Xconomy

Xconomist of the Week: Rebecca Lynn on the Financial Services Boom

Wade Roush 5/4/12

Morgenthaler Ventures partner Rebecca Lynn shows up at just about every Health 2.0 event in Silicon Valley—heck, she organizes some of them, like Morgenthaler's annual **DC to VC** health IT showcase. So if you only went to those events, you might think that was Lynn's whole investing focus.

But in fact, the **Xconomist**'s portfolio at Morgenthaler ranges from health (**Practice Fusion**) to cloud computing (**Socrata**) to financial services (**Lending Club**). That kind of variety is mirrored in Lynn's own resumé, which includes a BS in chemical engineering from the University of Missouri, a JD from the U.C. Berkeley School of Law, an MBA from Berkeley's Haas School of Business, and jobs at Procter & Gamble and NextCard, an early online credit card company.

Lynn thinks it's a great time to be innovating in financial services, for at least three reasons. First, an economic environment where interest rates are so low and lending practices are so strict that people are looking for places other than banks to park their money or get loans. Second, the advent of "big data," including social data, which gives Web-based financial services companies new ways to evaluate risk and tailor their services. Third, the mobile revolution, which gives everyone instant access to information about their finances.

I talked with Lynn a couple of weeks ago about Lending Club and **Pageonce**, two Morgenthaler portfolio companies that are busy exploiting these trends. That week, Lending Club had just announced a big coup: the addition of John Mack, who served as CEO of Morgan Stanley until 2009 and chairman of its board until 2011, to its board of directors. Mack is a heavy hitter in the financial world, so Lending Club signing him up as a director was roughly equivalent to a music startup recruiting David Geffen or a food startup roping in Gordon Ramsay. Lynn was very happy about the news—and she explained in our conversation why financial services is an increasing focus for her firm.

Xconomy: You joined Morgenthaler in 2007 and financial services has been one of your focus areas, along with health IT, mobile, and Internet services. But you have a background in financial services that predates Morgenthaler.

Rebecca Lynn: I spent four years at NextCard, the first online credit card company. We owned the patent for real-time online approval for credit card consumers. I was employee number 30, was the first product manager, and ended up running all of their online marketing. That background gave me good exposure to consumer credit. A lot of VCs on the West Coast have payment experience, but very few people have credit experience, so I see a lot of deals in the credit and underwriting world just by virtue of that. When I first came to Morgenthaler I did a deep dive in financial services because that was my background.

X: One of your biggest financial services investments is in Lending Club. How did that come about?

RL: I was really intrigued by their model, their vision. They were disintermediating the banks. You can't get much bigger than that. And they were doing this in the right way. They were scoring the loans themselves. They were also playing in the prime and superprime market, which, as I learned at NextCard, is super important. NextCard got into subprime [loans] very early and that is really what brought the company down. Subprime is something you can do later in a company's life, but if you are doing prime and you have runway in front of you, you should keep doing prime.

I also liked how analytical and rigorous the company was, in terms of their understanding of the loan business. They didn't take a balance-sheet risk. It's not a bank; it's not a financial institution at all, it's a technology platform. That is exactly the kind of model I like to see when I'm doing early stage investing, because it's a capital-efficient model. This is a marketplace where investors and borrowers are able to meet.

X: Say more about their model. Why is it more attractive than just starting a bank?

RL: Lending Club has a lot of efficiencies. They are not taking on deposits; they are strictly a platform. A borrower comes in, applies for credit, and they will match that person with a lender, and investor on the other side who wants to put money into the company. It's not a brick-and-mortar situation. If you look at banks themselves, they are incredibly inefficient. If you put money into a savings account, you are getting virtually nothing back in interest. If you have an 880 credit score, which is incredibly high, you are still going to pay 13 percent to borrow money. The bank is keeping that. When you're paying 17 or 18 percent on a credit card, you are just servicing the inefficiency of running these big institutions. There is a much more efficient way to run a company.

What Renaud [Laplanche, Lending Club's founder and CEO] did is create a platform for investors and borrowers to interact directly. If you are an investor, you can choose to put your money into individual notes, or into a bucket of notes. You have a choice of whose notes you fund and what your credit risk criteria are. There wasn't a way, before this, for investors to get access to consumer notes. The return for the investors has been anywhere from 5.8 percent to 12.7 percent on an annualized basis, which is pretty phenomenal from an investment perspective. Instead of parking your money in a savings account or a CD you can put your money into consumer loans.

X: This is a naïve question, I know, but why would anyone want to put his or her money into consumer loans? Isn't consumer lending the very thing that blew up the economy back in 2008? What's in it for both sides?

RL: There are a couple of things to understand about Lending Club. They don't underwrite subprime consumers or people with shaky credit histories. About two-thirds of their consumers are taking their credit card debt, which usually has a revolving rate of 13, 14, or up to 18 percent, and putting that into a fixed-rate loan that they are paying off. Those consumers are drawn to the platform because it helps them pay off their credit card debt. On the management side, we see that the default rate is about 3 percent, compared to the industry average of about 5 percent.

The unique thing about Lending Club is that they are essentially a public company—they had to register with the SEC to offer bonds, so the platform itself is completely transparent. You can see the return rates and how the market actually performs, and all of that draws in additional investors. One interesting thing that we're seeing is that there has been more and more institutional interest in the platform. When it started out, it was more small investors, people putting a couple thousand dollars into the platform. Twelve to 18 months ago, we had about five people on the platform who had over a million dollars invested, and that was a big deal for us. Today we have over 65 people with over a million dollars, and some of those have tens of millions of dollars on the platform—family offices and large investors who see this as a great place for returns and who believe in the model itself.

X: What are the biggest challenges Lending Club faces as they scale up? If they are indeed a technology platform, then I imagine they have to solve a lot of the same problems as other Web-based platform providers—security, reliability, customer acquisition.

RL: I think the challenge they face is that they are creating a whole new category, a whole new vehicle. They have a dual marketing and acquisition challenge. It's the chicken-and-egg thing. You have to acquire the borrowers, and those people have to be aware of the option of a Lending Club loan as opposed to taking out a high interest rate credit card or going to a bank. But they also have to acquire investors—those two things have to be balanced. What we have seen is a fabulous management effort within the company, where they are doubling year over year in terms of revenue and loan origination. They've been doing a really amazing job of predicting where things will come out, and the market is beginning to have its own internal balance.

X: How does Lending Club make money?

RL: They have two types of fees. They charge a one-time origination fee that is paid by the borrower, and a small fee that the investors pay from their side that covers the cost of servicing the note itself. The origination fee is roughly 4.5 percent and is collected up front. The servicing fee is about 1 percent and it's collected monthly over the life of the loan. The maximum loan size is $35,000, but the average loan is around $12,000. They have been increasing the maximum loan size as they learn. They are doing things in such a smart way—that is why I love the company.

X: Lending Club just recruited former Morgan Stanley chairman and CEO John Mack to join its board of directors. How did they pull that off, and what does Mack bring to the board?

RL: Renaud is a fabulous networker, so all credit goes to him for actually getting an introduction to John Mack. Yes, he was at Morgan Stanley, but he is retired now and he is at the phase of his career where he wants to reinvent how things are done on Wall Street. He was in the saddle at Morgan Stanley long enough to know where the big opportunities lie. That in itself was a big validation for Lending Club. Also, John Mack knows a great deal about fixed-income products—he was a bond trader and what he really knows is the investor side of the equation, which is 50 percent of the equation at Lending Club. And the huge advantage is that he knows Wall Street. As the platform matures and we see larger and larger investors coming into it, I think John will be a great asset. That's the value he brings.

X: You have other financial services investments at Morgenthaler, right?

RL: The other company where I lead the investment is Pageonce. It's a mobile wallet play. I'd been tracking the company for a little while; we were watching where Steve Schultz, who was the general manager at Yahoo Finance, was going to land. He was a rising star there and we felt like he had his pulse on what was going on in financial services. When he left [and joined Pageonce as chief operating officer], we took notice, and we believed that from a product and team perspective they were a very exciting company in the mobile payment space, so we made that investment last summer.

X: Describe their business.

RL: They position themselves as a personal financial services company. People want bill paying to be easy and pain-free and they want to know how much they have in each account, what bills to pay, and an easy way to clear those bills. That was exactly the tack that Pageonce took. If you look at the Pageonce screen, it's a beautiful user interface, but it's what they have under the covers that's even more interesting. They build all of their own backend for account integration. They don't use Yodlee. They also built their own bill presentment and bill pay functionalities. So they have this very robust technical backend that other people have not focused on.

X: How is it different from Mint?

RL: They are most often compared with Mint, but Mint has more of a budgeting focus, whereas Pageonce takes the view that most people don't balance their checkbooks. People are really managing from day to day and trying to make sure they pay their bills on time. They are much more in the mainstream. Wells Fargo or Chase will let you pay your bills online, but only from your Wells Fargo or Chase account. Pageonce lets you pay with any account you want, such as your rewards-points card. And they let you manage all of those accounts in one place. I open the app and in one place I can see what bills I have due, and pay them at the touch of a button.

X: Do you think this is an especially good time for venture firms to be investing in financial services companies, and if so, why?

RL: I think there are really three key things. One is that even though interest rates are phenomenally low, access to capital is very constrained. That is creating a very interesting ecosystem for people to disrupt the current models. There is an obvious imbalance, and that is where Lending Club came in. Another is that with the advent of social data, there is just so much more data out there, so there are new ways to evaluate and underwrite consumers that don't just rely on FICA scores and things like that. If you look at companies taking out small business loans, for example, you can look at their FedEx history or their merchant transactions or the cash balances in their bank account, and there are event some startups starting to look at social graph data and figuring out if they can make some assumptions about creditworthiness based on that. (I don't want to get Lending Club in trouble, because they are not doing that yet—it's an area we are looking at.) So there is a lot more data out there. Then the whole mobile ecosystem is actually here now. The walled gardens have come down. Back in the NextCard days we talked to every version of a mobile wallet company you can possibly imagine, and none of them took off. But now with the iTunes and Android ecosystems it is a different ball game.

X: Do you feel like financial services is an area that competing venture firms have been neglecting, and one where Morgenthaler has a head start?

RL: Venture capital goes in cycles and waves, and in every cycle there's always a handful of billion-dollar companies created in financial services. So I don't think it's an area VCs have neglected, so much as that that innovation comes in waves over time. My own experience is in consumer financial services and online credit. We also added Mark Goines as a partner recently. He comes with a wealth of experience from Charles Schwab and Intuit that is very complementary. He was also an early investor in Mint, and ironically enough he was an angel investor in Pageonce before he came on board.

Between Mark and myself, I do think we have a deep understanding and a deep network in the financial services space.

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