PODCAST TRANSCRIPTION SESSION NO. 74: BRENDAN ROSS

Welcome to the Lend Academy Podcast, Episode no. 74. This is your host, Peter Renton, Founder of Lend Academy.

Peter Renton: Today on the show, I am delighted to welcome back Brendan Ross. He is the Founder and CEO of Direct Lending Investments. I've known Brendan for may years, he has been around this industry a long time and he has now a very sizable private fund that I've invested in. Long time readers of Lend Academy would know that I started investing in Brendan's fund when it was still very small back in 2013. I share my returns every quarter and pretty much every quarter his fund has been my best performer. I wanted to get him back on because it's been a couple of years and a lot has changed, not just with his fund, but with the industry as a whole. We cover all kinds of things in this podcast, we go in depth into how his fund works, what platforms he's interested in and how he views the market today. It was a fascinating conversation, hope you enjoy the show!

Welcome back to the podcast, Brendan.

Brendan Ross: Thanks, Peter.

Peter: So for those listeners who don't know you, why don't you give us a little bit of background about yourself and your company.

Brendan: Sure, absolutely. So I graduated Brown in '95, I was a management consultant, I ended up as a turnaround CEO, really decided I didn't want to be letting people go for a living and I was sitting with a blank piece of paper and I ended up founding Ross Asset Advisers which has since shut down. That was a financial advisory firm providing traditional financial advisory services. It was in that context that you and I met and I spoke at the first LendIt a little over three years ago and at the time I was the first financial adviser to be putting money into peer to peer loans.

In the Lending Club Broad Base Fund and another private fund. I ended up shortly after really wanting to create further diversification for my own clients and for myself into marketplace lending and I ended up settling on small business loans because the decline in bank lending to small businesses had created such an unusual opportunity for private companies to lend to small companies at healthy rates. About a year and a half later I ended up shutting off Ross Asset Advisers, we went ADVW, which is the official way to describe the end of a financial advisor and focused full-time on this company since. We're about 20 professionals now located in Los Angeles and really focused across a fairly broad spectrum of credits, but still with a major focus in small business.

Peter: Right, okay we'll dig into that in a little bit, but I just want to get a sense of where you're at as far as scale because when we had you on the show last it was about two years ago and you mentioned you were at $73 million AUM, so where are you now?

Brendan: Peter, it's been one order of magnitude. (Peter laughs) As of September 1st, we are right at about $739 million.

Peter: Wow, so that's ten times, that's quite the run in really less than two years since we last spoke. That's amazing! So then I want to dig into...can you just talk about your process and how you actually invest the money because as I said in my introduction, I'm an investor in your fund, have been for many years and I know that you've moved away…you started off buying whole loans and you've moved away from that and are providing more funding lines now. I want to just dig into that a little bit, get right into the weeds so we can understand exactly how your fund operates. Can you give us some color there?

Brendan: Yeah, absolutely. So as you said initially, I was just really trying to recreate the peer to peer experience but it was in the context of small business loans. So I was buying whole loans and paying a servicing fee. Now there were some differences. I wanted that servicing fee to be tied to a percent of interest income so that lenders would be particularly focused on keeping interest rates up and I also generally prefer to have a segregated bank account. So rather than having an Internet account that shows how much money I have, I wanted to have an actual bank account that the small businesses' actually deposited money into. I also prefer non-anonymous loans so I wanted to actually work with lenders that were focused on institutional buyers and would allow for full transparency so I would have the identity of borrowers.

So those were sort of the ground rules as we started and then in kind of late 2013, we did our first deal in which we added kind of a credit enhancement. So credit enhancement is sort of a technical term and what it generally describes is ways in which you can have an improved position relative to the incentive alignment that you have with whoever you're buying the loans from. So in our case, the way that worked was that we would get a servicing fee rebate if the loans underperformed so that was a credit enhancement. And then fairly quickly after that…we have two deals that have that.

Fairly quickly after that we moved to actually just simply extending credit facilities for which loans were collateral. Of course banks have been extending credit facilities forever and the story arc for Direct Lending Investments says in some ways kind of parallel the re-embracing of banks that's happened in marketplace lending. As we know, banks have started buying marketplace loans and we have pretty much adopted the form of a bank. So as banks have pulled back from extending credit to small businesses they've done the same with lenders that lend to small businesses and we stepped into that gap with paperwork that makes us look an awful lot like a bank.

The advantage of that structure is that the loans are actually not on our books, the loans are on the books of what's called a special purpose vehicle or a special purpose entity. The special purpose entity is designed to house the collateral separately from the lender so that we can lend against that as a pool of assets and we can also have clear title to those assets in the event that the lender underperforms or goes out of business. So the idea is that the loans go into a bucket, the bucket sits separately from the lender, we review that bucket and can lend against that and we have one loan instead of a thousand loans. We also have that loan at a fixed rate of return so even if the collateral performs a little bit better or a little bit worse, what we've done is pegged our return to a specific rate.

Now that action, that change has cost us some returns as you've seen and the trade has really been to accept a modest diminishment of returns in exchange for the incentive alignment that you get when the lender has to provide us with a fixed rate of return and eat any defaults that occur. So it's been that incentive alignment that has really been the key to the shift that we've made as a firm over the course of the past two years, really since we probably last spoke on the podcast such that 75% of our assets are currently in this credit facility form.

Peter: Okay, so I just want to make sure I'm clear here that you provide a credit facility against loans that have already been issued, at what point…like the special purpose vehicle has the loans as collateral so these loans obviously have already been issued, are they seasoned? I mean, what's the sort of typical…I know it probably varies between platforms…sort of what's the typical kind of age that you get them at, how does it all work as far as the mechanics go?

Brendan: So there's a very brief and appropriate seasoning period to comply with season and sell, but generally speaking it's within less than 30 days certainly, the loans are in the facility. So the facility has what we can call a 'buy box' so imagine as you do that you're giving advice to someone about the nature about how their whole portfolio of peer to peer loans should look so they should have a certain fraction of 36 and a certain fraction of 60 and this percent of A,B,C,D and E and you might give them advice like you should have no fewer than 20% A loans, but you should also have no more than 20% F loans and G loans.

So the idea of the no fewer than and no more than rules combined with these sort of target percentages, you could think of that as being kind of the shape of your portfolio. We will define that with crisper rules into what we would call the buy box. So the buy box are the loans, both individually and also in terms of their entirety, that can go into a portfolio that we finance. So if the lender has room for 12 to 24-month loans then they can make 12 to 24-month loans and sell them into the facility. If they don't, because they are at their cap there, it could either be a discussion or they would just simply not be able to put those into the facility.

Peter: So when you're working with these platforms, how big of a portion of their business are you? I mean, obviously they probably want to have diversified funding sources, are you just one of many of these kinds of deals or are you really large?

Brendan: We're generally at least 50% and in many cases 100%. It's interesting because there's a certain phase in the development of a lender when what it really wants is reliable funding, it doesn't really matter whether or not it's diversified so much that as that it comes in every month. Our reputation in the industry is such that we always deliver the money, it's something that we've been able to do since inception.

So when we're working with lenders they're generally fairly comfortable being exclusive or almost entirely exclusive with us so it's a different sort of relationship. When we talk with a lender what we're saying to them is...look, you're in a phase, right, you've been making with your own equity loans for a year, maybe two years and now you're ready to scale with capital and you just need a reliable source of capital for now and here's some things you don't need.

We don't even necessarily think you need to be your own servicer. We think that these lenders are creating value by identifying unique sources of deal flow and by capturing that deal flow. Just as we're looking to "capture" them and be able to finance them with some level of exclusivity, they're doing the same thing with how they're going to get their deal flow and it's that sort of collection of them locking down their capacity and us locking down ours that gives the end investors that are in my fund the confidence to know that they're going to be able to keep that capital deployed at these attractive rates for some time. So there's kind of an end-to-end focus on finding unique pools of borrowers and being certain that as the lender scales that we'll be there with them with the capital.

Peter: Right, right. You're obviously a lot more expensive than a bank so I imagine eventually some of these platforms will move on from you to someone else. Is that sort of just part of the plan, would that be your expectation?

Brendan: Yeah, that's right. I mean, we operate in the same time frame that a lender might get a facility from a venture debt provider.

Peter: Right.

Brendan: Or, a private debt provider that works with a lockup so when we're having conversations with lenders, their choice set is definitely between us and we're going to be a little more expensive, but not want any of their equity and somebody that might be a little bit less expensive, but would want warrants in their company. So what I think is great about our model, which is very much focused on extracting current income today and letting the lender build value themselves with their equity, is that it allows lenders who work with us to be those lenders that are self-selecting into our portfolio because they can afford our coupon and they value their equity very highly.

Peter: Right, right, that makes sense. So can you share some of the names of the lenders that you're working with?

Brendan: So I can share some of the names. Of course, IOU we worked with first and I think folks know we work with QuarterSpot, Dealstruck and Biz2Credit. Some of the later additions have been LoanHero, another one very much more recently is called CarePayment. So some of these are examples of companies that are outside of what we've traditionally done. So we started doing almost exclusively small business loans and then as we began to develop our own thesis about where we could find unique deal flow, we began to get comfortable with other types of assets in this space.

So LoanHero, for example, does consumer purchase finance. So you go to a doctor or you go to a mattress store and you can't pay cash and you find that you're going to be offered credit and that credit is going to be at a relatively attractive rate. One of the reasons for that attractive rate is that the store that you're sitting in as a consumer is actually providing a discount to the lender so in other words, the lender may actually be able to give you an attractive rate as a borrower because they're being partially subsidized by points, origination points effectively so in that way there's a real "win-win" because what the store is really doing is discounting its product to consumers that are not cash payers.

That's really what's happening and they're using that discount to close the sale because they're subsidizing the loan. So that's a very interesting mechanism because it's fairly high barriers to entry. Once a store or chain of stores is comfortable working with a lender and they're confident that they can get ten people that are asking for a loan that eight or nine of them will end up getting one then there's a real loyalty that is established there and I like that much more than the direct mail generated businesses that we see elsewhere in consumer.

And then if you look at company like CarePayment, they do receivables so we also believe very strongly that very, very short duration paper like receivables can provide attractive rates and can give lenders an opportunity to be able to do their business and frankly, afford us. You asked a question about what happens next for these lenders. So they'll work with us for some period of time, typically it's for five years and then absolutely they'll either scale to the point where our facility is full and they'll be able to bring on lower cost facilities next to ours or they'll outgrow us and outlast us and will exit the trade. Those are both completely acceptable.

Peter: Okay, so then how many lenders in total do you have as part of your $739 million AUM. You can't tell the names of every one of them, but can you tell us how many?

Brendan: Absolutely, we've done 15 deals since inception.

Peter: Okay and so it's still primarily small business. I know you did that deal with RealtyMogul, have you moved on from that, is there any real estate in this?

Brendan: Yeah, there is so it is not easy to get real estate as collateral and still deliver double digit returns to investors.

Peter: For sure.

Brendan: But we do have about 30% of our portfolio that has real estate as collateral although the loans themselves might be more like a business loan, but where we can actually attach to real estate as collateral so we are not completely unsecured. If you were to add receivables and real estate, both of which I think can essentially be considered secured we are about 48% secured and maybe 52% unsecured consumer and small business.

Peter: Interesting, interesting. So then how do you choose the lender to work with? I mean, are you looking for...obviously you have a return target that you want to hit, but is there anything else that you're looking for when you're signing up a new deal?

Brendan: Absolutely, so the first thing that we want to understand is the story and that's because unique deal flow is something that we place such a premium on so we want to know how the lender is planning to scale and where it will be getting its customers from in such a way so that they're not competing against dozens of other lenders or even one or two other lenders. So we want those unique relationships where they can find those borrowers and then once they have that and we understand how they'll scale that then we're going to dig into their data. You obviously know Bryce incredibly well, Bryce or Dr.Mason, another pioneer in this industry that came aboard over a year ago now and he's our Chief Investment Officer so Bryce then digs into data.

What we're looking for is two things; the first thing of course we're looking for is the performance from the collateral and the second thing that we're looking for is at the least that the model that they're using, the underwriting model that they're using to score the loans is the source of their excellent returns. So you can imagine a lender that is delivering excellent returns, but actually doesn't have a good underwriting model.

Peter: Right.

Brendan: Because it's actually smart humans that are making the difference there and of course that won't scale so we need great data showing good performance and we need to be able to connect it to an underwriting model that we believe works. And because we've seen so many of these underwriting models and Bryce himself has actually built some, we're excellent judges of the relationship between good performance and the underwriting model.

Then after that there's a long testing process because we're audited and because we hold ourselves to a very high standard we do a lot of what are called procedures testing so we're looking for the control points at the lender...where their software and where the humans intersect in order to do critical things like 'okay' a loan, wire money, how money is received and where all that money goes so there is a whole set of tests that we do to make sure that their business is completely buttoned down and we may even have recommendations for them, we often do. Once they're through that there's things like background checks that happen and then we can get to a term sheet which is a fairly long legal document and then get to a definitive agreement. It's not a particularly lengthy process if we're really interested in the lender, but it is a very in depth process.

Peter: Yeah, it certainly sounds like it. I want to talk about the SEC and the filing you did...I know we wrote about it on Lend Academy back in January, can you give us an update on that and what went on?

Brendan: Absolutely, so the way this works is you file what's called an N-2 if you're going to create a closed end fund so we did that in December and then you get comments back from the SEC and the comments reflected an interest that the SEC had in really very, very current valuation and if you look at the success of the two firms that have launched in this space, they've both been able to do daily valuation. It's very difficult to daily value a loan facility that has a borrowing base. Banks don't do that on a daily basis, they would typically do it on a monthly basis and so because we look far more like a bank than we do like a buyer of marketplace loans, the conclusion that we came to is that we just weren't going to be able to get to daily valuation and that we would be well served by pulling the N-2 which is a simple thing to do.

There's no harm and no foul, you just pull it and in fact a lot of what we're doing now is pivoting to some extent around the investors that we're looking for so that we are now focused a little more on institutional investors. That's not to say that retail investors aren't welcome in the fund, it's just that if you look at who writes $25 and $50 million checks and when they become interested in you, we're at the point in time with the staff, with the internal controls that we can now be attractive to large institutional investors, pension funds and endowments so that's a priority for us.

Peter: Right, so that brings me to my next question. Is that where you're focusing then? I mean, you obviously started this with individual investors, myself included and I know many others who joined you in your fund, so it sounds like now while you're still open to those…and is the minimum...was it $500,000, what's your official minimum these days?

Brendan: So it's lower than that by a lot, but let me not get into very, very specific details about the fund. Instead we can sort of keep it at the level of the portfolio and so on.

Peter: Okay, sure. I guess it sounds like today it makes sense as you get scale, scale begets scale and suddenly if someone wants to come and write a $50 million check to you, you can handle it today that you probably would not have been able to two years ago so I take it that's where you're focusing most of your attention, is that right?

Brendan: Well it's a virtuous circle, you simply can't attract institutional investors into a private debt fund unless you have many, many people. The reason why you need such a big team is because you need things like clear separation of duties between the folks that evaluate investments and decide to pull the trigger on making new ones which is the Investment Committee, that's Bryce and I, and folks that value the investments and contribute data and have dialogue with our third party administrator, our custodian and our auditors.

And all of this infrastructure requires both people on our side and also expense so you know you can not launch a fund in this space and expect that it's going to have the belts and suspenders necessary for an institutional investor. To have a third party administrator and a custodian, to all the insurance that's required and all the other bits and pieces and audit at the level that we do our audit, you're just not there. And when you get there then you're there and all of a sudden it's possible for you to have conversations with endowments and pension funds and why not. I mean, who wouldn't want a $50 million check.

Peter: Right, right, sure. Can we talk about returns for a second. Obviously, I share my returns quarterly on Lend Academy, but can you share anything when it comes to your returns?

Brendan: Let me just say, rather than talking specifically about our returns that I believe that it's possible and I think we've demonstrated that to folks, that it's possible to still get double digit returns without leverage in this space if you are thoughtful about how you construct your portfolio so that it consists largely of lenders that are not competing for borrowers right at the point at which those borrowers are coming aboard and that's kind of what I can share.

Peter: Right, okay. Let's talk about the environment this year, it's been challenging for many companies. Lending Club had a down second quarter, Prosper was significantly down, many other platforms were down, has that affected you and your ability to deploy capital or even attract capital for that matter? I mean, how has the downturn been for you?

Brendan: So the downturn has been entirely positive and it's been really positive for three reasons. The first one is that some lenders who I think are moving away from marketplace lending have come into our fund so we've definitely been the beneficiary of inflows as there has been outflows elsewhere and that's not something I necessarily encourage. If you look at my parents' retirement accounts there is a healthy portion of peer to peer loans in there. That's certainly not something that I think people should be moving away from, but nevertheless, money moves and it definitely moved away from marketplace lending to some extent and we were the beneficiary of that.

The second thing is that when we have conversations with lending platforms, they really understand far better than they did before how fickle it can be to have a financing relationship.

Peter: Right.

Brendan: …that is really as month-to-month as this is and I'll give you a counter example. I listened to, obviously as I do to all of your podcasts, to your interview with Marlette and one of the things they didn't face was a drawdown or a need to lend less and it's because they have great capital partners backing them and that's what we are and it's actually been very helpful for conversations with lenders.

I think the last thing that kind of dovetails off of that is that we're letting lenders know...look, we don't want to sell you loans, we want to extend you a facility, you own the loans and then those loans will be your profit by default right, you have to keep the quality of your portfolio high. We just want to attach in a bankruptcy remote way to the portfolio and then you'll be responsible for it. That argument has been made a little bit easier by the challenges that the marketplace lending companies have experienced with respect to funding. It's a little harder for a new lender to think that they're going to sell loans, they'd love to, right, but on the other hand what we offer is also attractive and now it's becoming clear that it's maybe it's the de facto norm.

Peter: Right, because obviously what platforms are really looking for now is stable sources of funding and that's something you can provide. I know you don't invest in the Lending Clubs or Prospers of the world with your fund, but I know you've had a long history there and I've seen you quoted in various articles about the marketplace lending industry so I just want to get your perspective as someone who's been around this for a long time. I mean, what do you think the industry needs to do, the marketplace lending platforms need to do to get back to a good kind of level of growth that they enjoyed really until this year?

Brendan: Yeah, so a couple of thoughts on that. The first is, you know Lending Club in particular has had an absolutely extraordinary run. I mean they've just been on an incredible tear for I guess probably seven years, right, maybe eight years and then all of a sudden they have this hiccup in which they're now making approximately the same volume of loans that they were making a year ago so this is kind of a one year setback. I think for a company to go through eight years of tremendous growth and have a one year setback, I think we should all acknowledge that that's not...because the setback is happening right now it's harder to look back on it as we will a few years from now and say, that was a one year setback, what was it related to?

I think it was related to two things; the first was governance issues, but I don't think that's actually the major thing. I think the major thing is that it was related to the way marketplace lending works and really the first pendulum swing inside of marketplace lending. So marketplace lending first had fewer investors than it did ability to find borrowers and then it went through a period in which it had more investors than borrowers. This is probably from let's call it early 2014 to around early 2016 and during that period Lending Club did what it always said it was going to do, what it was essentially obligated to do, which is to lower yields a little bit in order to bring more borrowers in and you know defaults essentially were sort of held constant for the most part, not in every credit grade, and I think there's a little bit of randomness there, but they lowered rates as they would. This is just what any Fortune 500 company, any government would do if they have an increase in demand, the yields come down a little bit.

Peter: Right,

Brendan: It's just that marketplace investors hadn't totally understood that that was the nature of marketplace lending, that is what's supposed to happen and now that's happened once and now we're seeing credit tightening, rates going up so I think there will always be this slightly in-favor, slight of out of favor dynamic that both investors and lenders who are really focused on this sales model, this marketplace lending model will face. It's something I don't love about the industry, I don't think it suggests that the industry doesn't work, it works great, it's just that it works in this way.

Peter: Right, exactly.

Brendan: So that's I think really what's been going on and I think this too shall pass. This is a tremendous model, there are others, we like ours more in our fund, but I'm always thrilled to…the thing that I know when I talk to an investor who is currently invested in and happy with marketplace loans...even if they're a little bit anxious about the troubled waters that I think we've hopefully sailed through, they'll be an easy close for me because they get it and I love talking to people who understand this stuff inside and out.

Peter: Right, right, sure. So before I let you go, I want to ask you, because you've got a $739 million portfolio now across the spectrum, I'm curious to know what you're seeing in your portfolio as far as delinquency trends, is there any sign of weakness, are you seeing it pretty consistent...what's happening inside your portfolio?

Brendan: It's the exact same as what's happening in every other portfolio of similar assets that are tied either to consumers or small businesses or little borrowers which is strength. It just isn't weakness here, there will be, some day, at some point right. We're in the second largest bull run etc., we've heard all that, but the thing is that consumers are just not defaulting, they are not over-leveraged. We don't do a ton of consumer, but it's a good bellwether for the general economy, at least for how small borrowers are going to repay, small businesses are doing great.

Look, one of the conversation points that I spend the most time on with investors is that if and when we go into a recession, my fund will absolutely have lower returns. I think it will have higher returns relative to lots of other asset classes because there's still a premium inside the lending that we do, this regulatory premium that we tap into, but still our returns will be lower. So it's not some mystery what will happen if we go into a recession. Right now, we just don't see it, it's just not there.

Peter: Right, that's good to know. So then what do you have...what's next for Direct Lending Investments, what are you looking at for 2017?

Brendan: So the team is 20 and I think on our way to what I think will likely be a $2 billion cap; we will end up with somewhere between 25 and maybe 27 people so we'll continue to hire top talent; we will probably do our next billion, probably majority institutional investors, I hope, and we're just going to sort of keep doing more of the same. I mean, if it ain't broke, right.

Peter: (laughs) Indeed, okay on that note we'll leave it. It's always a pleasure talking with you Brendan.

Brendan: Thank you, Peter.

Peter: Okay, see you later. Bye.

I think Brendan makes a great point there about the marketplace lending model and how interest rates will fluctuate, depending upon the supply and the equilibrium between borrowers and investors and we've certainly seen that over recent years and now rates have started to tick back up again. So that's why I think when it comes to diversification, it's not just good to have diversification among marketplace lending platforms, but also good to do it among different kinds of investments, ones that really won't be impacted by the supply of investors or borrowers kind of thing.

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

(closing music)