LEND ACADEMY

## PODCAST TRANSCRIPTION SESSION NO. 128-BRIAN DALLY

Welcome to the Lend Academy Podcast, Episode No. 128. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of LendIt.

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**Peter Renton:** Today on the show, I'm delighted to welcome Brian Dally, he is the CEO and Co-Founder of Groundfloor. They're an interesting company, they're focused on the real estate space and they've got somewhat of a unique niche. They are really focused on non-accredited investors and they have made it a very simple and easy offering with the lowest minimum in the industry. You can get started for as little as $10 and so they've built a business around that, but they're now scaling, they've got institutional investors coming on board now. So we talk a little bit about that kind of...the tension between the two, we talk about how they were able to scale their deal flow to bring in more deals to satisfy their growing investor base and we talk about the future. It was a fascinating interview, I hope you enjoy the show.

Welcome to the podcast, Brian.

**Brian Dally:** Thanks so much, Peter, it's great to be with you.

**Peter:** So let's get started and give the listeners a little bit of background about yourself and what you did before you started Groundfloor.

**Brian:** Well before this, I started a wireless carrier, a disruptive carrier that some of your listeners may have heard of or used called Republic Wireless, but that was...that was after about 20 years. I did my first startup about 20 years ago while I was in law school, at the time the web was just starting to happen and I wanted to figure out how to write code for a website. So 1996, there I was going to law school by day, writing code at night and I got bitten by the bug and had been doing that in Silicon Valley in the wireless industry....you know, Silicon Valley, London, I did a mobile gambling startup in London that was funded by Bessemer Ventures for a few years.

I've been on a founding team or an early stage executive, worked for a couple of public companies along the way, but the whole time I always thought of myself as a founder and with Groundfloor we're taking what we did with Republic and getting the band back together and doing it again in a different industry.

**Peter:** (laughs) Okay, so then just go back to the very beginning there. Where did the idea come from for Groundfloor and when did you actually get this thing off the ground?

**Brian:** Well actually, Groundfloor, although it's not a wireless company obviously, it's in finance, came out of our experience with Republic Wireless. We started to wonder, as I left Republic Wireless and was part of a larger company...couldn't work in wireless anymore because I had a non-compete, I started to think about how we could take some of what we did in wireless and apply it to a new industry.

I had the good fortune of meeting Nick Bhargava, my Co-Founder, five years ago…as we started to brainstorm and get to know each other it turns out we shared some ideas about how a network for capital formation could be built, how we could reformat capital formation. Nick had just come off of his work with the JOBS Act working on Title III, he had a background with FINRA and the SEC and we each had a long time interest in sort of personal finance and investing so the idea really came out of imagining what capital formation could look like if it were built like the Internet. That was the genesis of the idea and we realized that creating a mass market financial product was the right place to start with that.

**Peter:** Okay, so why did you choose real estate specifically?

**Brian:** Well we actually had about 20 or 25 categories, sort of asset classes that we were looking at when we started and we realized two things as we looked at the asset classes. Some of them were real estate, some of them were not. We knew that we needed an asset class that people understand and if you compare something like Lending Club or Prosper to Groundfloor, the great thing about what we do is at some point, in any given point, 60% of Americans are homeowners and they understand the asset class. You know, people can watch a house flipping show and understand how to do a house flip. So we wanted an asset class that people could understand, not something exotic.

We also, as we did customer discovery with investors, realized with individual investors...we realized that people...the gap for self-directed individual retail investors...the gap in the market was there's no debt product that's short term, high yield...you know, when I say short term it's six to twelve months, when I say high yield it's commonly 10 to 12% if not more, there was no product like that that was available to retail investors.

We asked ourselves, what if the stock market were set up so that you could invest in stocks, but only through a mutual fund or only through an index fund and you couldn't buy individual stocks. When we looked at the market for private investments for the non-accredited 95% of investors, that was the state of play and so we set up to fix that and found that real estate was in this particular sub-asset class that we're in was the perfect place to start as a beachhead market.

**Peter:** Right, so fix and flip is your primary focus today?

**Brian:** That's our beachhead market and that's because these loans are small balance loans that...you know, when we started Peter, we were only operating in one state and had a couple hundred investors participating on our platform that we acquired on Facebook and so we needed a small balance loan that a couple hundred people could finance. You know, it used to take us 30 days to fund a $50,000 loan, now we routinely sell out a $150,000 loan in minutes so it’s a different ballgame at a different scale, but at the time we were really looking for something that was small balance, short term, high yield and fix & flips were certainly that.

**Peter:** Right, right, and so how many states do you operate in now?

**Brian:** We lend in 27 states, notably not California, and we offer securities in nine states, represents about a third of the US population.

**Peter:** Okay, one of the challenges when you're setting up these platforms is actually sourcing the deals. It doesn't sound like you have a background in real estate, how did you go about that process of finding deals to put on your platform?

**Brian:** Well in the early days, it was personal networking and we were fortunate to recruit some very experienced advisors, early angel investors and ultimately, executive staff who have the experience in real estate generally and the specific markets that we're addressing. The way we source today, much like everyone else in our category, is through online marketing qualification, but in this market there's really a ton of word of mouth and a lot of repeat business.

That's another great thing about this business. You know, with a Lending Club or Prosper borrower, if they borrow too much you start to get worried about the credit risk. Borrowing frequently is part of the nature of the business for the customers we serve. These real estate investors, the good ones, are borrowing dozens of times per year so there's a built-in sort of repeat business opportunity that doesn't exist in some of these other markets and we get a lot of business from that as well.

**Peter:** Right, so then just going back to the investors' side, you've always been focused on non-accredited investors and I presume that's still your focus today? We'll get to institutional down the track here in a bit, but I just want to talk about why and how you're approaching these non-accredited investors.

**Brian:** Well as I said, we noticed a gap in the market and we stepped in to fill that gap by qualifying our offering under Regulation A. Our offering is not the typical Regulation A offering, it's structured the same way that Lending and Prosper are structured just using a different set of rules. They have registered offerings, we have an exempted offering for the securities law geeks in the audience.

You know, we alone out of anyone who is serving accredited or non-accredited investors, have 174-page offering circular on file with the SEC. We have audited financials, we have ongoing compliance and proponents reporting obligations. That makes our product very different and it makes I suppose our level of disclosure and the consequences of our disclosure much higher and I think that provides a level of investor protection that is unique to Groundfloor for the investor.

**Peter:** Right, but also obviously that comes with a cost, a much higher cost than if you're just going out to accredited investors which some of the other platforms in this space are doing. So the non-accredited route...obviously going Regulation A+ is a good way to do that, but I guess...were you committed from the get go to do non-accredited or….because it could have gone either way, I imagine, but just tell us about your decision to not just focus on accredited investors.

**Brian:** Yes, from the beginning that was our vision. And this goes back to what I said about our vision from the beginning, from the beginning we imagined what it would look like, what finance would look like, what investing would look like if the broadest base of capital were applied to the market we're serving today and future markets. What we realized is that the design of that network creates a very different credit product, not just because we're regulated, but also because of what we can do, the flexibility that we have, the cost advantage that we have.

We realize many competitive advantages through the process of focusing on the non-accredited investor and I think those will start to really show themselves in the next year or two with the next market cycle. But the reason we started there is because that's the gap in the market, the non-accredited 95% do not enjoy the same financial opportunity that accredited investors do and we think that's an important gap to fill as well as being a strategically smart gap to fill.

**Peter:** Right, right, so then what's your minimum investment per deal and is there a minimum investment total that you can start with?

**Brian:** The minimum investment is $10 and that's true per investment, that's the unit price of the investment, much like Lending Club and Prosper have a $25 unit price. Unlike Lending Club and Prosper which have raised their minimum deposit, we do not have a minimum deposit today.

**Peter:** Okay, so you can literally transfer in $10 and do one deal and you're done with it?

**Brian:** Yes, although very few people end up just doing that.

**Peter:** (laughs) Right, right.

**Brian:** On average...as you can imagine the median and the average are much, much higher than that. We thought that was important to allow everyone, no matter what your bankroll, to build a diversified portfolio...and so we do have people who have a portfolio of 100 loans at $10 each and then we also have people who invest tens of thousands of dollars per deal and have portfolios of maybe 50 loans and everything in between and that's purposeful. We built Groundfloor that way on purpose.

**Peter:** Right, right, okay and so then when you're going out there to investors...obviously one of the good things about the fix & flip market is that these are relatively short term loans and you can build up a history fairly quickly, much quicker than you can with a 3-year loan product.

**Brian**: Right.

**Peter:** So can you share sort of the historical returns and how you set the expectations of your investors today?

**Brian:** Well everyone's hunting for yield; institutions are hunting for yield, accredited investors are hunting for yield, non-accredited investors are hunting for yield. The hunt for yield is on and it has been for a long time and it's not going to go away so we try to temper expectations. If you look at our website, we say it's possible to earn returns of 10% or higher. In fact, if you look at the 2,741 portfolios that have returned capital as of the end of July...in fact, 70% of them have earned returns of 10% or higher. Overall, the portfolio has earned 14.31% so if you look at all 182 loans that have repaid capital, the yield is much, much higher than that.

**Peter:** Right, okay got it. So then how are you managing sort of...you know, one of the challenges with any of these marketplace platforms is managing both sides of the marketplace. If you've got loans that are filling in within minutes, I mean, it sounds like you've certainly got a lot of investors, but how is that sort of tension between the two going for you guys?

**Brian:** Well today we are supply constrained. If we had done this interview six months ago, I'd have said we've put a lot of effort into originations. We had a backlog of originations for a while and that's the nature of building kind of a marketplace and keeping it in balance. Today, investor demand is growing 15% month over month, 15 to 20%, and so we are racing to keep up with the originations and that's why we made an announcement yesterday. Some people might see that we have launched our origination network where we're now working with third party brokers for the first time and we're focused on scaling the origination side of the business now.

**Peter:** Right, right, that makes sense. So you're in nine states for investors and it sounds like you're not going to expand that until, I imagine, you get more supply. Is that fair to say?

**Brian:** That is the priority although we have been actively in discussions with the SEC about expanding to a Tier 2 offering and as soon as we catch up the supply that will be our next move. In fact, we've already started that process and so when the time comes...we're very eager to open it up nationwide. I just think we have a responsibility to our current investors to make sure that we're meeting their demand before we open it up.

**Peter:** Right, well if you can keep those returns happening for investors I imagine if you open up nationwide, you will be inundated with new people wanting to put in money. Anyway, I just wanted to move on and talk about sort of the competitive market. You know, as you said, real estate, I love real estate, I think it's a great asset class because you can explain it to a six-year old and they can understand the product. You can't do that with some other products in this business, but given we've got lots of companies doing fix & flip, there are lots of companies doing other areas of real estate. How do you differentiate yourself…obviously you've got the non-accredited investor side, but just even on the supply side, how are you differentiating yourself?

**Brian:** Well as you say there are important differentiators that we've already covered for the investors. I mean, for non-accredited investors we're the only way you can build your own portfolio instead of using a middleman or a fund and for accredited investors, we're the only issuer in real estate that's actually qualified by the SEC, has the disclosures, has audited financials. But if you look at the supply side and how we differentiate ourselves, this is where I think our model is going to shine as we scale and grow.

Our theory, and we think it applies not just to the market where we are today, but to successive real estate markets and successive other credit and equity markets, is the platform with the broadest base of capital has the broadest credit box, has the lowest rates and differentiated features. As the yields compress, because we have a broad base of capital, we can compete. We can step in and go toe to toe with any originator and win on rate with any borrower because we have such a broad base of capital. So one way we differentiate is with the breadth of our credit box...you know, we have loans graded A to G, we'll do a broader range of credit which is a helpful competitive differentiator. Our rates are lower, you know, apples to apples our rates are lower, but then we also have differentiated features for the borrower that nobody else has.

I'll give you one example, is our deferred payment product. You know, if you are investing in a property, we as your lender and you as the borrower want every bit of cash to go into improving that collateral and hastening the exit. It doesn't make sense to provide debt service in that market and so we do have a monthly payments product because certain investors want that monthly yield, but when the term is so short and the use case is so cash dependent, we're unique  in the nationwide lenders offering of deferred payment balloon product. So those are a few examples of how we're different.

**Peter:** Right, right. Okay, so can you just tell us a little bit about your loan book. As you said, you've done 100 and something loans that have paid back, what about defaults? I mean, if you're doing a large range of risk, I imagine there's some non-performing loans, can you tell us a little bit about that?

**Brian:** Yeah, the goal as a lender, especially one that's operating for the benefit of investors, is actually not to have no defaults. You'll hear the executives from Lending Club say this all the time. The goal is to have net returns that are in line with the risk and to make sure that the grades correspond to losses and that the losses are controlled and predictable, we're achieving that. Our book is performing well, we have...you know, in real estate the term default means something different from what it might mean in consumer.

We often use, as any asset manager would…we will declare default as a tactic in real estate lending to bring about a better result. So default doesn't necessarily mean you're not going to get paid. In fact, in over 90% of the cases where we declare default, there's full principal and interest and often penalty interest on top of that. People learn to actually like default in the real estate business.

So we've developed a record that is performing as expected and as designed with our credit standards and we're very comfortable with that. I think in total, we've realized a loss expressed as a portion of the portfolio overall it's been only a 46 basis point loss ratio so we're making

14.3% net of the 46 basis points. You know, we're proud of that record and the most important thing as we scale, that the credit is performing according to the risk grade and when you get a look at our SEC disclosures, you can see it for yourself, it is.

**Peter:** Right, and just on that, I just want to be clear here. So you're making revenue from the origination fee and a servicing fee? What is your revenue model?

**Brian:** We earn revenue from borrowers who pay origination fees and service fees during the term of the loan. That's our principal source of revenue today.

**Peter:** Okay, and then what about investors?

**Brian:** Investors, while we've been building the marketplace in sort of this lower scale release, investors don't pay fees today. Obviously, as with any investment business there will be fees in the future, but we haven't introduced them yet so it's a good time to get in on Groundfloor.

**Peter:** (laughs) Okay, so I want to talk about your first institutional investor, Direct Access Capital. It came out, I think it was last month, does this signify a change in direction for you guys or what is your approach to institutional partners today?

**Brian:** Direct Access Capital is a specialty lender who we know well, they work with many originators in our category, there are hundreds. Some people would say thousands of originators in our category all over the country, highly fragmented market and the most important thing as a partner for DAC is that they're very familiar with our credit box, they've become very familiar with it. They are willing and able to buy a very broad expanse of it that I would estimate is about 85% of our credit matches up to their credit standards and credit box, they're comfortable with our underwriting standards; we're very deeply partnered.

Now the goal with our retail base is to deliver a high quantity of loans so that people can build diversified portfolios. Well obviously, if you want to have a high quantity of loans and you're originating a certain volume, the goal with a retail base, if you work out the math and you just kind of think about it logically, you know, smaller balance loans are better for that use case. Institutional buyers want to put a lot of capital to work and they want to buy larger balance loans so the average loan that we offer to the retail investor is $120,000 to $150,000. Institutional investors are ready to buy loans that are half a million or a million so partnering with an institution gives us the critical mass that we needed to go scale up this origination network that we announced.

So in the name of driving the number of loans, we needed to do business with a partner that'll allow us to serve more of the needs of our borrowers. You know, we'll talk to a borrower who's doing a $100,000 loan one day and is doing a $500,000 loan next month; we want to be able to serve more of their needs. The institutional partner just allows us to do that, you know, it's a slightly different use case.

**Peter:** Right, so are they only going to invest in larger loans, I mean, I'm just trying to get a sense of the competition on the investor side. So you basically have a whole loan program created just for them that is different to the retail program?

**Brian:** Actually, the main standard for that program is that the credit box needed to overlap. So we originate loans, our origination funnel is not specific to a retail or investment supply chain so we originate a loan as per our standards full stop. If it is a larger loan, we earmark it for....you know, so if it's a 10% loan that's $400,000, we will earmark that for institutional purchase. And over time we have to become adept at balancing these things, we have to convince our retail investors that we are allocating the credit in a fair manner and I know that's been an issue in the industry in the past. At the moment, it breaks down pretty nicely by size of loan.

**Peter:** Right, it has been an issue, you're dead right about that, but it is no longer really an issue. I mean, I don't think you...when institutional investors first came on...obviously I've been investing in Lending Club since 2009 and back when I started investing you had your pick of any loan on the platform, you could take your time, nothing invested within 24 hours and then it changed. There was this period probably of about six to twelve months, I think, where they hadn't worked it out and there was a lot of discontent because we had had it all to ourselves and then suddenly institutional investors were coming on and snapping up loans very quickly.

**Brian:** Right.

**Peter:** I think today the vast majority of Lending Club and even much more of Prosper is institutional, but you don't hear about investors saying, oh, I don't get access to enough loans. They just make sure they have enough loans on the platform. Today with Lending Club, they're ten times where they were or 20 times, 100 times even where they were when they were just primarily retail. There's fewer loans on the platform at any one time, but there's enough to go around, for the most part, there are sometimes issues, but…

**Brian:** We thought deeply about this issue and we have turned away other institutional buyers or kind of slow rolled them, frankly, because we view institutional capital as a means to an end. We think there are plenty of options out there for deploying institutional capital, we think we happen to be a good one as well and we're happy to have the validation that we have. But the reason we did the institutional deal that we did with the party we did was for the benefit of the retail investor and that's important because the thing that's different about this category...I actually think it's a better retail investor category than unsecured consumer credit.

I think it feels more familiar. Instead of the three or five-year term, it's six to twelve month term. It's an asset class that people can understand and so as successful as Lending Club and Prosper has been at attracting retail investors, I think this category is poised to be 10 to 20 times as successful with retail investors. And so we built the institutional relationship with an eye to that, we haven't lost focus on that.

**Peter:** So down the road, are you expecting this will be like a 50/50 type business where you have 50% of your volume is institutional investors and 50 is retail?

**Brian:** We'll see, I'd say that's at the high end. We planned for this for a long time, our earliest model even going back to 2013/2014 always had institutional capital coming in. We actually modeled it at about 25 to 35% rate, but time will tell whether it's 25%, 50% or something less than 25%. We hope, and our vision since the beginning and we're unique in this, is that this is next great mass market investment product. This product as it reaches into the RIA channel, which I think it will, this product has all of the makings of being as successful with the retail investor as the ETFs are and that's where we're headed.

**Peter:** Right, I agree. I feel like...it does make sense because you've got the...unsecured consumer credit I think is a great asset class and I think what's great about it is that no one has exposure to it. I think if you're having a portfolio today, having exposure to consumer credit is a great diversifier. Now a lot of us have exposure to real estate, but we don't have exposure to fix & flip real estate unless we're actually in that business. I don't think there's fix & flip publicly traded funds out there, it's a relatively new product from the investor side of things and I think it has got a lot of room to move.

**Brian:** Even if there were, we feel strongly that philosophically, there ought to be an option for everyone to participate directly in the asset class not just through a fund. I mean, funds are useful and important obviously, but we think this market and other markets benefit from an approach that involves retail investors directly and that's why we started Groundfloor is to explore that and build on that idea.

**Peter:** Right, just on that I think if you want to go mass market, you've got to have an easy way to deploy capital, you've got to have a one or two-click kind of thing. Is that in your future?

**Brian:** Very much so, we're very, very aware of that and we have an extensive, well thought out, long term roadmap that started with 12 securities law firms telling us that this would never work, (Peter laughs) that the SEC would never qualify it back in 2013. Today, the product is nowhere close to what we envisioned and I think the next year or two will be an important inflection point for that. I mean, there's a lot that we know we need and want to do with the product to make it better.

**Peter:** Right, I know we're just about out of time, but I want to get just one more question on that. So are you committed to the fix & flip vertical, as you said, this is an entry point I think at one point you said.  Like where are you taking this business long term?

**Brian:** Well the fix & flip market, that credit market is large enough to build an interesting company at scale. There are credit cycles though and there are other sectors of real estate, there are other use cases that we want to explore and I think in the long term there's no way that we'll only be offering fix & flip credit. We will be offering many new products, many new use cases and you know, it's possible that we may even expand outside real estate some day. Time will tell.

I think we're as focused as we need to be to be successful with what we have in front of us. You know, we're very focused on preparing to raise our next round of capital to afford some of these investments that we want to make, building our origination network to increase supply because that's the number one product feature from our retail investors, by the way, is more loans. After that, we're ready to roll out our nationwide offering.

You know, it's an exciting time just in the near term. Longer term we have all kinds of ideas about new products for investors and who knows where it will go. That's the exciting thing about building a platform is once you have that in place and some early success under you, you get these opportunities to put offense in other sectors which has always been our intent.

**Peter:** Okay, we're out of time, unfortunately, but I wish you all the best. You've certainly got a great idea here and I think it's going to come down to execution and I feel like you guys seem to be well positioned for that.

**Brian:** Thanks, Peter.

**Peter:** Okay, see you later, Brian, thanks for coming on the show.

**Brian:** You bet, I appreciate it.

**Peter:** See you.

One of the things that is disappointing to me about the online lending space and even with the new regulatory structure brought in by the JOBS Act, the reality is there is still very few opportunities for non-accredited investors. So I applaud Groundfloor in really building a business really from the ground up where they're focused on the non-accredited investor. The challenge obviously is building it to scale so I think there's not many examples of profitable businesses globally, outside of China anyway, that have built profitable businesses at scale focused just on individual investors.

I'm not saying it's impossible, but it's easier I think to have both the institutional and the retail. They can exist in harmony, as I just said, and I think what Groundfloor are doing, hopefully, they'll be able to do this as well. It helps them scale the business quicker, it helps really control their costs when they can bring both kinds of investors on to their platform.

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

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