UK Peer-to-Peer (P2P) Finance

3 February 2015

Market set to smash £30bn barrier by 2022

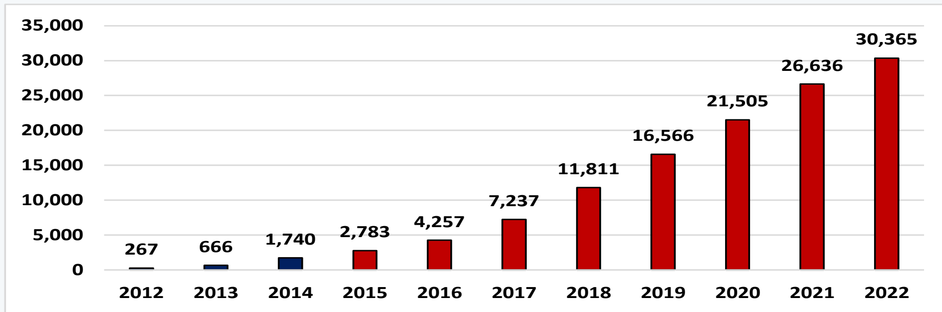
William Shakespeare was undoubtedly a talented writer, but his genius doesn't seem to cover finance. In his play *Hamlet,* the King's chief counsel Polonius warns his hot-headed son Laertes to "*Neither a borrower nor a lender be*". This well intentioned advice appears to have fallen on deaf ears, as globally today there is $200+ trillion of outstanding debt (240% of GDP).

The big problem now is getting this cash into the right hands, as most European **banks continue to shrink their balance sheets** (Re Basel III). Meaning millions of creditworthy small businesses (SMEs) and consumers are being starved of credit. So what's the answer?

One increasingly popular way of bridging the funding gap is via 'peer-to-peer' (P2P) exchanges, commonly known as AltFi or CrowdFunding. Here investors provide capital directly to individuals and/or SMEs via low cost internet platforms, such as **Funding Circle, RateSetter, ArchOver and Zopa**. Being **circa 3 times cheaper**, we think this model offers superior returns for both borrowers and lenders alike versus the traditional banks.

In fact the **sector is experiencing unprecedented demand**, **soaring from £267m in 2012 to an est. £1.74bn last year** (Nesta). Amazingly, this has been achieved with relatively little advertising. Going forward, as market awareness builds, we anticipate the industry to **climb at a CAGR of 43% pa for the next 8 years** - tipping £30.3bn by 2022 (see below).

UK P2P Finance set for exponential growth (£m)



Source : 2012-14 actuals in blue (source: Nesta), ED forecasts in red (2015-2022)

Shareholders can make hay too. In December 2014 the world's largest P2P finance provider, **LendingClub** (Ticker: LC.) floated on the NYSE. It has a market capitalisation of circa $7.2bn, and is **worth 3x more than TSB plc**.

Yet nothing is risk-free. P2P lending is not guaranteed by the Financial Services Compensation Scheme. Nor does anyone know exactly what future default rates will be, especially in a rising interest rate environment. And there are currently only a few secondary markets, thus limiting investors' ability to sell loans prior to maturity. Nonetheless, across the cycle, **we think that P2P lending ultimately will deliver net returns** (after all costs/defaults) **for investors of between 5%-6% pa**, or 2x-3x more than yields presently available on 3-5 year fixed term deposit.

5 quick facts about UK P2P Finance

1) The sector witnessed explosive growth in 2014, soaring 161% YoY to £1.74bn from £666m in 2013 and £267m in 2012 (source Nesta).

2) Looking ahead, we expect these trends to continue with in excess of £30bn pa of P2P capital raised by 2022, driven by lower costs, constrained bank lending and greater industry awareness. Globally, Foundation Capital predicts the industry to reach $64bn in 2016 and $1 trillion by 2025.

3) There are 50+ P2P platforms in the UK, albeit the top 10 generate more than 90% of arranged deals by value.

4) We estimate future returns from P2P loans (after all costs and default losses) will be similar, but higher than for high yield debt.

5) The main areas of P2P finance are: SME business loans (43% by value), invoice discounting (16%), consumer credit (31%).

Pure equity CrowdFunding (aka Dragons Den) represents a relatively small part of the market at 5% (source: Nesta).

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P2P, or not P2P, that is the question

What would you say if I offered you an opportunity to earn 5%-6% pa (net) on your hard earned cash without taking on too much risk. You would be suspicious, right? However, if the underlying investment was a commercial loan secured by trade debtors, which in turn was insured against default, then you might reconsider?

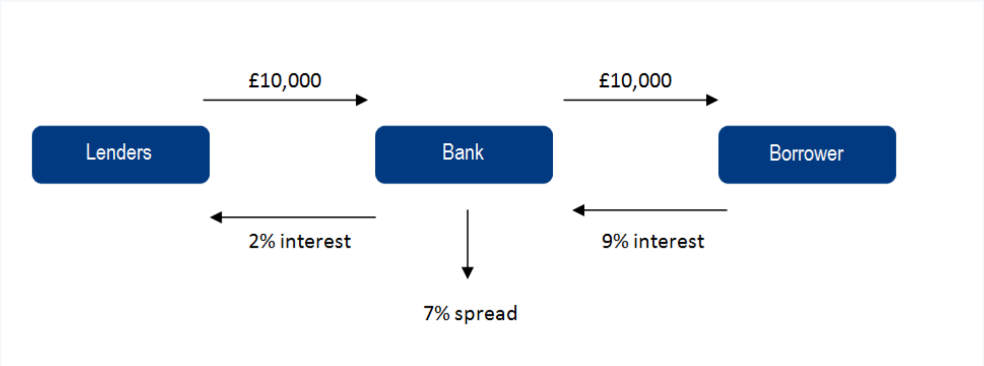
In fact, millions of people worldwide already have - and are enjoying returns significantly higher than those offered by the banks. So how is this possible?

Welcome to the world of 'peer-to-peer' (P2P) finance, or marketplace funding - combining the 'power of the crowd' with clever 'social network' and credit checking software, together with heaps of data mining to ensure non-performing loans (NPLs) are kept to a minimum.

Traditional banks, in contrast, are burdened by expensive branch networks, large head offices and antiquated IT systems, which often restrict vital credit from flowing to small, medium sized enterprises (SMEs) and consumers. What's more **bank 'interest margins' are almost wide enough to drive a truck through!**

For example, the best rate high-street banks currently pay yield-hungry savers on their cash is 3% pa, assuming of course the balances are locked up for 5 years. Equally frugal on the other side of the ledger, these deposits might be lent out at 9% pa (probably requiring a personal guarantee too), thus **pocketing a cool 7% margin** (see below) on top of a hefty arrangement fee.

Traditional banking model is heading for a crash



Source: Internet

Worse still, some banks have also been known to remove overdrafts at very short notice and simultaneously point SMEs in the direction of their invoice discounting services. Here, interest/charges are usually in the upper teens and sometimes 20%+ pa (source: ArchOver). Thus making these facilities both expensive and labour intensive, since every invoice has to be forwarded to the discounter. The borrower ends up running two sales ledgers - one for themselves and one for the discounter.

This is where CrowdFunding fits in. **P2P lenders aim to speed up this fuddy-duddy process, as well as reducing the interest costs and boosting returns for investors**. They are able to efficiently and quickly match both parties online - typically charging a 1%-2% pa fee, and hence allow more of the margin to be shared by all parties.

P2P cost base is around 3 times cheaper than Banks'

In fact, according to Renaud Laplanche, CEO of Lending Club, **P2P costs are approx. one third of a bank's.** This is exactly the same disruptive model that many internet giants (eg Alibaba, Uber, Airbnb, Facebook and eBay) have already successfully deployed in other verticals.

Comparison of P2P platforms vs banks

Traditional Banks	P2P Lending
High overhead costs (office buildings, support staff, bonus structure, T&E)	Low overhead (online, scalability)
Low returns on investment (1-3%)	Meaningful returns (12.7%)
Banks have discretion to use deposits (black box)	Investor's direct their capital
Institutionalized	Community building
Offer multiple products and services	Focused on peer or business lending
Cash liquidity	Limited secondary market
Systemic risk due to proprietary trading and leveraged/packaged/synthetic instruments	1 pound in 1 pound out simplicity
Government insured	Not government insured

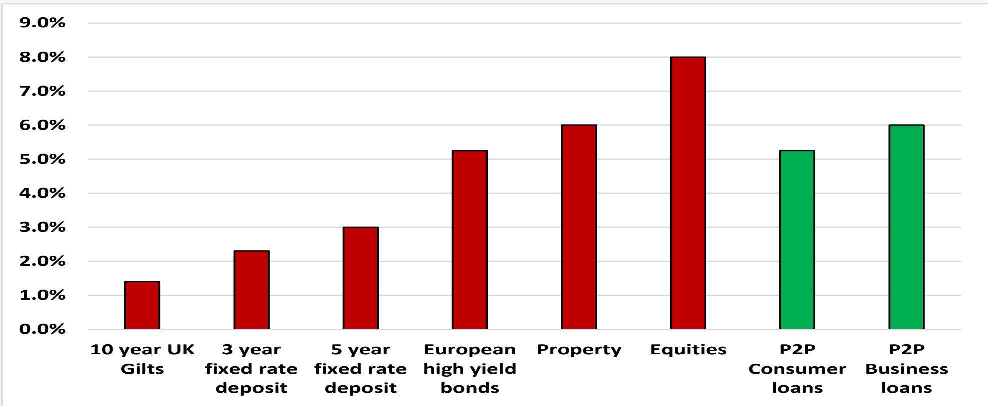
Source: Assetz

Another key point for lenders is that not only are they getting superior returns (versus banks) from their cash, but also in some cases the collateral on which the loans are secured is insured by a third party. The upshot being that in the unlikely event of a default, the loan can be repaid either from the borrower's secured trade debtors or the insurance proceeds.

So what does this mean in terms of investor profits?

Well, although generally higher today thanks to low insolvency rates, **we think ultimately P2P lending will** - across the economic cycle and once it has reached maturity - **deliver net returns (after defaults/costs) of between 5%-6% pa,** which is similar but slightly higher than for European high yield debt (see below).

Expected future 'net' returns from P2P loans vs other asset classes



Source: Equity Development estimates (after defaults)

We suspect that P2P business loans will prove slightly more profitable for investors than their consumer equivalent, thanks to higher loan values and lower default rates.

Revolutionising Small Business Funding

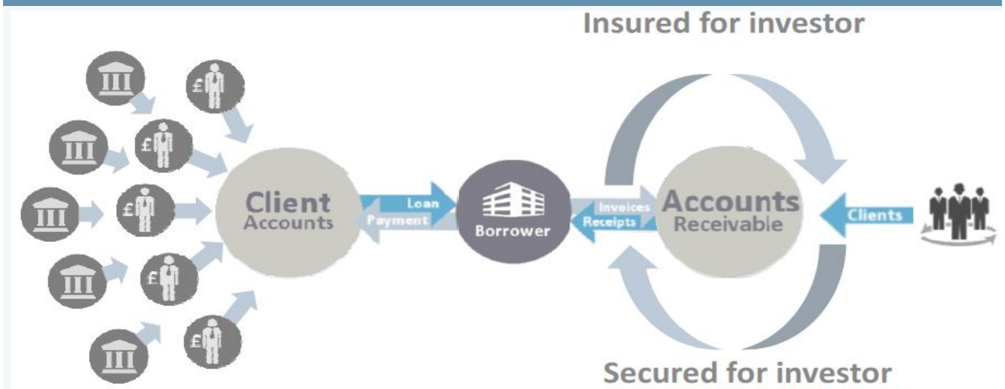
We believe this is the future for SME lending - a model that is being pioneered by P2P operator ArchOver (authorised and regulated by the FCA), who focuses on **high quality commercial credit.**

The company screens SMEs for default risk (e.g. minimum 2 years trading), manages the supply/demand of the marketplace, obtains security (eg 1st charge over accounts receivable, AR) for the loan and arranges insurance on the collateral, along with facilitating interest payments and debt collection. Deal values tend to be within the £75k - £10m range, which is higher than the industry norm, thus making the economics more attractive for all parties concerned.

On top of the 1.5% pa processing margin, ArchOver levies a one-off 4-5% arrangement fee from the SME to cover due diligence and setup, thus reducing the overall risk of NPLs. Approved borrowers usually pay interest of 7%-10.5% pa, with lenders receiving 5.5%-9% pa (gross) dependent on term and the type of collateral (e.g. AR, new/existing assets, etc).

Better still as a result of the 3rd party insurance, there is **no need for personal guarantees,** which is often disliked by company directors/owners.

ArchOver's differentiated "secured and insured" P2P model



Source: Company

A few other notable horses and riders

Elsewhere, in terms of volume, **Funding Circle** has lent out £505m to date across 7,100 businesses from 36,822 people (source: website 30/01/15). Its loans of between £5k-£1m are funded by retail investors, local councils, the British Finance Partnership and the Government-backed British Business Bank, who have committed £40m from its £300m investment programme.

But it isn't just SME loans where P2P platforms have started turning the screw on the cosy world of banking.

In consumer loans, operators such as **Zopa**, **RateSetter** and **LendInvest** are also making significant inroads. Here, detailed information on the borrower is obtained, including identification and fraud checks from one or more independent ratings agencies. After acceptance and assigning a credit score and interest rate level, the proposed loan is then (usually) bid for by prospective lenders via an online auction. Once complete, the debt is activated and principal/interest is repaid on a monthly basis for the specified term. Investors earn interest net of service fees and defaults.

Key players in UK P2P market

Source: Equity Development

Zopa was the world's first and is still the **UK's largest P2P platform** (£703m lent to date – source website). It aims to match consumers in search of 2 to 5 year loans with lenders, who can earn annualised net yields of 4.0% - 5.1% (post 1% pa fees and average default rates of 2.6% pa) on 3 and 5 year loans respectively (Source: Zopa website).

Another bell weather of the sector is **RateSetter** (£485m lent – source website), offering expected yields of 4.6% to 5.9% pa on 3 and 5 year loans. Likewise for the humble mortgage, where future homeowners may find themselves canvassing strangers online using **LendInvest.com** or **Wellesley & Co**.

Moving from 'cottage industry' into mainstream Finance

Encouragingly too**, institutional cash is now pouring into the industry**. A sure fire sign that the sector is both growing up and attracting smart money from sophisticated investors.

Take US provider **Interface Financial Group**. It has formed a joint venture with **Assetz Capital** to buy invoices from businesses at a reduced rate, then collect when they are paid, typically within 60 days. This allows companies to access cash quickly, and is seen as lower risk.

Assetz has 7,000 registered investors and has already lent out £59m at an expected default rate of 1.5% pa. In addition to personal guarantees, the platform takes asset security, including charges on property and equipment.

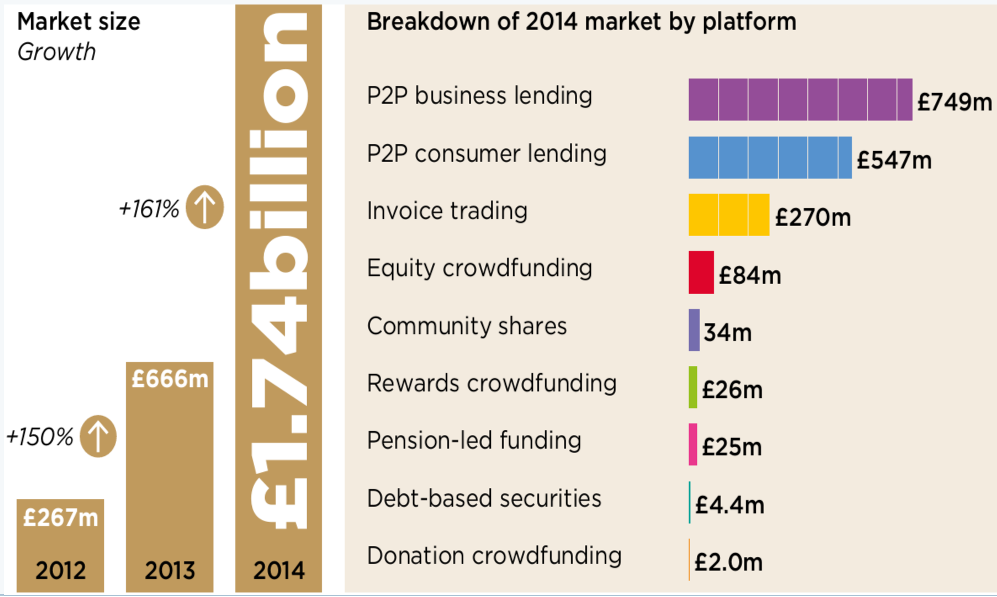
Other P2P invoice discounters include **MarketInvoice** – where >£300m has been funded, generating returns of 11.6% pa (post 1.6% default losses, source: website) and **Platform Black** (£84m traded to date).

Moving to the other side of the pond, the world's biggest P2P provider is US giant **LendingClub** (NYSE: LC.) with loan origination of $6.2bn, offering net returns of 4.7% to 8.0%. The 2nd largest American consumer platform is **Prosper** (net returns of 5%-8%) with 2m+ members and $2bn in funded loans (source: websites). Professional investors are backing circa 80% of all new loans on LendingClub. While last month **BlackRock Financial Management** packaged together a bundle of P2P consumer loans (Source FT) originated through Prosper, which was awarded a credit rating by Moody's. This is important because securing a formal assessment from a globally recognised ratings agency should open the door to a broader range of institutions such as pension funds and insurers.

Great expectations for the Industry

The upshot of this **demand surge** is that the UK P2P Finance sector expanded by an estimated 161% YoY in the UK to £1.74bn in 2014 according to Nesta (see below) – with the bulk of the growth coming from business lending (see below):

UK Alternative Finance (AltFi) market

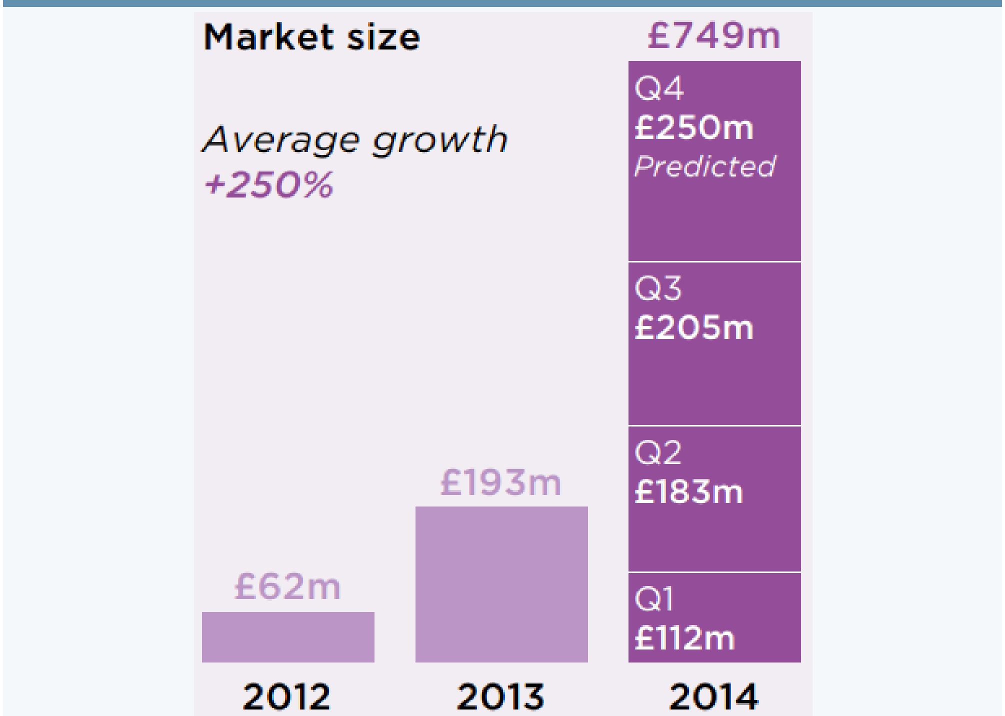


Source: Nesta

Loan volumes doubling every 8 months

This collaborates broadly with recent figures from the Peer-to-Peer Finance Association, which estimates there were £1.3bn of P2P loans in 2014, of which £346m was generated in Q4, split 1/3rd: 2/3rds consumer and SME.

Smart money piling into P2P business lending



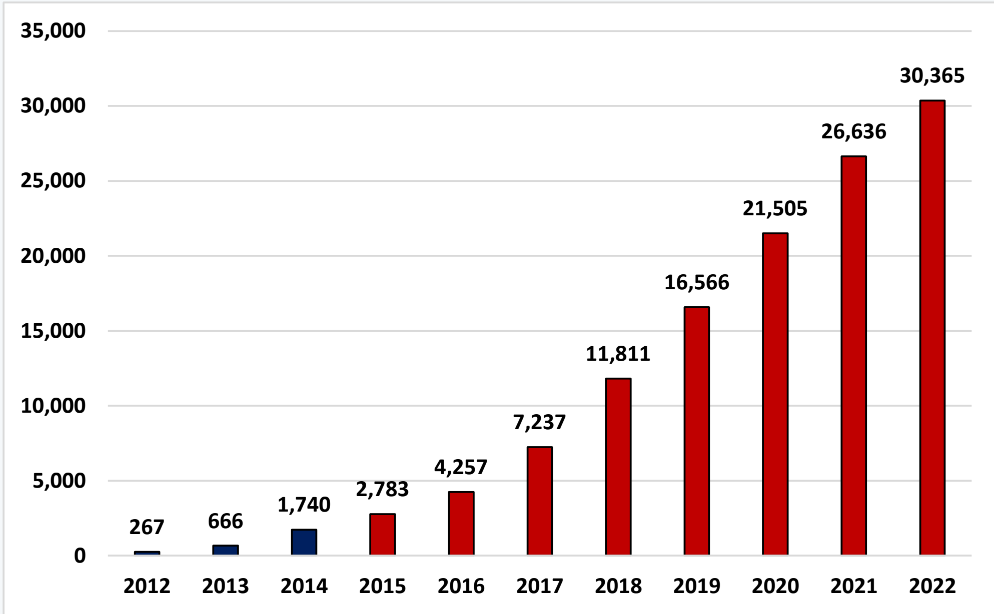
Source: Nesta

CAGR of 43% p.a. P2P growth expected 2014-22

Looking ahead, we believe these positive trends will continue with the **UK industry delivering a CAGR** (compound average growth rate) **of 43% pa over the next 8 years - reaching £30.4bn by 2022** (see below).

With regards to scale, this is still **less than 10% of the predicted addressable market** in 2022, which we estimate is currently worth over £270bn. This taken from Bank of England data, where the value of new loans granted to SMEs and residential mortgages was £48bn and £189bn respectively for the 11 months ending November 2014. What's more, according to themoneycharity.org.uk, there is presently £1.3 trillion of outstanding household mortgages and another £169bn in consumer credit.

Predicted growth of the UK P2P funding market (£m)



Source: Equity Development

Globally, too, **Foundation Capital** forecast the sector will hit $64bn in 2016 and $1 trillion by 2025.

Writing is on the wall for traditional banks

This is pretty scary for the banks who can see the potential for damage being inflicted on their bread-and-butter businesses. In response they have started to dip their toes in the P2P waters as well.

Last month Société Générale and Goldman Sachs were among several institutions discussing plans to back **Aztec Money**, a P2P platform that has created an online market place where people can bid for commercial invoices.

Elsewhere, Santander and Royal Bank of Scotland (RBS) have struck partnerships with P2P firms. RBS expects to refer thousands of prospective loans to **Funding Circle** and **Assetz Capital** following a pilot that has just commenced in Scotland and the South-West of England. This follows Santander's announcement of a partnership with **Funding Circle** last summer.

Regulatory environment set to further boost growth

Additionally, the industry looks well placed to benefit from future government reforms, where P2P lending is considered an investment and is not covered by the Financial Services Compensation Scheme.

In the March 2014 Budget, it was decided that from April 2015 onwards, P2P loans – which are under the regulatory control of the Financial Conduct Authority (FCA) – can be included within ISAs. They are already permitted within SIPPs, which is an area of expertise for **ThinCats.**

Also, the FCA has introduced a new regulated activity of '*operating an electronic system in relation to lending*' – covering disclosure (eg risks clearly stated), promotions, minimum capital requirements, client money protection (eg segregated accounts), dispute resolution (eg Financial Ombudsman Service) and the need to take reasonable steps to ensure existing loans continue to be administered if the platform ceases to operate.

There is greater protection for consumers investing in equity crowdfunding too, which involves buying shares in start-up companies. From April 2015, investors must confirm that they aren't putting more than 10% of their assets, excluding property and pensions, into this kind of scheme.

Taxation improving for investors

Assistance is also coming from HMRC. In the last autumn statement, Chancellor George Osborne revealed a package of measures to support P2P finance, as part of a wider plan to inject competition into the banking sector.

The tax changes mean that from April 2016 individuals lending through P2P platforms will be able to offset any losses from bad loans — such as when a borrower defaults — against other P2P income.

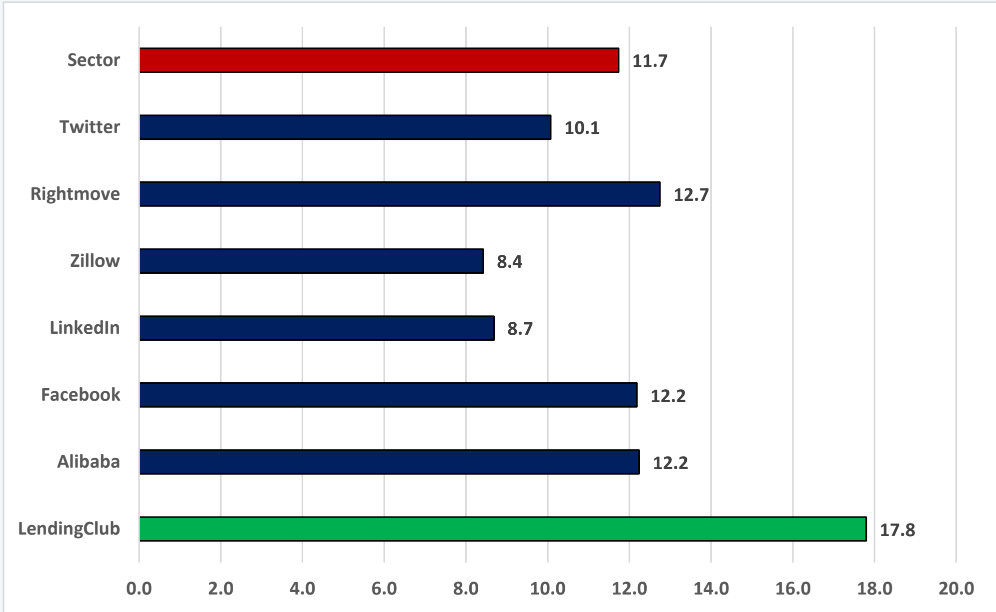
For instance today an investor receiving gross interest of say 9% pa - incurring 2% from bad debts and 1% in fees - receives a net return of 6%, but pays tax on the entire 9%. Going forward, the new regime means investors will pay tax only on the 6%.

Valuation of P2P Platforms

Although there are only a few listed P2P finance providers, we believe the sector should be valued at a premium to other fast growing internet exchanges.

In fact this already seems to be the case, with **LendingClub** at $20/share, trading on a 2015 EV/sales multiple of 17.8x - which is circa 50% higher than the wider internet / social media space at 11.7x (see below).

Current Year EV/Sales multiples



Source: Equity Development (prices as at 29th January 2015)

Conclusion

Despite being only at the **very early stages of its gestation**, the industry is already providing vital funding for creditworthy consumers and SMEs alike, who may have been locked out of the traditional banking sector through no fault of their own.

We view these types of pure P2P marketplaces as the **most attractive business assets in the internet space**. They are not only disrupting the finance industry by leveraging technology, data and software, but also improving user experience and driving costs down.

The growth potential is enormous.

Key risks for lenders

Nonetheless, inexperienced investors (as always) should exercise some degree of caution, before committing their money given the industry's short history and the lack of FSCS protection.

We think there are a number of areas to consider:

- Firstly, P2P loans have not yet experienced a full economic cycle, which makes it difficult to accurately assess underwriting quality, borrower behaviour and future loan losses in a downturn or higher interest rate environment.
- Next, the boom in cross-border P2P raises complicated legal questions. National rules often determine how credit is issued and debts are collected. But they offer little help when the money comes from hundreds of individuals across dozens of countries.
- Although secondary markets in P2P loans are developing (eg Funding Circle), these investments are still generally illiquid, and investors could find it difficult to get their money back quickly (ie pre maturity) if required.
- Being online exchanges handling financial transactions, there is naturally a risk from cybercriminals or similar web attacks.
- Possible disruption caused if, say, a P2P provider became insolvent. That said, most operators (if not all) have Living Wills in place, where the underlying loans would continue to be paid off. Furthermore, any un-lent funds should also be protected, as they have to be held in segregated client accounts.

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