LEND ACADEMY

Podcast Transcription Session 26: Brendan Ross

Peter Renton: Welcome the Lend Academy Podcast, session number 26. This is your host, Peter Renton, founder of Lend Academy.

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Peter: Today on the show, I am delighted to welcome Brendan Ross. Brendan is the President of Direct Lending Investments and they run a small business loan fund investing in high yield, short-term, small business loans. Full disclosure, I am an investor in his fund. I have been so for about 18 months now.

I've actually known Brendan for quite some time. I profiled him on Lend Academy back in 2012 where he was one of the first registered investment advisors back then to really take an interest in the space. As he mentions in the podcast, he was one of the first investors in Lending Club's broad-based fund through LC Advisors. So he's been following the space really for almost as long as I have. I wanted to get him on the show just to talk about his fund, where he sees the industry going and really how the opportunity of small business loans is really such a great place for investors to put their money. I hope you enjoy the show.

Peter: Welcome to the podcast, Brendan.

Brendan Ross: Oh, thanks for having me, Peter.

Peter: Let's get started just with giving people a bit of background about what you've done in your career and how you ended up running a fund.

Brendan: Sure, I graduated Brown in '95 and became a management consultant after that. I found my way through e-commerce product management to being a turnaround CEO so I run three companies. As turnaround CEO, I had to let a lot of employees go. I kind of wanted to retire from firing people for a living (laughs) exactly and switch to something that had a more positive karmic balance (laughs). I found my way to investing first for myself and, of course, I found my way to Lending Club and Prosper some years after you did. I found my way in 2011 to the Lending Club broad-based fund and actually was one of the first institutional investors there, as you know. That was really probably when we first met.

I love market place lending, I love the idea that there was this transparency, that duration was short and you could see what was going on in your portfolio and I wanted to have more underwriter diversification. I thought to myself, put my futurist hat on...I thought to myself, what would be next year and I figured sub-prime auto loans, private mortgages, small business loans, elective medical, real estate. We've actually seen a lot of it come to pass. I focused on small business lending because the bank decline in small business lending has been so dramatic and I felt that that would give a lot of support for high yields and for the types of volume growth that would be necessary if I was going to convince existing small business lenders to sell me loans.

Peter: Okay, so then when you started...I mean, we chatted before you even started and you mentioned that you had something coming...this is new, this is really....you were really the first one to sort of put all of these together, what was it like putting it together? There was really no major brand that you could just hook into, you've really had to go and.....you said you did Google searches and you found out like dozens of these potential platforms?

Brendan: Yeah, I started by typing "small business loans" into Google (laughs) and really just learning the ecosystem phone call by phone call. What I found were brokers, I found lenders, I found just a variety of people that were figuring out how to plug the holes that the banks had left.

What's interesting about small business loans is that the yields are significantly higher than consumer loans. So the challenge is in convincing the platforms to sell me the loans. If you look at consumer loans, what you can see is that the internal rate of return that a venture capitalist would expect from investing in Lending Club or Prosper is pretty high. That would probably be in the low to mid 20's whereas what you can earn on the loans is lower than that and so as a result it's very natural for the venture capitalist to want to own the platform, but not own the loans. That's why we see this very clear cut model and what we've seen in small business lending is really not that all. Many of the companies that make these loans have chosen to keep them all on balance sheet and run as what we would call FINCOs so companies that do their own balance sheet and have complicated arrangements with Goldman and others that provide them with credit facilities and head towards securitization. Really, OnDeck is a company like that.

What I did was focus my energy on some of the smaller players that were maybe making $5 to $50 million in loans a month and on convincing them that their next dollar of loans should be sold to me. The reason is because let's say you're a small business lender and you have a $40 Million loan book so you've got $10 million in equity. This is the value of your company and you're borrowing $30 million and you're loaning $40 million. Now, if you want to loan $80 million, well, you have to go raise another $10 million, you have to grow your balance sheet. Whereas, if you sell $40 million worth of loans to me then you've actually made more loans which means your company is more valuable, but you haven't had to raise more money to do it. That is the argument that I'm making. It feels so natural when you're working with Lending Club and Prosper to imagine that the whole world understands why these platforms would not want to own the loans, but for small business lenders I've really hard to work to proselytize that message, the market place lending message, and that's been very satisfying.

Peter: Right, that's great. So when did you start your fund? When did it launch?

Brendan: I began doing more serious research and trying to get a deal done initially with IOU Central and Vista Credit in April 2012. The fund actually launched in November with a relationship with IOU Central and I've since added relationships with QuarterSpot, with Biz2Credit and with Dealstruck and finally, as you noted, with Realty Mogul, with the TechCrunch announcement.

Peter: Sure, sure, we'll get to that in a little bit. How many assets...what you managing right now?

Brendan: Right now, there's $73 Million in assets in the fund itself and there's a waiting list. I tend to run the fund with a waiting list. There's a waiting list of about $20 Million. I think we'll finish the year at just over $100 Million so that's pretty exciting….. celebrating our two-year anniversary in seven days. Shortly after that, we'll cross the nine digit mark.

Peter: Excellent, well, congratulations, that's great. So let's just talk about the small businesses for a second. Give me a profile of actual borrowers that are going to these platforms like IOU Central, Dealstruck, Biz2Credit. Who are these companies?

Brendan: The decline in bank lending to small businesses have been so marked that really the companies that have been left without places to borrow money are really all the companies that you see when you walk down Main Street. If you look, what you'll see is about 25% of the portfolio is retail stores, about 20% is medical, 15% is restaurants. We have doctors and dentists who are borrowing money from us at fairly high rates. It's just not possible to get bank loans today, one of the odd things about our current environment. The borrowers themselves, the business owner who will also be the personal guarantor of the loan, will have an average age of 51 years old, they'll have a personal credit score of about 680, very similar to Lending Club and Prosper loans, sort of in that B grade. They will have been in business an average of 12 years so definitely not start-ups. We want businesses that, generally speaking, have weathered multiple business cycles, we want committed business centers who have kept good personal credit through multiple business cycles. Businesses will be between $500,000 and about $20 Million in revenue. So it's a pretty broad range and that reflects the relatively broad range of interest rates which the platforms will lend from something like 15% to something like 35 or 40%.

Peter: Okay, so some of these loans are pretty high interest rates, what are you finding when it comes to defaults? It's now almost two years, you've obviously had a few defaults. Have they met your expectations, exceeded or what?

Brendan: Yeah, let me address that question in two parts.

The first thing to understand is my typical loan will be a one year loan and the borrower will make 248 payments to pay off that loan. That will be a payment every single business day. So instead of 60 payments on a 5-year loan, it's 248 in a one year loan. As a result, because the loan is amortizing, that means that just like a Lending Club or Prosper loan, the loan goes down to zero at the end of the loan. The result of that is that the borrower.....let's take an example, let's take a dentist that borrows $100,000 to fix some things up in the office and they borrow at let's say an example rate of 30% interest rate. What they would actually pay in interest over that one year period is about $15,000.

Peter: Right.

Brendan: So, in other words, they're not borrowing $100,000 and paying $130,000 on the last day, the principal going down. For the borrower, the effect of the loan is that it feels like a 15% loan. While the interest rate can seem high, it's really very doable for a small business center, most of whose cost is they're on salary so they'll make a sacrifice in exchange for buying a piece of equipment. New equipment will be our most popular purchase, buying a new piece of equipment and in a year they'll have paid for it and then they'll be making the money on it. So that gives you a sense of that.

In terms of the default rates, the default rates are similar to consumer loans. In my portfolio, they've run at about 6% on their annualized basis, trending down a little bit and that has mostly to do with just a mix of credits I have and the work I'm doing with partners to help them grow and improve. But, generally speaking, around one out of every 200 loans will go bad every month. So the portfolio now has about 2,500 loans in it. My expectation would be in a given month that about 12 would go bad.

Peter: Okay, okay, so is this like a daily repayment thing....is this a requirement that you have of the platforms that you work with? Are all the platforms providing that for their borrowers?

Brendan: No, it just happens to be that most of the loans are daily pay. We also have weekly pay, we have bi-weekly pay, we even have a few monthlies, but, generally speaking, daily and weekly best matched with what a borrower....they best help the borrower match their cash flow with the expectation for what's going to sort of disappear from their bank account each day.

Peter: Right, okay. What about selecting the loans, are you doing that personally? Do you have credit people on staff to sort of run models for you? How does that process happen?

Brendan: Yeah, this is an area that's very interesting and very different. If you look at how Lending Club has evolved including how they've done some of their newer products, you know, they've really moved in some ways to a bit more of a round robin-type approach where loans are actually assigned and as long as they meet the criteria, if you're participating, then you would buy those loans. That is, I think, going to be the model more and more because the idea is that the platforms are rating the loans and that what the buyers are buying is something that is meant to be the same.

Now, of course, that has not always been the case and there are arguments back and forth about how much alpha remains on the platforms and by alpha I mean an ability to choose C-loans that will be performing like B-loans versus C-loans that will perform like D-loans. What I've done though is I've tried to sidestep the issue of........I've tried to create ways to eliminate adverse selection structurally. What I mean by that is if you look at IOU Central and you look at the loans that they sell me, they'll make all the loans themselves and then under my contract, they'll sell me a fraction of those loans directly from their balance sheet and the loans that they don't sell, they keep to term.

In other words, when they make a loan, they don't know whether they are going to keep it or sell it to me. In other cases, I have participations. In other cases, I have deals where service fees may change depending on default rates. I call these things structural trust mechanisms so I'm always looking for ways to avoid having to outsmart my business partners and instead, bake the trust into the contract structure.

Peter: Okay, that makes sense, that makes sense. I know that is a way that a lot of ....both Lending Club and Prosper like that idea of really allocating loans and having the investors take everything that's given to them basically. You are doing whole loans only then?

Brendan: Except in rare cases where I have a platform that is focused on participations, sometimes the trust mechanism might be I own half the loan and they own half or I own three quarters of it and they own a quarter of it. Even when I am buying those, the participation is a different kind of a legal transaction than buying a slice of a loan that's coming through an SPV.

Peter: Okay, so then what about the structure. Just talk a little bit about the structure of your fund. Are you a 3C1 fund? How is it structured?

Brendan: Yeah exactly, so we're SEC-registered and ultimately, while we're currently a limited partnership, we may outgrow that and move towards some kind of an SEC-registered structure. That's possibly out on the horizon for us and I think we'll see that with other funds. Certainly, Barlow did that in Europe with the fund that he created, they created a public structure. Right now, it's a limited partnership and the investors all to the extent that they come in, it’s accredited only, they end up as limited partners which means they own an undifferentiated slice of the underlying pool, same as my parents and friends and my own position.

Peter: Right, sure, sure, okay. So then let's talk about the investors then. Are you going after individual people, are you going after... institutional investors, who comes on board your LP?

Brendan: We're following the prototypical path for a limited partnership which is that initially our investors were high net worth individuals and then once we cross the $50 million mark it became possible to woo register investment advisors. So independent advisors who are trying to figure out how to participate in alternative investments. For them, I think the fund is one of the most attractive types of alternate investments there could be because it replaces fixed income which is where everyone is hurting right now, the duration is short and there's no lock-up so it works for RIAs as a way for them to toe-dip into different alternatives.

As a result, we have a handful of RIA partnerships and those have been going well so that sort of steadily bring business in and now that we're getting bigger, it's time for us to begin to have conversations with what you might consider to be true institutional investors like insurance companies and others whose bite size is more in the $10 to 25 million range. Our biggest investor right now is a fund to fund that has committed $10 million and below that we would have another fund to fund at $6 million and them some individual investors that range from $6 million on down. That gives you kind of sense of how a fund evolves. I don't think we have done anything particularly atypical on that in that respect.

Peter: Right, okay, so what returns are you providing to investors and how have they been tracking.....I mean, you've now got almost two years of track record. Can you share some numbers with us?

Brendan: Yeah, it's been very consistent. Our audited returns last year net to investors in the current fee structure was 12.4%. This year, we're trending probably to closer to 11.7%. The gap there is just related to some growing pains. We end up with a little bit of cash drag. Cash drag is what happens if you have cash in the fund that you're not able to deploy in investments. You're not taking any risk with it, it's just that it has a natural tendency to reduce the fund's returns and we don't have a wad of it, but we have a little more last year than we had two years ago.

Peter: Right, I mentioned you have a $10 million investor coming on board, I mean, how quickly can you deploy.....the question is you said you've got a waiting list, what amounts per month are you deploying these days?

Brendan: Deploying in the last two months was about $10 million per month and I don't ever bring in money that I can't deploy. The point of the waiting list is investors will experience a little frustration because, of course, they want to invest starting November 1st. Right now, if an investor asked to come aboard, they would end up in December and soon will be into January, but the advantage is that once they're in the fund, they'll know that I don't take in cash if I can't spend it on loans.

Peter: Right.

Brendan: So just as an important part of the trust relationship that exists between the investor and the manager.

Peter: How are you getting the word out about your fund? I know you've come to the LendIt Conference and you've done a lot of speaking, how else are you getting your name out there?

Brendan: Yeah, sure, I would say it's mostly speaking and there's definitely an element of PR. I have had a lot of .....people do not want to call it luck. By being an early entrant, I managed to end up being a popular source of comments for folks in the press and because everything that we're doing is interesting in it's whole space. It's so interesting and it's so relevant today in this low yield environment. It's just been natural for there to be a lot of press.

So I would say, at this point we're two years into the fund, it's probably a third word of mouth, a third PR and a third conferences. You know, you mentioned conferences, what's interesting is for every conference that I go to to meet investors, I go to three conferences to meet with lending platforms. When you have a waiting list, the burden is actually on the manager to identify intelligent places to deploy capital and I've spent more time thinking about how I'm going to deploy capital than I do about where I'm going to find my next investor.

Peter: Interesting, interesting. Have you been chatting with Lending Club? They've been offering small business loans now for a while. It's a bit long a duration than what you typically do, but are they on your list?

Brendan: Of course, Lending Club would be on anyone's list. If they did what I am doing I wouldn't want to ...you know, I wouldn't want to get sort into that. I am typically under NDA about the platform and...........

Peter: Right.

Brendan: And because there's so many folks that have been sort of fast followers with respect to deals I've done, I also tend to kind of to keep my new deals very close to my chest until I've executed on them.

Peter: Right. Okay speaking of new deals, let's talk about the Realty Mogul deal which was recently announced. It seems like a bit of a departure because you're....obviously, they're a real estate platform. You focus on small business loans, so what's your thinking with adding Realty Mogul into your platform list?

Brendan: Sure, so I've known Jilliene Helman, the CEO of Realty Mogul, for some time and I have a lot of respect for her intelligence and for her commitment to building a big company. And, also, I think it's fantastic that she has Canaan Ventures and others as her partners, of course, Canaan being one of the original Lending Club investors. What I wanted to do with my deal with Realty Mogul is I wanted to find a way to find loans that would fit my buy box and my buy box are short duration small business loans. Residential rehab loans actually are really almost a perfect example of the type of loans I like to make. These are one year loans made to businesses, not hobbyists, but businesses that are doing residential rehab and there's actually collateral in the form of the asset, the house that they're repairing and in all respect, these are business loans. They seem a little bit different, but I think it's a sleeve in the fund. I think they're really appropriate and I think they'll be nice to get...some of that real estate risk exposure here as well because it's an attractive place to lend.

Peter: Sure, these are secured by assets too, these loans. They are slightly different. I imagine most of your other loans are not ....I mean, you get personal guarantees, but they're not secured by assets, right?

Brendan: You know, we always have a UCC1 filing for all loans over $25,000, however, as you've identified these are generally service business or even if they're not service businesses, they don't have a piece of heavy equipment that you're not going to go repossess. I mean, the reason why I'm doing works is because the United States over the last 50 years has had a transition in small businesses from manufacturing to service and the banking sector is not an appropriate place to make loans to undercollateralized service businesses because banks are so heavily levered by the Fed. So a lot of folks look at this and will say, boy, the banks are foolishly missing a great opportunity, but it's also possible to think of this from the perspective of the bank should our banking system consist of banks that makes loans to undercollateralized service businesses. In fact, it may make more sense for a bank to loan money to me potentially providing leverage to the fund and participate in that way in small business lending rather than actually lending the money themselves. So it's not necessary to view the bank as foolish lumbering giants in order to understand why they shouldn't own these and I think that gives great comfort to investors.

Peter: Sure, let's just talk about downside for a second. I'm sure you get this from most investors that come on board. I mean, what do you tell people when they say, okay, we got another financial crisis like we had in 08/09, what are your expectations for returns to investors if that happens again?

Brendan: Sure, so this is perhaps the most important question that an investor could ask and we need to understand...and I think Lending Club and Prosper lenders have gotten comfort with that in a few ways,

The first of which is Lending Club's returns through the downturn which are actually decent.

The second is by looking at that famous graph that we've seen and I publish research on it as well that shows that gap between the rates charged by credit cards and the charge off rate so you can actually see that credit card loans were never underwater, even during the great recession in aggregate. My default rate is about 6% right now, as I said it's trending down, but let's call it 6. Because of the gross returns in the fund, I could have a default rate of about 21.8% and still break even for investors. So I would have to have defaults go up by about 3 to 3.5 times what they are today and that completely flies in the face of what we have seen in other asset classes during the recession.

If you look at adjacent asset classes like credit cards, default rates went from 4% to maybe something like 10% and in business loans under $2.5 million which is a place where I've gotten good data from PayNet which is a great consultant in the space, you see default rates going up from 2.5% to maybe 6%.

So if you look around, what you do not see is default rates going up that much and I think that makes sense. I mean, the idea that one out of every four businesses or one of every five business that sits on Main Street...that's brick and mortar business that I'm lending money to is going to be gone during a one year period. You know, I think most people intuitively would recognize that that wouldn't happen. In mean, the fact is that when you're lending money at....when borrowers are overpaying for credit and you get both high current yield and strong downside protection.

Peter: Right, and so with that point how do you feel .....so you feel like the loans that you're investing in...these interest rates that potentially....like you said, are these businesses overpaying on these loans? Do you think they really deserve a lower rate, but that's just the reality of.... the economics of the situation is they don't.......do you think these small businesses should be paying less?

Brendan: Well, when you loan money, I mean, there aren't that many factors to consider from a macro perspective, right? There's the duration of the loan which will translate into interest rate risk and then there's the credit risk which translates into a default rate. So if you look at the duration of these loans and you look at the default rate, what you do not come up with is the conclusion that these borrowers should be paying the rates they're paying. They're definitely overpaying for credit in the simplest sense of the word which is that the risk adjusted return here is just very high.

Peter: Right.

Brendan: There's not room for $10 billion in the strategy, but I could build a billion dollar fund here and I'll do it with borrowers that are paying more than their....I mean, if these businesses were 10 or 20 times as big doing the exact same thing, you know, they just would pay a lot less. That may not even be a great way of communicating it, you can sense it. I mean, these are great credits so my feeling is that they're just sort of alpha. There's excess yield in the entire space just as there is, I think, to a similar, but slightly lesser extent in consumer loans, but still there's no question that it's there.

Peter: Right, right.

Brendan: I do think the borrowers overpay and I think that they'll continue to because the banks are not coming back into the space.

Peter: So do you foresee though when this, you know, marketplace lending gets a lot more competitive, there's a lot more platforms out there, do you think the rates are going to come down as people are really trying harder to win customers?

Brendan: This is a very interesting question. We started with defaults and now we came here. This is sort of...the second most interesting question...is this sustainable? Then it's absolutely what people should focus on. Again, I'm sort of trying to describe a graph that folks have seen. This is a graph that Renaud has led many presentations off with, which is a graph that shows the federal funds rate since the 80's declining so the rate at which banks borrow has gone down from over 10% to around zero over the course of the last couple of decades. If you look at the rate that these banks have charged first on personal loans, then on credit card loans it just hasn't declined by much. In essence, what you're seeing when you look at this graph is you're seeing a market, a credit market for small loans becoming increasingly inefficient over time. Does that make sense that it's actually.....in other words, the savings from the banks borrowing at cheaper rates have not been passed on to the consumers in any way shape or form.

Peter: Right, right.

Brendan: They're paying.....so when I talk about people overpaying, and I talk about an inefficient credit market, I mean, that's the picture of it and it's a big market. I mean, consumer lending is $870 billion just in revolving credit card balances. So it's actually not the case that small loans necessarily tend towards efficiency and I think that's what we'll see. You know, borrowers do not have a very easy way that they're extremely constrained for time. They're going to find their way to a loan and they're going to pull a trigger on it. In many cases opportunistically, based on what feels right them, and in many cases they won't necessarily have figured out how to find their way to the cheapest way to borrow.

Peter: Yeah, right, that makes sense, that makes sense. So before I let you go, I want to get your thoughts on a couple of just general questions here. You've been around this industry almost as long as I have and you've seen.....when you first came on to LC Advisers Fund, I mean, you were one of the first, no doubt, doing it in early 2011 and we've come a long way in the last three and a half years. Has the growth of this industry surprised you since that period?

Brendan: It really hasn't, it really has not and, of course, I love this industry and I believed in it so much from the beginning just as you did that I really just can't say that the growth has surprised me. It's not surprising that institutional investors have adopted this because it typically takes institutional investors three to five years to participate in some new form of economic activity and the entire time this industry has always had more people willing to buy loans in it than it has loans that it has been able to find.

What's been extraordinary is to see teams like Renaud and teams like the Vermouths and Ron Suber attacking the space and doing it in such a thoughtful way. I mean, if you talk to these executives what they'll say is that they can find borrowers faster and they can find lenders faster. What they need to do is build organizations efficiently and I'm doing the same thing on my end. I mean, my team is relatively small, there's five of us, and I'm adding staff and I'm very thoughtful about these hires because that's the most important thing that I'm doing. So, I think, what's going to happen in marketplace lending is it will grow as fast as it can create homegrown talent and take talent away from banks.

Peter: Yeah, that makes sense. What do you see as a possible risk or things that can really hold back this growth because the growth doesn't seem to have an end in sight. As you said, the platforms can grow faster if they wanted to. What do you think can hold it back?

Brendan: You know, I would hate to see a big platform and some kind of a financial challenge. I don't there's anything like that on the horizon, but I think that would be something less than ideal. For the most part, this is something that's happening. I mean, this is really a new kind of securitization. It's a securitization in which the lender does not have to create a huge warehouse facility prior to putting the loans into a securitization. Instead, the loan could be sold one by one and the result is that the people who are best capable in this country of figuring out how to use big data to solve problems which is the venture capital community and the CEOs that work for them. That group can now tackle all the different parts of the banking system and to me what's fascinating is to see it spread from consumer loans to service businesses, undercollateralized service businesses and now into real estate.

Real estate had historically been probably thought of banks as a relatively safe place for them to continue to own it. They have low borrowing costs and they are able to make loans against collateral and we have borrowers who are working with Realty Mogul who are paying not much more than they would maybe pay at a bank but because they're getting the loan more quickly, they're interested in overpaying maybe a little bit. Now we have a situation which marketplace lending has spread to collateralized loans and from there it's really just a matter of time until it takes over more and more pockets of credit.

Peter: Right, that's for sure. Okay, last question, what's on tap then for next year, for 2015 for Direct Lending Investments?

Brendan: 2015 is going to be a really exciting year. I expect to roughly double the number of platform partners that I work with. I expect to finish the year at somewhere between $200 Million and $250 Million and really just continue to be an amazing partner to the business partners. What I'd like to see for my firm is I'd like to continue to be a growing recognition that a deal with Direct Lending Investments is something that new small business lenders would really like to have, that venture capitalists would like them to have and that it's really some kind of a proof point for them. So If I can establish myself as the brand that counts as an investor then I can really continue to have a lot of luck being a business partner and acquiring the ability to deploy capital.

Peter: Okay, well on the note, thank you for coming on, Brendan. Best of luck to you and I'll be following your exploits.

Brendan: Thank you.

Peter: Well as an investor I think Brendan sums up my feelings around small business loans pretty well there. Let's face it, small businesses particularly those seeking loans of less than $500,000 have simply been underserved tremendously for a long time now. It is platforms and companies like Brendan that are really providing the funds now for small businesses to get access to capital. Now they may be paying too much for this and I believe over time that is going to come down to some extent. But I think we are always going to see as an investor having a portfolio with small business loans… I think will always be a great place to earn a good yield on your money.

So on that note I will sign off. Thank you very much for listening and I will catch you next time. Bye

[closing music]