PODCAST TRANSCRIPTION SESSION NO. 87: CHRIS JOHNSON

Welcome to the Lend Academy podcast, Episode No. 87. This is your host, Peter Renton, Founder of Lend Academy.

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Peter Renton: Today on the show, we're going back to the investor side of the business. I am delighted to welcome Chris Johnson, he is the Managing Director at Prospect Capital Management. Prospect have been a significant investor in this space now for many years so I wanted to get Chris on the show just to talk about their approach, talk about the platforms they invest in, how they do due diligence and we also talk about a new initiative that they have coming up here later this year. It's a fascinating interview. I hope you enjoy the show!

Welcome to the podcast, Chris.

Chris Johnson: Thank you, Peter, good to be here.

Peter: Let's get started...I want to give the listeners a little bit of background about yourself. You've got a fairly interesting background, you started off it sounds like in the Navy and then you made your way to Wall Street. Can you just tell us a little bit about your career and how you've come to this time?

Chris: Sure, well first of all, what I do now is I run the online investing business at Prospect Capital Management which is the external manager to Prospect Capital Corporation. To date, what we've done and we'll get into it in more detail is we've invested in online originated consumer and SME loans.

Taking a step back, my background is mostly credit. In between college and my MBA at Darden at University of Virginia, I was a nuclear submarine officer on a fast attack submarine and qualified as a nuclear engineer by Naval Reactors. That's not necessarily a credit background… (Peter laughs)

Peter: It's a risk background.

Chris: …but I think it's a good background for attention to detail.

Peter: Indeed.

Chris: I started at Merrill Lynch in 1984 after my MBA. By 1995 I was running the leverage finance group globally at Merrill Lynch and I ran that until 2001 so leverage finance at Merrill Lynch at the time was high yield bond underwriting, bridge loans, syndicated loans and then I went to Deutsche Bank in the last decade and I ran the restructuring in the media and the telecom groups at Deutsche Bank. And then I came to Prospect Capital in 2012 where effectively, I came over to the buy side as opposed to being a banker for almost 30 years.

Peter: Right, right, got it. Okay, so then you work at Prospect...Prospect are a BDC and not everybody understands exactly what that is so can you explain what a BDC is and how it's sort of structured?

Chris: Sure, so a BDC is...the formal name is Business Development Company. This was a form of entity that was enacted in 1980 legislation. BDCs are investment companies under the Investment Company Act of 1940. What's interesting about a BDC is most BDCs elect to be called a Regulated Investment Company, RIC. Effectively, what that means is as long as the entity distributes 90% or more of its income to its shareholders...and a BDC can be either private or public...as long as it distributes that income, it does not pay federal income taxes.

So view a BDC as a corporate finance version of a REIT and as a result BDCs can be an attractive investment for an investor, whether it's retail or institutional, that desires yield and so you will see that most BDCs spend a lot of time investing in middle market lending and other yield strategies. Publicly traded BDCs, if you pull up a run on Bloomberg you would see that they typically yield between 7% and 13%. Again, I'm making a generalization, but it is a yield-oriented vehicle and it is...when I say yield, it's really cash flow, it's a distribution.

Peter: Right, so which means you invest in companies that pay dividends of some kind or you get cash flows coming in. Can you…and I was actually looking through some of your recent filings because you're a public company and you do have quite a diverse portfolio. Can you just run us through some of investments you guys have?

Chris: Sure, so we're a little bit different. Most BDCs, 80% to 100% of what they do is middle market debt lending and this is partly because the banks have gotten out of the cash flow lending business since the 2008 crisis and the BDCs have gone into that vacuum.

We're a little bit different, that's about half of what we do is middle market lending; the other half is we are always looking for yield-oriented investing themes that are always credit-based and always can create diversity for Prospect Capital Corporation, a BDC. So if you look in our filings, you'll note that we've been an active investor in CLO equity which in our filings is defined I think as residual interest.

We've also been very active in the topic that we're talking today, marketplace lending, and the reason for that in each of the CLO equity business and marketplace lending is you can achieve a relatively high current cash return or distribution, particularly from the time you initially make the investment.

Peter: Okay, so then can you share some of the platforms that you're investing on today in the marketplace lending space?

Chris: Sure, so we've been active since 2013. There are four platforms that we have invested in since that time: Prosper, Avant, Lending Club and OnDeck. We've been a very active investor in Lending Club, whether that's prime or near prime. You can find detail on our investments in our

10-Q for September 30, 2016 and our fiscal year end is June 30, 2016 so there's also detail in that.

We have spent a lot of time since really 2012 on the diligence standpoint looking at both consumer and small business platforms and we've diligenced over 50 platforms, substantially all in the US. The other thing that we invested in is back in the summer of 2014, we purchased a small business portfolio out of Direct Capital. Direct Capital was being sold to CIT primarily for it's leasing business and we purchased that portfolio which has substantively been realized.

Peter: Right, I also read that you completed a securitization of Lending Club loans, I think that was in Q4, can you tell us a little bit about that deal?

Chris: Absolutely and I can discuss this publicly because of the information that's out there.

There is a securitization tracker that has been published by PeerIQ recently which describes this. So there were eight marketplace lending securitization deals in the 4th quarter of 2016, one of those was the one that we sponsored in October which is called Murray Hill Marketplace Trust 2016-LC1 and what that was...it's a securitization where 100% Lending Club near prime assets were put into the securitization vehicle. The deal was not rated, the collateral that was put in was $314 million of the collateral of the near prime loans and we sold a Class A note and a Class B note to non-affiliated third parties.

The private placement agent was Morgan Stanley and our view generally on securitizations...we've been very active in the credit markets for the last three years in terms of credit facilities, but that's floating rate debt and we view securitizations as basically a form of fixed rate financing so we felt it was time to do that and as you'll note in the PeerIQ tracker, the rates were 4.19% on the A and 6.19% on the B note.

Peter: So basically most of the loans, you are just doing a buy and hold strategy, it sounds like, but there's a portion that you're taking off and doing a securitization. How do you decide what to buy and hold and what to securitize?

Chris: Historically, we buy and hold. I view still the securitization as a buy and hold, we've retained on this one the equity residual and so it's fixed rate. We view it as fixed rate financing so it still is consistent with the theme that we're really a buy and hold investor. This is very consistent with that.

Peter: So I want to talk a little bit about 2016, the year that was, at least I know…you probably can't comment on the 4th quarter yet, but at least through Q3 of 2016, did you increase or decrease your exposure based on some of the headwinds that the industry experienced in 2016?

Chris: We increased our exposure overall, not everything goes totally in a straight line, but just to give you some numbers out of our public information to put this in perspective. At December 31 of 2015, the consumer assets that we own at fair value were $611 million so if you put that as a marker...at September 30, 2016, that fair value of consumer assets is $728 million. So over the course of nine months we did increase our exposure. I think this is partly because we remain constructive on the asset class, but also we view, as I've mentioned earlier, we view this as a nice contributor to our ability to create yield.

Peter: So it's fair to say then that the pullback that the industry experienced not just due to the Lending Club issues...you guys really didn't participate in that pullback, it sounds like.

Chris: I think that's fair on a secular basis. I will say though that we, like our peers, we re-underwrote every one of our platforms and spent a lot of time going back and re-underwriting risk and effectively everything that the platform does.

One thing I would like to add to put this in perspective, we do as part of…if you look in our public filings, we do own certain companies and there are three notable companies in consumer finance that we own.

When we look at purchasing or going into a whole loan forward flow agreement, we essentially diligence the originator of those loans like we were going to buy the company. Obviously, we're not buying the company, but we take the same care in terms of our diligence and so we did that again obviously when the pullback occurred and we always continue to do that on a continual basis.

Peter: Right, right, makes sense, makes sense. So then I want to just talk a little bit about leverage. Do you use leverage in all of your investments, in some…what's your approach to leverage?

Chris: We use leverage in all of our investments except small business. Small business is a smaller, much smaller part of our portfolio. If you look, for example, in our September 30, 2016 10-Q, the cost basis of our small business assets is $15.8 million, but on the consumer side we do use leverage, whether it's a credit facility, a warehouse financing or as I said earlier, the securitization.

Peter: Right, okay. Obviously interest rates went up recently, people are talking about interest rates going up two or three times in 2017 so how's that going to impact you guys in your approach to leverage?

Chris: I'd say a very careful look at it, not being facetious, what's interesting about this asset class is the duration of the three year consumer loan which has become really the predominant part of pretty much everybody's portfolio is 14 months, roughly 14 months when you consider contractual amortization, prepayment. So it's not as much interest rate risk as maybe some other categories so we will certainly see some impact in it, but given the short duration, we may see a little bit less impact, but LIBOR has certainly, obviously as everybody knows has gone up and our credit facilities are floating rate.

Peter: Okay, so I wanted just to talk a little bit about your approach to looking at these platforms. You said you went back and sort of redid your diligence on a lot of the platforms. What does that look like, what's your approach to the due diligence that you do?

Chris: Sure, so we first have a very detailed due diligence checklist agenda items that we send to the company. We're always looking for extreme transparency at the assets, we will not diligence a company if there isn't full transparency. After the company gets those questions, we will go out, visit with the company, spend time with them.

I would also say to put this in perspective and make it more tangible, the marketplace lending platforms tend to have what I would call seven or eight functional areas that all have to work together to make the platform work. So whether it's regulatory compliance, underwriting risk, marketing, many others, servicing collections of course. We do onsite diligence with regard to all of those and then, obviously, very important, management, technology.

At then at the end of the day, the asset that that platform is originating has to meet our return requirements. We mentioned credit earlier, we generally either have a credit provider we're working with on this asset class or on that particular asset or we're in discussions with it so it all sort of has to fit together.

I would tell you that we have diligenced platforms as long as off and on for two years before we've ended up going into the...you know, we could diligence a platform and decide it's just a little bit too early maybe from a data analytic standpoint, but I would say we've never diligenced a platform less than six months. It's a very detailed, ongoing process.

Peter: Okay, so you go in with your credit provider so...

Chris: By ourselves at the beginning, yes.

Peter: ...by yourselves and then you bring in your credit provider. They've got to be comfortable with the deal as well, it sounds like.

Chris: That's correct.

Peter: By the time you bring them in are you pretty confident that...having worked with these people you know that it's going to be okay?

Chris: I think the short answer is yes, we have some very deep relationships on the credit side. So I think the short answer is, yes, we're not going to waste anybody's time and I don't think they're going to waste ours.

Peter: Right, right. So then you said you've only invested in four, are you looking to expand that number or you're comfortable with adding just to the positions you have in four?

Chris: No, we're looking to expand. Let me put a little bit of background on this.

I talked earlier about the BDC, we've also...and I welcome folks to get on the SEC Edgar website, but we have filed a closed-end fund called Prospect Marketplace Lending Corporation. We filed it in late October 2016, we filed Amendment No. 1 early this week and it will be a closed-end fund designed to invest in marketplace lending assets, primarily whole loans. So in that regard, we are diligencing additional platforms that we could use as investments into this closed-end fund.

Peter: Okay, so that's going to be a brand new entity so I guess you're not going to move existing assets into that I presume, you would be buying new assets?

Chris: Right, it's all new assets, you cannot move the assets under the 1940 Act. The closed-end fund will be externally managed by Prospect Capital Management which externally manages Prospect Capital Corporation and it will be a…what I would just call it is a...obviously, because it's going to be substantially all marketplace loans, it will be a very focused fund.

Peter: Right.

Chris: Not unlike the main two that are out there right now.

Peter: So it's going to be an interval fund then like...

Chris: We're still working through exact processes, but at a minimum it's a closed-end fund.

Peter: Right, right, okay, I had noticed that, I was going to ask you that. That's great to have another player there, I feel like we need more...one day we'll get an open-ended fund, but that's not going to happen anytime soon, I'm guessing, but that's great to know. You may end up with more than four platforms in there, that's fair to say.

Chris: I think that's speculative, but I think it could be more than three. (laughs)

Peter: (laughs) Okay, we'll wait until it actually launches.

Chris: I mean we are diligencing additional platforms.

Peter: Right, okay. So I want to talk just a little bit about loan performance and it's something I'm sure that you're watching very, very closely. I've noticed in my own personal portfolio that defaults….some of the vintages in late 2015 and late 2014 have not performed as well. What have you noticed in your portfolio?

Chris: Our observations...and, again, I have to be careful because this is public information, but our observations are not that different from yours or from other...a few other websites that track this very closely.

Peter: So obviously, given the fact you've increased your...it's fair to say that you're not like overly concerned or you feel like...obviously, you've increased your assets throughout 2016 so are you sort of changing the mix of loan grades or is there anything you can share on that as far as your response to…

Chris: Sure, again, if you look in our public filings we have the breakdown of whether it's super prime, prime or near prime. The majority of our assets are near prime. If you go back in our filings over the last two years it's just edged up slightly, but it is over 50% so we're still comfortable with that.

I will say though, you know, we're always running recession scenarios. We've spent a lot of time on that in the last two years, whether it's mild recession, dramatic recession so we're always doing that kind of data and analytics as I would expect other investment managers to be doing on this asset class.

Peter: So what is the view inside Prospect on the economy for 2017? Do you guys have a perspective on what you think will happen?

Chris: Well we do not have a formal perspective. I would say that my perspective is not that different from the Fed. The Fed has recently published projections for 2017 where there's going to be slight real growth as compared to 2016 and I feel that is reasonable, but that's my personal opinion.

Peter: Right, okay. So what's your view on the overall industry? We're in a new year now and we put the challenges of 2016 behind us, what's your view on the industry today? Are you bullish on 2017?

Chris: Yes, I am bullish, I think that the industry...one of the big positives...I think the way that the industry, the ability for it to grow, it's going to have to continue to develop the securitization market. I hate to keep coming back to that, but if marketplace lending is going to continue to grow, the securitization market, particularly rated securitizations, is going to provide incremental third party debt investors. And I think the important thing about rated securitizations is that it opens up to the insurance company market an easier way to invest in this asset class, particularly, obviously, the Class C notes.

Peter: Right and I feel that has been a bright spot in 2016...the PeerIQ, you can see that we've had tremendous growth in the securitization market so it's different than the overall market. I feel like it has become more important…people, I think, are agreeing with you that it is something we need to focus on.

Another question just on a secondary market, I'm curious to know whether your view on the secondary market, beyond securitization which obviously has its own form of secondary market. I sometimes think about the Holy Grail being the open-ended mutual fund. It seems like a secondary market is something that is really needed for something like that to happen. What are your thoughts on the secondary market? Is that something that you think is going to happen, it should happen? Where do you stand on that?

Chris: I think it will happen. I mean, it won't be any different than a whole number of other asset classes over the last 30 years. It has been fairly slow to develop and I think that's primarily because of non-standardizations between platforms. I do think though, in particular and again I guess I'm giving them a bit of a plug, but dv01 for example, is doing a lot to try to standardize data.

Peter: Right.

Chris: And so they're not necessarily front and center as I'm going to create a secondary market like some others, but I think the more standardization of data that we have, I think that will enable a secondary market to develop. I know there have been some folks out there that have been trying to develop it and maybe…I give them credit for that, but I think there needs to be a little bit more standardization of data, but I think it will happen.

Peter: I hope so and I think so as well. I was talking with Matt Burton the other day and he was saying for his company it's just crazy how different companies store their data and it makes it much more challenging for investors to compare apples to apples.

Anyway, we're just about out of time here, but what are you working on personally now and for 2017? Are you working on the closed-end fund the most or what's on your plate for this year?

Chris: We are spending a lot of time on the closed-end fund that I mentioned. We're also spending a lot of time, as we always do, on what I would call portfolio management, but that's really data and analytics. So I would say...and then as part of this closed-end fund we're looking at a few new platforms.

Peter: I guess you don't have an expectation of when it's going to be, I mean some of the other closed-end funds took forever to go through. You're still going through the SEC process, I take it?

Chris: We are still going through the process.

Peter: Okay, anyway on that note, I really appreciate you coming on the show today, Chris.

Chris: Great and I appreciate the time. Thank you, Peter.

Peter: Take care, see you.

Chris: Bye.

Peter: I think it's great to see Prospect doing another closed-end fund. I think we need more of these funds in our space and, as I said, eventually we need an open-ended mutual fund because as I see it the way this asset class is really going to hit scale is that we need a way for everyday investors to be able to have a simple way to access the yield this asset class offers.

The simplest way is through an ETF or an open-ended mutual fund…now we're not there yet. I think the closed-end mutual funds are a great way to start, particularly those individuals going through financial advisors. That's a way for them to access the asset class, but for it truly to get scale I think we're going to need that open-ended mutual fund, the Holy Grail, as I see it I feel like having Fidelity or Schwab, having like a marketplace lending offering that when you go and sign up at your job you can just check the box saying, yes, I want access to consumer credit or small business credit or just marketplace lending in general. I feel like that is the Holy Grail, we're not there yet.

We're probably several years away from something like that, but I think when we have an offering that is simple, that provides high yield, that provides permanent capital to the platforms I think then we are going to see this scale beyond the billions of dollars into the tens, even hundreds of billions down the road. It's not going to happen next year or even before 2020 possibly, but I think when you look long term that is the way the asset class is going to scale.

Anyway on that note before I sign off, I just want to give a quick reminder about the LendIt Conference. It's coming up March 6th and 7th in New York. Go to lendit.com, if you have not bought a ticket yet, I highly encourage you to do so. Everyone in the industry is going to be there.

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

(closing music)