Welcome to the Lend Academy Podcast, Episode No. 125. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of LendIt.

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Today's episode is sponsored by LendIt USA 2018, the world's leading event in financial services innovation. It's going to be happening April 9th thru 11th, 2018 at Moscone West in San Francisco. We're going to be covering blockchain, digital banking and of course, online lending and other areas of fintech. There will be over 5,000 attendees, over 250 sponsors and registration is now open. Just go to lendit.com/usa to register.

**Peter Renton:** Okay, I'm here in London today at the offices of Pollen Street Capital with Simon Champ. Simon is a pioneer and something of a legend in the online lending space and he launched the first publicly traded investment vehicle in the peer to peer lending space back in 2014. We're going to talk a lot about that and many other things today so let's get going. Welcome to the podcast, Simon!

**Simon Champ:** Thank you very much, Peter. That was a tremendous introduction, I'm not sure if it is fully deserved.

**Peter:** Aw, come on, come on. Anyway, so why don't we start with a bit of background about yourself and what you did sort of before you started this fund?

**Simon:** Sure, yeah, I think like lots of people in alternative lending, we didn't necessarily spend all of our career in alternative lending. (Peter laughs)

I've actually spent 20 years in equity broking so raising capital for small businesses at three banks, a German bank called Dresdner, a very English bank called Cazenove which was later acquired by JP Morgan and then a bank I helped set up called Liberum Capital which, not coincidentally, had a quite big role in raising capital for some of these permanent capital funds in our space. It was whilst at Liberum that, along with a couple of colleagues, we saw an opportunity to create a different type of funding maybe for some of the early platforms which was the birth of that listed vehicle, P2PGI.

**Peter:** Right, so were you looking at Zopa and Funding Circle, what sort of first got on your radar?

**Simon:** I'd actually been privately and interested and a very modest investor in a number of other disintermediating peer to peer businesses, not to do with finance, so in music, in gambling, in art. So I'd had an interest in the concept of using the internet and technology to disintermediate high cost businesses. So when I met, coincidentally, when I met Zopa, RateSetter, Funding Circle and Lending Club in early 2013/late 2012, there was some sort of resonance maybe with some of those earlier business models I'd seen and really that's where
the concept came from really, a learning maybe from other industries that had been down the same path.

**Peter:** Right, right. When we first met, I remember it was at the very first LendIt actually, we met for breakfast, if you remember.

**Simon:** I do remember.

**Peter:** And you've come a long way since then and you talked about launching this fund back then so what was the original intent, what was the original focus of the fund, like you called it P2PGI so I imagine it was a peer to peer focused fund, but tell us a little bit about those early days.

**Simon:** Yeah, I think in those days having met three or four of those early platforms and being really excited by what they were trying to do, but also recognizing, as they spoke to us back then, about the challenges of matching...back then they were all matching fragmented loans between consumer buyers and consumer sellers. All of those platforms were doing that at the time, not whole loans but loans they were fractionalizing to create liquidity.

**Peter:** Right.

**Simon:** And it became probably apparent that, as it would to anyone, that they were doing that because they needed to create liquidity because most of their investors were relatively small ticket investors and wanted diversification.

**Peter:** Right.

**Simon:** If an investor wants to put a thousand pounds down, he didn't necessarily want to expose his entire thousand pounds to one borrower.

**Peter:** No.

**Simon:** So the platforms were doing a great thing, they were fractionalizing the loans. We could also see though that that fractionalization created challenges in itself about the provenance of the loan, about what happens to the loan if it needs to go into recovery. So we started to talk to the platforms about the concept of whole loans being passed to a single buyer or a number of buyers. So I think the early thought was to create liquidity, a pool of liquidity, to allow the platforms to work with in addition, alongside their retail customers.

It was never designed to somehow replace retail or be any better, frankly, in some ways than retail. It was meant to give institutions an access point to an asset class and bring in some fiduciary skills that maybe aren't always present in retail so maybe multiple platform access, different grades, some form of loan selection possibly, geographic diversification, potentially the use of leverage which would only really become available if you own the whole loan.

**Peter:** Right.
**Simon:** So we set about creating a whole loan vehicle, institutional fiduciary sort of confidence to investors. Because on the other hand, having raised money for lots of companies for 20 years, it had become apparent by 2012/2013 that there was a real appetite for income that you would not necessarily getting through other financial exposures like traditional banks who had had a tough time by 2012.

**Peter:** Okay, so then what was it like, I think you raised it was 200 million pounds, wasn't it, for that first fund. What was it like actually going out there and raising money? Was there a lot of resistance, was it a hard selling point?

**Simon:** You know, I think everybody likes to think that they are good at raising money….but the reality is (Peter laughs) you're only as good as the product. I mean, no one's going to invest in your product unless….and I think it had a resonance at the time that many of the investors we went to see….remember, we didn't go and see retail investors, we went strictly to professional investors and equity investors, that was key.

You know this is an asset class of debt, but P2PGI is in equity so you're wrapping debt in an equity wrapper and delivering something that maybe those equity managers haven't seen before or hadn't had the opportunity to be exposed to. I found back then the immediate comparison and most of the meetings was with banks…...the investor who liked the vehicle saw that you were accessing lending just like a bank does.

You were delivering a good chunk of that coupon back to the shareholder, just like a bank tries to, but because of the more direct relationship and the lack of infrastructure of a bank in the peer to peer model then you are effectively trying to deliver that return without the leverage, without the many layers of leverage that banks require to turn an ROE.

And it was that resonance, the lower leverage and therefore lower risk, we believe lower risk, that I think drove a lot of interest at the time. For many investors it was seen as a partial bank replacement. They were still funding the growth of the UK or the US consumer through their capital commitments.

**Peter:** So then when you launched, how many platforms did you launch with, do you remember?

**Simon:** We launched with four actually, we launched with Zopa, RateSetter, Funding Circle and a relationship with Lending Club. That was around the same time, you might recall, that we acquired the business called Eaglewood in the US.

**Peter:** Yes.

**Simon:** It was set up in the US by Jon Barlow, Steve Lee. They had almost in a sort of...in a mirror world done a very similar thing in the US, I just hadn't been aware of them. They had done a great thing and gone out and created a relationship with Lending Club that we saw an opportunity to maybe bring that into that whole building or bring it in-house and create a truly
global product for UK listed investors. Otherwise, I don't think there was anything wrong with Zopa, RateSetter, Funding Circle at the time, but it definitely gave an international feel of breadth and diversification. We also became aware that leverage and the possibility for leverage was more mature in the US at that time.

Peter: Right.

Simon: It was mostly because of the work the Eaglewood guys had done at Lending Club to create that part. So four platforms on day one which quickly evolved to...I think we've worked with close to 20 over the last four years.

Peter: Okay, so geographically, where are you now?

Simon: I think geographically, there are whilst it says P2PGI I think a couple of things have evolved, many things have evolved over the last 4 years, I mean it has changed immeasurably. We can probably touch on the concept of P2P, the very name of the platform because that's evolved tremendously, but we've tried to bring diversification into the trust, both geographically and across asset class so the trust invests in the loans of consumer platforms, consumer originators, consumer loans, small ticket SME, small balance SME, trade finance where it can and that's not always been easy to find in reasonable scale and increasingly secured lending which we do quite a lot of lending secured against prime property.

Peter: Right, right.

Simon: And then geographically, we found working within Commonwealth countries or English speaking countries where we understood the law like the US, which obviously is not Commonwealth but it is a standard of law that we understand Australia, New Zealand, the UK.

We haven't really done much in mainland Europe partly I think because regulation hasn't fully got there, across Europe; many platforms operating as pseudo banks or under maybe inappropriate banking licenses. Still flourishing, but we haven't really found anything that's worth...and also, there tends to be a lower interest rate culture in central Europe so turning that sometimes into a return for UK shareholders isn't always the easiest.

Peter: Right.

Simon: So, yeah, we try to be international and bring that diversification. Sometimes that's not always been to the benefit of...the diversification maybe, we've had challenges with that internationalization. We spoke quite a lot last year about the challenges during Brexit, during Donald Trump winning the election, seeing US interest rates rise, seeing currency move very sharply. All of those, in one way or another, degraded return so whilst internationalization and diversification are good things, I believe, they don't come for free (Peter laughs) and we've experienced some pain for that.
Peter: Right, particularly with the British Pound, it got hammered right after Brexit and that must have done some bad things for you.

Simon: It did, we have hedged the pound, we wanted to expose the shareholders just to the performance of the loans, not to the volatility of currencies, but even the hedge costs you. You need to hold cash to deliver cash potentially to the hedge, whoever is managing your hedge. On the few days immediately after Brexit, we had to provide a lot of cash to our counterparty. We didn't lose any money per se, but you're sitting on idle cash, it's not in loans, it's in the bank.

Peter: Right.

Simon: We wrote about this back at the time, but it was well over 10% of the fund, it was circa 15% of the fund held in cash that's not earning you interest while you protect your shareholders against...so in some ways, you know, I look back and think one did an okay job of protecting investors, but it certainly didn't help your performance sitting with 15% of your investors' capital in cash. That's one of the challenges of an international business.

Peter: So I want to go back to talking about the p2p piece here because you know, obviously when LendIt began, LendIt was focused on peer to peer lending and we've evolved as the industry has evolved and now it looks very, very different now than it did four and a half years ago. So just take us through the evolution of your fund. I know now that you work with obviously companies that don't have anything to do with peer to peer, but are direct lending platforms somewhat...so just tell us about that evolution.

Simon: Yeah, I think the evolution of those initial peer to peer platforms was a gateway, the initial gateway or sometimes I use to say when I met investors it was almost the first ticket to the party that invited a different form of capital to be able to fund lending. Up until that point, at least in my experience, banks and a small number of financial institutions had been the lenders to consumers, SMEs, trade finance and property.

The peer to peer model broke that. For the first time it allowed non-banks to genuinely access the market using obviously low cost distribution methodologies like online aggregators and mail. So I think whilst the models evolved hugely, and not everyone is peer to peer anymore, many of the originators we work with today are not what appear to be effectively retail peers. That initial model gave the, if you like, lit the blue torch paper for different forms of capital to access the market.

And you're right, Peter, when I look back, how many of the platforms we work with today would you class as pure peer to peer? How many of them have 20,000 retail customers on one side and 20,000 on the other? Not many because....

Peter: Close to zero (laughs)

Simon: …as I said they've evolved and the platforms themselves have brought in institutional capital. I remember doing meetings, when someone said to me in the very first round of capital
raising when we raised the first 200 million pounds, saying we're going to work with peer to peer platforms and one very sharp investor said, well except you're going to break the name because it's about to become peer to fund isn't it, or p2b, and that's absolutely correct, as institutions have come into platforms like Lending Club and Zopa who work with institutions.

It's slight changed the people's perception and now we see platforms come to us or let's just call them originators, who actually just work with one or two institutions on one side and a conduit to lenders on the other maybe through a very small number of channels, specialist channels, and actually, that works perfectly well. In many cases it can work better. One of the great challenges, I think, with pure peer to peer is that the price of the loan, if you're not careful, can be driven by the crowd...rather the volume of the crowd rather than necessarily the risk price.

Peter: Right, we've seen that.

Simon: We've seen that and it's hard to work with every platform and get exactly the right...depending on the motivation of the platform so we've had to try and be careful of who one works with and how you structure who you work with.

Peter: Right, I just want to touch on leverage because you mentioned it a few times. How much leverage are you actually using today and how has that changed?

Simon: I don't think leverage is necessarily...it's not a sort of means to an end or it's not necessarily a goal for anyone. At P2PGI, we chose to try and focus on the lower, what we thought was the lower risk part of peer to peer originations. Because we were facing institutions, we had less of an appetite for the higher volatility areas of lending where maybe gross lending is at high interest rates and losses are at higher numbers, the net could still have been good, but we just felt that as a first vehicle to be offered to institutions, we felt institutions would look for a lower risk opportunity so that's how we set ourselves up.

We also saw that some attractive originations from some of the platforms wouldn't necessarily meet our shareholders' return target standalone. It didn't make them bad, they couldn't do that. If I give a real example, the fund tries to return 6 to 8 to shareholders, there could be extremely attractive risk-adjusted loans, we believe, at 5.5. It doesn't mean you shouldn't buy the loan or perhaps you could go and work with a bank and get leverage against that loan and bring that loan into the portfolio with a modicum of leverage.

So the trust is, I think, relative to a bank that might be 20, 30, 40 times levered. The trust has a cap at 1.5 times leverage and today is around half of that levered, but could it be unlevered completely? I think it entirely depends on the availability of attractive risk-adjusted loans. I think we found around the right level of leverage and now the key though is to try and drive down the cost of that leverage rather than necessarily worry about how much you have.

If you can drive down the cost, you arguably need less of it to achieve the same return. One of frustrations maybe over the last four years has been the cost of leverage. Borrowing money
from financial institutions or indeed the bond market or securitization market hasn't always been a smooth path. It's been quite costly to be the pioneer.

Peter: Right.

Simon: The very first time you do a leverage facility with a new bank... he wants a fee, he wants an arrangement fee, he wants a non-utilization fee. He has not necessarily seen this before so being first out of the traps isn't always best. I think probably the goal for the business over the next few years is to clearly improve returns. One of the levers we have to pull on that is driving down the cost of borrowing and I believe we're making great progress on that, but it's not always the smoothest.

Peter: Right, right, I'm sure, I'm sure. So I want to talk a little bit about... I know you've met with dozens and dozens of platforms over the years, can you tell us a little bit about sort of the due diligence process that you do when you're approaching a new platform and then how do you kind of make the decision to bring them on to your platform?

Simon: Sure, I mean, you're right, I've probably met, well like you, Peter. (Peter laughs) I don't know how many I've met, I'm going to guess it's something like 300/400 probably.

Peter: Oh, wow, that's a lot.

Simon: But I've been fortunate enough to go to Australia and meet platforms there and then San Francisco to your event and meet hundreds of platforms, I've come to your event only this week in Europe. I don't know how many platforms you had there, it couldn't have been far off a hundred or something, but a lot of interesting parties. So I think firstly, we do seek, I mentioned earlier, we do seek a sort of if you like, a quality of problems.

We want to see people with gray hair in businesses, if we can, who remember a tough cycle, who've had a tough time, who start with credit and not losing money as their first or rather than the first thing they say to you is how massive they're going to be. That might scare you a little bit more so we're less interested in their scale, in their equity value; we're far more interested in the quality of loans they can produce for us across and that ethos and I think that's where our conversation starts. We obviously want to be diversified. There's not much point in having seven US consumer platforms to work with. I think if you can work with the two or three best then we can bring in diversification.

You know, our due diligence process is typically six to nine months it's taken us to bring platforms on. I think one of the things that's changed in those early days, the IT, we built the IT to connect to Zopa, to RateSetter, to Funding Circle. We built it and it was a real challenge, I mean, no one had done it before, to connect out to these platforms with an API, to select loans or select grades or whatever it was we were doing. We saw real value in that tech beginning, the DD was that tech, it's become far more ubiquitous today and that's really... there's much less value to add in that area.
So the due diligence today is very much around the loan process and the mental, if you like, sort of attitude of the platform towards sort of protecting the investor rather than necessarily just growing. We've also, over the years, matured in terms of putting in skin in the game aspect. I think one of the most recurring messages from skeptical investors is their concern about the skin in the game, the different motivations of an investor like P2PGI versus a platform. How do you solve that equation?

I think we've worked really hard to bring in elements to our contractual relationships that provide skin in the game trying create an alignment between the platform and us. A good example of that is where we lend secured lending against some of the real estate. The platforms, we've had quite a strong hand in helping to build, have a first loss element in them so the platform wears an element of first loss on the loan. I think that really focuses the mind of the platform because he doesn't want to lose money.

Peter: Right.

Simon: And that's something that's evolved that wasn't necessarily in place in 2012/2013.

Peter: Okay, so I want to get to the performance of your fund. Obviously, this is a publicly traded vehicle, anybody can go and look in and see your performance over the last three and a half years or whatever. So just talk us through a little bit about the challenges that you've seen and now obviously it's trading at a fairly deep discount, so tell us a little bit about that.

Simon: Sure, the fund has had this return target set in 2013 of 6% to 8% to its shareholders. You know, at that time I think 6% to 8% looked like an attractive level of return for something that possibly to some investors certainly looked like a new asset class and maybe an asset class not everyone was entirely sure about. In the 40 months, I think it's now 41 months actually since we've been listed so a shade over three years, the fund has produced a NAV return of 17.5%ish so not quite the 6% yield if you spread that over. It's a little less, it's sort of 5.7/5.8, that is definitely disappointing to me.

I'd much rather clearly produced 7/8% during that time. In the first year and a half, performance was stronger than it has been in the last sort of 12/14 months. It's all too easy for a fund manager to make excuses so, you absolutely shouldn’t… I mentioned some of the external factors earlier that gave us a challenge last year and some of them you have to stand up. We don't get everything right, I think we were, at times, overly exposed to US consumer, it grew very quickly, US consumer.

I think Lending Club did a very good job, but at times possibly the portfolio became overexposed. We're now going through a rebalancing and I'm pleased to say I'm very confident about the rebalancing and the effectively re-shaping of that portfolio to be able to produce those returns. I'm more excited today than I have been about the external environment because we have far more choice today than arguably we had in 2012/2013.

Peter: Sure.
Simon: I think the ability to redirect the portfolio...it's worth saying, it's a little bit of a super tanker in that the typical loan that we hold may have a 3-year life origination, 18 months weighted average duration. It does mean that it takes time to adjust the portfolio. At any one time, 3% or 4% of the fund might be amortizing in a month, but it's not 20% of the fund amortizing in a month. So it can take a bit of time and that can be a bit frustrating to adjust and it's certainly, I think in some areas where maybe our exposure to certain asset classes through currency or through leverage hasn't necessarily worked perfectly. I look now at what we're doing and I'm quite excited about the future.

Peter: Right, so just on that I've written about this extensively, I share my own returns publicly and some of the weaknesses in US consumer particularly in that latter half of 2015, early part of 2016, I imagine you held a lot of those same loans that I did or similar type loans. How much was that a drag on your returns?

Simon: To be honest I think when people talk about performance of loans, they obviously focus on the delinquency, the net return they've received on the loans, that's about all that really counts, but as I said I think we also, in addition to some variance in performance and bear in mind that P2PGI has had a focus on the prime end of the curve, typically on A,B,C grades should we call them. Some of the challenges you're talking about occurred outside that area.

Peter: Yeah, very true.

Simon: Some of the platforms had weaker performance maybe in the more mid-prime. We're not exposed to that so I can't really point to that and I think one of the things I'm sort of proud of is that we stuck to our guns and tried to stay prime and avoided a lot of those challenges you're talking about. That said, we still had our own other challenges through currency, through Brexit, through possibly the expense of being a pioneer in leverage, the cost of being the first guy to borrow money in scale from JP Morgan or Deutsche Bank or whoever it be. There were other elements to fund performance.

As you know, to date we've not had a down month. Some of those loan performances when you look at them, whilst I think most platforms have had a cohort or two they're not proud of. To date, we haven't had that money losing sort of moment. The other thing I think is worth saying, and I said this the other day at your panel, Peter, at LendIt is...we launched with a target of 6% to 8% in 2014 actually when we raised the capital, huge amounts have happened since then.

The world's understanding of yield has shifted immeasurably and what the coupon you can achieve today from liquid credit assets is a fraction of what it was in 2013/2014. The bond market and other liquid fixed income markets have adjusted their expectation of what coupon they should expect for a given risk from lending downwards.

The equity market has not (Peter laughs)...I'm not saying that is wrong or right because the equity market seeks to you know, investors invest in our fund also invest in Vodafone or in British Airways or in Sainsbury's or Scottish & Southern and that's their benchmark and they want all of their stocks to perform above their benchmark, of course they do.
So we just have to… I think one of the challenges of working with a listed vehicle where your investors' benchmark is not necessarily the same as the assets inside the fund is one of the challenges but nor do I want to introduce unnecessary risk to sort of bolster performance, I don't think that would be a good idea either. I personally think this trust can achieve that 6 to 8 without doing that and probably taking some of the learnings of the last few years and applying some of them. We have quite a lot of learnings to regurgitate back into our processes.

Peter: We’re almost out of time, but I want to cover the recent changes that you had. I think it was just last month you completed your merger with Pollen Street, can you tell us about that process?

Simon: Sure, sure. I think Marshall Wace was an amazing partner for the original concept. When I first met Marshall Wace in 2013, both partners were enormously excited about the ability to work with them, incredible fund manager, enormously successful in equities and the idea being incubated by them and being able to draw on their skill set and experiences, and most importantly probably, their infrastructure. You remember in the beginning this is a very IT intensive business, but not just infrastructure but legal and compliance and all of the skilled people in the building, it was great.

I think as time goes on, they are very, very big, and very successful equities manager and I think as we evolved I think both they recognized and we recognized that maybe in a more mature phase that we might benefit from being part of a dedicated fixed income group. Marshall Wace isn’t that, it's an incredibly successful equities business. Pollen Street is a very successful PE and lending business, not a dissimilar size to Eaglewood either so the synergy of size, the synergy of merging with someone who does a similar thing to you, who has skilled people who do exactly in some areas what you do; synergies in areas like servicing and loan origination and understanding and so I think all parties recognized there that would be a synergy that would also resonate well with our shareholders.

I think the shareholders increasingly wanted the manager to be able to have a broader river to fish in, but with the appropriate skill set as well. It's all well and good saying I've got a broader river, but do you have the skills to do that. I think with the merger with Pollen Street, we're not only broadening the river but also broadening the skill set and giving the shareholders of P2PGI a broader skilled management team.

Peter: Right, right. So last question, I know you can’t make any forward looking statements so...

Simon: No, I can’t.

Peter: …so let’s just talk in general terms about like the future of your fund and the industry. Where do you see this all going over the next like three to five years?

Simon: Yeah, that's a great question. I think we're seeing really exciting growth. Consumer lending on peer to peer platforms was almost sort of the first, the pioneer…Lending Club, Zopa or Zopa was the pioneer, followed by RateSetter, Lending Club, etc., but the asset classes are
evolving now and we're seeing many, many different types of loans being made available to non-bank funders in different structures, not just listed funds, but also in private funds, closed-ended private funds; in some cases, open-ended which I'm less keen on.

Asset classes like leasing or like property lending or mezz property lending so really, really sort of products that you naturally associate with a bank are now opening themselves up to competition and other types of funding. So I think we're at the point where you'll see a growth in specialist funds. P2PGI was a generalist fund, it was offering investors access to the whole gambit of disintermediated small ticket loans. Back then, some of the individual asset classes were just not big enough to support a standalone fund, but today, it's perfectly possible.

We may see US SME funds or European trade finance funds because those asset classes are growing so I think the investors are going to see a wider choice. I really do think the concept of lending not through a bank, it's been around for hundreds of years, frankly. I just think that in the last few years technology has widened its availability. So I think fund managers like Pollen Street have a great opportunity to deliver products to investors that give them an alternative to investing in the traditional banking methodology.

Peter: Okay, we'll have to leave it there. I really appreciate you coming on the show today, Simon.

Simon: Thank you very much, Peter, nice to see you.

Peter: Okay, see you.

I want to go back to a point that Simon made a little earlier there and that is this whole idea of pure peer to peer lending platforms and the fact that they don't really exist today at scale, with the possible exception of RateSetter in the UK. We live in a world where large amounts of money are much easier, are much cheaper for these platforms to raise, you know, a small number of large investors...it's just a more efficient way to run a platform now. I wish that wasn't the case in some ways because I feel like...I started off in this industry as an individual investor and when I started there was only individual investors and that's one of the things that really attracted me to the asset class.

But the reality is, particularly in the United States, we live in a regulatory regime that makes it very difficult. Beyond Lending Club and Prosper, there's a small number of platforms that make their investments available to non-accredited investors. That is a shame, but that's just the reality of the world we live in. I would like to see more vehicles like Simon's fund in the United States, you know, publicly traded funds where individual investors can get access to a diverse investment across many platforms which they're able to do with P2PGI. But again, we're suffering from the regulatory regime in the US that makes those sort of offerings difficult to achieve in the United States.

Anyway on that note, I will sign off. I very much appreciate your listening and I'll catch you next time. Bye.
Today’s episode was sponsored by LendIt USA 2018, the world’s leading event in financial services innovation. It’s happening April 9th through 11th 2018 at Moscone West in San Francisco. It’s going to be the largest ever fintech event held in the Bay Area with over 5,000 attendees expected. We’ll be covering online lending, blockchain, digital banking and much more. You can find out more by going to lendit.com/usa.

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