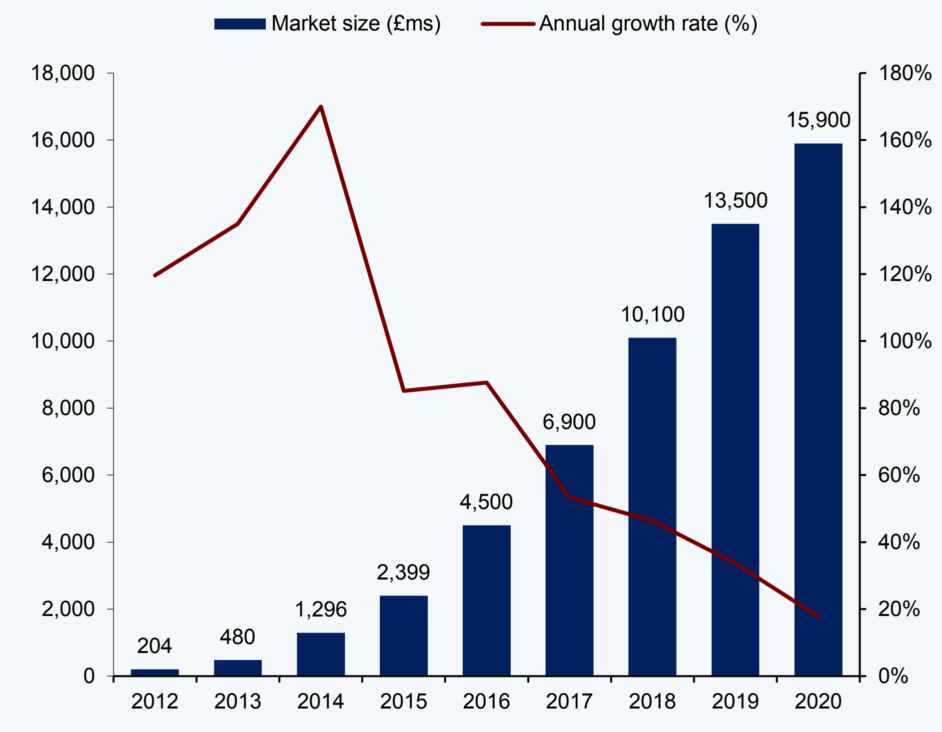
ArchOver Ltd

Autumn 2016

How to earn 5% pa without betting on the stock market

You can't keep a good man down. This year despite being rocked by a series of negative press articles – such as criticism from Lord Turner (former FSA chief), irregularities at industry heavy-weight LendingClub (NYSE: LC.) and the bailout of FundingKnight – we still believe the **UK P2P finance sector is in fine fettle**. Indeed according to research experts BI Intelligence, consumer/business lending is set to jump 87% in 2016 to £4.5bn, and more than triple over the next 5 years (see below) to £15.9bn by 2020. The reason is simple - economics.

UK P2P lending market to consumers and businesses



Source : Actuals Nesta (Feb'16), Forecasts BI Intelligence (July'16)

You see as long as everyone treats P2P as just another form of investment, rather than a FSCS (Financial Services Compensation Scheme) protected savings scheme, then **the sector saves everyone a great deal of money.** Not least by cutting out expensive middlemen (eg banks, invoice financiers), implementing next generation credit checking software and automating cumbersome back-office functions.

No arrears, no defaults and no losses

Take ArchOver, **the pioneer of 'secured and insured' loans to financially viable SMEs** (small, medium sized enterprises). It launched in 2014 and is now part of the Hampden Group (90% controlled) – itself a **substantial privately owned financial services firm** (£64.5m net assets as at 31/12/14) operating the largest Members' Agency at Lloyds Insurers. In 2015 originations hit a record £10m, and are predicted by CEO Angus Dent to climb another 90% in 2016 to £19m, supported by £12m of bookings Sept'YTD.

Description

ArchOver operates the world's only (according to management) "secured and insured" Peer-to-Peer (P2P) lending platform, which aims to match companies wishing to borrow to those with cash to lend in a way that minimises losses - as well as avoiding the need for director personal guarantees.

Its loans to SMEs (small, medium sized enterprises) tend to be for 3 months - 2 years in duration, and worth between £100k - £3m (Average £250k); which is higher than the industry norm, thus making the economics more attractive. **To date there have been no late payments, write-offs or bad debts**.

Approved borrowers typically pay interest of 7.5% to 8.75% pa, with lenders receiving 6.0% – 6.75%, dependent on the term and type/quality of collateral.

On top of an annual 1.5%-2.0% processing charge, ArchOver levies a one-off 4.8% marketing fee from the borrower to cover initial credit checking and setup.

The business focuses solely on high quality commercial credit, and is a subsidiary (90% owned) of the Hampden Group (£64.5m net assets as at 31/12/14).

ArchOver is unlisted, but authorised and regulated by the FCA, along with being a past Altfi award winner for its Working Capital Facility.

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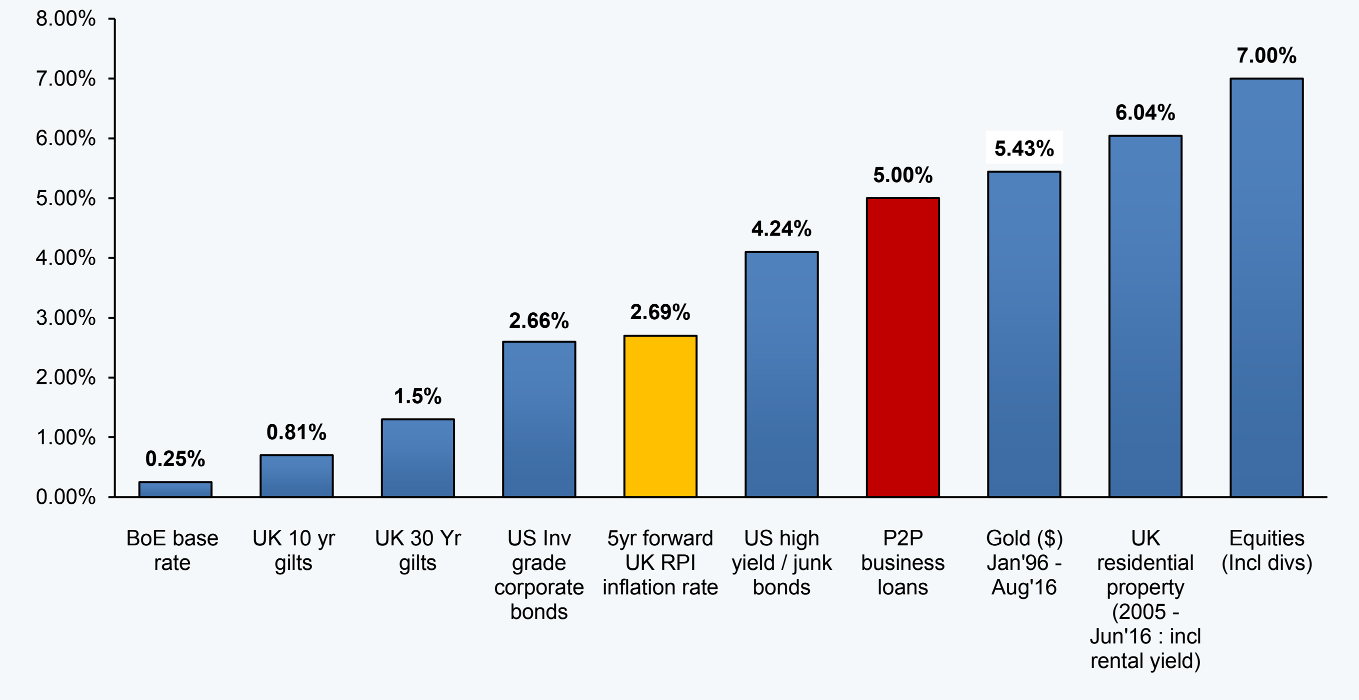
Crucially too for fixed income investors, there have been **no defaults or late payments** on any of its >110 loans (average size £250k) across 20+ different SMEs, funded by >200 lenders, who have earnt on average >6% pa. **This is much better than most of its peers** and reflects not only management's **rigorous credit vetting procedures** (max 80% LTV) where **all loans are secured against a borrower's debtors' book** and monitored continuously throughout the term, but also that **in every instance the collateral is independently insured** by Coface, a €800m+ mrkcap organisation listed in Paris (COFA.PA). Hence providing **a triple layer of protection**.

P2P is becoming a respected asset class

In fact even after factoring in possible future bad debts, we estimate lenders should still be able to pocket **a yield of 5% pa over the economic cycle** (see below) from owning a diverse portfolio of ArchOver's SME loans – whilst also suffering less volatility than typically derived from equities, gold or real estate. This is also broadly in line with the view from 4thWay.co.uk (22nd Sept'16), a ratings/research consultancy, of 4.6% returns from a basket of P2P consumer, business and property credit.

Estimated 'through-cycle total returns' across various asset classes



Source: 21st Sept'16 prices for UK base rate, gilts, AA corporate bonds, residential property (incl net rental yield) and high yield debt. Estimates for equities (incl divs) and P2P business loans from Equity Development

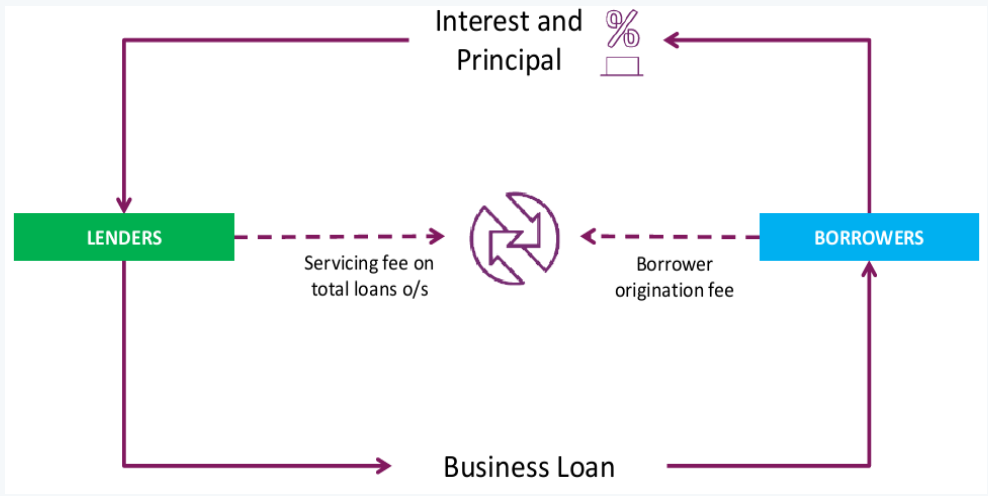
In relation to the recent newsflow, we think **it's important not to arbitrarily tarnish all operators with the same brush, solely because of a few bad apples.** ArchOver is different – which is why, with the **backing of a major finance house** to boot, we reckon its "secured and insured" business model should be considered as **best practise,** and may ultimately become **the *de facto* standard for P2P loans to UK SMEs**.

Lower costs translate into higher investor returns

Money like rainwater, tends to flow downhill until it finds a suitable home. The only problem today, after such a prolonged monsoon of record low interest rates and Quantitative Easing, is that most (if not all) traditional investment options are expensive – leaving many investors scratching their heads where to put their hard-earned cash, especially as >$10tn (4x UK GDP) of the global bond market trades on sub-zero yields.

Enter P2P finance (see below). It is not burdened by expensive bank branch networks, head offices or antiquated IT systems, and so can afford to offer **generous through-cycle returns to lenders**, whilst at the same time provide **a vital source of funding to borrowers**. Indeed we calculate that most **P2P networks can both undercut the interest margins charged by the mainstream banks** and generate a healthy profit.

P2P *business* lending model



Source: FundingCircle

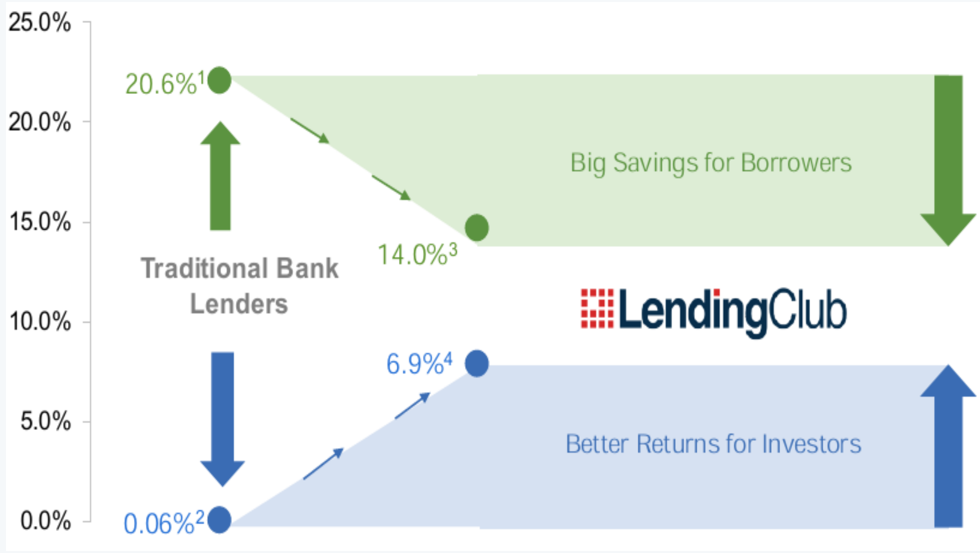
Compelling economics set to further stimulate investor demand

That said in May 2016, Deloitte published a study disputing this cost advantage - claiming that P2P's lower overheads were in fact more than offset by higher funding costs. This might be true in isolation, but we would argue that many operators like ArchOver don't actually lend money over their own platforms. Instead 3rd party lenders do, with many presently facing marginal returns on their spare cash of <3%.

Additionally going forward, why would the high street banks want to kick-off a potentially damaging price-war, as it could have a major ramifications on their already shaky RoEs? And besides the vast majority of P2P investors are simply looking for relatively safe yields above inflation, which frankly they can't obtain from many traditional asset classes. Certainly not from government Gilts, savings accounts or AAA corporate bonds.

Granted if interest rates were ever to normalise back to pre-2007 levels of between 4%-6%, then the situation might change. But even so, if this did occur, then we still think the key determinant of P2P lender demand will be what sustainable risk-adjusted returns are generated (net cost/defaults) verses other asset classes (eg cash, bonds, gilts, equities, property). And on that score, **the economics are compelling for all parties concerned** (see below).

P2P *consumer* lending model



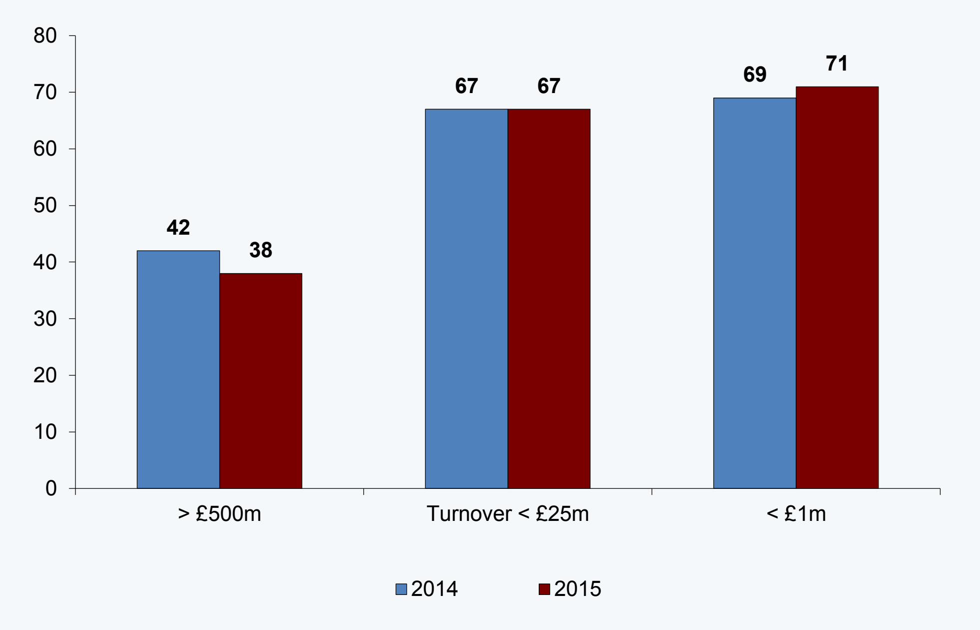
Source : LendingClub

Helping financially viable SMEs with much needed funding

So what about the borrowers? Well here too there is a lot of interest, especially from **SMEs who on average are having to wait 71 days for invoices to be paid** - nearly double the time taken for larger organisations (see below) according to the Asset Based Finance Association (ABFA).

"*The impact of delayed payment on businesses' cash flow and capacity to expand order books presents a serious concern - particularly for smaller companies. Even when a business is thriving, just a few unpaid invoices can end up a real threat to survival*," said ABFA's Jeff Longhurst.

UK invoice payment periods for small vs large companies

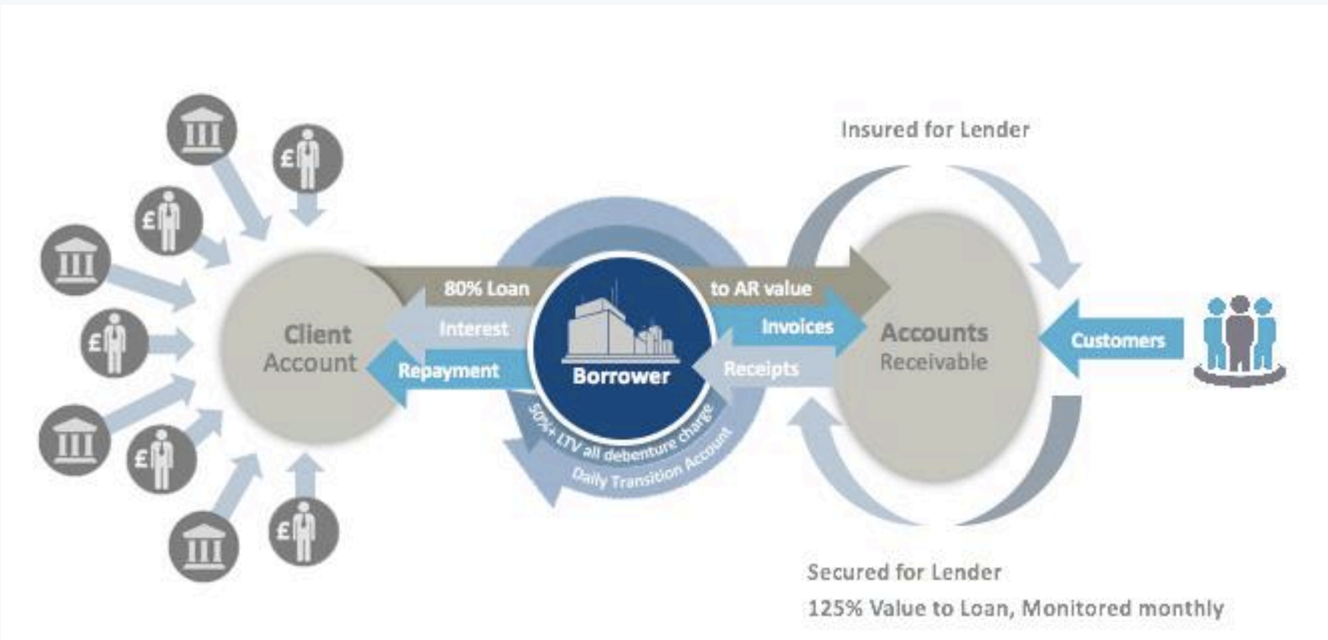


Source : Asset Based Finance Association (ABFA)

ArchOver's sweet spot is replacing Invoice Financing

Not surprisingly, thousands of the cash-strapped companies are being forced down the road of invoice financing, which can be expensive and administratively burdensome, often requiring two sales ledgers to be maintained. In contrast **ArchOver offers a cheaper and far less bureaucratic alternative**.

ArchOver's differentiated "secured and insured" P2P model



Source: Company

Admittedly like its peers, P2P loans are not covered by the Financial Services Compensation Scheme (FSCS), although we reckon the company's extensive **credit vetting procedures are at least on a par with the banks**; involving rigorous mining of 3rd party databases, face-to-face meetings and ongoing monitoring.

Firstly each approved **company must possess at least a 2 year trading history** (no startups), along with **good quality debtors**, over which an 'all-asset debenture' charge is held at Companies House with <80% LTV (loan-to-value).

Next ArchOver requires all borrowers every month to submit their aged debtors report and management information within 1 week and 20 days of the period close. The former provides a vital check that the underlying security is still fully in place, whilst the latter gives a more holistic financial picture – allowing ArchOver to promptly spot trends in the business and to quickly identify any issue that may arise.

Rigorous credit checking procedures

Thirdly, the collateral is 'insured' via Coface, a €800m+ marketcap credit insurer (COFA.PA), who provides an **independent assessment of the deal**, and an **extra level of reassurance for lenders**. ArchOver's position as 'Joint Insured and Loss Payee' also means that in the event of default, both the collateral and/or the insurance proceeds can be transferred quickly to the respective lenders. 'Personal guarantees' are not required either, an important differentiator for directors.

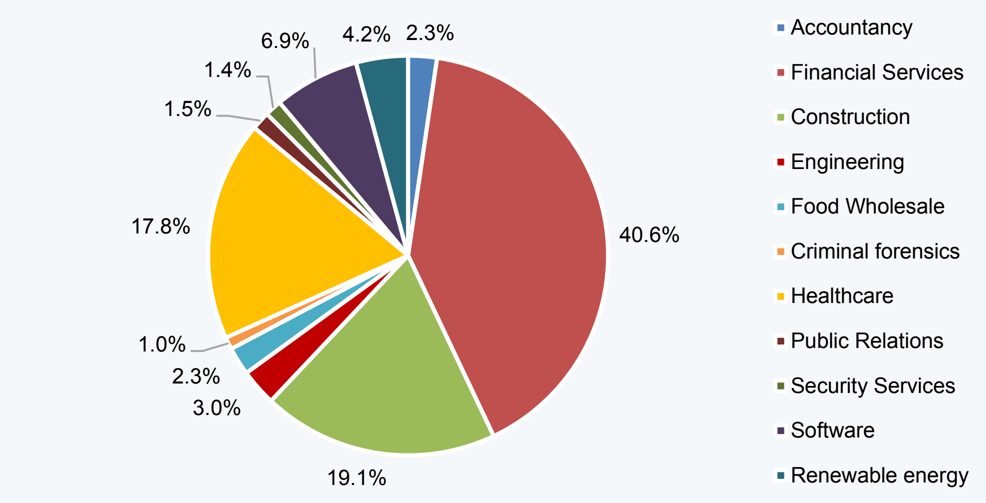
Finally in the unlikely event that ArchOver ever ceased trading, then we understand Hampden (90% owner) would step-in, initiate the company's 'Living Will' and back-stop any outstanding contracts, and/or alternatively appoint a 3rd party to run-off the remaining loan book.

Interestingly any future recession might actually help, since it could boost demand from investors seeking enhanced protection and SMEs being starved of credit. This is exactly what happened following the 2008/9 financial crisis, when several institutions drastically down-sized their loan books.

Only creditworthy borrowers are approved

Ok, but from a lender's perspective, what does a typical ArchOver borrower look like? Well these businesses will likely be head-quartered in Britain, spread across a variety of different verticals (see below), generate revenues of >£2m and be seeking between £100k-£3m over a 3 months to 2 year period. In exchange they will be charged 7.5%-8.75% pa, a one-off marketing fee of 4.8% and a further 0.15% pa of turnover for credit insurance. Thus bringing the total 'all in' cost to approx. 10.5% pa for an average 14 month facility.

Industry split of ArchOver's cumulative loan originations



Source : Company (cumulatively up to July 2016)

Of course investors are looking for a decent deal too, with the platform paying between 6.0%-6.75% pa. The minimum pledge is £1k, with the average for individuals being around £5k, and family offices / institutions at £50k. Importantly **all parties, however big or small, are treated equally**, including Hampden who have supported the platform from inception and lent the most so far.

ArchOver's P2P loans are less risky than equities

To date 200+ lenders have committed funds, producing many satisfied customers (see sample endorsements below). Cumulatively up to September 2016, ArchOver has arranged >110 loans - worth collectively >£22m and incurred **zero non-performing loans (NPLs), which is frankly much better than its peers**. These **agreements are fully funded too**, hence ensuring they don't fall into the same liquidity trap that went so spectacularly wrong at Northern Rock during the financial crisis.

With regards to credit quality, **we estimate the loans roughly fall within the BB to B ratings band**, pitching them towards the premium end of high yield corporate debt.

Client endorsements

Spirit Healthcare: Chris Barker: "*Raising finance through ArchOver's platform was fast, efficient and cheaper than the rates we were being quoted by the banks*."

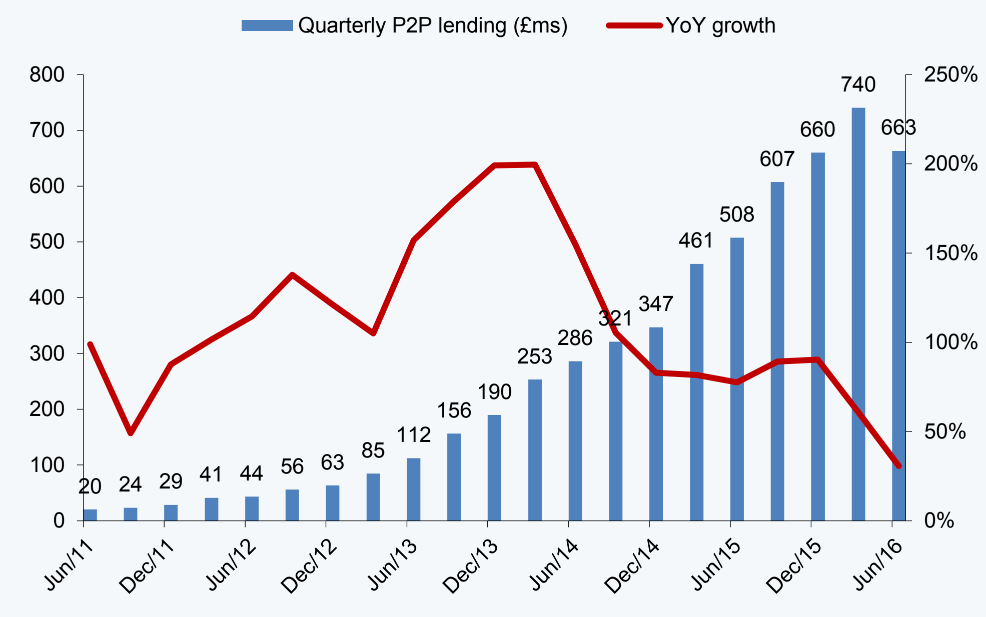
Knightsbridge: William Russell: "*There is always a risk, even with a bank, but we took the view that the ArchOver platform was as safe an investment as most options and its 6.5% return is much better than we could get anywhere else*."

Source : Company

Years, if not decades, of growth ahead

More broadly, in terms of the numbers, industry body P2PFA calculate that **UK P2P loan originations climbed 45% in H1**, despite suffering a **temporary dip in Q2'16**, falling 10% sequentially to £663m from £740m in Q1'16 (see below) due partly to the EU Referendum and less than complementary media coverage.

Quarterly UK P2P new lending (£'ms) to consumers and businesses

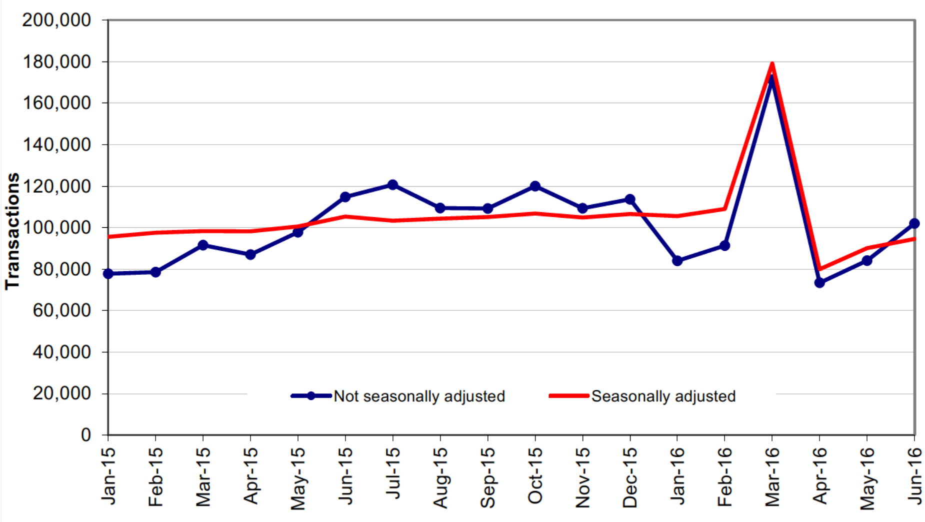


Source : Peer-to-Peer Finance Association (P2PFA) - Note: Historics slightly < Nesta figures

On top, Q1 was artificially inflated by the government's one-off hike in stamp duty, which brought forward many property transactions ahead of the 5th April deadline (see below). For ArchOver, however, **CEO Angus Dent has not seen a decline in lender interest**, albeit there has been less appetite from borrowers over the quieter summer months - and more widely there does appear to be a general softening of institutional money, as several P2P equity listed trusts have now deployed most of their spare capital.

Elsewhere, *net* UK P2P lending *growth* (originations less repayments/maturities) has decelerated July'YTD according to Altfi, and may even turn "negative in 2017" if trends continue. While overseas a similar pattern has been witnessed in the US, where analytics expert Orchard reported that Q2 consumer loan originations dropped 34% from Q1 - reflecting the problems faced at LendingClub (see later), rising delinquencies and a tighter lending environment - adding though that volumes should resume their upward trajectory in Q3, rising by "5% and 15%" thanks to "investors still searching for yield".

Number of UK residential property transactions

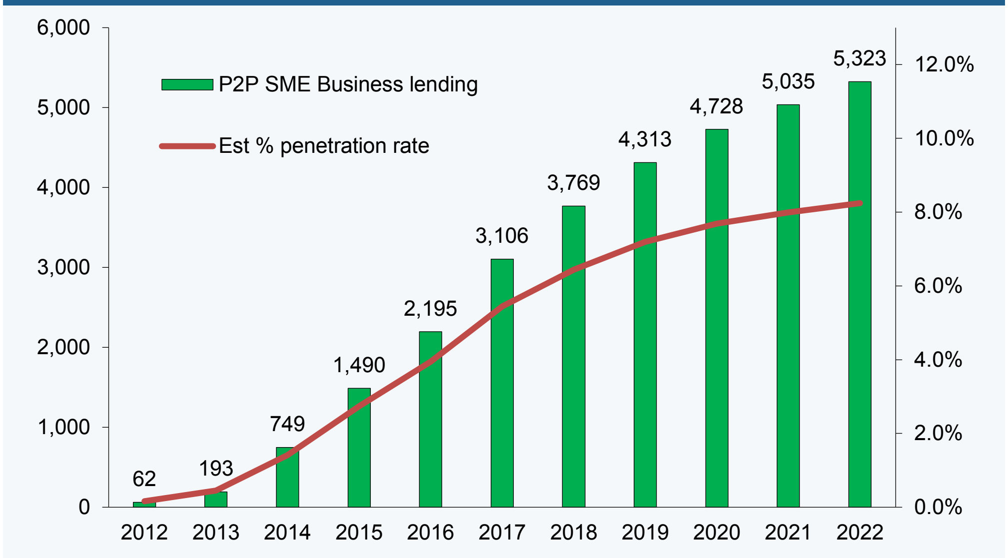


Source : HMRC

Clearly, given the macro data, it is difficult to precisely gauge what will happen next, although it is possible that the market may have already bottomed with the National Association of Commercial Finance Brokers (NACFB), saying that it saw a doubling in enquiries from UK SMEs in August vs LY - **implying grass-root demand from borrowers remains strong**.

On balance, therefore, **we expect the recent P2P dip to prove temporary, with new business volumes climbing by 47% in 2016 to £2.2bn** (vs £1.5bn LY) - equivalent to an estimated 3.9% penetration rate of the addressable market (ie SME loan originations) - and tip the £5bn barrier sometime in 2021 (see below).

Forecasts for new UK P2P *business* lending (£'ms)



Source : 2012-15 Nesta, Equity Development forecasts for 2016-2022

This view is consistent with BI Intelligence's estimates in July (post EU Referendum) of 45% CAGR between 2016-20 for UK P2P borrowing (including consumer), but slightly less than Research And Markets' August global projections of 53% pa over the next 5 years driven by "***the growth of small business lending***".

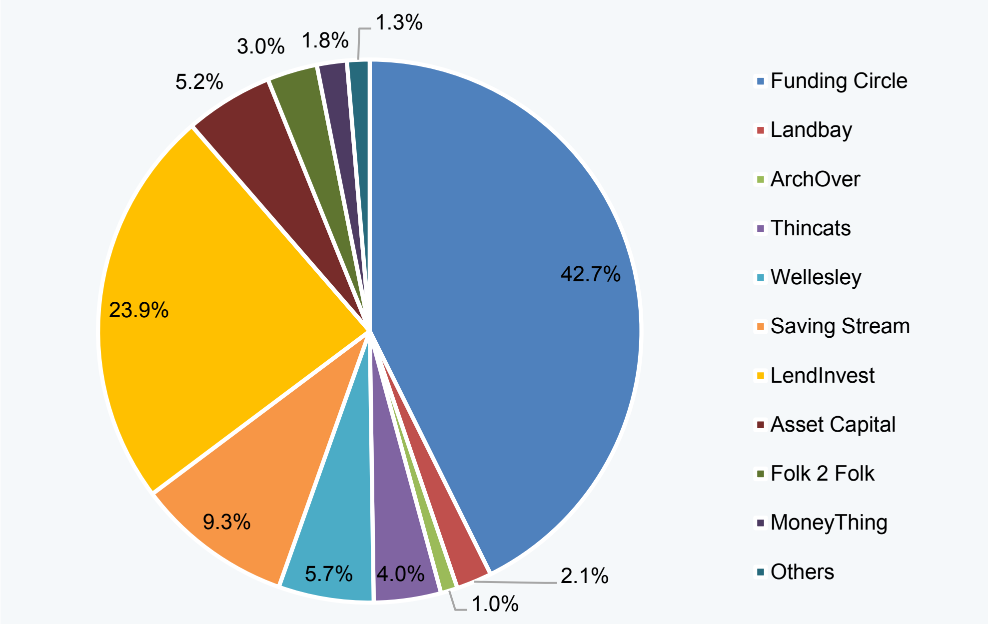
In fact this **pent-up demand may have actually been enhanced by BREXIT**, since it has created fresh uncertainty and extended the era of low, zero and/or negative interest rates. Encouraging more investors to look at P2P as an asset class in its own right, with Zopa, one of Britain's biggest consumer websites, saying that it has already seen a jump in new lenders because of the recent cut in base rates to 0.25% by the Bank of England.

Big isn't necessarily better

So what does this all mean? Well to us **ArchOver has developed a highly differentiated P2P offering**, which is why in February 2016, Duradiamond Healthcare selected it to provide a record £2.3m working capital facility. The loan consisted of 3 parts, all delivering returns for lenders of between 6.25% - 6.75%. CEO Angus Dent commenting "*Not only does this represent a record loan for ArchOver, we also believe it is be the largest non-property related working capital loan in the crowdlending sector anywhere in the world*".

With regards to direct competition, the **company's main rivals are the traditional invoice financiers**, augmented by some head-to-head activity with other P2P providers (see below).

2016 YTD market shares for UK P2P *business* lending



Source : P2P website Altfi.com (5th September 2016)

Consolidation should provide opportunities

The good news is that, despite there being >100 platforms in the UK, it is becoming increasingly clear who will be the winners and losers. Here we suspect **the market will eventually polarise between the volume players** - Zopa, RateSetter, Funding Circle, LendInvest and MarketInvoice – **and the niche specialists**, like ArchOver. Many in the middle ground could get squeezed, possibly leading to consolidation.

In fact it may already be happening with the number of new entrants over the past 2 years decreasing (*source: Nesta*), as P2P moves into the 'mainstream' on the back of greater public/business awareness, regulatory protection and economies of scale. Longer term ArchOver itself could even be acquired by a larger player and/or a bank, wishing to enter the space.

So what's all the recent media kerfuffle been about?

Well unfortunately of late, there has been some less than favourable media reports that we guess was inevitable, given the sector's rapid pace of expansion over the past few years.

Firstly in February 2016, Lord Adair Turner (previous head of the FSA, now FCA) warned in a BBC interview that "*the losses which will emerge from P2P lending over the next 5 to 10 years will make bankers look like geniuses*". Sure tearing a strip off the industry might make good headlines, but in doing so we feel Mr Turner has wrongly lumped all operators into the same bucket. In reality there are many differences across networks, with **ArchOver being** in our opinion, **towards the top when it comes to lender protection thanks to its 'secured and insured' model**.

From a fiscal perspective, the government seems to be supportive too, wanting to stimulate much needed competition and boost small business lending. P2P networks are already regulated by the FCA (Financial Conduct Authority) and possess capital buffers of at least £20k (rising to £50k+ in April 2017). These regulatory 'checks and balances' are important in building trust, especially following the alleged overseas frauds last year in Sweden (TrustBuddy) and China (Ezubao).

Moreover from 6th April 2016, **P2P loans were allowed by HMRC for inclusion within the newly created 'innovative finance' ISAs.** That said these tax efficient vehicles are still relatively thin on the ground, since the FCA has had difficulties processing the volume of applications.

Don't condemn P2P simply because of a few isolated incidents

The next batch of unsupportive newsflow came in May 2016, when the world's largest listed platform LendingClub (NYSE: LC.) had to turf-out its CEO/founder for supposedly playing fast and loose with investors' money, including instances where employees falsified documentation on $22m worth of loans. Fortunately no monetary harm was done, since all injured parties were ultimately reimbursed, but nonetheless the incident didn't exactly engender confidence.

Lastly in June, UK operator FundingKnight fell into administration, and had to be bailed out by 23.4% shareholder GLI to protect around 900 investors. Granted, there is always a risk that ArchOver could suffer the same fate, yet with the backing of Hampden's deep pockets, the chances of such an event appear remote. What's more even if this did occur, then we understand a **comprehensive Living Will** is in place, which should protect investors/borrowers, with all client money being held in segregated accounts, and hence outside the official powers of an appointed receiver. (Source: company).

Greater regulation should weed out any remaining bad apples

Ongoing regulation should also improve standards, with the FCA currently undertaking a consultation on the whole P2P ecosystem. Here we suspect the financial watchdog will propose a series of measures to tighten safeguards for all parties concerned, especially around advertising, where head Andrew Bailey commented that he was "pretty worried" about the way P2P is sold to the public.

Another area being reviewed is "maturity mismatch": where people are offered 3-5 year loans, and promised access to their cash within 30 days. This issue though is not confined just to P2P, since many investors have experienced similar difficulties trying to withdraw their funds from property based unit trusts after BREXIT. For ArchOver, we understand neither of these 2 issues should be a specific concern (Source: company).

Summary

In conclusion therefore, although P2P's reputation has undoubtedly been dented over the past year or so, **we are nonetheless confident that it has a prosperous future, involving plenty of years (if not decades) of strong growth**. Advances in technology will continue to keep costs down, while low interest rates should further spur lenders to seek better returns, as well as encourage borrowers to look for cheaper and more flexible debt.

Additionally we think ArchOver will become much more prominent in the industry, particularly as more of its lenders **enjoy the estimated 5% through-cycle yields** (post costs/defaults) – reassured in the knowledge that their cash is protected by the firm's 'secured and insured' model, combining detailed credit-vetting, collateral backing and 3rd party insurance.

CEO Angus Dent adding *"In July 2016 we tipped £20m in cumulative loan originations, a major landmark. Going forward we have ambitious plans, and are targeting another £40m in 2017, rising to £120m by 2020*".

Key risks

- There are presently >100 P2P platforms in the UK. In our view this will decline, and inevitably lead to some consolidation.
- P2P platforms are operationally geared to new loan originations. For instance 90% of LendingClub's (NYSE:LC) 2015 revenues of $427m were derived from deal fees with only 10% generated from recurring income. Without new loans, revenue would fall.
- Negative publicity, say if a large P2P operator became the victim of fraud/malpractice – thus potentially damaging the reputation and future prospects of the industry as a whole.
- Possible pull back of institutional money, say in the event of a recession or concerns over credit quality.
- Despite being FCA-regulated, P2P lending is not covered by the Financial Services Compensation Scheme, as is the case for consumers and very small businesses (but not large corporates) deposits of up to £75,000.
- Impact of an economic downturn, and subsequent knock-on effect wrt non-performing loans (NPLs).
- ArchOver, being a niche player, is relatively small and could get squeezed by larger rivals.
- P2P exchanges handle financial transactions, so there is an inherent risk from cybercrime, hacking and/or web attacks.
- Due to its high growth, ArchOver is loss making - hence it is important that sufficient resources continue to be made available to fund its expansion.
- Finally there is no formal secondary market in P2P loans, so they could prove difficult to resale in the event the investor wishes to liquidate their holdings.

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