PODCAST TRANSCRIPTION SESSION NO. 86: DENISE THOMAS

Welcome to the Lend Academy podcast, Episode No. 86. This is your host, Peter Renton, Founder of Lend Academy.

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Peter Renton: Today on the show, I am delighted to welcome Denise Thomas. She is the CEO and Founder of ApplePie Capital. Now ApplePie have somewhat of a unique business, they are a small business lender, but they have focused purely on franchises and it's an area of the market that no other...at least no one in marketplace lending is completely focused on. So they've certainly got a unique business and they've been going a couple of years now. We talk about how they've structured their business, how they do their underwriting and the fact that they recently closed a large funding round, both on the debt side and on the equity side so we talk a little bit about that and they've also got quite a large bank involved as part of their latest equity round. It's a fascinating business. I hope you enjoy the show!

Welcome to the podcast, Denise.

Denise Thomas: Thank you, Peter, nice to speak to you.

Peter: Likewise, so let's get started, give the listeners a little bit of background about yourself, where have you spent your career, what did you do before you started ApplePie?

Denise: Well, I'm a serial masochist (Peter laughs) which is a different way to say a serial entrepreneur in that I love building businesses from scratch, I like taking complex ideas and concepts and making them a reality and my history of doing that particularly in financial services has always been in market making dynamics where there's buyers and sellers that have to come together and find each other in different asset classes. Prior to ApplePie Capital, I did that in the secondary market for pre-IPO stocks so a founder who wanted to get liquidity, needed to find buyers. My firm did 40 auctions in Facebook for example, we did LinkedIn and other companies that eventually went public prior to their going public. So our focus was really to find investors for those sellers and conduct auctions to find price in a private environment and also to do liquidity programs for companies.

Peter: Okay.

Denise: And when I got this idea for ApplePie I was actually at that business. I'll explain that further if you'd like.

Peter: Yeah, sure because I feel like you've got…let's just go with what triggered the idea and then I also want to know why you decided to focus on franchise financing which really...no one else has really done much of so why don't you give us that story.

Denise: Sure, so I was really working on how I could participate in the new phenomena of alternative lending and I saw companies like Lending Club and Prosper doing that in the consumer space back five years ago now or more and a company called Colchis, who is now an investor in ApplePie, comes full circle, was an early buyer of those loans in those marketplaces and we actually worked with them on their fund in marketing to our high net worth investors way back then and I saw the opportunity through that lens and I thought this is very interesting, but no one is doing anything other than merchant cash advance. I saw the OnDecks of the world. In the small business space I didn't see kind of a disruptor using technology and using new models to underwrite small businesses. It's a very fragmented area and one of the things I did was work back from a view that you had to have a scalable model and you couldn't just do this for Joe's Sandwich Shop on the corner easily if you were going to fund a new business.

New businesses account for...at least franchise businesses account for 12% of all new businesses in the United States and that was very intriguing to me, but more importantly, it was an organizing principle for scalability. A franchise model is business in a box and I set out to look at whether we could do finance in a box for that industry. Just personally...my family has been an investor in franchise for the past, over 25 years on an equity basis and so I've seen up close really how a brand can sustain the test of time and return to investors really nice returns. I also had family ownership in that one of my family members owned an entire state area of mailboxes, etc. before it was sold to UPS.

Peter: Interesting.

Denise: So it helped to solve for the things that you need if you're going to do a scalable platform and I liked that idea. I still didn't know if there was a problem in financing other than the global problem of...a universal problem of small businesses not getting financed by banks if there were under a million dollars start-up costs which in 2008, with the regulatory changes of Dodd-Frank and other changes required too much overhead for them to affordably originate in that small loan size.

So I studied that, I went into the market, into the franchise space to find out if there was a problem and a need and to look at whether or not that need was adverse selection or if there was really a quality product that could be built and marketed. My answer was unequivocally yes and I saw how large the franchise space is compared to all of small business and it was significant. So I took that hypothesis and built the business on that. Now as you know we've been lending for two years now and have found exactly what we expected to find which is there is an efficient origination opportunity through a channel like this.

Peter: Right, right. So it's interesting because franchises are really unique and I guess your process must be unique along with it because you have…there is sort of two components to your underwriting I imagine there has to be because firstly, you've got to decide, okay, this franchise is a solid franchise, the franchisees have a good track record historically of making money in various regions, so that's one step. Then the second step is the individual who is taking out the loan.

Can you just tell us a little about your process, maybe firstly, talk about how do you decide which franchise companies to work with?

Denise: Absolutely, you're spot on, that is a very big part of what we do. We are brand-centric so we work with the franchisor first and there's a lot of data available, both from the franchisor, some of it is proprietary, some of it is private. They don't share it publicly, but a lot of information is contained within a federally regulated document called a Franchise Disclosure Document. So we begin there as a pre-qualification process in order to understand the brand, but the brand has to give us more information than that. We like to understand how many stores they've opened, how many they've closed, over what period of time and very, very specifically, in granular stages we go through that information to qualify a brand. Once they are qualified, we then educate them on our product and its fit for their borrowers and their franchisees and we work with them to generate those opportunities.

It's really important...you said something really important, Peter, about knowing a lot about the franchise unit level because their unit economics...a brand knows what a store should make in volume or revenue and they know what the cost is to build and they know the time to break even. Now there are variations in that across the country based on geography and footprint size because stores vary in size, but we've built a model that really understands all of those things and we understand what the unit economics should be so that we can write a very, very sound loan to that individual. That’s the key.

Peter: Right, so I guess...once you obviously isolate a franchise...one of the great things about the franchise business is once you say, right, this franchise business I like, it's got good economics, I feel like it's positive, you can make loans again and again and again to that same franchise because sometimes obviously, it's even the same business owner, but I guess what I'm curious about is...I imagine there's a level of due diligence that the franchise itself does before you even get to a franchise owner wanting a loan. I imagine they have to be vetted somehow by the franchise business. Can you just explain that process a little bit?

Denise: Sure. So the franchisor pre-qualifies their candidates on the basis...and this goes to why franchises succeed or fail...the first most important is that individual borrower, that individual who would operate the unit and/or manage the unit. So it's called Operator Selection in the industry and they have to be very good at that. They have to know...and I will give you a very simple example.

If you're a pizza manufacturer, there are different types of pizza manufacturers, there's businesses that are optimized for delivery from the hours of 5 until 11:00 pm in a college town and there are pizza sit-down restaurants. They know when they're selecting an operator that it's more important not just to have pizza experience, but really to have delivery experience if that's the model. So if the person doesn’t have pizza experience but they run businesses with delivery models, they're more qualified than a person who hasn't done that, as an example.

Peter: Right.

Denise: So it's very important that the brand know how to select operators.

The second is that they know how to select and carve out the United States' for territories because if you think about the number of people that need to support and purchase goods and services in an area, you have to know that that business is located in a spot where that's going to be a positive unit economic situation because that's how franchisees make money. When the franchisee makes money so does the parent franchisor because they're paid in royalty fees off of the revenues of those units. So it's very, very important that they get those two things right and there's aligned incentives in that.

The third thing they have to do is franchisors have to support their franchisees in many ways; training, the blueprint for how to start that business, how to market in the area, advertising dollars for national marketing or local marketing. They have to provide a lot of ongoing support to make that franchisee successful and so we interview, we have a very multi-dimensional screening process for the franchisor and then they in turn screen their potential operators and many franchise businesses like to have an operator that opens more than one unit because they're not training someone twice and they're really getting leverage. We like those too because they've already shown that they can succeed in one location. So it's a very interesting model because of the leverage points you get all the way through the system.

Peter: Right, so can you just tell us, what are some of the franchises you're working with actively today?

Denise: So we have several, what I'll call sectors. There are eight sectors that we work with. The biggest and fastest growing sectors are personal and business services, quick service restaurants you might imagine are a significant part of the market...that's about 20% of the industry of units opened and the personal and business services are things we use everyday like hair salons, get your haircut every day; it's gyms for exercise, it's…you know an example of a couple of brands I'll just highlight…Sola Salons is a client of ours, they open units where individual hair stylists can move their book of clients over to a rented chair model so they make more money. It's a very nice business because it cash flows very quickly, great margins. Then you look at something like Orangetheory Fitness which is a new sort of fitness model where they're doing interval training and you kind of compete with yourself but you're amongst others who help you get your workout done efficiently. It's a very, very strong and growing brand. So you can imagine, it's day-to-day services that we all frequent.

Peter: Right, right. So I'm just curious about your marketing model because you've obviously got a...once you're hooked in with one of these franchises, I imagine, then you can duplicate...I'm looking at your website right now and I see Orangetheory Fitness again, again and again, you've done lots of deals with them, you've done lots of deals with the Sola Salon, Marco's Pizza so how does it work? Once the franchisor gets an operator, I think you called them, coming towards them do they then say, right, here are three options for a loan; one's a bank, one's ApplePie, one's somebody else. Are you sort of a preferred supplier? What's the relationship like?

Denise: Yeah, we are considered a preferred supplier. As you may know, one of the things that happened in the industry of small business finance in 2008, the Small Business Administration really created a job stimulus program and there was a guaranteed loan program by the government so SBA accounts for about 20% of loans done in the franchise space. What happens is that the SBA process is pretty ideal for a first time owner because it's going to be the lowest cost of capital, but it is slow and it does take time and if you don't want to die by a thousand paper cuts (Peter laughs), you may not want to go down that path.

Peter: Right.

Denise: We do have people who choose not to do that and they'll still choose our product, but we fit nicely in the one to ten unit space of a franchise multi-unit owner. We help them grow because if you get an SBA loan you may or may not be able to get your second loan in a time frame that makes sense because you have to pledge all of your collateral to that one loan.

That's one of the differences in our product, but ours is focused on a growth engine for the brand and for the multi-unit owner and we see the cost of capital coming down over time as well now that we have interest from banks, that's the lowest cost of capital so we will see even our cost of capital go down and I think that will continue to widen the market for us.

Peter: Right, right, okay, fascinating. So then can you give us some idea of what loan volume you're putting through your business today and also...let's just start with that then I want to get into the details of the loans themselves.

Denise: So we have done about 130 loans and we've funded over $55 million across those loans. We have 42 franchise brands and so far we've returned about $7 million in principal and interest to investors.

Peter: And so what are the terms like? Are these 5-year loans, 10%, what are the terms?

Denise: They are 5, 7 and now we have 10-year payment schedules as well and the interest ranges from 7.5% to 12%, but on average it's about...I'll give you what the book is today. Our average deal size is $430,000, the interest rate average is about 8.6% of the book right now and the average term is 69.7 months and average amortization period is 84.7 months.

Peter: So the multi-unit operators, are you giving them multiple loans? You obviously have got to make sure that...I guess let's just back up a second, what's the collateral on these loans, what's the security for the investor?

Denise: So it's a personal guarantee. The average net worth of our borrower is $2 million and the FICO score average is 750. These are really prime borrowers.

Peter: Right.

Denise: They are also, we're looking at asset coverage and debt to EBITDA so we are very careful about that. The multi-unit owner...we have had repeat borrowers in our system already, people who will recapitalize a profitable unit to open a new unit. We require 20% to 30% down so they have skin in the game as well so if you're looking at a $500,000 loan, they're putting $120,000 to $150,000 into that loan.

Peter: Right, got it, got it. Okay, let's talk about the other side of the marketplace, the investor side. I want to get to the big announcement you made earlier this month. This will be published in January so it'll be last month when people are listening to it.

Denise: (laughs) Right.

Peter: Firstly, what kinds of investors are you working with today?

Denise: So we work with several types of investors. Early on, we had interest from an institution…before we ever did our first loan we were working with institutional investors. The marketplace…and I'll give you some sense of that because it has been very organic. We've had both family office and individual high net worth investors who've been buying loans fractionally so they participate. We've had about…I'd say a $400,000 loan, you might see $80,000 in a fractional participation from the marketplace and that's all been organic. We've even seen people from within the franchise industry, franchisors, multi-unit owners who have invested in other brands that they are aware of for their own fixed income opportunities so you see an organic evolution happening there. We have not advertised to attract people for that, they just come by word of mouth and then we have a very large institutional deal that I think you're referring to in our announcement where we have a $180 million facility from TowerBrook with leverage from SunTrust Bank and that is a vehicle that will be buying over the next two years $180 million of our loans.

Peter: Right, right, that obviously is a very big deal. Right now, are you holding anything on your balance sheet or is it all going out? You said a typical loan $80,000 is fractional, what's the rest of that loan, where's the money for that coming from?

Denise: Well, my personal balance sheet bought every loan (laughs).

Peter: Right (laughs).

Denise:...fractionally, but for the company we have a small participation in the TowerBrook Fund so in essence we have participation, we do not hold on our balance sheet, but we are using capital to participate.

Peter: Right, right. I also noticed on your website you have an ApplePie Trust which is a bankruptcy remote vehicle for investors. Can you tell us a little bit about that, when did you start that?

Denise: We just released that, but it is retro in terms of all loans that were previously made on a fractional basis are now part of the trust. That is modeled after other online lenders and publicly registered companies, we have…Bankers Trust Company has provided the trust related services, they'll service as the indentured trustee and borrower payments will be directed into a separate collection account that is controlled by Bankers Trust which also serves as the paying agent to ensure continuous payment activities. The trust structure really is to define all the activities necessary to ensure that note holders receive payments even in the unlikely event that ApplePie was unable to process payments. And then we also have Portfolio Financing Servicing Company act as the successor servicer which helps ensure continuity of key loan servicing functions.

Peter: Right, right, sure. So I want to dig in now to the big announcement that I thought was the most significant one and that was the…you had a Series B funding round that was led by Fifth Third Bank and QED and QED, obviously, that's no surprise there, they're in many, many deals in this industry, but Fifth Third, I hadn't seen that name before in this industry. I wanted to get the story behind that and how all of that came about.

Denise: Sure, we're extremely excited about that development. They had previously done a very large investment this year in GreenSky.

Peter: That's right.

Denise: And we've been compared on several fronts with GreenSky in terms of model because GreenSky also has a channel to receive their borrowers through. I think that's the common theme that Fifth Third found in our business as well and they also do franchise lending in the

SBA form of franchise lending, as well as conventional lending in larger deal sizes. So we are very excited by the investment, we also are working with the business side of Fifth Third Bank as you've seen them do more innovative things, I think, than many banks on a regional basis. They're just a different bank, they work quickly, they have a model because they've done the GreenSky deal. As you can probably imagine, it's very hard to work with banks at our stage.

Peter: Yeah.

Denise: The fact that they have a venture arm is a really powerful thing and so we feel very excited to be one of the fintech companies that they are placing a bet on and working with. They are very, very good partners.

Peter: So they obviously participated in the equity round. Are they also going to be buying loans or is it just purely equity?

Denise: We don't have anything to announce there, but we are exploring with Fifth Third and working with their business folks.

Peter: Okay, okay, well congratulations, that's certainly great for a company of your size to get a bank of that size coming on board. That's certainly a testament to what you guys have been doing.

Denise: Thank you.

Peter: I want to talk a little bit about your loan book. You said you've done $55 million, obviously you haven't been in business a long time and it's still a fairly young loan book…so can you give us some idea of expected losses and actual losses. How has the loan book performed, so far?

Denise: Sure, out of the 130 loans, we've had only one loan in delinquency, we do expect that loan to default. There are no other losses to date and we believe we're tracking very well to our expected loss rate of 1%.

Peter: Okay, okay, that's great. So I'm just curious then about the underwriting process. You really are sort of doing a lot of consumer underwriting, I'm guessing, because you were talking about the franchise owner. Can you just tell us a little bit about the underwriting process and maybe the technology that you're using behind that?

Denise: I'd have to kill you, Peter. (laughs)

Peter: (laughs) You can speak in generalities.

Denise: Sure, we do have a fairly involved model, it's a proprietary model, it's two tiers. First, the brand that gets a base rate and then we take the borrowers' specific information and we're looking at many attributes; are they experienced, do they have an existing unit, is it profitable, what is their net worth, their liquid net worth, their FICO? We're looking at their history, you know, of running small businesses, whether it be in-franchise or outside in the same domain that they're looking to run in the franchise.

We also look at really the business model itself; are they in a model that is going to take 12 months to break even or three months to break even and that's going to affect really how we size the loan and what kind of cushion we're expecting them to have in the event that they're off that by a month or two, or whatever. They have to be able to weather that storm personally in their assets so we're really looking for enough coverage to look at that unit in getting to the profitable state.

About a third of our book is with existing operators opening new units. So we have re-cap and refinance and then we have basically a new unit financing structure. So it's about a third, a third, a third in our book which is great because that's very diversified in terms of the type of borrower and the type of loan that we're doing.

Peter: On that, I am curious about your plans because obviously franchising is an international phenomenon, there's many American franchises that are now all over the world. I'm curious about...I know you're still a pretty small company, but what are your thoughts about international expansion. In some ways it would be easier for you than many other businesses to expand internationally.

Denise: Yeah, it is a global business and we estimate both in equity and debt. This is well over a $120 billion market. The US is about $45 billion of that so we have looked at...and I think one of the most obvious places has been Canada where we have Canadian brands that want to come to the US and US brands that want to go to Canada. The big variable for us is really in-country knowledge of the regulatory and banking environments and the models with which you can do alternative lending. I think the UK is a really interesting area because of the program for how they do the government-backed lending in that country is so smart, in my opinion.

Peter: I agree.

Denise: I wish the US would adopt…I mean they're really channeling funds into platforms like ours....

Peter: Yep.

Denise: ...to make sure that they're issuing good credit.

In the United States, on the other hand, the SBA program, you know, in some areas has tremendous losses and it's really the taxpayers' dollar that’s going to that. I'd love for the UK model to get adopted in the US and who knows what's going to happen in the landscape of politics this next year but I would like to author a paper on that, Peter, and with the help of potentially a very well-known VC in this space who understands this too because I'd like to put that agenda forward. I think it's a really, really strong opportunity for us here in the US.

Peter: Yeah, I completely agree.

Denise: We will go into other areas, it's just not clear that that will happen this year. We do have some test cases we're working on with partners and we'll look at probably Canada first.

Peter: Okay, we're just about out of time, but one question before I go. I'm curious, why did you name your company ApplePie Capital?

Denise: (laughs) I love telling that story. You know how hard it is to find a URL…if you've ever typed in to GoDaddy to find out if a URL is available...

Peter: Oh, yeah.

Denise: ....you know, we have a lot of squatters out there, squatting names and I have a real love of naming companies and knowing when you hear the right one that you really need to move with it and frankly, I had a naming party and I brought all my favorite marketing people into my home and I said we're not leaving until we come up with a name because I have customers and I don't have a name. It was the holidays and I bake a mean apple pie and it got to dessert and they still hadn't come up with a name and when I brought out the apple pie everybody looks at me dumbfounded and said, why aren't you naming this company apple pie?.

Peter: (laughs) Alright, so it was named after apple pie, an actual apple pie.

Denise: It was and it's an accessible name. We wanted a name that was friendly and non-bank like, yet serious which is why the word "capital" really helps to ground the name, but we tested it and...I always say that if it's a little uncomfortable, it's probably a good name because it will be memorable.

Peter: Right, indeed. Well on that note, I'll have to let you go, but I really appreciate you talking with me today, Denise.

Denise: Thank you, Peter, really appreciate it. Thank you for the opportunity.

Peter: Okay, see you.

Denise: Bye, bye.

Peter: One of the things I really like about ApplePie is they do have this unique kind of borrower acquisition channel insofar as once I sign up a franchise, that's just not making one loan. They may end up making 20, 30, 40, 50, hundreds of loans over the long term with that one business going to obviously many different individuals and once they're hooked in, I imagine that's going to be a very sticky relationship. I think that's probably why they've been able to obtain the confidence of one of the larger banks in the country.

They've also got QED, the most prolific VC firm in our industry as a backer as well. They're certainly a company to watch, they're still pretty young, but I see as long as they can keep delivering on solid underwriting which is what they seem to be doing, at least so far, then I think they certainly have a bright future.

Anyway on that note before I sign off, just a quick plug if I may for LendIt USA. We are going to be gathering on March 6th and 7th in New York. Go to lendit.com and you can sign up and buy a ticket. Every single major company in the industry is going to be there and I'll be there and I hope to see you there.

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

(closing music)