PODCAST TRANSCRIPTION SESSION NO. 69: JON BARLOW

Welcome to the Lend Academy Podcast, Episode No. 69. This is your host, Peter Renton, Founder of Lend Academy.

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Peter Renton: Today on the show, we have someone who I would consider one of the true legends of this space. He has been around for many, many years and I'm referring to Jon Barlow, the former CEO of Eaglewood Capital Management, he was also the Founder of that company and he built that up from zero to just under $2 billion in AUM when he left and that's the largest asset manager dedicated to this space. Since then he has been doing a lot of interesting things. I see his name around a lot, he's been investing in different companies, he has joined the board of several companies, but I wanted to get him on the show really to talk about the early days of Eaglewood, talk about sort of the institutional type approach that he really brought to the industry. I think the industry has been a lot better off because of Jon Barlow. We also talk about the Lending Club saga, we talk about what platforms can do now to attract the institutional capital that everyone so desperately wants. We cover that and much more on the show, hope you enjoy it!

Welcome to the podcast, Jon.

Jon Barlow: Thanks, Peter, appreciate the opportunity to be on with you today.

Peter: Okay, so you are one of the old hands of this industry, but before we get into your experience that you've had in this industry, can you just give the listeners a bit about your background before you really made it into this industry?

Jon: Sure, no problem. I first read about marketplace lending in 2007 through an article in the Wall Street Journal about Prosper. At the time I was a buy side portfolio manager and did a lot of investing in the financial services sector and I was very impressed with the Prosper business model, you know having looked at hundreds of other financial services business models over the years. I actually looked at personally investing in their loans, but ended up not investing because at that time Prosper didn't have any loan grades and they provided very little borrower screening.

A few years later in 2010, I was introduced to Lending Club and was immediately impressed at how they improved upon the model with their loan grading system that effectively allowed an investor to quantify borrower risk. So I started investing in Lending Club loans and got to know the company very well while doing my due diligence and during our conversations I suggested that they try to line up leverage on their assets and effectively take what was an 8% to 10% returning asset and turn it into a 15% to 20% return asset and I felt strongly that the assets they were producing had all of the ingredients necessary for leverage, reasonably high yields, high credit quality, short duration and they could produce these loans in scale which was very important. And this was a combination that just didn't exist in traditional fixed income then and I would argue even today.

So I initially started seeking for leverage on my personal lending portfolio, but after a few months of discussion with the company they suggested that I actually create my own fund to provide investors with levered access to the loans and by that time I had become aware of dozens of other online lending startups funded by Silicon Valley and so I really saw the foundation for tremendous industry growth and yet there were no asset managers at that time focused on the asset class.

So in 2011, I founded Eaglewood Capital, which I believe was the first asset management firm dedicated to online lending. In 2012, we launched our first fund, which used leverage and active loan selection to buy loans from Lending Club.

Peter: Okay, so before you started Eaglewood, what were you doing exactly?

Jon: I was a portfolio manager on the proprietary trading desk at Lehman Brothers and I specialized in investing in financial services and real estate companies. I did that at Lehman…shortly before the Lehman bankruptcy I moved over to another hedge fund doing the same thing, George Weiss Associates, invested on both the equity and fixed income side, but a very strong focus in financial services and credit sensitive sectors.

Peter: Okay, so did you have knowledge of consumer credit or was this other kinds of fixed income?

Jon: No, sure I had invested in a lot of financial services companies that focused on mortgage credit...

Peter: Okay.

Jon: ...a lot of time in the mortgage space, you know prior to the financial crisis and I know this is public so I can talk about it. I was quite successful actually shorting a number of the sub-prime mortgage originators, ironically while I was at Lehman Brothers (laughs). Yeah, so...knew the mortgage space, the residential mortgage space extremely well and had also invested in some auto companies and credit card companies and other financial services sectors.

Peter: Right, so you obviously didn't really have a background in consumer credit, but you saw this as a great opportunity for a fixed income investment. Then you started Eaglewood and...what was it like back then because I mean I know that Colchis was launching around the same time, but there really wasn't...this was still a very fringe product. If you go out there talking to investors, no one really knew what this was so what was it like back then trying to find investors to come and invest in your fund?

Jon: Great question, we spent an enormous amount of time educating investors in the first couple of years I would say of Eaglewood's life. We really saw a sea change I would say around the middle of 2013 when the media attention around the space really exploded. We had started building a nice track record and we got to a point where we actually stopped marketing our fund because we had so much inbound interest, but in the early days, especially post financial crisis we were going to investors and asking them to invest in consumer unsecured loans originated over the Internet with leverage.

Peter: (laughs) An easy sell.

Jon: And we believed strongly that it was a fantastic risk adjusted return, but as you can imagine in 2011, 2012, with the financial crisis still on everybody's minds, it was a very difficult sell and so we spent an enormous amount of time educating investors on what peer to peer and marketplace lending were and then we had to sell them on Eaglewood and our particular fund so it was very much an uphill climb.

I'll also point out something that's probably less obvious. You know, there was no ecosystem for this industry at that time so in addition to educating investors we spent a lot of time with auditors, law firms, custodians, fund administrators. There was really no support system for the industry and so not only did we have to pave a path with the investment community, but we had to do the same thing with the community of service providers. It was quite a bit of work.

Peter: Right, right, I'm sure. While you were doing this you put together the first ever securitization. It's obviously a title that no one will ever be able to take away from you. This was back in 2013. So can you just talk us through that. It was a private securitization but I think we covered it on Lend Academy back then. Can you talk us through that deal and how you were able to put it together?

Jon: Sure, so when I founded Eaglewood Capital my thesis was that peer to peer loans were perfect for leverage and securitization because they have this very unique combination of high credit quality, high yield and scale. Before I launched my first fund, I had identified large investors interested in buying the senior tranches of a peer to peer securitization sponsored by Eaglewood. But like most securitization investors they wanted to buy a seasoned pool of assets and so roughly ten months after our initial fund launch, we closed our first securitization which was a $53 million transaction.

Aside from being the first securitization of peer to peer loans, the deal was unique because it had a weighted average FICO over 700 which is very rare in the ABS markets. As you know, it was a transaction that was publicized by the media really around the world and in hindsight, it was a major milestone for Eaglewood.

Peter: Yeah, it was a major milestone for the industry I think. It certainly brought in a new class of investor that wasn't able to access it before. I know it was hard work putting that all together. Anyway, I want to talk a little bit about the Lending Club saga because more than anybody probably you knew the company, you had done a tremendous amount of due diligence on them I'm sure…so what did you think when you woke up on May 9th and heard this news?

Jon: Well like everybody else, it came as a huge surprise. I think those of us who've been in the credit and lending markets for a long time were not necessarily surprised by the behavior…I am talking specifically about the loan alterations, that's something that has happened to a lot of other companies in different credit categories over the decades. Especially when money is flowing freely, a lot of mistakes get made in the back offices of loan origination platforms. That being said, it was a major surprise and shock to see this happen at the industry leader.

Peter: Yeah, yeah, I agree. So then as someone who is running a large fund...I know you left Eaglewood last year and we're going to talk about what you're doing now later, but what would you need to do, what do you think large investors like yourself when you were with Eaglewood, what do you need to see out of Lending Club now to get comfortable to put large amounts of capital to work again?

Jon: I think first of all, investors want to feel confident that all the disclosures coming out of Lending Club's internal investigation have been made and it feels like we're close to that point right now, but I still don't think we're fully there, so that's number one.

Secondly, I think that investors need to be convinced that the company has adopted strong internal controls and compliance procedures to ensure that this does not happen again.

And lastly, I think there were some problems with the company's credit even prior to this event and this goes back really over the past year. The company had seen some deterioration in their credit performance and I think investors want to feel that the company has regained control of the credit quality and is now properly pricing for risk. So I think if the company were able to put those three things in place I would be a buyer again.

Peter: Right, right, and I think that's obviously...I mean, this is part of the problem. This was already a difficult environment I think for Lending Club and for a lot of the industry because of some of that deterioration in credit quality. I've had many other people on that have analyzed the credit pretty closely. It wasn't like it was a huge uptick, it's not like defaults doubled, but there was an uptick and now the companies, both Lending Cub and Prosper have increased their interest rates significantly since late last year and it seems like now…I think investors now are being rewarded better from a risk perspective than what they were a year ago. Would you agree with that?

Jon: Well I haven't been terribly bullish on consumer unsecured credit as an asset class generally. I felt that the asset class was in a commoditization process over the past 12 or 24 months. You had a lot of cheap capital coming into the sector from banks, insurance companies, pension funds. All of whom who had lower return requirements and that allowed the platforms to lower their interest rates quite a bit. I do agree with you that the risk adjusted return has improved. You know I'm still waiting to see what happens with some these non-investment risks before I put money back into the sector. By non-investment I'm talking fraud and I don't think there was outright fraud at Lending Club but I think there's a lot of concern in this sector generally. There's obviously been a crisis of confidence and trust in the sector so I think we need to get comfortable that they've got the right controls and procedures in place to mitigate those risks.

Peter: Right, so that sounds like for you…if you were running a new fund today, you would still be hesitant today in putting money back into Lending Club or Prosper or any other platforms in the sector, is that correct then?

Jon: I don't think that's entirely true, I am investing in select platforms, both on the equity and the debt side, as you know. I think with Lending Club in particular I would want to make sure that there were proper controls in place to prevent this from happening again. There are some other really outstanding platforms out there and many of those platforms have had to offer incentives in order to continue raising capital. I think it is actually an excellent time to be investing across other sectors. I am not a big fan of consumer unsecured right now, but...and that's partially because of my views on where we are in the macroeconomic cycle, I think we're at or near the top of an economic cycle and a credit cycle and so I've been moving money out of levered vehicles and into senior secured asset classes and senior secured vehicles.

Peter: Right.

Jon: As you know I've invested in the commercial real estate industry and also done some things in the invoice factoring business.

Peter: Sure, well let's talk a bit about that. I think you're on the board, you've invested in the equity of Money360, just talk to us a little bit about that company and what really attracted you to them and to that asset class?

Jon: Sure, so first off I'm very bullish on commercial real estate lending as an asset class within marketplace lending. There are $3 trillion of commercial real estate loans outstanding in the United States.

Peter: Wow!

Jon: So this is an asset class that is much larger than consumer unsecured credit and yet no marketplace lender has achieved scale in this category so there's a very large opportunity that in my opinion remains untapped. I also see tremendous dislocation coming into this sector due to some regulatory changes in the CMBS (Commercial Mortgage-Backed Securities) market. I think that non-CMBS lenders like Money360 are going to take quite a bit of market share. It's an asset class that I think has been slow to develop under a marketplace model because the loan sizes are so much larger which makes it harder to raise enough capital to actually fund the loans and also harder for investors to diversify, but I think that's about to change and Money360 is working on some great solutions to that problem.

Money360 is also I believe unique among the real estate marketplace lenders as they have the ability to originate both permanent and bridge loans and this allows them to better capitalize on their marketing spends. Bridge loans in particular were very attractive to me and I am a debt investor on this platform. They have 8% to 12% yields, one to three year terms and 65% LTVs with a first lien position on income producing real estate so when I look at the risk adjusted return of this credit asset versus what I get with Lending Club and Prosper it's in my opinion, far superior.

The last thing I'll say about Money360 is I was very impressed with their team. Evan Gentry, the Founder is a very successful real estate entrepreneur, he sold his first company to Genpact over a decade ago and then started a distressed real estate asset management firm where he's delivered great returns for his investors over the past decade so multi-year track record of managing other people's money.

The chief credit officer is a 25-year CMBS underwriting veteran and the president of the company has run some of the largest commercial real estate lenders in the country. So it's a very seasoned team, they have a very strong culture of credit including in distressed environments and that's very important to me. One of my smartest investors when I was at Eaglewood was fond of saying…it's easy to lend money, but it's difficult to collect it. This is a team I feel comfortable with, they can collect money.

Peter: Right, okay so let's just talk about some of the other companies that you've become involved with. I think it's public about Harmoney in New Zealand who I've known from the very early days, they reached out to me and we've known Duncan and Neil and those guys for a while. What did you see...I mean, New Zealand is kind of not on the radar of many US investors so what did you see in New Zealand, what did you see in those guys that made you want to commit your dollars?

Jon: So New Zealand and Australia have been on my radar screen for a few years now. The banking sector in those countries is even more inefficient and oligopolistic than it is in the US and as a result it's incredibly profitable and there are some great opportunities for debt investors to achieve excess returns. I actually started out as a debt investor on Harmoney's platform but really became impressed with the management team. They're great operators, they've had two exits over the past decade with other consumer lenders that they've built in the region, one in New Zealand and one in Australia so I think this is a company worth watching. At the moment to my knowledge they are New Zealand's only peer to peer lender. I know they originate in Australia as well now which has some competition, but in New Zealand they're the only game in town.

Peter: I think there are others that have registered with the regulatory authorities there, but I don't know if they're actually operating yet. So they really are the only game in town and that's one of the things…just to point out, obviously I'm from Australia and I know the Australian system very well and New Zealand has a very similar market.

It's crazy because you could have an 820 FICO equivalent, obviously there's no FICO scores in Australia, but you could have a equivalent 820 FICO, a $200,000 a year income and you go to a bank to get a loan…they're going to charge you 10%. If you went to Lending Club or Prosper it would be several percentage points lower than that so it is an outsized return I think there. They would be happy to pay because banks have traditionally never...even if the interest rates are at zero or close...they're not at zero in Australia, but they're pretty low and banks continue to lend at double digits averaging well into the teens. As you said, there's a lot of profit to be made there.

Jon: It's a very profitable sector and what's interesting is that the peer to peer or marketplace lending concept is also very new in New Zealand/Australia and as I'm getting to know the platforms in that region of the world you know, it feels very much like the US peer to peer industry five or six years ago in terms of its development so I see just tremendous growth from there.

Peter: Let's just move on, I know you've got another investment that just announced very recently with Marketlend. Just tell us a little bit about that. They're based in Australia, tell us a little bit about them.

Jon: Sure, so Marketlend has one of the most unique debt products that I have ever seen in marketplace lending. They provide factoring lines of credit with yields in the teens that are secured by receivables of Australian SMEs, but they've lined up one of the largest Australian insurance companies to guarantee principal repayment on these credit lines. I like to call this product "secured and insured" and this is exactly where I want to be at this point in the macroeconomic cycle. We have a first lien position secured by receivables, but the most unique aspect of this platform is the insurance guarantee. I am not at liberty to disclose the name of the insurer, but it's a very well known and well-regarded insurance company in Australia.

The other thing that I really liked about Marketlend was the sophistication of their capital markets program. Leo Tyndall, the Founder is a former securitization lawyer and investment banker and he is very capital markets savvy. He has created an investment structure that mimics an institutional quality securitization even for the retail investors and it's one of the best structures I've seen with really great protections for investors. This is in my opinion, just a fantastic risk adjusted return for debt investors.

Peter: Right, right. So that sounds fantastic, I'll have to check them out for myself because I can invest in Australian platforms being a citizen there and I have a bank account still in Australia that I've maintained for many, many decades.

Jon: They'd love to have you on the platform.

Peter: So then what about other platforms, not necessarily that you haven't invested in yet. I mean, who do you like in…let's just go back to the US industry, who do you like in the US industry that you're looking at now that might be an up and coming platform?

Jon: So rather than name specific platforms, obviously I've already talked about Money360. Maybe I can talk about some larger themes that I'm really excited about in the US. You know, within the US I think that we will see marketplace lenders achieve substantial scale in some very large lending sectors outside of the consumer unsecured market. I think non-qualified residential mortgages are a very large opportunity, I think auto loans are a very large opportunity and marketplace lenders in these sectors are only now in their infancy. So beyond those sectors I'm also doing a lot of investing personally in what I call "picks and shovels plays" so key suppliers of data, analytics and technology to the industry who stand to benefit from tremendous volume growth over the next decade. Some of the investments I've made around this theme are companies like VeriComply, Cloud Lending and eOriginal...

Peter: Okay, that's interesting because it's like the gold mines of the 1840's and 50's, Many of them made money, many of them didn't.

Jon: The suppliers made lots of money. If you were selling Levi jeans in the 1850's you did very well.

Peter: Yes indeed. I want to ask you a question because this is something that…there's many platforms out there right now that are really struggling to find the debt capital that they would like and they would love to have someone like you on board. What is your advice to platforms today who are looking to raise new debt capital, what do they need?

Jon: Well I'm glad you brought this topic up because I think this is one of the…it's probably the number one area where platforms fall short, in my opinion.

First and foremost, I'll state the obvious by saying that you need to have a compelling risk adjusted return to offer your investors and then you need to go build a track record, a great track record of returns around that product. Without this, nothing else really matters and yet it's interesting when you look at the investment management business, the business I grew up in, you see managers that actually have great performance, but still can't raise money because they're not perceived to be quote "institutional".

When I was younger, my father gave me some very wise advice, he said...be the kind of person that you want to marry (laughs). I think the best advice I can give the platforms is very similar. If you want to raise institutional capital then you need to be an institution and this applies to really every facet of your business. If you want to raise large amounts of debt capital, you have to have a top quality management team, especially in your credit and capital markets teams. You have to have top quality service providers such as auditors, lawyers, custodians. Your investment program needs to have very strong legal structures with good protections for investors and this applies to both whole loan sale programs and to platform funds.

As the Lending Club situation taught us, you need to have great internal controls, compliance and back office systems to protect investors against what I call non-investment risks, things like fraud, things like regulatory risk, back office risk effectively. Overall, platforms really need to treat investors as if they were a customer, just as much as they do borrowers and really act as fiduciaries for investors capital.

At Eaglewood we worked very hard to implement these principles and build a top quality institutional asset manager and I believe that partially explains our success.

Peter: Right, right, so then you've looked at lots of platforms, where do you see...what are the themes where the platforms are falling short today, what do they really need to work on? I know you mentioned some of the things there, what are some of the specifics that you see as a commonality where they're re not performing well?

Jon: So that's a great question. Let me zero in just on capital markets. I think there are a number of topics I can discuss and answer your question, but let me focus on the capital markets division within these platforms. I think the platforms have generally done a very good job of creating a frictionless, seamless experience for borrowers, but they now need to do the same thing for investors and there's a lot of room for innovation here. You know, we've all heard the phrase barriers to entry. I have a phrase I've developed which I call "barriers to investment", in other words, the key obstacles that prevent investors from investing in marketplace lending and I can talk through a few of these.

On the legal side, almost every institutional investor in this sector is spending way too much money. Investors really want marketplace lenders to adopt high quality standards for their purchase and servicing agreements and then formalize or standardize those standards for everyone to lower cost and increase transaction speed.

Operationally, investing in thousands of small loans is a very back office intensive business and investors want to receive accurate reporting on time, every month in a very seamless manner. After the loans are originated, they're sold, they're warehoused, they're securitized and at every step multiple data points on every loan need to be verified, audited and custodied and all this can be automated. I also think the due diligence processes can be standardized to create a frictionless due diligence experience for the investors.

On tax, there are large amounts of capital offshore from offshore investors who want to buy marketplace loans in the United States, but they need them to be seasoned and most marketplace lenders don't have a large enough balance sheet to season them. Also on tax, if you look at onshore investors, they would like to find a way to defer or reduce taxes on assets that otherwise produce ordinary income. So you know, I think there are actually solutions in the works for some of these problems, but to the extent that the platforms can solve them, they can tap into large new pools of capital that otherwise aren't available.

And lastly, I know a lot of people in the industry have talked about this, but one of the biggest challenges in raising capital in this sector is the lack of liquidity and I think there have been some great innovations over the past year in this regard, you have Funding Circle that's created their publicly traded trust effectively giving investors daily liquidity. You have SoFi that has created their own internally managed funds to buy their own loans and even loans of other investors. So I think they are the early leaders in this regard, but there's a lot of room for innovation here and I think as platforms learn to transform what are otherwise illiquid assets into liquid assets they will raise a lot of more money.

Peter: Right, so are you generally bullish about the future of marketplace lending? Obviously, there's multiple different asset classes and some will come into favor and go out of favor, but are you generally bullish about the future?

Jon: Well, right now we obviously have a crisis of confidence and this applies to both equity and debt investors in the sector. They've all pulled back, we have regulators getting a lot more involved and there's no way to hide the fact that some of these events have been very negative for the industry short term.

But I do think there is a silver lining in all of this, which is that it will force the industry to institutionalize. Investors are not simply handing over money to platforms any longer without requiring them the meet higher standards of risk management, governance, internal controls, etc. This will actually make the industry stronger than it was before the scandal and eventually I think confidence and capital will come back in even greater numbers. And you take a step back from the current situation and look at the long term fundamentals. They're still quite fantastic, possibly even more so than they were a year ago or two years ago.

You have banks that remain highly regulated and highly inefficient at origination and servicing loans, especially small loans. Yields on government bonds around the world are at records lows and in fact have turned negative in Europe and Japan. I think that will ultimately force investors in those regions of the world to seek alternative sources of yield. You have record numbers of baby boomers that are set to retire in the coming years and they will need to reallocate their portfolios out of equities and into credit-oriented investments.

And, lastly, I'll point out that most institutional investors that I speak with currently have no allocation to marketplace lending and yet there's a lot of institutional investors with no current allocation doing due diligence, spending time...some of those may go to Lending Club and Prosper, but I think you'll see a lot of them invest elsewhere. So all this leaves me actually very bullish on the long-term outlook.

Peter: That's great, so I've got to let you go but one last question. You know, you are one of the pioneers, you're one of the most experienced guys in this industry, you've been an advisor, an angel investor it looks like for the last year or so…are we going to see you back full time in the industry sometime soon?

Jon: (laughs) Great question, so when I left Eaglewood my original plan was to take six months off before getting back involved in this sector and that lasted about two months (laughs). The activity in marketplace lending and even fintech more broadly is just so exciting, it's been impossible for me to stay on the sidelines.

Since I left Eaglewood I've invested in about a dozen fintech companies including three rounds that I led, mostly early stage rounds. I've also joined six board of directors or advisory boards and done some consulting work for some platforms and investors for one off projects. So I'm actually as busy as I've ever been. I really love what I'm doing right now especially working closely with other founders and CEOs and helping them grow their businesses, but I have been incubating some new business models. I love what I'm doing now, but at some point I may launch a new venture when the timing is right.

Peter: Okay, well we'll have to hear about that if and when that happens. Okay, on that note I'll have to let you go. I really appreciate your time today, Jon.

Jon: Thanks for yours as well, Peter. Take care.

Peter: With all the negative news we have had over the last couple of months it's easy to forget some of the things that Jon mentioned there, the tailwinds that are in our favor; the fact that all these retirees need yield, the fact that there are still many investors that aren't here and many of the other things. I think as long as we get our house in order, as long as we keep managing risk well and we make sure our internal controls are bank quality, that we don't have any more missteps like what happened at Lending Club, if we get our house in order...I think we're going to have a few rough months here there's no question. 2016 will go down as a tough year, but we get our house in order, I think 2017 and beyond is still looking very, very good for the industry.

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

(closing music)