stock markets at all–time highs, investors are left with few alternatives. We continue to see references to T.I.N.A. or "there is no alternative". As a result, over the last few years, the yield-hungry public has embraced the opportunities the online lending sector was offering. These investments were deemed to be of high quality, solidly underwritten, with low default rates and providing ample yields on average of 9% to 10%. One online platform (Orchard Platform) has a weighted average coupon yield of nearly 14%. It is not just the retail environment chasing yields - despite an unproven business model, institutional investors are also attracted to double-digit lucrative yields.

**Lending Club:**

Lending Club is the largest online peer-to-peer lending marketplace. Having helped fund more than $18.7 billion in loans to-date, the company itself does not assume the credit risk of the loans it helps to sell, but it acts as an intermediary simply connecting borrowers and investors. This online platform is a great example of a "Fin Tech" business.

Since its inception in 2006 and its wildly successful IPO in late 2014, Lending Club has made over 1.6 million loans worth nearly $20 billion. It anonymously matches users who need smaller-sized loans with investors willing to lend, while not assuming the credit risk of the loans arranged. It simply connects borrowers and investors through its online platform. Lending Club loans are under $40,000 in size and are intended for high quality borrowers only. These borrowers, with FICO scores above 660, seek funds for anything from weddings to medical procedures to home renovations. The loans are divided into $25 securities, which any investor can purchase. Lending Club assigns an interest rate on this security, utilizing its proprietary algorithms. This branchless model leverages the power of the Internet, with an unprecedented amount of data, to connect borrowers and lenders. The concept and premise is a wonderful "Fin Tech" opportunity.

**Management:**

The founder and initial CEO of Lending Club was Renaud Laplanche. He was a polished, professional securities lawyer from a well-known firm. *Lendit*, the industry's annual online lending conference, chose Laplanche to be its keynote speaker four years in a row. Lending Club was the most reputable company in the industry and it wisely added established people to its board of directors including former CEO of Morgan Stanley John Mack and former Treasury Secretary Larry Summers.

**Early success:**

Laplanche started Lending Club with the stated goal of overturning the old financial order. Lending Club had a market capitalization of over $10 billion dollars and was widely considered the darling of an emerging "Fin Tech" industry. It was transitioning from a Silicon Valley start-up to an established financial innovator.

The demand from investors was dramatically rising. Private investment funds were created solely with the intention of buying Lending Club loans in bulk. Laplanche was even successful at attracting banks to purchase Lending Club loans for their own balance sheet. The market was embracing this industry and things could not have been better.

**The business model:**

Online peer-to-peer lenders have one of two distinct business models. Balance sheet lenders use their own capital to originate a loan. In our minds, this is as close to the traditional banking model as it gets. The loan underwriter takes all of the credit risk and earns the net interest margin or spread which like a bank, is the difference between its cost of capital and its yield. The loan underwriter accepts any risks from charge-offs or defaults and eventually can earn greater cash flows. With this model, the lender usually has a formal application process that investigates prior bankruptcies, credit scores, financial resources, employment history and the ultimate use of the loan.

The marketplace business model is much more aligned with our investment style and this is the model that Lending Club pursued. Under this scenario, lenders connect borrowers and investors. For each loan made, the platform earns transaction-based revenue, in the form of an up-front origination fee. In the case of Lending Club, up-front origination fees accounted for over 85% of its revenue and averaged nearly 4.5% per loan. However, in order to generate revenue, this model must maintain and grow its lending volume.

In addition, some online lending platforms can earn a servicing fee throughout the duration of a loan. This revenue is less predictable, smaller in size and entirely dependent on the quality of the loan. In our opinion, these fees are reliant on generating quality loans. However, driving loan growth runs counter to a platform with less standards, less controls and lower levels of due diligence. In fact, there may be an increased opportunity for borrowers to commit fraud due to lax controls on the ultimate use of funds. For example, in the event a loan is designed to aid in debt consolidation, the marketplace model does not lend itself to repeat customers. On the 1st quarter 2016 call, Lending Club management stated over 10% of all loans were made to repeat customers. This should have been a warning that something was not kosher.

**Transparency:**

This industry has a short history and it has not lived through a full economic cycle. Time will tell how its credit withstands external pressure. It is attempting to re-create the underwriting practice and utilize significant amounts of data to score each loan.

Silicon Valley has a somewhat dubious history of generating metrics it feels Wall Street wants to see. Going back to the dot-com era, there were numerous tricks to boost page views or "eye balls". In the Valley, this is known as "growth hacking". Lending Club seems to have fallen to the allure of creating a model to push growth rates regardless of lending standards or protocols.

It is our preference to identify transaction-based business models. In the payments industry, we are attracted to merchant acquirers and processors, as well as the payment networks. These businesses earn small amounts of revenue each and every time a purchase transaction is made. In addition, we like the derivative exchanges, which post real-time transaction data. This allows us to simply model revenue, earnings and free cash flow. On its website, Lending Club publishes vast amounts of information on its loans. In daily filings with the US Securities and Exchange Commission, Lending Club provides 100 fields of data, from job titles to locations to use of funds.

**Algorithms**:

Lending Club was relying on its new-age algorithms and decided it did not need to verify the incomes of its borrowers. Management stated that this was not necessary as its unverified loans performed just as well as verified ones. Have we heard that before? If the claim was Lending Club had standards that were more rigorous than conventional banks, then this seemed odd. Yet many investors simply believed management when it stated, "we evaluate each borrower's creditworthiness based on the most up-to-date data". A "Monday morning quarterback" would claim that this should have been a red flag warning. Some counter that since credit card issuers do not fully vet and verify incomes, neither should online lenders. We disagree.

Card issuers earn roughly 70% of the merchant discount rate. Since they take on the credit risk, they justifiably earn the bulk of the transactional fees. At Manole Capital, we do not invest in card issuers because there is too much uncertainty regarding their credit sensitivity. We prefer the more reliable, sustainable and predictable merchant acquirers, processors and payment networks. Like a credit card issuer, there is too much credit risk associated with online lending. Lending Club was attempting to offset this credit risk to lenders and simply become the de-facto platform connecting borrowers and lenders. While admirable in theory, it seemed almost impossible to accomplish.

**<u>The Collapse:</u>**

Everything changed in early May of this year. Renaud Laplanche, was forced to resign as CEO. Numerous ethical breaches were cited, including misdated loans and conflicts of interest. The initial cause of his resignation was from misrepresented details on a $22 million loan package sold to Jefferies. Once the board began to investigate this loan, additional information surfaced. Laplanche owned a personal stake in an external investment vehicle, which he was proposing Lending Club co-invest in. This vehicle was set-up to specifically invest in Lending Club loans. In our opinion, this appears to be a clear violation of self-dealing rules.

It soon surfaced that starting in 2009, the management team of Lending Club was pushing the practice of insider borrowing. In its early days, it was widely known that it advocated insiders taking out loans to lift important metrics like loans issued and dollar volumes. Yet, executives and insiders claimed that these insider loans, while widespread, were "not important".

Lending Club recently disclosed that back in December of 2009, Laplanche and three of his family members had taken out 32 loans totaling $722,800. While we have no insight into Laplanche's financial condition, we assume he did not need the funds for personal use. We imagine that these 32 loans were made to boost platform loan volumes before year-end. Loans made with misleading information on SEC registered securities could be considered fraudulent. Even if it does not qualify as fraud, it certainly is a poor reflection on management's integrity.

By August 2016, the CFO Carrie Dolan had resigned. Shareholder lawsuits have since emerged and the company has lost over 80% of its peak market value. Lending Club has been notified that the SEC is opening an investigation and it has also received a subpoena from the US Department of Justice.

New CEO Scott Sanborn is the former chief marketing officer of the company. He believes prior problems were "isolated" and that Lending Club is "back on track". When questioned about its past activities, one board member does not believe the type of behavior mentioned above was illegal or even unethical. Some might claim that these are only mildly deceptive tactics used to lift the prospects of a scrappy start-up. The Board and insiders stated that the loans in question only generated $25,000 in revenue and should be deemed inconsequential.

In our opinion, it all points to management credibility. Financial companies tend to be asset-light. The value of many financials is in ideas, service, brand, culture or the quality of its people. In the event a financial loses its trustworthiness, who would look to work with it in the future? Loan originations are the key metric for Lending Club, as it indicates the volume of loans processed on the platform. In the most recent quarter, it rose 2%. Growth was 68% the prior quarter and 90% in the year-earlier quarter. Given all that has happened, in our opinion, this is a tainted company, with questionable prospects.

**Trust:**

There is a great quote we find appropriate for the online lending industry. "Trust takes years to build, seconds to break, and forever to repair". Using advances in technology, the online lending industry was a "Fin Tech" darling, but as we have witnessed, it takes only one bad move to break this trust. Without this trust, Lending Club might find it difficult to regain its leadership position in the online lending marketplace.

In order to bring lenders back to the platform, Lending Club is making undisclosed cash payments. We have examined Lending Club's most recent regulatory filings. We are troubled with some new disclosures and have highlighted a few items for emphasis.

The 10q filing states *"With the announcement of the initial results of the internal board review on May 9, 2016 and additional results disclosed on June 28, 2016, many investors paused or reduced their investment activity. The Company has been focused on working with these investors to resume their investment activity and on bringing new investors to the platform. During the second quarter of 2016* ***the Company offered cash incentives to investors in exchange for investment activity****. If the Company's attempts to secure additional investor capital to meet platform origination volume are not successful, the Company may choose to provide further cash incentives, or enter into different additional incentive structures or terms, including the use of the Company's equity, to attract investor capital to the platform. Failure to attract investor capital on reasonable terms may result in the Company using a greater amount of its own capital to purchase loans on the platform compared to prior periods, or reduce origination volume. These actions may have material adverse impacts on the Company's business, financial condition (including its liquidity), results of operations or ability to sustain and grow loan volume."*

These investors may not be satisfied with current security yields or just may not trust the platform. Either way, the cost of doing business has risen for Lending Club. Investors are requiring costly incentives in order to transact. By Lending Club's own admission, it is harder to earn back investors' trust and this has negatively impacted volumes. Based on prior management actions, this is a sizeable and open-ended risk for us.

## Changing its Model:

We were attracted to Lending Club's marketplace model. It was not using its own capital to fund loans, but was acting as a toll-keeper or intermediary. From its most recent 10q filing, this seems to have changed. It states *"Although the Company's overall business model remains premised on the Company not using its balance sheet and assuming credit risk for loans facilitated through our marketplace,* ***the Company may use its capital to support contractual obligations*** *(Pool B loans and* *repurchase obligations), regulatory commitments (direct mail), short-term marketplace equilibrium, customer accommodations, or other needs."*

In addition, we liked how Lending Club attracted institutional investors to its platform to act as the ultimate lender. We do not want or trust management to invest in these person-to-person loans. This too seems to have changed. In the same 10q filing, *"The Company* ***may use its capital to invest*** *in loans associated with the testing or initial launch of new or alternative loan terms, programs or channels to establish a track record of performance prior to facilitating third-party investments in these loans".*

**Valuation:**

Lending Club currently trades at $6.50 per share implying a market capitalization of $2.5 billion (with 383 million shares outstanding). With cash on the balance sheet of $573 million, Lending Club has an enterprise value of $1.9 billion.

2015 was a successful year for Lending Club, as it posted revenue of $430 million, EBITDA of $70 million and $0.14 in earnings per share. The news and hiccups this year essentially wiped out any profitability and dramatically lowered the growth profile for this year and next. Earnings expectations are now forecast to be negative this year and Wall Street is looking for only $0.07 in earnings per share in 2017. At this stage in its lifecycle and growth, one could argue a P/E is irrelevant. Even if there were no questions about Lending Club's future growth, we would feel uncomfortable owning this company at a P/E approaching 80x. The problems of 2016 wipe out more than a full year of growth for this early stage business, but it also highlights an ongoing concern.

Earnings can be manipulated, so we tend to focus our attention on cash flow. The cash flow statement rarely lies. Before the surprising revelations in May, Lending Club averaged nearly $50 million of cash flow from operations for 3 quarters straight. This was promising, as Lending Club was widely considered by many as the leading platform for online lending. It had a bright future and was expected to continue to leverage its position to drive growth higher. Now that there are questions about its platform (and integrity), future business is uncertain. We are uncertain regarding the size and scope of cash incentives management will pay to attract lenders to the platform. Cash flow went negative last quarter and will likely stay this way for a few quarters. Will investors look to purchase Lending Club loans? Will Lending Club only draw the most risky borrowers to its platform? These are troubling questions we struggle with.

We unfortunately do not have confidence this is *the* winning company in this emerging industry. The sell-side analyst community agrees with us. There are 17 sell-side analysts covering Lending Club with 1 buy, 15 holds and 1 sell rating. The investment community also agrees with us, as there are 62 million shares short or roughly one-fifth of total shares outstanding.

**The Industry impact:**

The need to diversify funding sources and bring in institutional investors is important. This will favor the most established and well-known players. For online lenders to build scale, the industry needs to provide increased transparency and value-additive information around loan performance. An influx of capital into online loans will be made possible with heightened transparency. If tools are available to analyze single and packaged loans products, the industry can mature and prosper. Over the next one to two years, we anticipate that the market will continue to mature. However, institutional investors and the important secondary market for such loans might struggle. Again, the key element here is trust. How will lenders and the institutional community embrace these loans when so much dishonesty has occurred?

We are now seven plus years from the financial crisis. We are eventually going to encounter another industry downturn and questions remain over how this new sector's credit scoring, and its algorithms will perform. For instance, are some borrowers using online lenders because it is an easier process or because traditional lenders denied borrowing requests?

**Conclusion:**

Since we are "Fin Tech" investors, one would expect many of the items we highlighted for the online lending industry would lead us to participate. Since it avoids bringing the loans on its balance sheet, we were intrigued. Since Lending Club provided huge amounts of data for lenders, we were comforted with its transparency. However, one item that prevented us from initially owning Lending

Club was a concern about its credit. Also, an important checklist item was Lending Club's management team. We never had an opportunity to meet or hear them speak. Now that details are emerging about their past, we are happy we avoided this company. As of today, there simply is too much evidence of a disturbing culture of mis-information and dishonesty, and so we remain on the sidelines. In terms of investing specifically in financial companies, we continue to focus on credit risk and management credibility.

At the 2002 Berkshire Hathaway annual meeting, the legendary duo of Warren Buffett and Charlie Munger had some wonderful comments regarding investing in financials. After Munger discussed how he is often uncomfortable around most financials institutions lack of transparency, Buffett had this great quote. "There is so much about a financial institution that you don't know just by looking at the figures that if anything bothers you a little bit, we're never sure whether it's an iceberg situation".

In terms of Lending Club, we see a company struggling to right itself following years of mis-management. While we do not believe this is another "iceberg situation", we believe we can find better investments elsewhere.

While there probably is some value in this company, in our opinion this is outweighed by too much uncertainty and risk. In the event Lending Club posts better than expected results next quarter, one would anticipate a positive response from a short squeeze. But in the event it disappoints (on any of its important metrics), we would expect a sizeable fall from its still lofty current valuation. This type of volatility is not to our liking—with this type of odds, we would suggest visiting the roulette wheel in Las Vegas and betting on either black or red.

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Tampa, FL
Phone: 813-728-3344
E-Mail: warren@manolecapital.com
Website: www.manolecapital.com



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