LEND ACADEMY

PODCAST TRANSCRIPTION SESSION NO. 122-RAY STURM

Welcome to the Lend Academy podcast, Episode No. 122. This is your host, Peter Renton, Co-Founder of LendIt and Founder of Lend Academy.

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Peter Renton: Today on the show, I am delighted to welcome Ray Sturm, he is the CEO and Co-Founder of AlphaFlow. Now AlphaFlow is a relatively new company in the real estate space, but they're starting to get some traction so I wanted to get Ray on. He's actually been around the real estate crowdfunding space from the very beginning pretty much. I wanted to get him on to talk about what his company does, how they're adding value for investors who want to invest in real estate and how he's able to connect to all these different platforms. We talk a lot about the real estate crowdfunding industry today and he prognosticates on where he thinks it's going and how many successful companies he thinks that this industry will eventually be able to support. It was a fascinating episode, I hope you enjoy the show!

Welcome to the podcast, Ray.

Ray Sturm: Thank you for having me, Peter.

Peter: So I'd like to get these episodes started with a little bit of background about yourself, just to give the listeners a sense of who you are and what you've done in your career so far.

Ray: Absolutely, so my background is a bit different than some of the startup world in that I actually went to law and business school before starting my career on Wall Street. I actually worked in leveraged finance at Bear Stearns until the bank collapsed in 2008, then I worked in restructuring at Lazard so I spent a lot of my early career in debt.

From there, I worked in private equity as an investor, but at that point I needed something more entrepreneurial so I left Wall Street for the startup world and actually hooked up with Nav Athwal in 2013 to launch RealtyShares which was one of the first real estate crowdfunding platforms at the time. So I was responsible for all of the financial underwriting there, I did all of the investor relations so I got to know a good chunk of the business on both sides really of how it worked, but I'd say my background of my core is really as a finance professional.

Peter: Obviously you were at RealtyShares and you've now created AlphaFlow. What was the thing that sort of you saw that really...you felt there was an opportunity here with AlphaFlow?

Ray: You know, I think RealtyShares was doing very well and I had the idea for AlphaFlow really coming from our clients and it's something that didn't necessarily make sense for RealtyShares to do so it made sense for me to leave and start AlphaFlow. Really what it was based on is this marketplace model that you're seeing in a lot of real estate crowdfunding platforms today. It's exciting, it's giving investors new access and new opportunities to these new types of investments, but the reality is there are a lot of investors out there who just need something more passive.

We tested that out early on in the industry where we did the industry's first multi-platform funds in 2016 and it's really what a lot of our larger investors were looking for. They said, I like these investments, but I don't want to pick these loans one by one, you're good at this, can I pay you to do that? We thought there was a business there and that worked very well. Actually this last March, we launched our first automated investment platform bringing that to the industry and we actually launched it at LendIt in New York City in March.

Peter: Okay, so then just explain a little bit, when you meet someone for the first time at a cocktail party or whatever, how do you describe AlphaFlow? What's your elevator pitch for what you do?

Ray: Yeah, it's an automated investment platform for real estate and so really all clients need to do is invest capital with us, as little as $10,000 and within a week or two we're going to build them a portfolio of 75 to 100 different real estate loans around the country. These days within a few days most likely, we've got them 85 loans across 20+ states. We're getting them 8% to 10% returns on first lien debt so this is debt that's backed by an actual house behind it so if something goes wrong there's fairly low LTV.

We've got a max LTV of 75% so they've got a lot of equity cushion in there and we do all of this, all of the work for them, they don't have to do anything, but at the same time, unlike a fund, they get full transparency into their actual portfolio. So we do all of the work, we back it up with institutional level analytics and they get all of that for a 1% AUM fee.

Peter: Okay, I want to get into that in some depth, but before we do just explain the platform, just tell the listeners what are the platforms that you're working with today?

Ray: Yeah, so today we're actively working with five online platforms. I'll list them in alphabetical order so I don't hurt any feelings like I have in the past. (Peter laughs). So we've got basically Fund That Flip that we work with, LendingHome, which is the biggest in the industry today, we've got Patch of Land, PeerStreet and Sharestates. We're also looking at expanding to a couple of more platforms online so we're talking to Groundfloor and InstaLend as well right now and I think we'll be working with those guys. That said, given our growth and we really need to see more loan inventory, because we've got a lot of clients coming in now building portfolios. We're starting to also work with traditional offline hard money lenders.

Peter: Interesting.

Ray: Yeah, that's new these days. I think by the end of the year, you'll probably see us split 50/50 online and offline in terms of loans.

Peter: Wow, that soon, that's quite impressive. Okay, so then I'm interested in your due diligence process because with being a marketplace you have really two steps in the due diligence. You've got to due diligence a platform to allow them onto your marketplace and then you've got to due diligence the loans themselves. Can you just describe how that two-step process works and maybe even start talking about the...if there's someone from the real estate platforms listening, what do they need to do to get into your marketplace?

Ray: Absolutely, I think you described it the right way, Peter, so before you're looking at any loans and whether this is us or any investor looking to invest their own money, you need to look at the platform first. So for us there are a couple of different pieces there; first, you want to make sure they're capitalized, you want to make sure someone doesn't have three months of basically runway in the bank and you're buying a 12-month loan but they might not be around so you want to look at who their backers are, understand if they're set up the right way.

For us, it always means meeting with their team in person; you want to assess their experience, you want to understand are these people that understand how real estate works, how capital markets work. Do they actually have a real underwriting policy and procedure and then more importantly, this is the part that a lot of people don't do, do they follow it.

So you need to look at their loans and say do their actual loans match what they put over here, in terms of their underwriting policy. You'll be surprised how often that's not the case. Ultimately, what you're looking at is their track record so if all of this works out, the track record these days candidly and the way the market's been is probably the least interesting because it's hard to lose money in this market at this point, but that'll change at some point.

At that point then we start looking at loans. So if someone wants to work with us they need to make sure they have things in order. They need to have a clear underwriting policy, they need to have their loans actually laid out for us to evaluate. These are things that sound obvious, but a lot of platforms are just working loan to loan and they haven't built their companies like this to track their own data in the right way.

Peter: Okay, so then once you've onboarded a platform...assuming you're comfortable enough with these platforms that they're underwriting in a way that you're comfortable with, but you then choose only a portion of the loans that they're underwriting, how do you decide what loans to invest in on each platform?

Ray: Yeah, so to do that the right way, earlier this year, we built our own basically real estate analytics platform where we work with a partner out of New York called The Number, that is our data partner, and with really just a name and an address we can pull a tremendous amount of information on the borrower, on the property itself and then on the market which can be the most important really if a market is going down no matter how good of a job you do, you're going to be stuck with a house.

So we look at all of those in depth. The reality is if we look at that on top of the information provided by each of the lenders themselves in their files, these days we're rejecting about 90% of the loans we evaluate. So it's a pretty stringent box; there are a lot of good loans out there, but there's a lot of noise to sift through as well.

Peter: So just talk about those loans. I mean, are you exclusively in the fix & flip space, what's the average length of these loans, interest rates, loan amounts, LTV, that sort of thing?

Ray: Sure, the use case they're all bridge loans, but they're not necessarily fix & flip, some are fix & hold. One of the things you're seeing more in the market these days is people holding on to these properties as rentals. So our loans basically are the bridge between them buying it and then a year or so then getting traditional mortgages on the properties. Every property you see is going to be 12 months or less in term. That said, anyone that's been in this space knows that these loans prepay pretty early very often so what you'll see with us and really industrywide is a duration of closer to probably 6.5 months.

So these days, in terms of AlphaFlow, we've invested in just over 500 loans, we crossed that mark last week. We're invested across 29 states so it's really across the country there. If you look historically, and this is going all the way back to 2016, our average coupon on those loans is about 10.1. That said, I wouldn't expect that today. When people are coming in, yields have come down over the last six months or so and so you're seeing closer to 9.7 for our averages these days.

We could've kept that high mark, but we just thought the risk was too high, it didn't make sense. Our LTV is right around 69% so it's fairly conservative. I think you can get more aggressive if you're out there on your own. These numbers might sound low to you because you might see 11% or 12% loans out there, we just tend to pass on those loans, we see them as too risky, they're often first time borrowers and we tend to avoid those loans.

Peter: Okay, makes sense. So then I believe earlier this year you guys became an RIA, a Registered Investment Advisor. So tell us about that process and why you decided to do that.

Ray: Yeah, it was an in depth process to go from being a marketplace and really using exemptions to actually being a regulated entity there. So today we're a California RIA, at some point soon hopefully we'll be with the SEC at the national level, but ultimately it was a legal need. So our offering, the way we've structured this…this isn't a marketplace where we just put this out there and allow users to pick this. We're actually exercising our own discretion about what’s a good investment and what's not and to do that we legally needed to be an RIA; there are benefits though.

The flip side is for investors we're 100% aligned with our clients so we can focus on really building portfolios that we think are good, not just taking in everything that's offered. We can exercise our discretion there and there really isn't any pressure to just simply push volume. So we can work with multiple partners, we can actually build portfolios in different ways and over time we can get creative if we have different investors with different risk return appetites. We can make that work as well as an RIA.

Peter: Right, so let's talk about the investors. I mean, who are they, who's coming to your platform today. Individual investors? You've got other RIAs, funds, other institutional investors, what's the mix that's coming today?

Ray: Yeah, it's two groups. We've got high net worth investors which...they're all accredited investors at this point. Our early clients were often clients of the platforms themselves and so they got familiar with the space, they like the underlying assets and the investments, but over time that was just too much work for them to keep up with. Oftentimes, they were actually referred to us by the platforms, we've got great partnerships with these guys. They know that ultimately it's better for their clients to come here than they leave the space because they don't want to invest so that's one group.

These days we're getting more and more people who were never involved in the space at all just because the way we're offering it makes sense to them, but we've also got a number of institutional investors. So today, we've got family offices investing with us, hedge funds, we've actually got a charity and one university endowment investing with us.

What we see as our future though is RIAs and wealth managers and building towards that. We're actually working on our first RIA partnership right now, hopefully in the next few weeks we're be able to announce that.

Peter: That's pretty cool. I just want to dig in a little bit into sort of the investment process and the structure of these investments. I mean, you said it's all about a process and obviously full disclosure, I am an investor on your platform, I've actually gone through this process myself. I'd like you to just explain to the investors what the structure that they're actually investing in and how it works.

Ray: Sure, our structure is very similar to what you see around this space. Around this space you'll see what's called a BPDN, a Buyer Payment Dependent Note structure; we've got a BPDC, it's got 'certificate' instead of 'note' at the end but ultimately it's similar. Basically what it is, we have an entity, AlphaFlow Holdings, that is making all of these investments. It's investing in loans around the industry, we're doing it on our own balance sheet and otherwise and as investors come in they're investing into that entity. What they're doing is they're getting slices with their investment of 75 to 100 different loans that are in our inventory. That's how we're able very quickly to give people a diversified portfolio within days, instead of this taking months to build this on their own.

It's also different than a fund where you get exposure to everything in there. This way you've got a specific portfolio; each investor has got a different portfolio and over time what that's going to mean for our investors is they're actually going to be able to customize it for their own needs. Sometimes they don't want to be in a certain state, sometimes they don't want certain LTVs; we're going to be able to facilitate that soon. So from an investment standpoint, it's a fairly simple signup process. Outside of accreditation once you've read the PPM and you feel comfortable with actually making the investment, it's a matter of minutes of actually getting signed up. It's a little bit longer if you want to invest through your IRA, but you can do that as well.

Peter: Right, and the thing that I noticed was how quickly my capital was deployed because I can't imagine...I can't remember the exact number, but it's like 80 something loans. I can't imagine there was 80 outstanding loans that all got filled in the short time that my investment came in. So are these loans that are fully funded already and you're kind of putting in a slice of my money into each one...I'm just trying to work out what the process actually entails.

Ray: Yeah, this is I think the necessity for us to actually keep our own inventory of loans and these aren't stale loans, these aren't loans with any issues that have gone bad, but we've got a team that's basically looking at the best loans on the market every day, regardless if investors are coming in or not. So at any given point, we do have some inventory of loans that haven't been tapped into at all but we also have other loans that our investors are already into.

So when a new investor comes in, we'll take their capital, we'll allocate it to one of the loans that hasn't yet been invested in, but then algorithmically, we rebalance all of everyone's portfolios, basically, and in bringing in new investors we actually get to improve everyone's diversification because it allows us to bring in more loans. So when you came in, within a few days we probably bought three or four more loans, but then we rebalanced everyone's portfolio that have recently come in and basically spread you amongst the last 80 or so loans that we had invested in. That's how we were able to do that so quickly.

Peter: Okay, okay, that makes sense, that makes sense. I want to talk a little bit about the technology side of things. I presume you're connecting with these platforms via API, but can you sort of talk a bit about that process?

Ray: Yeah, absolutely. It's actually, it's their API, but we design them so in early 2016 when we wanted to do our first fund, my co-founder Bogdan Cirlig actually designed and specced out an API configuration for each of the platforms and sent it to them and said if you build this, we can connect to you. So they did that, each of our partners did that and we have that open now to anyone who who'd like to do that and connect to us.

They can basically apply to us to do that and what it does is once in a while you've got hiccups, but it makes it pretty seamless for us to basically track our investments, to make our investments and then track them on a daily basis, make sure everything is working well and as payments come in, it all works through the API. So that's critical to making this work, we're a small team and that's one of the ways we really leaned hard on technology to actually make this work well.

Peter: Yeah, yeah, sure, but then you mentioned earlier that you've got some hard money lenders that are coming in, offline type lenders. I imagine some of them are small, some of them don't have much in the way of tech capabilities, I mean, are you going to be able to do the same kind of process with them?

Ray: I don't think it will be as hands off for us in those cases, in those cases I think…we've already started developing some fairly simple software that would allow them to send us the same sort of information over to us. Now some of the things would be easier because we wouldn't need them necessarily to maintain servicing of these loans which really means we're sending the bill to the borrower and collecting the capital. We may take that over for those offline guys, but in terms of them submitting loans to us to evaluate, to underwrite and such, that's probably going to be some simple software that we give them to allow them to do that. You're right, I don't see them building an API because they don't have a tech infrastructure to connect to today.

Peter: Right, right, so from your perspective you will still have a system in place that will allow a pretty seamless integration, it sounds like.

Ray: I think you have to for this to be successful, you have to do that and we just brought on a new head of product who's fantastic with working on exactly challenges just like this.

Peter: Right, okay, so can you give us an idea of the scale you're at today? I know you talked about…you've had 500 deals, but can you share like your total AUM or amount of customers, that sort of thing?

Ray: So this is where things get a bit tricky for us as an RIA. So it's certainly a fair question, but our lawyers asked us to stay away from this sort of thing because pretty soon we're going to be going through that SEC evaluation and if I say the wrong thing anywhere that can create real headaches for us so I apologize for...either AUM or actual portfolio returns are the two things I've been asked not to discuss.

Peter: Right, okay, no problem. I won't ask about your returns then (laughs). Okay, so I think it was last month or sometime recently, you raised a seed round, I think it was $4.1 million from some pretty big names. Point72 was one that sort of...it sort of captured my attention. I mean, Steve Cohen who…he's had a checkered past, but at one stage he was the most successful hedge fund manager in the country, possibly the world so just tell us a little bit about how you went about that process, how you got on someone like his radar and what that was like.

Ray: Yeah, honestly, I couldn't be more excited about the people we have around the table with us now. The round was led by Resolute Ventures and like you said Steve Cohen's Point72, but we also got participation from others; Social Capital, one of the big rising stars in Silicon Valley, Upside Partnership, Red Swan. So for us, what we were really trying to do was get a blend of both Wall Street and Silicon Valley expertise. To build a good fintech company, I think you need both and if you weigh too much on one side or the other, you're just not going to be successful and so I've been getting to know the Point72 team for probably the last 15 months or so.

We came out of Y Combinator in spring of 2016 and got to know them and they were just building venture as a strategy and they've done a handful of investments, but working with them was certainly different than working with any traditional VC. I think the in depth underwriting they do on your business, understanding how this would work, how to scale your underwriting model, I think it's much deeper than we've dealt with anywhere else.

Stevi Petrelli in particular over there is probably the most insightful fintech VC I've have ever dealt with, she was fantastic, but to get through that you needed to show them that you weren't just a traditional maybe startup here that was focused on Facebook ads and just thinking about things the way a lot of KPIs are measured and just really the Silicon Valley world...about how many clicks go to your website, how many signups. They were focused really on AUM, they were focused on how do you get on wealth management platforms, is this really a model that works and for us to get through the process with them, it took a few months and it honestly made us a much better business. It was tough though (laughs). It certainly was tough Peter.

Peter: Well that's great. Now that you've closed the deal, how active are these guys going to be in your business going forward?

Ray: Every one of these groups has already been massively value add for us and that was part of this where one of the benefits honestly Peter of raising for my second company here is you stop looking at necessarily firms as the whole and you start looking for individual people that you want to work with.

Peter: Right.

Ray: And so while I was very excited about Social Capital, in general, I wanted to work with Arjun Sethi n particular, he was incredible. The Point72 team might be an exception in that everyone I've met there seems to be a good fit, but I can tell you Point72, in particular, they introduced me to someone on their team, Alex, over there whose sole job is to figure out ways to make the Point72 asset management firm useful to AlphaFlow.

If we need any help with data analytics, if we need help with getting introductions to Goldman Sachs Wealth Management, etc., they are there to help and so that's been impactful. When you're a small team like ours, if you can really stretch your team and expand it into your cap table that means a lot. Candidly that's not always the case with investors who often write the check and then disappear until the next board meeting so ours has put money to work on the platform. They help with partnerships already and they're helping us with some large strategic initiatives right now so they've been great.

Peter: Okay, so I just want to talk a little bit more broadly now about the real estate crowdfunding space. You've been around it almost…pretty much such inception and we've seen a flurry of activity, we've seen some companies go out of business. How do you view the overall real estate crowdfunding industry today?

Ray: Yeah, it's an interesting time. There are still a lot of players, you know, there were more before and that was growing and growing, but the players that are here you see them getting more specialized. RealtyShares when we launched it, we were excited to do debt and equity, commercial and residential, really do everything, build a full service platform. It's a very successful platform, but even recently, they just sold off their residential business, for example.

So I think you're going to see more of that where people are learning in this space that it's very hard to do everything very well and so you're getting the Sharestates' of the world, the Patch of Land's of the world that know how to do, for example, just debt very well. And then you've got others like RealtyShares and RealtyMogul that I think have just narrowed their focus over time, just towards commercial equity. That's really where their futures lie if they're going to be successful.

And so I think you're going to see a little bit of house cleaning in this space, I think it's going to be tougher to raise funding rounds in the coming year, especially when...if it looks like a space where there won't be a clear winner and if you're trying to raise from venture capitalists, it's tough for them…say you're going to be one of ten big players, it just not necessarily how their model works and that creates some challenges. So I think you're going to see some of them go away, but I think actually what you're going to see more is a lot of them, maybe get a little bit smaller and they'll turn profitable and basically stay that way, and not necessarily grow to LendingHome size which was able to get a lot of venture capital early on.

Peter: Right, right, so how many companies do you think can be successful long term in the real estate space?

Ray: I think a lot of that depends on your version of the word success. (Peter laughs) I think you can have tens of them being successful, but not necessarily venture successful. So if we're talking about venture capital backed companies, I think you're only going to see a handful of those because at some point these guys need billion dollar exits. If you're getting an investment from Union Square's $700 million fund, you need to be able to return that fund for that to make sense.

I think others, some platforms I'm talking to and I won't necessarily say their names, but they're already telling me that they're looking for alternative capital, things like family offices that are happy to have them profitable and growing to maybe $100 million businesses but not beyond that. If that's successful and they're able to actually get that interest, and I think they will, I think you'll see a number of players, but from volume standpoint, I think you'll still get to a point where ten or so platforms represent 95% of the volume in the space.

Peter: Right, right, okay, So I want to talk a little bit about the future of your company and...we've been talking about real estate for a long time, but it strikes me that your name AlphaFlow, has obviously nothing to do with real estate whereas many of the companies in this space do have that as part of their name. So AlphaFlow, we all know what alpha is and people looking to get alpha and we still live in a low yield world and we may live in a low yield world for many, many years to come where people are always be looking for good fixed income. So just curious about how you think of the future, I mean, is this going to be a real estate play for a long, long time or are you going to expand your horizons?

Ray: Yeah, I am glad you asked because a lot of people just see us fully as a real estate company and I think from day one we saw an opportunity to go much wider than that. Really our focus is trying to fit the fintech world onto traditional platforms and one of the challenges of fintech in general, and I saw this first hand at RealtyShares, it's one of the things everyone talks about in the space is CAC or customer acquisition cost is astronomically high. And a big piece of that is if you've got an investment account, you've really got to take dollars out of there and move it over to a platform. So for us, when we think long term with AlphaFlow, it's how can we connect the fintech world as a whole to RIAs, to wealth managers, to the groups that already are sitting on these billions and trillions of dollars that want to invest.

We're starting that with real estate today, it made sense to start with real estate bridge loans, it's both my experience and it looked like a good industry to get tied together, but there are multiple other asset classes and fintech companies providing them asset classes like student loans, international finance, cross border finance, factoring, things like that where they already approached us and said could you take your model and actually apply it to what we're doing.

So while I think we have a lot to do still do in real estate and our clients actually want us to do other things in real estate like offer equity instead of just debt as well, I think within the next 24 months or so you're going to see us expand beyond real estate as a whole and bring in other asset classes too.

Peter: Yeah, that makes sense. It makes sense to start in real estate because, I mean, particularly if you're going after the RIA market and I want to ask about that in closing, but before I do I feel like from my perspective real estate is such a well established asset class, it's the biggest asset class. You don't need to convince anybody what's going to happen in a recession because there's decades, multiple recessions that real estate has gone through whereas the fix & flip craze hasn't been around for a huge number of years. I mean, it was well and truly established. I remember friends of mine who were crazily fixing & flipping in 2005/2006 and then we went through the real estate crash and everyone realized oh, real estate doesn't go up every year guaranteed, what a surprise, (laughs) but it makes sense.

But my last question, because I know we're running out of time here, is what is going to be….it's really the investor that is going to allow you to scale and you mentioned just briefly about the wealth managers and RIAs, where do you think...how are you going to build AlphaFlow into a business that's a 100X where you are today, where you basically can hook into these companies. I mean, how are you actually going to try and do that?

Ray: I think it all comes down to what we're starting with here is good investment offerings backed by strong analytics because when you're speaking to Morgan Stanley or a Merrill Lynch or a UBS and we've been in those discussions, they want to see not only volume, but they want to understand are you doing that well, what you're doing today. We're doing real estate, not only can it get bigger, but what you're doing today; are you executing on that very well. At that point, you're right, you need to look at other asset classes. Even within real estate, bridge lending is anywhere from $30 to $60 billion a year, in the Wall Street world that's a pretty small industry right there.

Peter: Right.

Ray: It's a way for us to build this framework, but if you start looking towards, for example, rental properties. You know, Roofstock just did a great Series B, fantastic. They're looking at a $7 trillion industry and so we can expand to those, there's everything from there to cross border finance is a multi hundred billion dollar a year industry, commercial lending gets to be a $150 to $250 billion a year on the alternative side of things. So there are plenty of places to expand, it's about doing this very well first. Once you've plugged into those partners, once you've plugged into those investors, it's much easier to bring the next asset class that further diversifies their portfolio, if you've done a good job on the first one to start. That's the way we think about the business.

Peter: Okay, we'll have it leave it there, Ray, it was fascinating chatting with you. Best of luck!

Ray: Thanks so much, Peter, appreciate the time.

Peter: Okay, see you.

So I wanted to end the show today with a little bit of a personal anecdote here to just explain why I decided to invest with AlphaFlow. I opened up an account earlier this year and the reason being is that firstly, I love real estate as an asset class. I've said on the blog several times that I want to increase my exposure to this asset class, but the reality is I don't know very much about it. I mean, I've got my own home, I have a second home up in the mountains here in Colorado, but I'm not a real estate investor, I never have been and I don't really know the first thing about doing that.

So I've been investing directly on one of the platforms and I'm happy with it, but I also like the idea of having someone come in and sort of filter out what they think are the best deals so that's one reason that I like AlphaFlow. The other is that you can get very diversified. Unless you're investing hundreds of thousands of dollars, it's difficult to have really great diversification on these real estate platforms. So I like the fact that with AlphaFlow you get quite diversified, as I said, quickly and with a relatively small investment.

So anyway, before I let you go, one last thing. I would really appreciate, if you haven't done it, I would really appreciate you going to iTunes or Stitcher and giving us an honest review. I would love to see more reviews there. It helps people find the show and helps us really grow the industry.

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

(closing music)