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WHITE PAPER

Alternative Lending Market

A Valuation Perspective

Contents

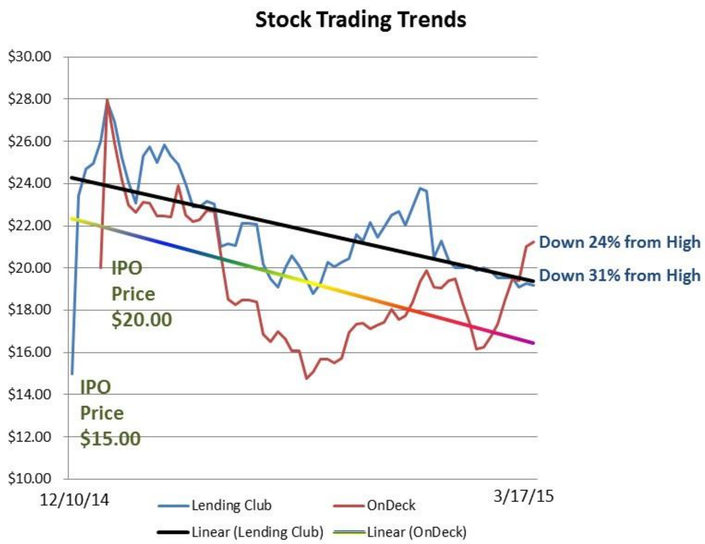
Recent Technology-Enabled Alternative Lending Valuations

December 2014 witnessed two significant initial public offerings in the technology-enabled alternative lending space. Investor demand was strong resulting in the IPO's becoming the second and sixth biggest in 2014. However, despite being in the same sector, Lending Club and OnDeck Capital have fundamentally different business models.

Lending Club, a peer-to-peer lender allows applicants to obtain a loan, which it then sells to individual investors (either whole or in a participatory manner). In the process of connecting borrowers with lender-investors, Lending Club earns origination and servicing fees on the loan, but does not assume any direct credit risk. On December 10, 2014, the Lending Club Corp.'s IPO was priced at $15.00 per share and quickly raised over $865 million in capital. The next day the stock rose to $23.43 per share giving the company a market capitalization of $8.5 billion, larger than the market capitalizations of some banks designated as "systemically important financial institutions." The IPO was second only to Chinese e-commerce firm Alibaba (the largest IPO in history).

The following week, on December 17, 2014, OnDeck Capital's IPO occurred. OnDeck is an alternative lender with a technology enabled platform and has provided small and medium size businesses with loans since 2007. The company uses proprietary software to aggregate data about the applicant's business operations and then applies a series of algorithms to determine loan eligibility. OnDeck uses its own balance sheet to fund the loans, obtaining financing through bank warehouse lines and by selling loans in the secondary market. Its initial public offering prior to opening was priced at $20.00 per share. It opened at $26.50 and by the end of the first day rose to $27.98, ending with a market capitalization of approximately $1.5 billion, becoming the sixth largest IPO of the year.

Both stocks had a significant price "pop" on their initial trading. However, as of closing March 17, 2015 both stock prices have decreased from their previous highs.



Fundamental Analysis

Valuing established and profitable companies with consistent, clear accounting statements, long stable histories and lots of comparable firms is relatively straightforward.[1] However, technology-enabled alternative lenders are young, high growth companies with different business models in a rapidly evolving sector. Given the significant impact of expectations about future profitability and earnings growth will have on a valuation, and the associated uncertainty surrounding such expectations, it is understandable that the valuation of many companies in the sector have a very wide confidence interval.

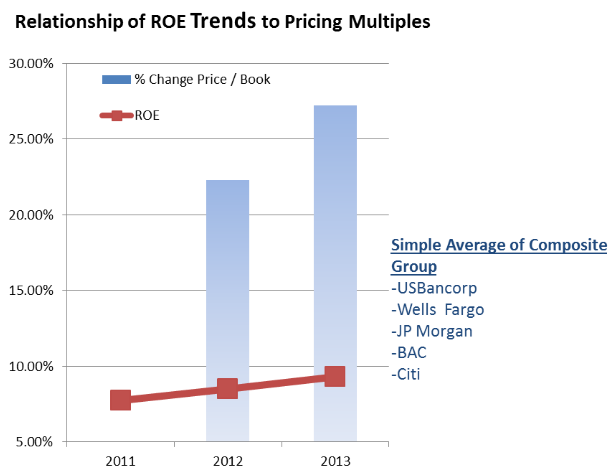
Given the uncertainty (and current unprofitability) of many players, analysts seek to assign value on a relative basis by establishing a peer group. However because these companies are innovative, there naturally does not exist a well-established set of comparable companies for benchmarking.

In order to achieve a higher valuation, technology-enabled lenders will seek to be viewed as technology companies, rather than finance companies.[2] This is because high-growth technology companies are often valued on revenue multiples and are trading at enterprise values of ~7–8x current annual sales. In contrast, traditional banks are generally valued by the market as a multiple of book value, with current price/book multiples of ~1.2x.

[1] See Aswath Damodaran presentation "The Dark Side of Valuation" available at: http://people.stern.nyu.edu/adamodar/pdfiles/papers/HighGrow.pdf

[2] See, e.g., "At IPO, Lending Club Straddles Line Between Finance and Tech" by Kevin Wack, American Banker, December 10, 2014
http://www.americanbanker.com/news/consumer-finance/at-ipo-lendingclub-straddles-line-between-finance-and-tech-1071606-1.html

However, multiples are the dependent, not independent variables in the valuation process. At the end of the day, every company's stock price must be reconciled with the earnings and cash flows that its shareholders are expected to receive over the life of the investment, discounted at the appropriate rate. The graph below reflects a composite group of banks and their relationship between return on equity trends and corresponding changes to price multiples.



Further, while many investors compare OnDeck and Lending Club to each other, as both are online alternatives to traditional finance institutions, their models are very different.

Company	OnDeck	LendingClub
Founded	2007	2007
IPO	2014	2014
Credit Risk	Yes	No
Borrower Focus	Small businesses	Historically consumer credit (debt consolidation, credit card refinancing, major purchases)
Source of Funds	Bank warehouse lines, securitizations	Consumers and institutional investors
Value Proposition	Speed, convenience, and access for underserved small business market	Interest rate arbitrage where borrower receives better rates and investor receives better yields

Three distinct business models have emerged, creating structural silos that limit comparability among operational and credit risk for technology-enabled alternative lenders:

- Funders not only underwrite and fulfill loans, they also fund the loans via their balance sheets. They most closely resemble the traditional financial institution with the exception that they purport superior underwriting analytics and processes, allowing for significantly quicker decision and fulfillment timing as well as lower costs to acquire. OnDeck is a leading Funder focused on commercial borrowers.
- Marketplaces underwrite and fulfill loans but then turn around and sell them to institutional or retail investors either in whole or through various participation levels. The Marketplace companies not only purport the value-added items that Funders do but they also tout the removal of credit risk as the loans are sold off without recourse. Lending Club is the leading Marketplace and focuses on consumer credit, but the company has moved into other segments, including commercial loans.
- Aggregators connect borrowers with a range of traditional and alternative lenders allowing the applicant choices. While there have not been any IPOs for this model of technology-enabled alternative lender, this silo includes players such as Biz2Credit and Lendio. Aggregators follow early innovators, such as Bankrate and LendingTree, which have benefited from the shift toward consumer use of the internet to research financial products. Aggregators place significant valuation focus on their superior technology aggregation and delivery platforms as well as the complete lack of credit risk.

The structural differences of each business model creates challenges in appropriately weighing and comparing all valuation considerations across their sector as well as a traditional financial lending institution, such as a commercial bank. The difficulty in valuing these technology-enabled alternative lenders is exacerbated by other factors and considerations such as:

- Barriers to entry and market positioning
- Growth opportunities
- Compliance and risk environment
- Short versus long-term cost and delivery advantages
- Economic and cyclical exposure
- Regulatory reporting variations
- Business sector long-term competitive environment

Management of each technology-enabled alternative lender quickly and aggressively point to their technology and platform competitive advantages when pushing for higher valuations than traditional lenders. The recent declines in post IPO prices, however, may be the beginning of longer-term market corrections as investors begin to grasp the aforementioned "other considerations." It is interesting to look at traditional financial lending valuation considerations and how they stack up to the current considerations being given to technology-enabled alternative lending values.

Traditional Financial Institution Valuation Considerations

The valuation of traditional financial institutions typically is measured as a multiple of book value or tangible book value. For community banks, trading multiples range from one to two times book. Differences such as higher earnings growth rates, higher dividend payout ratios, and lower cost of equity capital all result in increased price to book ratios. There has also been a strong, demonstrated relationship between returns on average equity and price/book value multiples. All else being equal, a bank with a higher ROAE should trade at a higher multiple of book value than a bank with a lower ROAE.

From a competitor or M&A perspective (theoretically translating to a market driven stock price) the valuation of a financial institution would consider the following:

- Current market reach and ability to expand
- Customer channel access and delivery / operational infrastructure / platforms
- Management strength
- Expense structure and potential level of synergies
- Earnings power and cash flows generation (current level, growth, quality, stress and sustainability)
- Credit and operational risk
- Funding diversification, liquidity and asset / liability management (margin and credit risk)
- Balance sheet assessment including intangibles, reserves and fair market accounting
- Current PE trading multiples relative to the valuation considerations above

These items and their resulting assessment provide a very thorough view into the financial institutions current and long-term value (standalone or as an acquisition target). Each consideration can be ascribed either a power rating (e.g. internal ranking based on predetermined components) and or actual value that allows a stacked view of the ultimate trading value of the financial institution. Extensive "stress-testing" is usually conducted on each consideration allowing for the creation of a number of valuation scenarios.

Technology-Enabled Alternative Lender Considerations

The valuation of high growth technology driven companies is typically viewed as a multiple of revenue or sales. Their current trading multiples are in the seven to eight range. As previously mentioned, technology-enabled lending management aggressively points out the technology driven advantages around speed as well as additional underwriting insight from their proprietary algorithms. Management within these companies believes these technology differences command higher valuations versus traditional financial institution lenders. Other key valuation considerations these type of lenders point to include:

- Untapped potential of future growth (specifically, these lenders are filling a void left by the traditional lenders retrenchment, particularly in smaller dollar loans that banks now view largely as unprofitable)

- Robust partnership and broker origination channels, including easy to use and fast access linkages catering to today's internet savvy customer base
- "Big Data" and its extensive use in underwriting
- Compliance and regulatory advantages (at present, not falling under any specific compliance/regulatory guideline and therefore not yet incurring the significant costs associated with such, our intelligence suggests a 100bps to 200bps advantage)
- Management strength
- Cyclical factors resulting in investors chasing yields which creates expansive funding opportunities

Many of the considerations used to support current valuations in this sector lack empirical/historic performance data and results due to the rapid evolution and growth in this space. As such, their long term ability to predict true value, particularly in changing credit cycles, has not been firmly established. Undeniably, something is happening in the specialty finance space and technology is certainly relevant in terms of its ability for greater market penetration. However, at the end of the day, while technology gains and advantages warrant incremental value, the companies in the Funders and Marketplace silos truly are creating a loan portfolio and as such traditional financial lending institution valuation considerations must be given their due weight.

The recent decline in OnDeck and The Lending Club's stock prices may be the first signs of the market beginning to account for more traditional lender valuation considerations. The following table may give some indication of the potential magnitude of valuation issues for Lending Club. It would be interesting to look at the valuation in a reverse fashion for perspective. If one were to hypothetically look at the amount of business that would need to be originated in support of the IPO value through the lens of a more traditional financial institution view, fully recognizing that it is not necessarily an "apples to apples" comparison, a different light is shed on the matter. Based on its post IPO market capitalization and a range of historic technology enabled multiples of revenue, Lending Club would need to originate between $14.1 billion to $21.1 billion of annual volume to support its post IPO valuation.

Origination Volumes Required To Hit Technology Firm Trading Multiples

	Lending Club 2014 Actuals	**Annual Originations to Support Tech Trading Multiples Against Lending Club's 2014 Market Cap.**		
		12.0	**10.0**	**8.0**
Annual Originations (M)	4,378	*14,100*	*16,919*	*21,149*
Revenue	213	687	825	1,031
Revenue Yield	4.87%	Intentionally Left Blank		
Market Capitalization	8,247			
Stock Price	$ 22.82			
Shares	361.4			
Trading Multiples				
Originations	**1.9**	**0.6**	**0.5**	**0.4**
Revenue	**38.6**	**12.0**	**10.0**	**8.0**

Valuation Considerations How Do They Stack Up To Each Other

Presented below is a comparison matrix providing insights into the level of scrutiny typically given to each valuation consideration for financial institution lenders as well as the technology-enabled alternative lending companies. Longer term, the technology-enabled alternative lending valuations (particularly for "Funders" and "Marketplace") should converge with more traditional financial lending institution scrutiny levels. Recognizing the diversity of specialty finance providers, this paper uses a community bank as a proxy for a traditional financial institution.

Heavy/ High	
Medium	
Little to None	

Valuation Considerations	Traditional Financial Institutions	Alternative Lenders		
		Funders	Marketplace	Aggregators
Current Market Reach / Expansion Ability	Heavy/ High	Heavy/ High	Heavy/ High	Heavy/ High
Customer Channel Access & Delivery	Heavy/ High	Heavy/ High	Heavy/ High	Heavy/ High
Management Stength - Lending	Heavy/ High	Little to None	Little to None	Little to None
Management Strength - Portfolio Management	Heavy/ High	Medium	Little to None	Little to None
Management Strength - Compliance and Regulatory	Heavy/ High	Little to None	Little to None	Little to None
Management Strength - Technology	Medium	Heavy/ High	Heavy/ High	Medium
Expense Structure & Potential Synergies	Heavy/ High	Heavy/ High	Heavy/ High	Heavy/ High
Net income and cashflows	Heavy/ High	Medium	Medium	Medium
Control Environment	Heavy/ High	Little to None	Little to None	Little to None
Funding Diversification	Heavy/ High	Heavy/ High	Heavy/ High	Heavy/ High
Balance Sheet Assessment	Heavy/ High	Little to None	Little to None	Little to None
Current PE Trading Multiples	Heavy/ High	Little to None	Little to None	Little to None

The comparison matrix points out a number of consideration areas where the current environment weight given to the emerging technology-enabled alternative lenders is significantly lower than the traditional lender. It is obvious that the traditional financial institutions are weighted more heavily in most categories. This is largely due to the fact that they "need to be" given how heavily regulated they are both from a banking and SEC perspective. This is creating an advantage to the other players for now, however, that could change in the future. Key factors include:

- Lending and banking experience appears to be light in the senior management levels within technology-enabled alternative lenders in some instances, particularly early start-ups. Understanding and managing credit risk will be paramount as the alternative lender loan book grows whether on its balance sheet (Funder) or passed through to investors (Marketplaces and Aggregators). As such, ongoing valuations should put more weight on this consideration.
- Portfolio management experience, whether on or off book, is a critical area that appears not to be given its due weight at the current time. At the end of the day, no matter how you package it, the technology-enabled alternative lender is booking loans that inherently house existing and cyclical credit risk that requires portfolio management.
- Compliance and regulatory management experience and ultimately their related processes and structures will become a critical valuation component. Currently, the emerging technology-enabled alternative lenders shoulder lower compliance costs than traditional lenders enabling a different margin profile. However, this advantage could be short-lived and therefore should be considered as such for valuation purposes.
- Balance sheet assessment as a consideration for valuing Funders is in its early stages but items such as mark to market, intangibles, reserves, financing sources, and asset / liability management should be given more weight in their valuations. For balance-sheet-light business models such as those used by Marketplaces and Aggregators, weighting would be considerably lighter.

There are signs that the market is beginning to recognize the above and is actively adjusting for it.

Long Term Technology-Enabled Alternative Lending Valuation Outlook

In addition to the evolution of valuation considerations mentioned in the previous section, other factors that impact technology-enabled alternative lending institution valuations are as follows:

- Short-term speed to market and delivery advantages will likely erode as traditional financial lending institutions adopt technology either through direct capital investment or through partnerships within the technology-enabled alternative lending sector (already occurring).
- Traditional financial lending institutions will increase their presence in the underbanked segment either directly or through partnerships.
- Technology-enabled alternative lenders will need to grow their originations year over year in order to stay ahead of potential economic / cyclical factors (accounting for losses). The market ability to achieve this is likely to consolidate the players over time.
- As mentioned, compliance cost advantages will wane as anticipated oversight increases.
- Longer-term regulatory movement that could force “mark to market” will likely reveal embedded loss curves that are higher than originally thought, reducing published investor returns and should flow through to valuation considerations.

Ultimately as emerging alternatives becomes increasingly mainstream, valuation approach and scrutiny level differences for technology-enabled alternative lenders versus traditional financial institution lenders should converge with perhaps only two real tangible discerning considerations:

- Some level of incremental value for technology (albeit much smaller than current levels)
- Greater funding options in the open market (Marketplaces)

These two factors will warrant some degree of valuation difference between the technology-enabled alternative lenders and the traditional lending institutions but to a smaller degree than present in the current environment. One thing for sure, the emergence of non-traditional banks has certainly made waves and undeniably tech-enabled alternative lenders have established themselves as relevant.

Contact Us for More Information

We would be happy to talk freely about our experiences in this area and help you understand where our services would be most valuable.

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About Bridgeforce

Bridgeforce, a specialized multi-national consulting firm, has been solving complex problems for companies involved in consumer and/or small business lending and payments for nearly 15 years.

Over 75 percent of Bridgeforce consultants come directly from client-side leadership positions across multiple parts of the credit lifecycle. Combined with subject matter expertise in operations, technology, strategy and regulatory issues, Bridgeforce brings a deep and practiced understanding of the lending and payment environment to each new client.

With market, regulatory and technological changes continually altering the risk landscape faced by sophisticated lenders, corresponding business changes require hard choices and the courage to make them. Bridgeforce has a strong record of helping clients make these choices by providing best-fit solutions that are achievable and provide meaningful change for each client.

The company operates in several regions with core markets and offices in the US and UK and additional operations in the Euro zone, North America and Latin America. The close working relationships between Bridgeforce with the US and European banks gives the company valuable insight into the interconnected regulatory movement and strategic trends across countries.

The Bridgeforce success can be attributed to a culture of collaboration, support and trust fostering innovation, thought leadership and evolving best practices recognized within the industry.

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