A New Investment Frontier: An Introduction to Private Lending

Albeit a relatively new asset class, institutional and private investors are increasingly considering direct lending for their investment portfolios. For the purposes of this paper, direct lending is defined as loans made by parties other than commercial banks, credit unions and government entities. The attraction to direct lending (also known as private lending) is understandable as the investments offer relatively high interest rates in a low interest rate world. And while direct lending has existed since the creation of money, the rapid growth of direct lending as an investable asset class has generated substantial investor confusion.

This paper is intended to shed light on direct lending as an asset class to help potential investors better understand the opportunities and risks within these types of investments. Our examination begins with an overview of the reasons why direct lending has grown so quickly since the Financial Crisis. We then describe the opportunity set and the types of direct lending available in the market. Finally, we conclude with a discussion of the investment risks and potential portfolio applications of direct lending.

Market Inspiration

Generally, we view the development of the direct lending market as having been the result of two factors:

• Technology-Based Efficiencies and
• Regulation

With more sophisticated technology and data has come more automated processes for evaluating borrowers. Using online interfaces, direct lending originators can collect relevant information and then easily gather additional data from credit rating agencies. While the largest “platform-based” consumer lenders (Prosper and LendingClub) epitomize this trend, we are also
seeing this phenomenon in business lending (Funding Circle, Kabbage, OnDeck) and in other sectors of the credit markets. In some ways, this is simply the disintermediation of traditional banking coming by way of technology - similar to the manner in which Uber has disintermediated the taxicab industry.

In contrast, traditional lending came as a result of human underwriting of borrowers. This was a labor-intensive process that resulted in both high costs as well as long lead-times. As such, borrowers were generally limited to lenders with which they had established a relationship - generally banks and credit unions. These institutions had easy access to important data points related to the underwriting process and could therefore more efficiently process loan applications and underwrite borrowers. The longer the relationship, the more information the lender had, again aiding in the underwriting process. Largely, however, this was a human endeavor, whereby human underwriters evaluated a variety of factors to determine if a borrower was credit worthy. This could be either a business or consumer.

At the same time that technology was allowing for more efficient lending processes, regulation and the economic environment were conspiring to limit lending to many types of borrowers. Following the 2008/2009 Financial Crisis, bank regulators pushed banks to reduce leverage and improve their loan books. Indeed, a central element to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is the requirement that banks hold onto a slice of loans they originate. Concurrently, as the risk bearing capacity of banks diminished (with a need to maintain ownership of a portion of loans originated), banks reigned-in lending significantly to rebuild balance sheets that were impacted by the 2008/2009 Financial Crisis.

Still, Dodd-Frank was not the only legislation enacted since the Financial Crisis, and there have been additional legislative responses that have had similar affects. The Collins Amendment\(^1\), in particular, has imposed stricter capital and leverage requirements on banking subsidiaries, bank holding companies and systemically important non-bank financial companies. While, in theory, many of these provisions should increase the capacity of the banking system to absorb losses (allowing them to lend more) the result has generally been a curtailment of lending. This is logical, as increased capital requirements would generally require banks to have more equity per dollar lent, leading to either an increase in equity issuances, a curtailment of dividends (and buybacks) or a decrease in lending.

The result has been and remains an environment where lending has been significantly reduced. Add to this a multi-year trend by banks to move away from non-collateral based business lending and it becomes clear that there is a dearth of traditional capital sources available for lending - allowing for the emergence of non-bank alternatives.

### Opportunity Set

The direct lending market is a growing market globally, but even the U.S. represents a fairly small proportion of the overall marketplace.

Consumer debt is an important element to this market and provides a glimpse into the size of the overall opportunity set. As the chart on the following page shows, even over the past five years, the consumer credit market has grown at an average rate that exceeds 5% (July 2017 estimates). This is despite the U.S. economy experiencing only modest growth since the last

---

\(^1\) As well as Basel III, which is a global regulatory framework.
recession. The size of this market is very large with more than $3.5 trillion in outstanding consumer debt in the U.S. alone and almost $1 trillion in revolving credit. For platform based lenders, the revolving credit market is a fertile ground for sourcing new customers. The size of the addressable group within this subset, estimated to be approximately $462 billion, is about half of the total market size. This owes to the nature of this business and the fact that a large percentage of revolving credit borrowers use credit as a transaction mechanism, carrying little to no balance. Moreover, another subset of this group have small balances that are not economical to transfer to an online peer-to-peer platform\(^2\).

### U.S. Consumer Loan Growth

[Graph showing U.S. Consumer Loan Growth from 2012 to 2017]

In short, since the 2008/2009 Financial Crisis, both revolving credit and total consumer credit have grown at a rate that exceeds the rate of growth in the overall economy. However, it’s worth noting that in spite of significant growth in direct lending platforms, they remain a very small proportion of the overall lending market. Currently, it’s estimated that online peer-to-peer platforms maintain an approximately $20 billion foothold in the consumer market. As the chart on the next page reveals, this is just a fraction of the addressable market and an insignificant proportion of the overall consumer credit market.

\(^2\)This is estimated from a methodology used by Morgan Stanley in their paper Global Marketplace Lending: Disruptive Innovation in Financials\(^*\), May 19, 2015, Morgan Stanley & Co. In this paper they estimated, using Consumer Financial Protection Board data that approximately 41% of borrowers used credit cards for transactional purposes while another 12.5% maintained balances that fell under $1,000.
The consumer market, however, is only one slice of the overall direct lending marketplace. While smaller in comparison, similar inroads are being made in business and real estate lending. Lend Academy’s Peter Renton offered the following perspective on three main direct lending origination marketplaces:

### Consumer

<table>
<thead>
<tr>
<th>Company</th>
<th>LendingClub</th>
<th>Discover</th>
<th>SoFi</th>
<th>Lightstream</th>
<th>Prosper</th>
<th>Total of Top 5:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value ($)</td>
<td>$8.7 billion</td>
<td>$4.0 billion</td>
<td>$3.2 billion</td>
<td>$2.3 billion</td>
<td>$2.2 billion</td>
<td>$20.4 billion</td>
</tr>
</tbody>
</table>

### Small Business

<table>
<thead>
<tr>
<th>Company</th>
<th>OnDeck</th>
<th>PayPal Work. Cap.</th>
<th>Kabbage</th>
<th>CAN Capital</th>
<th>Square Capital</th>
<th>Total of Top 5:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value ($)</td>
<td>$2.4 billion</td>
<td>$1.5 billion</td>
<td>$1.3 billion</td>
<td>$1.1 billion</td>
<td>$0.8 billion</td>
<td>$7.1 billion</td>
</tr>
</tbody>
</table>

### Real Estate

<table>
<thead>
<tr>
<th>Company</th>
<th>SoFi</th>
<th>LendingHome</th>
<th>RealtyShares</th>
<th>Sharestates</th>
<th>PeerStreet</th>
<th>Total of Top 5:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value ($)</td>
<td>$1.6 billion</td>
<td>$0.7 billion</td>
<td>$0.2 billion</td>
<td>$0.2 billion</td>
<td>$0.2 billion</td>
<td>$2.9 billion</td>
</tr>
</tbody>
</table>


1 "Global Overview of Marketplace Lending", Peter Renton, 2017. Lend Academy.
As with the consumer market, small business and real estate lending on online platforms only represent a very small proportion of the overall addressable market. Indeed, Ernst & Young LLP estimates that the addressable market for small business lending exceeds $280 billion while the addressable market for real estate lending exceeds $1 trillion.

It’s important to note, the technology-enabled, online lenders are only one component to the overall direct lending universe. While they are the fastest growing component and offer newer opportunities for investors, there are more traditional direct lending models that continue to be a source of opportunities. We’ll turn our attention next to discerning between these two groups.

**Forms of Direct Lending**

We divide direct lending into two different forms:

- Directly originated loans
- Platform-based loans

Generally, this distinction is based on the dollar size of the loans as well as the degree of human interaction. In the case of platform-based lending, a technology platform with a robust underwriting mechanism is used to evaluate and rate loans that are then purchased by investors. There is no “human” underwriting involved in this process and the process can, as a result, satisfy the needs of small-dollar-amount borrowers (both consumer and businesses). There are many platform lenders operating in various markets today, including those found in the graphic below.

---

4 “Alternative lending: Commoditizing loan applications through technology while paving the way for big data investing”, 2016, Ernst & Young LLP.
In contrast, there are direct lenders that are not as reliant on technology and, instead, depend on “human” underwriting. Given the cost, these tend to be larger dollar amount loans that have some form of collateral backing. Still, while the dollars that are deployed in such strategies tend to be larger than those found in the platform-based space, they can still be small in relation to commercial banking. These types of directly originated loans tend to compete less on rates and more on expediency. Given the underwriting lead time for commercial banks, the ability to act quickly can be the difference between seizing an opportunity and missing one. Direct lending has stepped into this void, providing either permanent or bridge financing to investors that want, or need, a loan quickly. Borrowers who utilize direct lending as a financing source tend to prize speed and surety of closing over the ultimate financing costs. In general, these types of loans have been embraced in real estate investment (both development and non-development), but can also be found in business lending. These types of loans are frequently bridge loans and are often backed by collateral.

Risk

Evaluating the risk of direct lending is important in the investment decision process. We tend to view investments as having a particular driver variable that creates opportunities and risks. This driver could be changes in interest rates, changes in the growth of the overall domestic or global economy or changes in some other alternative variable. While the income element to direct lending is affected by changes in interest rates, we believe that this effect is trumped by changes in domestic or global economic factors. As such, while a declining rate environment might be beneficial to traditional income-oriented securities (such as the prices of bonds), such environments tend to coincide with a softening economy if not outright economic contraction. Given the nature of direct lending we believe a conservative assumption is that the benefit accruing to a contraction in rates would be largely overwhelmed by an increase in delinquencies. Still, this is not to say that the nature of the investment (being essentially a private bond) doesn’t offer some insulation. While we would expect that returns would come down in an economic contraction and some of the corpus may be at risk, the downside risks would seem to be much less pronounced than one would experience as an equity holder.

Another consideration is the avenue by which a strategy or subset of the market is absorbing or protecting investors from the effects of defaults. There are essentially two methods to guard against losses from defaults:

1. Collateral
2. Interest Coverage

Many are familiar with collateral-backed lending as many investors themselves borrow using collateral (mostly for residential real estate). In assessing collateral, one needs to be cognizant of the quality of the underlying collateral, its marketability in a distressed environment and its value in relation to the loan size (loan-to-value). Collateral, however, need not necessarily be real estate, but could be equipment, automobiles, receivables, or tax credits.

Less familiar to many investors is the notion that the interest rates serve as a mechanism to absorb losses. For example, banks have recognized that they can make unsecured loans to consumers and be protected in a poor economic environment by the magnitude of the interest rate they charge on the loans. In short, making smaller-dollar loans at high rates of interest has been a fairly safe proposition as the interest rates can absorb the losses from the continual defaults that arise from this type of lending. Most of the platform based loans to consumers are seeking to essentially displace what consumers maintain in credit card balances. A portfolio of loans with a gross yield of
Many funds in the space use leverage for one of two reasons:

1. To manage cash flows in illiquid markets – either for distributions or for opportunistic purchases that will eventually be de-levered.

2. To enhance returns, by serving as an inherent component to reaching the return target established for the fund.

While the first reason is to be expected in this market for some strategies, it is worth monitoring and should be an important data point in evaluating a fund’s growth, success and management. However, we do think the second reason is becoming increasingly prevalent as the market has become more crowded in some sectors. In short, we don’t believe the use of leverage to enhance returns is a prudent practice given the options in the market, but a more nuanced understanding of the tradeoff is warranted.

There is a spectrum of funds in the market that have various return targets and profiles. These range from mid-single digit, prime consumer loans to warehouse facilities for lenders catering to niche markets, such as the “un-banked” or sub-prime borrowers. Our sense of the market today is that many participants are looking for an upper single digit to low double digit return for most individual strategies. We believe a reasonable return target for a diversified portfolio of unlevered strategies is between 6% and 9% today. Yet, in today’s interest rate environment one is not going to achieve this target by purchasing prime consumer debt from platform lenders such as Prosper and LendingClub.

As a consequence, it is very common in the market to find funds that are lending to consumers and businesses and employing leverage to bring returns to more appealing levels. At this point in the cycle and with a robust and growing interest in platform loans, we question whether the rates on these loans are sufficient to compensate one for the ultimate risk of using leverage in the space. It should be noted that most of the volume in platform-based lending is unsecured and not discernably different from credit card debt. While leverage looks appealing today, we suspect that ultimately these funds could take capital losses when defaults rise (as they would do in times of economic contraction). Moreover, debt in general has limited upside by its very nature – be it directly originated loans or high quality U.S. Treasury securities. The lower the starting yield on these loans, the more susceptible they are to both “Black Swan” events and economic upheaval.

In contrast, niche credit sectors where institutional involvement is limited or strategies that reflect a dislocation in markets (owing to technology, regulation or trends in the banking industry) more fully reflect the inherent risk to those markets and generally do not need or use leverage (to generate high single- or low double-digit returns). While such strategies generally cater to borrowers that are “riskier”, by putting together a diversified portfolio of such strategies we believe that an investor is better compensated for risk than leveraged funds catering to prime borrowers.
Applications

Our view is that the return drivers for direct lending assets resemble those found in equity and hard asset markets – mainly economic growth. Thus, the asset class itself can be used in a variety of ways, but we caution against its use as a replacement for high quality fixed income investments such as U.S. Treasuries. As a carve-out from the economically-sensitive component to portfolios, direct lending should be assessed in relation to investments like stocks, commodities and high-yield investments. While these other asset classes offer better liquidity, the advantages of direct lending include lower volatility, improved capital preservation, and a higher probability of reaching a targeted return.

Conclusion

Direct lending is an appealing asset class, but one that needs to be carefully considered and entered into with caution. While we remain in the early-years of what is likely a long-term disintermediation of banks, there are risks associated with making investments in the space. Recognizing that this asset class is economically sensitive is a starting point, as direct lending is likely not a surrogate for traditional fixed income. Being cognizant of how leverage is utilized and the manner by which capital will be protected from defaults are other ways that one can safeguard against making poor investments. In short, direct lending, while offering very appealing rates of return that can help one achieve their investment objectives, can be a complex area of investment where professional guidance is worthwhile.