PODCAST TRANSCRIPTION SESSION NO. 72: JOSH TONDERYS & KARAN MEHTA

Welcome to the Lend Academy Podcast, Episode No. 72. This is your host, Peter Renton, Founder of Lend Academy.

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Peter Renton: Today on the show, we are going to talk to two leading executives of one of the top consumer lending platforms. I am talking about Marlette Funding and the President of Marlette, Josh Tonderys, the Head of the Capital Markets team, Karan Mehta. They are going to be joining me and talking about their company, we're going to discuss what makes their company different, we're going to talk about securitization. They just completed a very successful securitization. We're talking about their partnership with Cross River Bank, we go into some depth about capital markets and we find out whether or not the slowdown in the capital markets this year has impacted Marlette. Finally, we also cover risk in some detail with talking about the US consumer and where they are today. I hope you enjoy the show!

Welcome to the podcast, Josh and Karan.

Josh Tonderys: Thanks for having us, Peter.

Karan Mehta: Thank you, Peter.

Peter: Okay, so I just want to get started...I like to kind of give the listeners a little bit of background so they can get some context for who they're actually listening to today. So Josh we will start with you, can you just give people some background about yourself and what you did before you came to Marlette?

Josh: Yeah, so I've been here at Marlette for about three months now as President and helping out on a lot of different things including some of the risk and operations and marketing. Before that, I spent my entire career in consumer finance. I most recently was the Chief Operating Officer at Prosper, I was there for about three and a half years and not coincidentally, I spent the majority of my career at a company called Barclaycard which is a place where many of my colleagues here at Marlette have spent some time as well so kind of rejoining with prior colleagues that I spent about a decade with in the 2000's.

Peter: Okay, and Karan, what about you?

Karan: So I've been at Marlette for a year and I head the capital markets effort, so initially that was getting our warehouse lines in place, developing the whole loan buyer platform and then more recently has transitioned into developing securitization capability. Prior to Marlette, I was with Deutsche Bank for 12 years in a securitized products group or rather at a desk in the securitized products group covering consumer and small business industries so did a lot of coverage of this asset class then and Marlette was my client so I actively jumped to the other

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side of the table. Also at Deutsche, I was involved in debt principal, mortgage-backed securities, shelf platform and business development internationally as well.

Peter: Okay, great, well let's just start off with talking a little bit about your business model and who you guys are. I mean not everyone is going to be familiar with the Marlette name so tell us a bit about the business model and where on the credit spectrum you focus.

Josh: Sure, so Marlette Funding, just kind of overview is a tech-enabled finance company. The principles and folks involved here...there are about 110 employees, based in Wilmington, Delaware primarily and this team actually has a ton of experience in consumer finance, really deep, not just on the risk side of the business which is what you‘d see in many of the other pure marketplace businesses, but really throughout all the functional areas of the company, be that credit, compliance; real, real deep, deep understanding of consumer lending, non-secured context.

We are focused with our first product we market under a brand called "Best Egg." The corporate company is called Marlette Funding and under that umbrella there will be future products besides the Best Egg product. The Best Egg product is a personal term loan, a three and five-year installment product, we are lending to a prime audience so we're lending 640 and up. Our customer is a little bit north of what you see on some of the large competitors in terms of credit quality.

We are lending to about a 750 in FICO score, these are consumers that have about $90,000 of individual income, three quarters of them are homeowners, they have a very thick credit file, they're using the proceeds generally, 3/4 of the time, for some type of a debt consolidation or credit card refinance and they're generally a Gen X type customer. So it's similar to some of the other platforms, but we have kind of squarely pointed a little bit north in terms of the credit profile and then I think the expertise that the company kind of lends itself a little bit deeper on the finance side of the line of fin and tech.

Peter: That's good to hear, I think we certainly...that's one of the things that I've been preaching for some time now, that the finance part, we've all realized this year is really the most important part of the business, that's become pretty clear. We profiled you guys on Lend Academy last year and you were almost at a billion dollars...I think at that stage you were the fastest platform to get to a billion dollars and then it seems like late last year growth slowed down. Can you talk about what happened there when you saw the slowdown late last year.

Josh: Yeah, I think last year it was probably at the billion mark that we were talking and now we're $2.3 and growing so we've made a lot of progress both in terms of I think origination volume, but more importantly capabilities since then. I think myself and Karan will talk about some of the capabilities that we've built.

What we saw happening, and this is kind of broadly across the industry was in the second half of the year there were signs of weakening in credit performance in some of the higher risk pockets. This was something that's been talked about kind of across the industry in terms of

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things like stacking and other things where consumers that had a profile that at one point in time looked like it was lendable, but the context changed a little bit. When I look at the performance and results from the Marlette portfolio they were very quick and nimble in terms of addressing in advance of where I think the rest of industry was continuing to grow in the second half of 2015. I think that being a hybrid lender, a balance sheet lender at Marlette and actually, you know, seeing some of the credit trends they were pulling back because they didn't see the likes of the credit performance that they wanted to achieve on the portfolio and so therefore volumes were a little bit slower in the back half of the year when there really wasn't the capital interruption that we've seen in 2016.

It was more of an intentional pull back here, both because of some of the credit performance and then also because of a very, very heightened competitive environment with very expensive cost to acquire consumers. And so because the platform didn't have a need to post additional origination growth per month…the hybrid balance sheet model was generating interest income along with origination fees. They were just more opportunistic and patient with getting to the right credit profile at the right cost and that has played out really well in terms of the market turmoil that's happened this year with significant changes in the capital markets that I'm going to let Karan add more detail on and here we've kind of been steady along with a focus of excellence in credit and making sure that we are forcing discipline in terms of marketing efficiencies.

Peter: Right, so it sounds like the slow down was planned, it was really a marketing type slowdown rather than a capital markets forced slowdown which…that is probably a good thing so we might as well bring Karan in here now and just talk about how…you've had that slowdown, but now we've seen across the industry this capital markets disruption. It seems to have started probably about six months ago I'm guessing, how's that been for Marlette and have you felt impacts like your competitors?

Karan: Yeah, I think that's a great question. I think that generally speaking our market...when I say our market I mean marketplace lending broadly speaking, they follow the lead of the equity and credit markets with some lag and we've seen a risk-off type of phenomena trickle in, call it October of last year and we're now back on risk-on. You can see where the Dow is and definitely the relative value of the space has now started to swing the other way. That's the macro environment.

Marlette in particular was very fortunate that through all this volatility managed to stay extremely stable and one of the things that we can count on is very deep relationships with our institutional investors, many of whom are closely involved with the platform on multiple levels and they stuck by us. They had a lot of transparency and access to management, they could see the credit, they could see the things that we were seeing and they believed in the story and so we didn't feel the disruption that some of the others felt. So both from a capital constraint perspective we weren't capital constrained through this period.

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That doesn't mean to say that we're not looking for new investors. I think it's responsible to be looking for capital at all points in time because you never know when the cycle can turn and so the same sort of dedication that we gave to credit and about making lending decisions we should also apply the same philosophy on the capital markets side.

Peter: Okay, well that's interesting. It's nice to know that not everyone has been impacted negatively in the last six months. So I want to just talk about marketing channels, you mentioned briefly some of the higher risk...the problems of late last year, what are the main marketing channels that you're using today to find customers?

Josh: So the primary channel is direct mail, it's a channel that has proven to be really reliable in terms of credit quality and also very predictable in terms of cost to acquire so that's a channel that we've really I think mastered our ability to target the right audience and get effective CPA's so we probably skew a little bit heavier in that channel than the other more online marketing focused companies. But we are diversified, you know, so we are using a variety of channels, email, digital, SEO display, all the channels we're in, to varying degrees.

We also have I think a somewhat differentiated business in terms of our focus on partnerships here. By partnerships what I don't mean is partnerships with affiliates that are selling lead gens, but actually rather partnering with large brand companies like airlines, like affinity groups where there is a loyalty factor that a consumer already has with that group or brand and we can leverage that loyalty and the channels that loyalty membership space has to get a very effective cost to acquire and present an offer to a consumer in a context where we're not necessarily competing against multiple lenders at the same time. We found that to be a very productive channel, both in this business here at Marlette and also in our prior lives in the credit card business.

Peter: Okay, that sounds good. So I want to switch gears and talk about your second securitization. You did your first one last year, you recently completed...it seems like very recently, it seems like execution was much stronger, can you share your experience with the second securitization and just how it was structured and why it seemed to go well?

Karan: Sure, so this was Marlette's first securitization as a sponsor and also our first rated deal. The deal last year was a private transaction, which was an amortizer, it wasn't broadly distributed to the capital markets. The Citibank CHAI transaction earlier this year was with Citibank and through their CHAI platform as a sponsor so Marlette was supportive but not directly involved.

This deal FT 2016-1 obviously marks a number of firsts for us and is a huge development. It was a team effort, we had to develop a lot of capabilities internally and growing new muscles so to speak. We think that securitization will be the cornerstone of our funding strategy going forward and that is something that we communicated with the broader investor base in this transaction. We had a lot of outreach with investors. I think that our efforts previously at conferences and through the whole loan side were also very useful. We had some crossover

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buyers come in and generally speaking in the current environment where the emphasis on fin and the alignment of interest has become all the more important. The fact that we can visibly demonstrate those points resonated with investors and the transaction went very well as a result.

We had well over a dozen investors, multiple times over subscribed on each class, tightened to the tight end of guidance inside of it and at the time of pricing was probably the tightest marketplace deal this year. So all in all, an excellent experience, something that we'll be looking to replicate in the future. We will be a programmatic issuer. We want people to think of us in the same sort of breadth as a OneMain or an AmEx rather than hold us to a comparable on the marketplace side because we think that builds liquidity in the bond, liquidity in the program and generally presents the company in a very cohesive capital markets (inaudible) manner.

Peter: And can we just talk about Colchis for a little bit? I mean, Colchis have been integral to your company from the get go and we shared that when we profiled you guys last year. So what was Colchis' role in this transaction and could you...the way I understand it is like Colchis completed the securitization by renting your shelf, can you just explain their role?

Karan: Yeah, sure so we've been fortunate to count Colchis and other loan buyers as being strong supporters of the platform from the outset and as a means for them to access the securitization market, Marlette sponsored and facilitated the securitization so I wouldn't quite construe this as a shelf rental, but rather a cohesive strategy. We have developed scale and most importantly we provide the consistency in accessing the ABS market. So we want the ABS market to view this as a Marlette transaction and I think we've been very successful in that respect, but what the strategy has allowed is a demonstration that an exit can…that a viable exit exists for whole loan buyers and our whole loan buyers can come back to the mothership where we undertake all the necessary steps and efforts to do a securitization.

So Marlette was the one doing the heavy lifting here in terms of drafting the documentation, engaging of third parties, running the rating agency process, working with the underwriter, structuring the deal, all the investor outreach, it was entirely Marlette. It was just simply sold back to Marlette and that's really where the relationship ended so it's very much a Marlette banner effort.

Peter: Okay, okay, that's good to know. I want to talk about Cross River Bank. I've had Gilles on the podcast before and I know that you guys have a pretty close relationship with them and it's deeper than what Cross River has with the many other platforms. Can you describe your relationship and do you feel like it gives you certain advantages, having this close relationship with Cross River Bank over other platforms?

Josh: Yeah, I can take that. I would say, you know, CRB...it's been a very strong partnership with CRB along the way and I think they've really distinguished themselves as being a thought leader in the space when it comes to really carefully constructing a lending program partnership with Marlette and some of their other partners that they provide the service to.

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Just a few things that I would highlight as kind of different in terms of how our partnership works versus some of the other bank partnerships that exist in the industry. CRB is obviously the originating bank, but in this case they are retaining an interest in loans that are being originated on the platform. In fact, they're not selling out all the loans to Marlette who would potentially resell those loans in some cases to other investors. They're maintaining an ownership stake on a random portion of the loan production that is being produced on the platform and then selling some to Marlette.

We've talked about Marlette as a hybrid lender, we're also owning loans and keeping them on our balance sheet and then as Karan mentioned, we're also partnering with investors who ultimately are going to be buying whole loans on our platform. The fact that they're not selling 100% of the loans through to Marlette and then ultimately into the marketplace is a differentiator; they have skin in the game. That matters, it definitely matters for questions around true lender and some of the heightened context around some of the other cases that you've discussed in your other forums.

The other distinguishing factor is that they're maintaining an economic interest in all of the loans that they do sell to Marlette and that randomly either Marlette holds or sells to its investors and that economic interest is a payment for really the ongoing activity that they are responsible for when it comes to compliance and testing and monitoring and really staying on top of the program from a servicing oversight and regulator standpoint and I think that's a real differentiator.

I think both of these are places where you can substantively look at how the program is being operated with CRB and say, you know, it does check the box in terms of really having all the right bells and whistles to say they are a true lender. We are operating a program on the marketing and technology side with them, we also have buyers of loans if they don't want to retain all of the loans and so I think that's a different setup than you see at some of the other platforms and I think probably Karan could talk to how maybe investors see that difference.

Karan: Yeah, it's clearly a differentiator and one that both rating agencies and investors have recognized. I'd certainly put that in the top three category for Marlette in terms of our points of differentiation.

Peter: Okay, so I want to talk about the investor side. We talked about Colchis and obviously they've been well covered and probably it's great for you guys to have one of the leaders in the industry as buying loans on your platform, but what are the other types of investors that are coming to Marlette today?

Karan: Right, so we have a broad cross section of investors. That includes banks, dedicated marketplace funds, credit funds/asset managers. They run the gamut of being those who can buy loans on an unlevered basis, those who buy then seek leverage down the line or those who come in and need leverage right away. That gives you some inkling as to how they perceive the

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asset class and the type of returns that they're after so in that respect, I think we have a good mix.

We're always looking for ways to balance that mix or rebalance that mix and continue to have new conversations with new investors as people come in and cycle through the platform, but generally speaking, we've been very happy with the mix of investors and again, we focus on large, deep relationships where the investor can have open access to the platform and to management and would be strong partners with us as opposed to those who will just be on for a short time and then off again. So we try and make this programatic with long term fixed commitments and sticky capital.

Peter: Okay, so on that note I just want to ask you about...you know, we're recording this, it's roughly three months since the Lending Club saga and I'm curious to know...you talked about banks there, you talked about different kinds of investors, did you see an immediate reaction from your investors after that happened and how, If there was, how did you deal with I guess reassuring your investors that everything was going well at Marlette?

Karan: Yeah, I think that it is very interesting that in the wake of the Lending Club events we actually did not have any noticeable fallout. It was ironic, the phone barely rang in fact and I think that was testimony to the fact that people had access to Marlette. We've been audited and diligenced up the wazoo and all our loan buyers have the ability to come in and kick the tires and they regularly do in some detail.

I think that we took that as a positive reinforcement that whatever they had done and whatever we had done was sound. What we did see was that leading up to the securitization there was greater attention to detail, with greater scrutiny by way of underwriting and due diligence just to make sure that everything was properly disclosed and properly represented, but that was something that we were prepared for all along. In fact, I think it turned out to be a positive because people were now, to some extent, look at us as being class leading/the benchmark.

Peter: Okay, okay, that's good to hear. So I'm curious about...you talked earlier about the macro environment and different opportunities for investors to achieve returns, what is your view about the...from the capital markets perspective about this industry...it sounds like for your investors it's still in favor, it's not really a pullback that we've seen in general, doesn't sound like its affected you guys very much so do you feel like it's a platform by platform issue, there's nothing about this asset class that has given investors pause or what's your perspective on that?

Karan: Yeah I think that to a large extent it insulated on each name and each platform. I think that within that you're going to have specific concerns around certain pockets of risk, prime versus sub-prime being the most obvious demarcation, but then broadly, to the extent that there are shocks to the space, I think that it's naive to expect that nobody would be impacted or only one name or two would be impacted. I think that contagion to some extent does spread. If investors don't know Marlette very well then they're apt to paint us with the same brush. So the

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challenge for us is to make sure that our investors do know us well so they're not painting with the same brush.

Peter: Okay, that makes sense. So Josh, I want to switch to you and talk about risk. I think it's something that's very much on the minds of every investor today and there is a bit more caution I think today than there was a year ago and you've been now in this space for some time, what are you seeing when you look at your loan book here. What trends are you seeing as far as delinquencies, are you seeing anything that would cause you concern?

Josh: No, I mean I think what I touched on earlier in terms of some of the shifts that happened to certain pockets of risk in late 2015 and how really most of the story about how things have played out at Marlette have been in terms of moving quickly to address changes in profiles. So if I look at the vintages that have been originated, late 2015 and all through 2016, we've had the best credit quality, you know life to-date on the platform over the last six vintages so we're really seeing very strong early delinquency performance and in general kind of across all of the vintages aligned with expectations and forecasts for defaults and pre-payments and really all the kind of credit metrics that you would size us up to say if this is an asset class that's performing.

We're seeing a lot of stability here and I think that has really translated and helped in terms of the stability of the capital flows on the platform, you know strong credit performance, access to the team, transparency that is difficult to do in a public companies standpoint. We're having one-to-one dialogues with all of our investors and so that level of transparency and I think results have given people confidence in the product that we produce so really strong performance so far.

Peter: If I hear what you're saying, you're saying you're not seeing any signs of a weakening US consumer right now.

Josh: We are not, we're seeing strong credit performance. Of course you have to be nimble and stay mindful, it's a changing environment and borrowers that are performing one way, one day, through one channel may not always perform the same way, but I think that what this platform has built is a really robust framework to stay on top of the credit trends and to be nimble to adjust to credit trends and that has resulted in stability of performance.

Peter: Okay, okay, so then if we go out over the near term, what are your...I know you're not an economist and even economists don't really know what the hell is going on, but when you look at the future, do you feel like...I mean, we've been on this expansion now it feels like for...it's not a very robust expansion, but it's still an expansion that we've been on now for many, many years. When you're looking at like originating customers next month, the month after, is this something that...what are you modeling out when it comes to the macro environment?

Josh: I think we're subscribing to a few different views in terms of what forward looking indicators are going to be predictive of change in performance in this asset class and keep a close eye on that. We subscribe to a particular consumer credit economist who, I think most

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recently actually took his forecast for loan performance to be improving in his forecast over forecast.

I think the US consumer is healthy, the primary kind of leading indicator that we've used and I think holds up in the past four recessions is the finance obligations ratio. If consumers are de-leveraging and have the ability to pay their loans because there are jobs that portends well for a lending environment, I think that we have hit a low in terms of...if you look at some of the credit card trusts and some of the chargeoffs I think those are at all time best performance in terms of credit. You know some additional increase in risk is to be expected as you can't be at your all time low forever. Eventually there's going to be a bottom, eventually there's going to be more risk in the system and so we keep a close eye on it, but we see a relative benign environment at this point.

Peter: Right, okay, we're running out of time, but I wanted to just end...and I'd like to get both of you actually to chime in on this as far as what the next 12 to 18 months holds. I mean, you mentioned Josh, in the beginning you talked about Best Egg as being the first product, does this mean there's future products, is this something that you're looking at over the next 12 months?

Josh: Yeah I mean, I think that our model has allowed us to be a little bit forward thinking where we've seen pull backs on a lot of platforms, we've actually been focusing on how can we introduce some new products to the market where we have some expertise and capabilities and so I think this is kind of a next interview/discussion, but you will see new consumer-based products that Marlette is going to introduce in the next 6 to 12 months. That'll be something that we'll be talking about for sure.

Peter: And Karan, what about you, are we going to see...are you going to become like SoFi and do a securitization, seems like almost every month these days, but are you moving in that direction, what's on your calendar for the next 12 months?

Karan: Yeah, I think that certainly within the next 12 months you will see us back in the securitization markets potentially even more than once. We do view securitization as being a central pillar of our funding strategy and I think that the good execution on this last transaction will probably prompt a move from some our loan buyers to consider accessing the markets sooner than they might have otherwise. And then generally we are looking at more innovative things on the capital markets side potentially packaging loans in different ways and so we're always doing a little bit of R&D in that respect perhaps in the next 12/18 months we'll start seeing things in different forms.

Peter: Okay, well on that note I'm going to have to let you go. I very much appreciate your time, gentlemen.

Josh: Thanks Peter, nice talking with you.

Karan: Thank you.

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Peter: See you.

There's been a lot of pessimism in this industry over the last few months and it's understandable in many ways. The press have contributed to the pessimism as well by really talking about the potential demise of the industry and how we should never have grown so fast or what have you. So it's refreshing to me to talk to a company that's been...you know, been chugging along nicely, they've obviously had their challenges as well, but the problems of the last few months particularly on the capital markets side is what has been plaguing the industry and it's great to hear from a platform that has been seemingly not impacted very much by this. I think there are other stories out there like this and I expect that we're going to see a change in sentiment here in the near future.

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

(closing music)

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