Welcome to the Fintech One-on-One Podcast, Episode No. 336. This is your host, Peter Renton, Chairman and Co-Founder of LendIt Fintech.

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Before we start today's episode, I want to tell you about a new event from LendIt Fintech. Nexus, the Dealmaker Summit, is all about making deals. We will be bringing together a select group of venture capitalists, bankers, fintechs and debt investors for two days of face-to-face meetings in Miami on February 7th and 8th. Also at Nexus will be LendIt's famous Industry Award Show back in person for the first time since 2019. You can find out more about all our upcoming events at lendit.com.

Peter Renton: Today on the show, I'm delighted to welcome Denise Thomas, she is the CEO and Co-Founder of ApplePie Capital. I had Denise on the show several years ago, but I wanted to get an update because they've really made some incredible progress. ApplePie provides financing for franchises and we obviously go into that in some depth on the show and it's interesting for me to hear Denise sharing that the franchise businesses, they're a lot more stable than just a regular small business.

So, consequently, their loans have performed much better than some of the other small business lenders so we talk about the franchise market, in general, and why it is so stable, we talk about how they underwrite, their loan terms, we talk about the scale they're at and some of the creative structured finance programs that they've put in place in recent years. It was a fascinating episode, hope you enjoy the show.

Welcome back to the podcast, Denise!

Denise Thomas: Very nice to see you, Peter, it's been a long time.

Peter: I know, it's been too long, but great to have you back on here. Actually, it's been five years since you've been on the show which is quite a long time in fintech. So, tell us a little bit about what's changed and how would you describe ApplePie Capital today.

Denise: Well, the great thing is we are what we set out to be and we've never veered off our course and we've stayed true to the mission which for us has been really to serve the American dreamers everywhere. You know, the average entrepreneur is a franchise owner who starts with one unit and grows to well beyond 20 if they choose to. And so, we really believe in that hardworking individual and I think as you'll probably hear today, there is a huge differentiation in franchise and when we spoke to you five years ago, I think we've done $60 Million in loans and we're over $1.3 Billion, nearly $1.4 right now.

Peter: Wow! That is some growth and still focusing on the sort of relatively small franchise owner, right?

Denise: We are. We really have serviced owners, small and large, but as they get bigger, their loan size gets bigger and then there's a little bit more pressure on rate and we also have limits, in terms of the size of loans we can do. We go up to $5 Million today, but our average loan size this year across-the-board is $750,000.

Peter: Okay, that's a pretty decent amount. I want to talk about the last couple of years and just as a small business lender, that's been a unique time period. Maybe, first talk about the PPP, did you participate in the PPP and what was that like?

Denise: We wrote over $500 Million in loans, but we processed $300 Million due to the SPA and the borrower panic in applying in multiple places while they were waiting in line for that batch to clear. So, we got shorted about $200 Million of our $500 Million.

Peter: Okay. And what about the existing portfolio you had going into Q1 of 2020, tell us a little bit about that. You know, obviously, different sectors were hit differently, but what kind of relief programs did you put in, how did all that play out?

Denise: Well, before PPP even got out as a government program, we had a uniform relief program of three months with no payments automatically if you elected and were in good standing at that point and an extension beyond that that allowed qualified borrowers to do three months of interest only so almost six months of relief even before PPP was even in market and that was to the benefit of our borrowers greatly. The lenders were very swift, all of our lenders trusted our recommendation, they went with that and we were able to roll that out in March of 2020.

Peter: Okay. And then, what about…

Denise: Performance.

Peter: …..performance, yes, exactly. That will be my next question. How did that actually go?

Denise: This is a great story. We are at 1.43% cum-loss in seven years even through the pandemic.

Peter: Wow!

Denise: So while you thought, you know, 30% of small business going out of business, we maintained a very low loss rate. Going into the pandemic, we were actually 1.6% so we've come down because the denominators increased obviously.

Peter: What do you attribute that to? That's a really remarkable low loss rate.

Denise: I would attribute that to several things. When you look at franchise lending, unlike lending in small business, it's uncorrelated for a number of reasons. First of all, there's a corporate entity, the franchise brand, that entity is serving their individual franchisees with training and in the case of the pandemic, they sometimes revamped their business model. If they were doing a percentage of online delivery, in the case of quick service restaurants, they increased that, they changed their menus, they downsized, the flavor was a problem, they figured out how to get around that, they might have raised prices.

So, the corporate guide is what we call the "collective intelligence" that's helping those unit owners do the right thing at the right time, negotiate leases, all kinds of changes, but the big factor is we have predictive information around that brand's performance and we select the best brands, in the first place, and our brands are smart. We have very significant examples of how they shifted and adapted during this time. Twenty five percent of the industry is quick service restaurants so you know those guys did better in the pandemic and then we have unique business models even in hair salons.

Ours was built for COVID, they're one operator with one person in a closed room so they didn't have an open floor plan and all of the operators in the open floor plan salon flocked to that salon model so they did better. We had a number of stories like that, but across-the-board, we believe it's the brand, the liquidity of our borrowers is higher, a median net worth of $2 Million, they can weather more storm than small businesses and those mom & pops don't have anybody helping them in that way. So, this is a collective and it works and we believed in that from the very beginning. We saw evidence in 2008 with franchise when we went back and looked at losses in franchise back in the recession and franchise comes through these times extremely well.

Peter: The economy has kind of done really well over the last year and I'd be curious about the state of sort of new franchise financing. I mean, are there new franchise locations going in, are people expanding at the same rate or even a higher rate than they were pre-pandemic? Can you give us a little bit of a sense of where you're at today.

Denise: Well, I can tell you that we were overwhelmed starting mid-year with this volume, we broke all records in the history of the company in this past year and all of it in the last six months of this past year. So, we had our best year ever, highest revenue, above plan, we were profitable because of it and our pipeline is already strong enough to nearly double our volume in 2022. I attribute that to the fact that we've created a product that works in this industry and this industry has performed well during the pandemic.

I think a lot of traditional lending has a hard time determining which brands are credit worthy, they don't know how to do that. That's the code we cracked seven years ago, we know how to predict that with the data that we collect and have on a proprietary basis and I think, you know, traditional lenders just do the easy thing. They focus on the largest franchise brands and the biggest operators in 25 national brands, there are 3,800 brands, there's a whole bunch of other world that's being served and we've done lending to 200 brands and consider 60 of them what we call "fully integrated partners."

Peter: What does that mean, to be a fully integrated partner?

Denise: That means we invest, we go to their conferences, we will help them with specialized programs, we will spend time on them, we'll devote a business development officer to them, we will do quarterly reviews, we'll put them on a portal, we invest technology connection with them so they can see their pipeline, etc. and we have regular meetings with them.

Peter: Okay, So, that's sort of those brands that are, you know, some brands add locations every day or every week. Are those the brands that are a bit more established that are adding a lot of new locations?

Denise: They come in all different sizes and stages. We segment the market in five groups based on how many units they have. So, we call a startup franchise brand 25 units, an emerging brand is 100 to say 200 and then from 200 up to 400 and on. We have representative franchise brands in each of those buckets, they're all growing at different growth rates and that is determined by their own market studies of how much the demographic in these various parts of the country can tolerate, meaning they're not going to over open units. They are opening the number of units that makes sense to open in that geography and different businesses have different opportunity in that so growth rates can be anywhere from 5% to, you know, well past 40% in a year on a given brand.

Peter: Are there certain areas of franchising that are doing more growth or is it really dependent on the brand itself? I mean, I'm just trying to think if quick service restaurants are really growing fast, like what are the areas?

Denise: Quick service restaurants, personal services is a big bucket and that is everything from gyms to hair salons to massage, there's a lot of health care emergence so we have a urgent care service center company that has been growing, as you might imagine, because of the trends of what's going on, health focus, anything that's relieving stress. Believe it or not, massage is back and people are going because they've had chronic pain and it's worse sitting at home in the non-ergonomic seating situation so many people have today.

So, there's a lot of underlying dynamics, but I would also say that franchise is just an industry that's unlike any other. They are small, but yet large and they're a community and the larger operators and even the medium-sized operators grow during these times because real estate is very available today and you saw the 30% close, what does that tune franchise to do, go, gobble up that real estate at a better price. So, they grow faster during these times because of that real estate factor and also because just the pandemic has been friendly to them, they are able to expand. So, yes, quick service restaurants expanding, gyms are expanding again and also the hair salons and other personal services that are helping people.

Peter: Interesting. I just want to talk about the loans themselves for a moment. You mentioned an average size of $750K, what are the typical terms on that loan, like as far as length of loan, interest rate, that sort of thing.

Denise: Yeah. So, we offer seven or ten-year amortization, you know, the most common is a seven-year term with ten-year amortization which helps on payments and obviously, the shorter the time, the lower the rate is going to be. But, we differentiate between a new unit financing which is a brand new operator or an experienced operator opening another unit and those start at 5.13% and cash flow to those operators will be about 100 basis points higher at 6.1 starting. So, you know, if you look at averages, you're looking at between a low, on a cash flow loan, of 4.8 to 5.7 or a high on the proforma of 5.8 to 6.7 so it's a very tight range and if you're an experienced operator, you get a better rate than an inexperienced operator.

Peter: Right, right, that makes sense.

Denise: So, we have, you know, risk-based pricing.

Peter: Right. So, how are you actually underwriting, I mean, you said particularly for someone who's a new owner, I imagine, there's a lot of like personal type underwriting that you do. Just tell us a little bit about some of the ways that you're able to underwrite your borrowers.

Denise: So, there are what we call three legs of the stool. The first is the brand, how has the brand performed, have they opened 100 units and kept those units open over time, how long, if they've closed them, why did they close them. So, that's the basis of our model is looking at the brand's performance and the brand's quality. I mean, assess them on mini criteria before we sign them as a partner.

Owner guarantor is the other leg of the stool so we're going to look at their credit score, we're going to look at the global debt service coverage, we're going to look at their liquidity and net worth and then we look at the franchise unit itself, what's the historical performance. If it's an existing operator, did they get profitable when they were supposed to, how are they doing today so we do a look back at any units they currently own, we look for sufficient cash flows there. I would say, you know, there are three criteria when you really think about the things that matter the most and I think the protections are the global debt service coverage, the FICO and any current DQ and that's really key for us to look at.

You know, a lot of hard cuts and those, you know, obviously come out the top, but no prior franchise experience or no prior business experience is going to be a consideration of weakness. Previous liens or judgments, we consider a weakness and/or could be a cut and so we look at this as an area of weakness. Doesn't mean they're not going to get financed, but they may be paying a higher rate or in combination, those weaknesses may add up to a no.

Peter: Right, got you, okay. Let's talk about the funding size of your business, you know, I read, you said there are some creative structured financing programs you have, some of the parts of the brand, can you explain what that means?

Denise: Well, out of the pandemic, a number of things happened. You might recall, many banks stopped lending to small businesses during that time and only did PPP when in fact, there were brands that should have continued to be financed. They can't make these distinctions, it's sort of an all or nothing situation with traditional finance. We continued to lend and we were prudent about that, we trimmed who we would lend to, we watched, we asked for data. If you look at what came out of that is brands sat back and said, how do I ensure my growth in good times and in bad, how do I ensure that I'll have capital, ApplePie, how can you help me with that.

And, what we looked at was you have brand ownership, you might have a private equity firm sitting on top of that brand, you can have a family office that owns that brand, both of whom have deep pockets, both of whom can put real credit enhancement on the table. It's gone all the way to a family office that owns eight brands being willing to put their own money so we're not using our bank partner, we're not using outside capital for that, it's called a Dedicated Captive Lending Program. They're bringing the capital, they're bringing to the credit box so that they get approvals faster and they're accepting the risk assessment that we're doing on that and they're accepting the losses.

Peter: Interesting.

Denise: So, that is a breakthrough, that is a first and that same family office just invested equity in ApplePie so they are very serious about doing this.

Peter: Right.

Denise: So, we're doing a custom program for them and then we also have another brand unbeknownst to us, they have been financing, what we would consider un-financeable credits, and these were people who had worked on their franchise. Take a quick service restaurant, somebody goes in, starts working as a cashier, goes to management, really is a rising star, they want to own one, but they have no money so they're not going to get a down payment easily and they have what's called scholarship programs.

This brand had a $20 Million scholarship program every year to pay it forward because the owner of that brand who has now 400 units and a multi-millionaire made his first unit was someone believing in him like that. It raises the hair, you know, it's so exciting that they give these kids a chance. So, they have a total performing portfolio sitting on their own book of $20 Million and they came to us and they said, if we'll give a corporate guarantee for that, would you be able to sell that to a bank so that we can release funds to do more. And we did, we sold that portfolio to a bank for them and now, we service those loans.

Peter: Okay.

Denise: So, that's another creative side. And then, the third one was an extremely large franchisee who owned 96 units, but never done this before, wanted a line of credit, nearly $100 Million and we collaborated with a partner of ours and we got that done. That was a very nice fee for us, it was more like a facilitation, you know, effectively doing the equivalent of 96 loans in one for us so that was huge.

Peter: And then, I also read about a deal you did recently with First Internet Bank, I believe you go back ways with them. Tell us a little bit about your relationship with them and what this deal was like.

Denise: Well, this is both thrilling and amusing. Twenty years ago, I was with a platform that would have been called fintech today that funded Series A and Series B equity rounds for entrepreneurs and they had to be serial entrepreneurs so they were experienced who did not want to go to venture row to get their money. We had an option engine online that would allow us to do an online roadshow, have a chat room. None of this technology existed in 1999 and David Becker who is the CEO today of First Internet Bank, more than 20 years, was an entrepreneur at that time who wanted a non-brick and mortar national bank, everyone told him he was crazy. We thought he had a tiger by the tail and our company funded his $4 Million round on our platform and this was literally no face-to-face meeting, it was all webinar, web-based communication roadshow online and he got funded.

I remember that and I saw that they were doing lending with alternative platforms so I basically re-introduced myself to David and company and I said, you need to know us. I think we could be an asset you would like and immediately, he resonated and they've done over a billion with platforms like ours in a very short time. In six months, they've committed over a quarter of a billion dollars to us in just an 18-month period. They're a very good partner, we love working with them and I just find it amusing. I just talked to him and sent him a video circa 1999, that I saved on that platform and the conversations that took place on that platform and he's very amused. I looked a lot younger too, by the way. (laughs)

Peter: (laughs) Right, I guess it was Skype, I'm not sure when Skype started, but it wasn't commonplace, that's for sure.

Denise: No.

Peter: Are you working more with banks now for the rest of your funding? You've got some good sources there, are you still working with some of the long time partners you've had before or…..

Denise: Yeah, we are and do both bank and non-bank, I will say that they're both very interesting and sizable for us. The thing that's new and interesting is bank syndication partners, partners who know how to go to the community banks and slice up the deal to be able to give them access to diversified asset class and that's going to be a growing part of our strategy this year, is increasing the number of community banks.

We don't do deals actively with them, but our intermediary partner does and they are phenomenal. They've also doubled and requested triple volume after six months of working with us for this coming year. And so, that has an exponential potential for us because every time they add a bank, it increases both the size of loan and the capacity that we can provide them.

Peter: Right, right, for sure. Let's talk about equity for a moment. You closed on your Series C a few months back and I've been reading about it and it was Bankers Healthcare Group, BHG, we know them quite well, they've been a supporter of LendIt for some time, tell us a little bit about how that relationship developed and what that fundraising process was like.

Denise: You know, I'm not shy, Peter, so I did another cold call into BHG after learning about them. They feel like a secret in this industry, but they've been around 20 years, they've done an incredible volume of loans in a vertical market and so they were kindred spirit on paper, from my perspective. I did not know a lot about them, but I cold called them and I said, I think, to the founder and CFO, you guys might like us (laughs), I don't know where it will go, but let's talk and we did. They started the diligence process and within several short months, we cleared diligence with them for both the equity and also for a lending program that they'll take us into the securitization market which is exciting for us.

So, working with rating agencies, we've done that before with another asset purchaser, but this is different. BHG is a long haul partner of ours and we will be working with them on that, we hope to be in their securitization in Q2, it's very exciting. They also have many other products that can be sold and cross-sold to our clients that are not lending products, you know, for business, but for consumer. They have credit cards, they have business banking, they have all sorts of things that will be interesting for us to test market it with them. So, the marriage is a very strong one, we absolutely love working with them, we think of them as being ahead of us in volume certainly and in a slightly different way in their tech and so it's complimentary in the sense that we can learn from them and they can learn from us.

Peter: We've first come across BHG, I think that might have been about 2018 or 2019 event, for the first time when I first found out about them. I thought, how did I now know these people because……

Denise: I said the same thing (laughs)…in that sense, they're as big of a secret in fintech.

Peter: Yeah. Now, they're getting their name out there a bit more these days, they're a great company, great you guys got together. Okay, so last question then, we're recording this in mid-January, what's on top for ApplePie this year?

Denise: Growth and scaling. I will tell that I've hired 25 people in the past six months, three of those were executive roles who are people who have been in lending businesses that have been much larger than ours to take us to the next level and I'm thrilled with the people that we brought into the company and we will be testing new products.

We are going down-market in size because it's not very profitable to do a manual underwrite or coarsely manual underwrite on those under $300,000 loan so we are learning from BHG and we are working on taking the goodness in our model and automating decisions in those smaller loans. We are also going up-market in size and then new products beyond lending and then also we think that staying with the franchisee as they grow is one of the key strategies going into 2023 so beyond $5 Million loans. So, we're going to be looking at ways in which we can participate in their life cycle even more.

Peter: Wow, it sounds exciting. Well, Denise, it's so great to reconnect with you and congrats on all the success and best of luck.

Denise: Thank you and you too, Peter, you guys have done a great job in the last three years. I'm happy to see you thriving again.

Peter: Thank you, thank you, yes, okay. See you.

You know, chatting after we stopped recording, we were talking about the old days and how there's very few of the small business lenders that were around on the fintech side of this is what I'm talking about, you know, they were around in 2014/2015 that are still around today, many of them have gone by the wayside. ApplePie has been somewhat of a quiet achiever, but as you can see, they've been very much focused on providing a good experience for franchisors and they've done that in a way that no other company in the country was able to do. Kudos to them, they've come through the crisis in flying colors and the future is bright.

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

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Before we go, I want to remind you about a new event from LendIt Fintech.Nexus, the Dealmaker Summit, is all about making deals. We are bringing together a select group of venture capitalists, fintechs, bankers and debt investors for two days of face-to-face meetings in Miami on February 7th and 8th. Also at Nexus will be LendIt's famous Industry Award Show back in person for the first time since 2019. You can find out more all about all our upcoming events at lendit.com