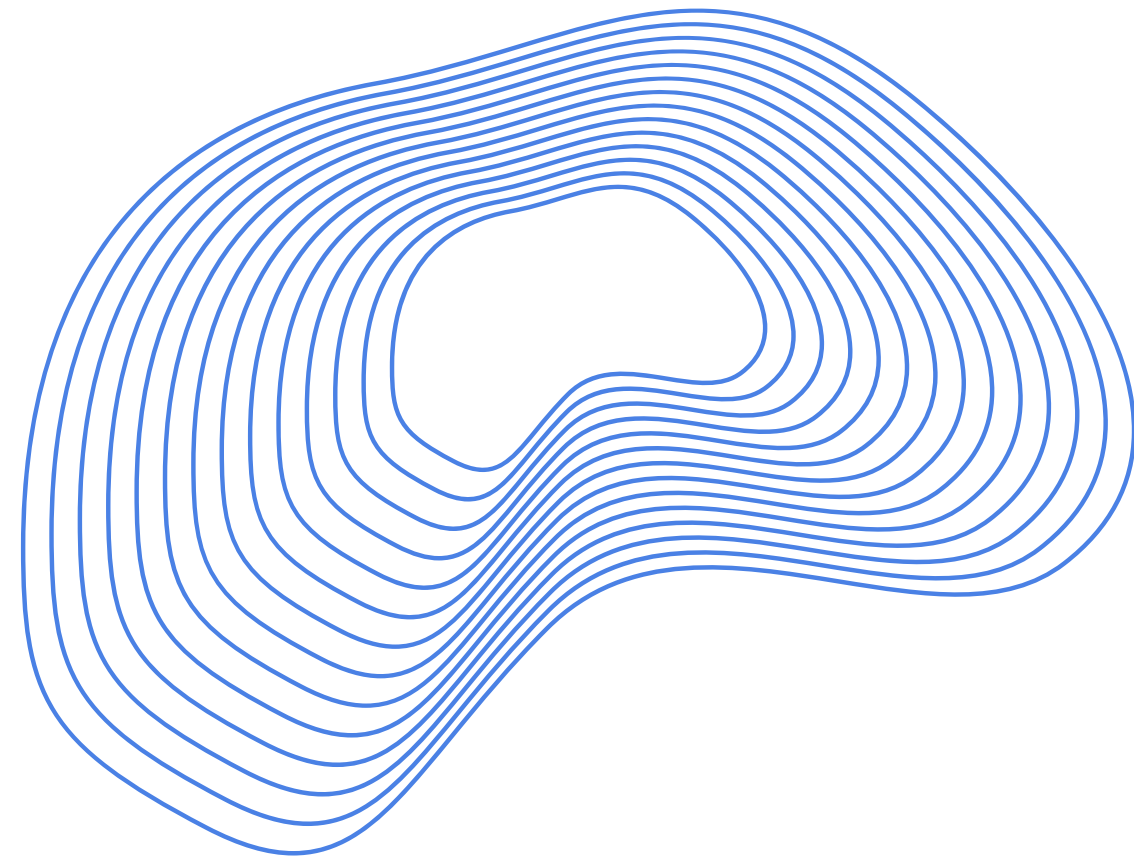


# Alternative Lending Deep Dive

By Van Wickle Ventures

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# What is Alternative Lending?



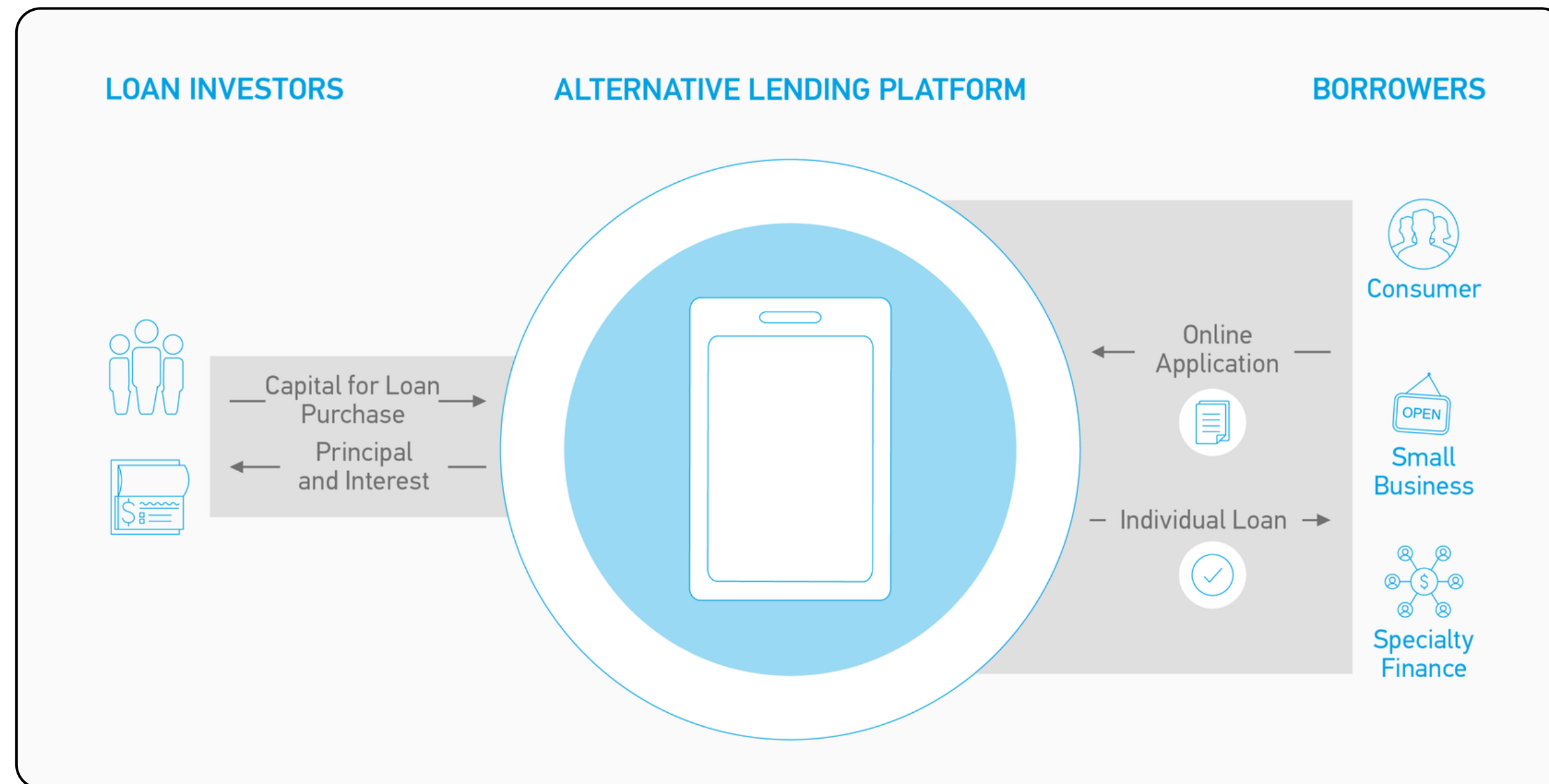
Also referred to as marketplace lending and peer-to-peer lending, alternative lending takes place through online platforms that bring together **borrowers underserved by traditional lending institutions** with **loan investors seeking attractive high-yield investments**.

## How is alternative lending different from a bank?

- **Eligibility requirements.** While bank loans are traditionally difficult to qualify for (strict requirements, extensive application processes, lengthy-time to funding), alternative lending has more flexible requirements (credit score, time in business, annual revenue).
- **Time of funding.** Conventional banks can take multiple weeks, but alternative lending algorithms can underwrite loan applications quickly, scan business financials and sync with accounting files within minutes.
- **Loan products.** Alternative lending includes everything that financial institutions offer (term loans, lines of credit, working capital loans, etc.) as well as invoice factoring and merchant cash advances (MCAs).
- **Support.** Alternative lending solutions are not burdened with costs associated with brick-and-mortar operations — instead, their focus is on streamlined processes completed online.

# How Does Alternative Lending Work?

The overarching goal of alternative lending is to **streamline the traditional lending process** by bringing borrowers and loan investors together and by using **tech-enabled models** to rapidly underwrite borrower credit risk.



## For borrowers

Borrowers seek alternative loans for debt consolidation and to pay down revolving credit card balances. By moving from a revolving structure to an amortizing installment structure, consumer borrowers can benefit from lower interest rates than those for a credit card.

## For loan investors

When borrowers accept loan offers, investors may purchase loans post-issuance by actively selecting loans or by taking passive pro rata allocations of loans.

## For lending partners

Platforms may partner with banks to formally originate loans they underwrite. In these cases, partners conduct oversight on a platform's underwriting models and ensure that they comply with relevant laws.

# History

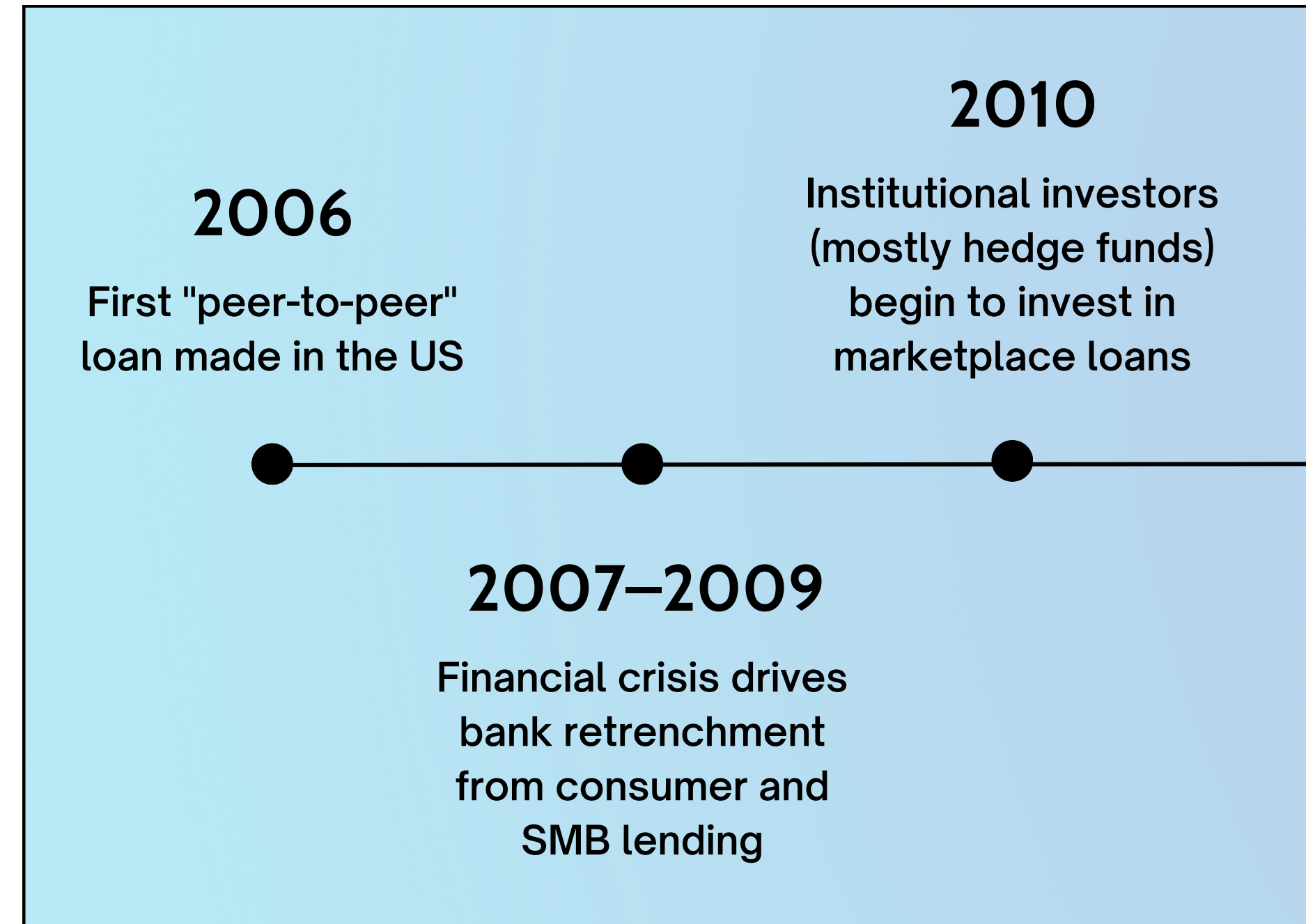
## How it started

Alternative lending grew out of **small-balance, peer-to-peer unsecured consumer loans** financed by individual investors. This filled the gap for SMBs ineligible for loans from traditional financial institutions, which viewed small businesses as risky investments and imposed strict eligibility requirements.

## The 2008 financial crisis

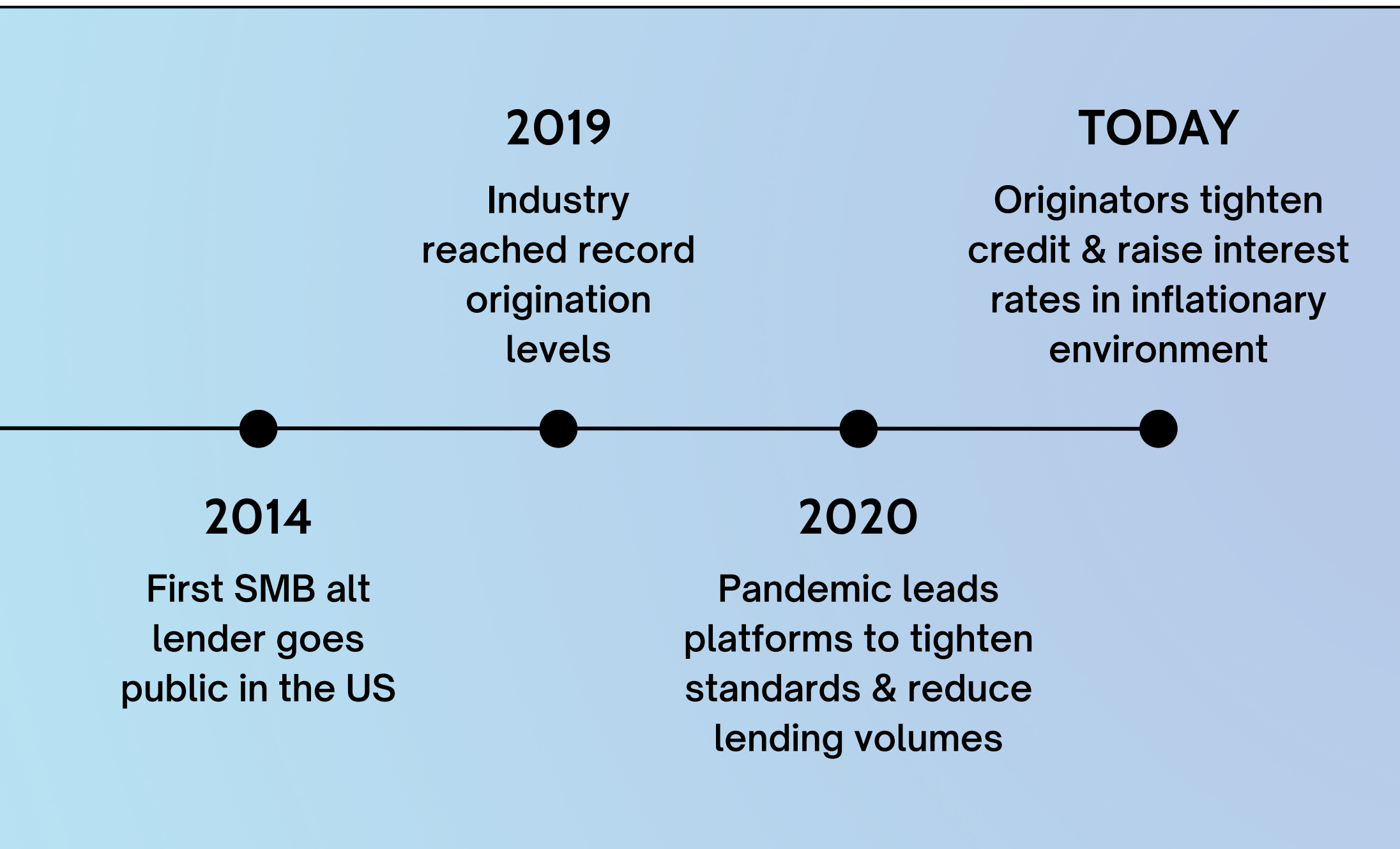
The 2008 recession upended the lending industry, driving banks to pull back from consumer and small-business lending. Business lending amounts saw a dramatic **38% decrease** over the span of 8 years, with the 10 largest banks lending just \$44.7B in 2014 (compared to \$72.5B in 2006). This allowed alternative lenders to tap into a growing market of underserved borrowers who found it increasingly difficult to access traditional sources of capital.

## Timeline





# History (cont.)



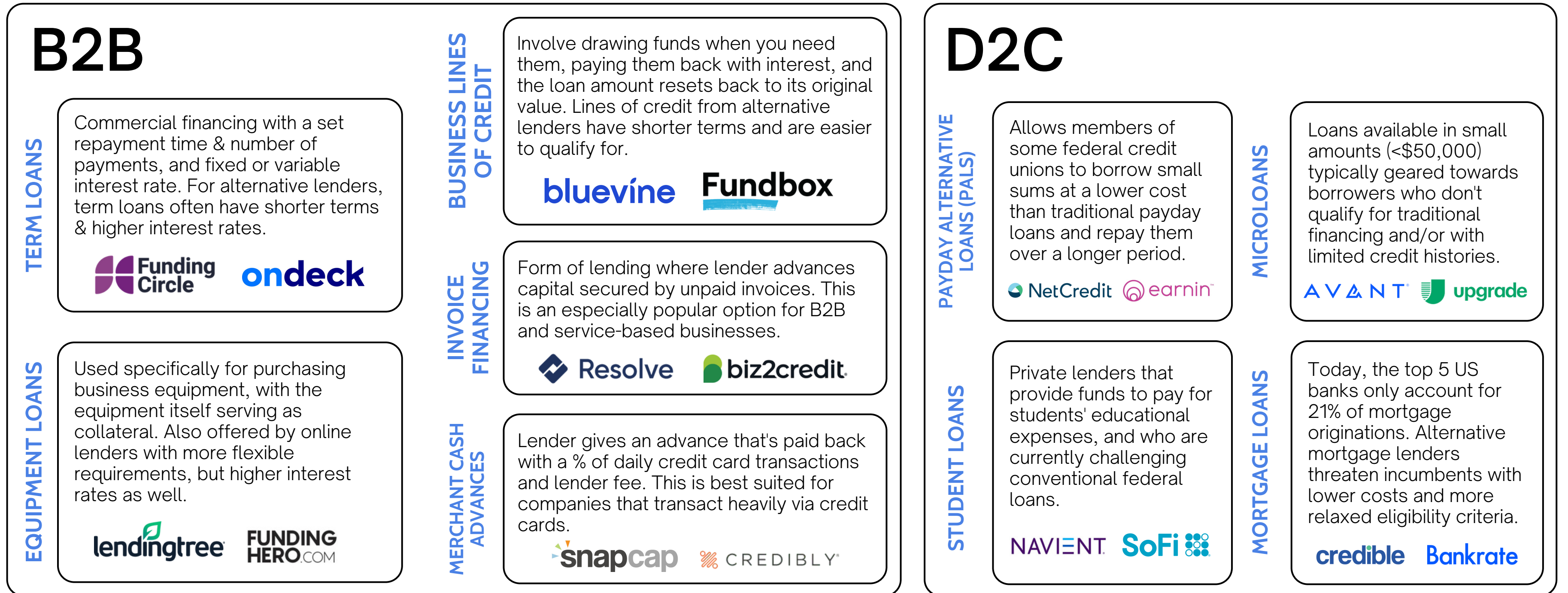
## Evolution

As the asset class matured, alternative lending began to be **increasingly funded by institutional investors**, which (perhaps counterintuitively) even include banks. Hedge funds were early buyers, who selected *individual* loans that were expected to outperform the platforms' average underwriting.

Morgan Stanley Research estimated that by 2021, **nearly \$15.3B** of asset-backed security issuance was conducted via the marketplace lending sector.

# The Landscape

Alternative lending covers a wide range of tech-enabled lending and credit businesses, which can be categorized into either **business-to-business (B2B)** or **direct-to-consumer (D2C)** solutions.



# Key Trends



From 2005 until today, alternative lending has expanded beyond the unsecured consumer to include small businesses, autos, commercial and residential real estate, receivables, student loans and other forms of specialty finance. The US is now the second-largest alternative finance market in the world, with **\$60B+** in alternative lending.



## Challenging traditional FIs

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Digitally advanced alternative lenders pressure traditional banks to digitize their own lending options. In an age where consumers demand ease of use, attractive interfaces, and stellar customer service, over **40% of customers** think non-banks can better assist them in personal money management and investment needs.



## Leveraging technology

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Alternative lenders are using technology like AI and ML to explore transaction data, online sales, or telco data to assess lending risk and enhance the performance of credit models. In fact, improving risk models can reduce the risk of nonperforming loans (NPLs) by **10-25%**. Additionally, technology can also be leveraged to increase the level of digital engagement with customers and reduce the number of manual processes for approval.



## Filling the gap for SMBs

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In 2018, there was a **funding gap of \$5T** between the financial needs of SMBs and the institution-based financing available to them. Major players in the alternative lending space, such as Kabbage and Bluevine, offer tech-enabled, efficient solutions targeting the vast SMB market, filling the credit void left by banks and other financial institutions following the 2008 Financial Crisis.



## Focus on DEI

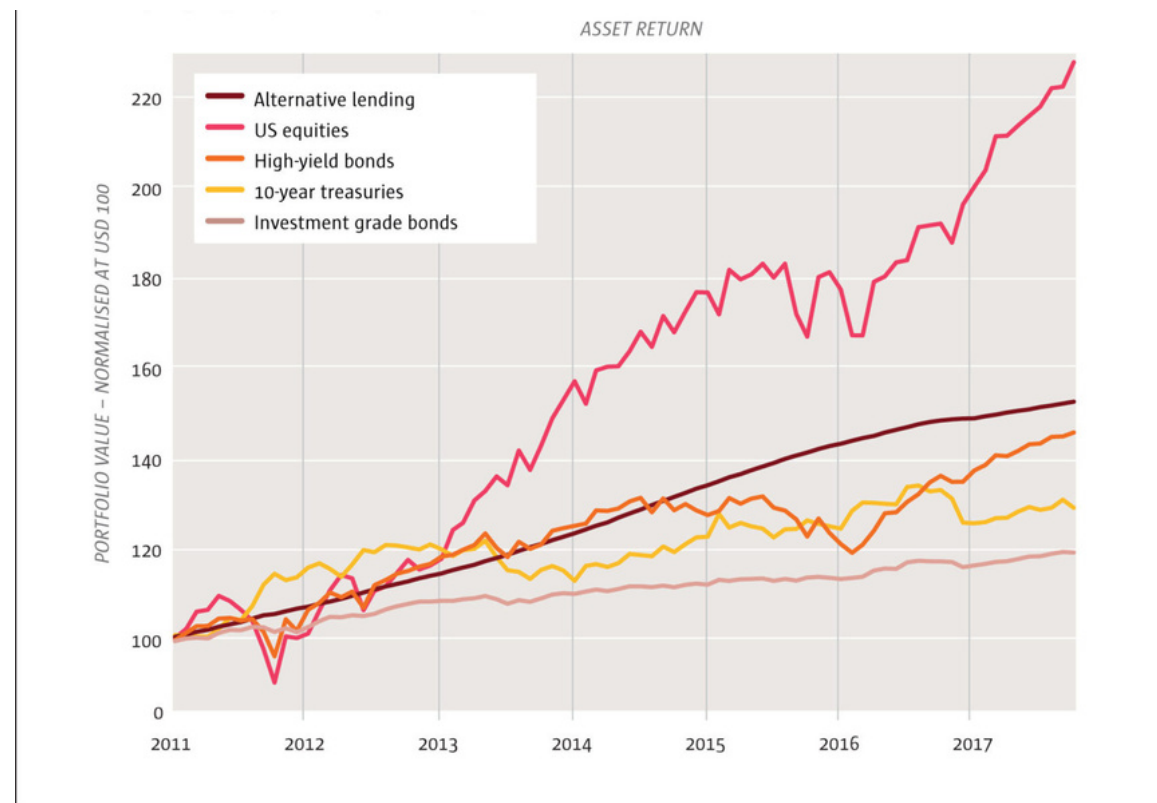
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Leaders in lending services—incumbent banks and alternative lenders alike—are increasingly committing capital to **uplifting and funding diverse & underrepresented groups**. Some examples of commitments include Bank of America's equity capital investments in 12 Minority Depository Institutions (MDIs) and Community Development Financial Institutions (CDFIs) as well as Union Bank's Business Diversity Lending Program.



# Key Opportunities

For institutional investors, alternative lending has become an increasingly attractive asset class driven by attractive risk/reward characteristics and the stability of cash flows it generates.



Source: [The Hedge Fund Journal](#)

## ▶ Steady returns

Alternative lending's steady returns are bolstered by several key drivers, including:

- Access to **consumer and SME credit at a single loan level**, with no leverage or tranching, which enables access to a credit risk premium in its purest form
- A "**fintech return premium**," which is gained from filling the credit void left by traditional lenders
- Semi-illiquidity, for which investors are compensated in the form of an **illiquidity return premium**

## ▶ Low volatility

Alternative loans' returns are driven exclusively by monthly interest payments on loans, which makes them positive, stable, and predictable.

## ▶ Diversification against other asset classes

Alternative loans' underlying credit exposure stems from *consumers* instead of *corporate or government* credit exposure (in contrast with traditional corporate credit), acting as an effective diversification tool during uncertain times.

## ▶ Fundamental resilience and flexibility throughout COVID-19 crisis

In response to COVID-19, alternative lending platforms displayed unprecedented flexibility by tightening credit standards, decreasing underwriting volumes, and increasing borrowing interest rates. Some lenders also offered short-term loan modification programs to impacted borrowers.

# Key Risks



Nevertheless, alternative lending faces significant challenges, especially as we enter an era of **sustained high interest rates and macroeconomic uncertainty**.

## ▶ **Regulatory pressures**

In the US, regulatory agencies have taken a reactive approach to monitoring alternative lending, including the Consumer Financial Protection Bureau (CFPB)'s requirement that payday lenders determine upfront whether consumers can afford to repay loans via credit checks systems.

In China, regulatory agencies also introduced a host of restrictions on alternative lenders, including license requirements, an annualized legal rate of 36% or below for all-in interest rates, and limits on the number of permitted loan extensions.

## ▶ **Elevated interest rates**

Alternative lending interest rates are benchmarked against traditional loan interest rates and are usually significantly higher. As interest rates continue to rise today amid the macroeconomic downturn, alternative lending platforms will also be forced to increase their own rates against the benchmark, reducing accessibility and loan volume for borrowers.

## ▶ **Shorter lending terms, higher default risk**

Because alternative lenders offer shorter lending terms than banks, borrowers have to inevitably make larger interest rate payments. In the current macroeconomic environment, lenders underwriting to companies and taking on mispriced risk will be exposed, while borrowers—especially SMBs—who suffer during the downturn will also be more susceptible to higher default rates.

# Investor Activity

Over the last few years, the alternative lending industry has experienced significant investor activity, market consolidation, and IPO activity, with some estimates that the alternative lending platform market could be worth **\$14.47B** by 2030, growing at a **CAGR of 23.6%** between 2022 and 2030.

## Investments

Company & Description	<b>fundera</b> by nerdwallet	<b>Fundbox</b>	<b>bluevine</b>	<b>lendio</b>
	Lending platform connecting SMBs with lenders, credit card issuers, & banks	AI-driven platform for business payments and credit network solutions	Innovative checking, lending & payment solutions for small business owners	App connecting SMBs with active banks, credit unions, and other lending sources.
Post-Money Val	<b>\$33.1M</b>	<b>\$1.1B</b>	<b>\$602.5M</b>	<b>\$203M</b>
Total \$ Raised	<b>\$25M</b>	<b>\$533.5M</b>	<b>\$426.3M</b>	<b>\$138.5M</b>
Investors	<b>LERER HIPPEAU</b> <b>khosla ventures</b> <b>First Round</b>	<b>SPARK CAPITAL</b> <b>GENERAL CATALYST</b> <b>khosla ventures</b>	<b>M12</b> <b>MENLO VENTURES</b> <b>citi VENTURES</b> <b>svb</b> Silicon Valley Bank	<b>Tribeca VENTURE PARTNERS</b> <b>BLUMBERG CAPITAL</b>

## M&A Activity



In Q2'17, after Sincero almost went bankrupt, one of the most active Chinese investors in US Fintech Renren acquired the company.



Earnest, a data science personal lending company, was acquired by Navient, the country's largest loan servicer focusing on student debt, for \$155M.



In Oct. 2020, NerdWallet, a platform to help people find the right credit cards and mortgage rates, acquired Fundera, an online lending platform for SMB owners.



In Oct. 2020, American Express, a leading credit card company, acquired Kabbage, an automated online lending platform for small businesses to quickly access to cash flow, for \$850M.

## IPO Activity



**Lending Club**, an online lending marketplace that connects borrowers and loan investors, was valued at \$5.4B at its IPO on the NYSE in December 2014.



**SoFi**, a student loan refinancing business, completed a reverse merger in May 2021 and began trading on the Nasdaq, putting its pre-money valuation at an estimated \$5.54B.



# The Future of Alternative Lending: LaaS



Although we see considerable challenges for some players in the space within a new era of normalized high interest rates and macroeconomic uncertainty, we also foresee the greatest potential within **the verticalization of loan lifecycle management software**, or **Lending as a Service (LaaS) platforms**.

In particular, we are watching players such as:



**Ezbob** is a fully automated smart lending platform cuts through time-consuming traditional underwriting practices by linking directly to businesses' key data sources, such as cloud-based accounting services, tax reports and bank statements, to make rapid lending decisions based on the business' performance.



**LendingFront** is integrated cash flow lending platform designed to automate processes and risk management activities. The platform offers a set of integrated or standalone modules covering all aspects of the financing process including application intake and workflow, underwriting, offer presentation, monitoring and servicing.



**Blend** is a cloud-based software platform that powers the digital interface between financial services firms and consumers. It supports and simplifies applications for mortgages, consumer loans, and deposit accounts.

These LaaS businesses offer both lenders and borrowers a whole suite of tech-enabled solutions that **automate and streamline every step of the loan lifecycle**, from loan origination to underwriting to loan portfolio management. **We believe that these credit-focused SaaS players can, if executed successfully, become deeply embedded within lenders and borrowers' daily workflows and provide the infrastructure to significantly augment the traditional lending process.**



# Sources

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- [MSME Finance Gap](#) (SME Finance Forum)
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