Podcast Transcription Session 27: Cormac Leech

Peter Renton: Welcome the Lend Academy Podcast, session number 27. This is your host, Peter Renton, founder of Lend Academy.

[music]

Peter: Today on the show, you probably will notice the sound is a little bit different. That's because I'm not using my regular recording equipment. I am actually here on the road in New York City recording this edition of the Lend Academy podcast. The reason I am is I'm here at the AltFi Conference and I wanted to get one of the speakers here, Cormac Leech, who is our very first ever returning guest on the podcast. I wanted to take him aside and talk to him about the state of the industry. He gave a keynote presentation earlier today. We talk about some of the things he mentions in that presentation, we talk about the big deal happening in the UK right now with the government considering opening up peer-to-peer lending for the ISAs, the UK retirement accounts, we talk about the industry, both in the UK and in the US. We look into his crystal ball and talk about where the industry is going so hope you enjoy the show. Thank you.

Peter: Welcome to the podcast, Cormac.

Cormac Leech: Hi, how are you?

Peter: I'm great, okay, so we get started just with giving the background about yourself so people know who you are, who missed the last podcast.

Cormac: Yeah, sure, my name is Cormac Leech. I work at Liberum, it's an investment bank based in the UK primarily, focused on marketplace lending and other financials. Been the bank's analyst for the best part of the last ten years.

Peter: So when we last chatted you said that you've really been spending much of your time in this marketplace lending sector. Is that still the case? Is this the focus of what you do on a day-to-day basis?

Cormac: It is, I've kind of quite like to personally spend more time looking at banks, but management at Liberum are very bullish on the space and frankly, have encouraged me aggressively to focus more and more on marketplace lending because they see the revenue opportunity.

Peter: Okay, so what have you been working on lately? What are some of the things that you're doing?

Cormac: Yeah, so we've been very active building relationships with a lot of marketplace lenders out there. Interestingly, we've also started to take some investments with our own capital in a couple of platforms in Australia. We're also working in terms of some innovative structures that probably don't want to go into too much detail on, but suffice it to say, we're actively trying to create value by structuring opportunities in the marketplace lending sector.

Peter: Okay, okay, so then let's just talk about the sector in the UK, I mean, like we're coming towards the end of the year now, how do you feel like the sector's developed this year? What's changed over the last 12 months?

Cormac: I think the sector.....the CEOs of the marketplace lenders in the UK, I would say they've become a lot more confident. There's certainly a lot more institutional capital chasing the sector. I think they've quite rightly kind of been moving up the risk curve a little bit and generating more attractive net yields. Frankly, we're seeing some of them start to create interesting JVs (joint ventures) with point-of-sale companies and so on creating value. I would say they're getting more confident and more creative.

Peter: Can you give us some example of that...point-of-sale?

Cormac: Yeah, I think this one would be RateSetters' relationship with GiffGaff who is a provider of mobile phones to primarily the student space but as I understand, Ratesetter provides financing for the actual handsets and it's a clear "win win" and RateSetter thereby builds a relationship with students, the right point in the life cycle, so that, you know, they become repeat customers. It's a very efficient customer acquisition strategy for RateSetter.

Peter: So are these still relatively low yield, short term loans, I mean.....

Cormac: They are, but what we're interestingly seeing is that with the arrival of institutional capital the Marshall Wace P2PGI Fund (?), the consumer finance platforms in the UK are actually making higher risk/higher return loans available to institutional capital. So you're actually seeing that the blended net average yield on the platforms increasing because they're basically opening up to these higher risk loans.

Peter: Interesting, interesting. I wanted just to talk about a little bit of news that came out in the last couple of weeks. RBS is one of the big four, big five banks in the UK and they had an announcement that they're really going to get involved in this sector by starting a peer-to-peer lending platform or partnering with somebody. What can you tell us about this announcement?

Cormac: Yeah, we know for a fact that RBS have been looking at the peer-to-peer space and I met the CEO of RBS about a year ago. He definitely gets the opportunity and we know they've been in discussions and exploring it, but, frankly, I think the story is actually a non-story. We think someone heard a rumor and treated it as factual. In fact, it has very little substance. I think, unfortunately, RBS and the other banks will be hamstrung by their own slow decision making processes and just won't be nimble enough to get a platform up and running in the near future.

Peter: So you don't think any of the major banks in the UK are going to do anything? What about some of the smaller banks. Are they going to be...I know that the UK is dominated by these large banks. Are banks going to get involved like they've done in Santander? Anything else on the write-up?

Cormac: Yeah, I think amongst the UK clearing banks, Barclays is probably head and shoulders ahead. They've been actively collaborating in terms of this innovative finance accelerator in the UK. More broadly, I mean, if you look at HSBC and Standard Chartered, Standard Chartered...actually, Peter Sands, CEO there, was really quite bullish on this whole AltFi space. You know, Standard Chartered has actually been working in Asia in terms of looking to partner with some peer-to-peer platforms out there so I would encourage people to think about Standard Chartered as probably ahead of the pack in terms of embracing alternative finance.

Peter: How do you think a bank is going to get into....are they going to just partner with somebody; the bigger bank create their own division that's going to be a peer-to-peer lending division? What do you think...how will they do it?

Cormac: I was having this debate with somebody today. I think in theory, you could see a bank set up a skunkswork, you know, deploy a special team and create their own platform. In practice, the basic view is that banks will really struggle to find the right personnel and then because of politics and so on would re-struggle to get it up and running. In theory, it's possible, but in practice, I don't think you'll see it. I think that they will continue to use the kind of model that we've seen with Union Bank. I think it's the Titan Bank you interviewed previously, you know, basically using the platform as a cheap way to acquire attractive risk-adjusted returns.

Peter: Right, okay, fair enough. So more big news that happened in the UK recently. The UK government is beginning a consulting period for the...including peer-to-peer lending and ISAs, can you explain what that it and what the process is going to be like.

Cormac: I think it's really interesting. The UK...I was just talking to some people today actually at the AltFi conference in New York, I mean, the UK government is embracing alternative finance much more enthusiastically than virtually any other government I am aware of. You know, George Osborne, the Chancellor, has gone on record saying he wants the UK to lead the FinTech revolution and as part of that, they are looking to open up the opportunities of AltFi to savers, both in terms of individual saving accounts which are basically tax-free wrappers that enable people to save efficiently, but also in terms of pension assets.

The ISA consultation process, part of that, if they figure out how to set the rules and regulations then in theory, the whole ISA market which is somewhere around 450 to 500 Billion Pounds opens up to peer-to-peer lending. If you assume, let's say, 10% of that moves into peer-to-peer over time, you could see about 50 Billion of balances in the marketplace lending space in the UK. Now that presents a very significant problem in my view because if you think about the available assets in the UK versus the available capital chasing those assets, there is a massive imbalance. Frankly, I don't think that you can balance up supply and demand until you have a peer-to-peer lender aggressively tackle the mortgage market in the UK. I think LendInvest is the most interesting platform focused on that space currently and I think that if they crack the mortgage market, I think there is a huge amount of capital; ISA capital, pension capital move in to the mortgage space in the UK.

Peter: Is that because it's lower risk or why the mortgage market? Is it because it's bigger?

Cormac: Well, I've asked some of the platforms in the past. What they say is that the banks take the mortgage space more seriously than the consumer finance space so big banks do mortgages better. I think people just have behaviorally, you know, typically gone to banks to get a mortgage and people haven't really got the head around the idea that you can just go to the Internet and actually efficiently find yourself let's say a 400,000 Pounds mortgage by going online. I think the penny just hasn't dropped yet in terms of ....you know, that's actually possible to....you know, the average public.

Peter: Let's just go back to ISAs. I know the UK government has very strict rules about what you can include in those accounts so when they....I presume they go through this consulting period and they say, yes, everything's good to go, is it going to be every platform, is it going to be on a platform by platform basis? How is going to work?

Cormac: Well, it's interesting. I think it's still a consultation period. I think they're going to create a separate asset class so you typically have cash ISAs and equity ISAs. Is there going to be a peer-to-peer ISAs? I think the platforms which are FCA-regulated...one would assume would be eligible to go into an ISA and we expect that lots of different ways to create these ISA funds. I mean, we would expect the platforms themselves to create individual ISAs dedicated to those platforms in particular, but we'd also expect the likes of Hargraves Lansen?, which is a large, I guess, it's a stockbroker wealth management portal in the UK to provide a competitor of ISA proposition for peer-to-peer lending. So there'll be lots of different kind of shapes and sizes of ISA products going after peer-to-peer lending. I think it really does create a very interesting investment option for the public in the UK in the near future.

Peter: Okay, so one of the things I know people here in the US talk about is risk and particularly when it comes retirement account, people want to maintain their capital, but don't really want to risk loss of capital. In your presentation today at AltFI you talked about Zopa's returns during the financial crisis so I guess what I'd like to do is sort of tell us what those returns were and also if you would have another financial crisis, do you think those returns will hold up?

Cormac: Yes, it's a good question. I mean. I think that the net yields during the last financial crisis for Zopa in the worst point were 4.5% which is a remarkable term. You look at the S&P that year... I guess was down....I mean, check the number, perhaps down, 50 or 60%, so as an asset class consumer finance performed extremely well. I think given that the net yields currently for Zopa are around the 4 to 5% per annum level, I think if there was an aggressive recession from this starting point, you would inevitably see those net yields come down, but I think it will stay positive perhaps from 1 or 2%. Of course, it really depends what the nature of the crisis will be, but I would expect Zopa to frankly outperform virtually any other marketplace lender in the UK with the possible exception of Lending Works, actually, which you may know has insured some of the credit risk with an insurance company where people don't pay a loan because of death or more relevantly unemployment then the insurance company will step in and absorb the loss. So with the exception of Lending Works, we think Zopa for uninsured platforms would probably outperform versus the rest of the sector.

Peter: Okay, so that's a really interesting point, can we just talk a little bit about that. Did they partner with a large insurance company and are they going to be, you know, do you know how the process works?

Cormac: I don't understand in detail, I mean, basically, my understanding is that they've developed a relationship with insurance companies whereby if a particular loans defaults due to death or unemployment then the insurance company will step in and absorb risk above a pre-assigned provision fund which has already been put in place.

Peter: Okay.

Cormac: But it doesn't protect against fraud risk or, you know, there's the "can't pay" and the "won't pay." I mean, it doesn't protect against the "won't pay" because they just don't want to pay the loan back. You can't protect against that.

Peter: Right, right, fair enough. Okay, so then let's talk a little bit about transparency because I know that that's something that....you know, we talk a lot about here in the US and you can go and download every single loan at Lending Club and Prosper have ever issued and I think the same is true...like the Funding Circle in the UK, how is transparency viewed in the UK and why is it important?

Cormac:I think transparency is very important and, of course, it is an increasingly sadly lacking, I would say, amongst the UK platforms. For example, if you look at Wellesley, RateSetter or even Zopa, it is quite difficult to get a precise fix on as a retail lender who the borrowers actually are and what kind of credit risk you're actually underwriting. This may not be a problem for the likes of Wellesley or RateSetter or Zopa, but longer term, in my view, is an increasing probability that let's say a more aggressive new platform emerges and is willing to write a lot of very high risk loans, but position them as being low risk and only offer retail investors, let's say, modest mid-single digits yield against that risk. There's massive potential, in my view, for the sector to be set back, let's say, a decade perhaps, if one of these platforms were to blow up and there would be a contagion effect to the rest of the sectors where retail money and the regulator will just clamp down or move away from the sector.

Peter: Right, now that's a very good point. Okay, so another thing I would like to touch on from your presentation...you talked about a $250 Billion market cap for the entire sector in 10 years. Is that the UK sector, the European, US? What was that and how did you come up with that number?

Cormac: Right, that was a preliminary estimate of the equity market cap for the US and the UK marketplace lending and I would say it's conservative. I mean, for starters it excludes the whole invoice factoring space and it’s based on relatively conservative assumptions and market share. I mean, it's assuming, let's say, a 10% market share in mortgages, perhaps around 25% share in SME lending and based on what some of the stuff we're hearing today at the conference, this increasing confidence of market shares could actually go above those levels. That said, $250 Billion is quite modest in the context of the current market caps of banks. I think what's going on is, frankly, marketplace lending is a very efficient way of intermediating between savers and borrowers. The flip side of that is that you would expect the market cap of the sector to be less than that of the banks because you're capturing less of the revenue pool of the economy. So you're freeing up resources and profitability to shift elsewhere in the economy so I would argue actually kind of a relatively modest marketing up of the sectors is actually a good thing.

Peter: Okay, the banking sector, I mean, this is in the UK alone would be many, many times that, I imagine.

Cormac: Yeah, I think if you look at the European banking sector, you're looking at something around, think around atrillion Euros and don't quote me on that, but I think that's ballpark, the order of magnitude. Globally, you're probably looking at ...I'm assuming $3 Trillion.

Peter: Okay, so you think maybe 10% roughly, 10% of market cap would be in 10 years time...marketplace lenders.....

Cormac: I would say and I guess it comes down to what market share they can actually capture. I would argue that there are lots of other adjacent spaces and financial services. You've got the whole payment space, foreign exchange space, insurance space which is still largely untapped. If alternate finance moves in to those sectors as well that will be an equally large revenue opportunity. It will imply a larger sector market cap.

Peter: Okay, so let's talk about the first publicly listed entity in the UK which is P2PGI. It' really a closed-in fund investment trust there. They're trading right now, anyone in the UK can go and buy shares in this investment trust. Can you just tell us a little bit about it, what they do and who they invest in?

Cormac: Sure, so P2PGI, the ticker is P2P and it's a closed-in investment trust with marked capital of initially 200 Million pounds and set up as permanent capital to be deployed on peer-to-peer lenders and really globally, but, initially primarily in the US and the UK. It started off obviously 100% cash and back at the end of May and at this point it's actually about 46 or 50% deployed in terms of cash put to work on platforms with small equity stakes taken. What's interesting is that the P2P....it actually trades at a premium to NAV which is very unusual for a business which is ...you know, 50% in cash. We would argue that as it becomes more invested in peer-to-peer loans that the price to equity will increase further. Actually, it's entirely consistent with our view that the cost of capital for peer-to-peer loans is actually well below the yields that are available. So in principle you will expect that when P2PGI becomes fully invested that it will trade at perhaps 1.4 or 1.5 times price maybe. Current yields about 8% and we think it is an attractive investment at these levels for relatively risk averse people because, frankly, I think it's quite a cautiously managed fund.

Peter: Okay, so then you cover this officially...that your company...you cover this closed-end fund. What you're saying is that...the yield you talk about at 8%, that' not a very conservative type of yield, but you're saying that conservative investors should play here?

Cormac: I think so. I mean, if you look at how they're generating those yields....for example, they're buying very high quality Lending Club loans and they're levering them up fairly aggressively...let's say perhaps 200% debt to equity leverage and they're also taking some loans in the US SME space, also the UK SME space and they're all going to the likes of RateSetter and Zopa focusing on higher risk, higher return loans. Now, someone who is not familiar with marketplace lending that might sound like quite a risky proposition. However, if you look at these asset classes over the last ten or twenty years and basically back test...back test always raises kind of question marks, but if you look at the historical data of these asset classes, it is very difficult to envision a scenario where the returns are anywhere close to zero negative from the P2P fund and, therefore, in my view is a very attractive investment from a risk adjusted point of view.

Peter: It's about leverage and conservative....there might be some people who will disagree. I guess my question is for this particular entity, closed-in fund,.. during another financial crisis, you still believe that they won't have negative returns?

Cormac: I do, because if you look at consumer financing generally...if you look over the last 10 or 20 years, the returns have been on average of about 8% or higher for consumer finance in general so the type of loans that the P2P funds are leveraging up are the higher quality consumer finance loans. If you back test that credit rate of consumer finance loans, it's essentially bullet proof unless you think we're going to go through a 100 to 200-year global financial crisis and at that point all bets are off. But even if you went through the last global financial crisis where people say is the worst in a hundred years, this particular strategy will perform very well.

Peter: Okay, so we've seen in the US a dramatic increase in institutional investors coming into the space....it's starting to happen in the UK we've seen yields come down a little bit in the US, what is the impact on yields going to be and can you look into your crystal ball, where are yields going? Is this a disparity between the two countries and I want to know where you think it's going.

Cormac: I think that's a good point. I mean, I think we'll see a little bit of margin erosion in the US, particularly in the peer-to-peer space, because there's so much institutional capital just walking up to the attractive risk adjusted yields developed by Lending Club and Prosper. I think more broadly in the US, direct lending platforms, which is to say platforms which don't take retail money, still offer very attractive double digit net yields to institutional investors that are willing to go let's say slightly off the beaten path away from Prosper and Lending Club towards some of the direct lenders which have gotten less attention. I don't want to disclose which ones they are for propriety reasons, but there are a lot of very attractive yields out there.

I think in the UK the picture is slightly different because historically, there has been very little institutional capital in the UK. It is coming into the UK currently and that's giving the platforms confidence to go up the risk curve a little bit and therefore, they're getting better net yields on average. I think in the immediate term in the UK, the picture will change radically. I think as the ISA money comes into the UK market...as we're talking earlier, I see a flood of capital chasing a relatively constrained pool of consumer finance loans and I would expect net yields in consumer finance in the UK on let's say a five-year view to plummet, frankly, down to...pick a number 3, perhaps3/4% or possibly even lower. At that point I think people will get very interested in the marketplace lending mortgage opportunity because people realize that's the only way to balance supply and demand and I think LendInvest is using that platform in that respect because they will have the technology and the processes to actively serve the mortgage market in the UK.

Peter: Interesting, so you think the flood of investor capital is not so much going to come from institutions, it will come from retail......

Cormac: In the UK, in the UK. Yeah, because as the government makes this ISA capital available...just the basic supply and demand in place, the yields are going to fall very radically,

Peter: Interesting, very interesting. Okay, I know you've got to go in a few minutes, but I wanted to talk about IPOs and we talked.....let's talk about the Lending Club IPO which we talked about eight months ago when we chatted and you gave a valuation of $6.2 Billion which at that time I thought was a little high, but maybe now it's not....are you still holding to that valuation?

Cormac: I haven't done a ton of work on Lending Club recently. I would expect Lending Club to be worth something of that or I think we still have a bet on $5 Billion.

Peter: We do, we do. (cross talking)….I am probably going to lose that bet.

Cormac: I think in terms of other IPOs you've got OnDeck. In the UK, a lot of people ask which will be the next platform to IPO. I actually think LendInvest could be the dark horse that actualy IPOs first

Peter: Really.

Cormac: I think the management there really get the opportunity, the value of building brand by being a publicly listed company. It's a fantastically profitable business...LendInvest so I would not be surprised to see LendInvest first out of the gate in the UK.

Peter: What about Funding Circle, Zopa...they're obviously the main that most people will think will go first. What's the timeframe on when you think they might go public?

Cormac: Difficult to say. I mean, normally platforms are very tight-lipped actually about their plans. It's difficult to say, but my bet actually would be on LendInvest.

Peter: Okay, well on that note I'll let you go. I appreciate your coming on the show, Cormac. Thanks a lot.

Cormac: Thank you.

Peter: In many ways, we're very lucky in this country. I think we've been able to invest in Lending Club, Prosper, other companies in online lending. We've been able to invest through our IRA for many years. The same is not true in the UK. ISA is really the equivalent of the IRA in the UK. That is a vehicle that has not been allowed into this sector, into this asset class and that is going to change. One of the things I thought was fascinating that Cormac said was that he expects such a flood of money to come in not from institutional investors, but from retail ISA money into this and that's going to drive down yields. The consultation period is still going on, people are saying 2015 is the year when this is going to happen and if it does we will, obviously, all be watching very, very closely.

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

[closing music]