

How Lending Club Is Shaping the Future of Small-Business Loans

In just eight years, Lending Club has figured out how to provide a faster small-business loan--and paved the way for a growing group of financial disrupters.

BY ROBB MANDELBAUM



IMAGE: Mathew Scott

It did not take long for the daily rhythms of prosperity to establish themselves at Hungry Ghost Coffee Bar and Café, a recent arrival in a gentrifying Brooklyn neighborhood. The café bustles, and makes its money, in the morning, when commuters line up for a handcrafted caffeine charge on their way to the subway. Around 10:30, the freelancers arrive and park themselves on stools at the bar along the wall, beneath a row of large mirrors, and open their MacBooks. It resembles a very elegant workstation, with a jazz soundtrack.

"When I was looking for the place, my idea wasn't to do this," owner Murat Uyaroglu says as we survey the space from a pair of \$1,300, riveted steel, round-back chairs.

Such costs were intimidating: "It adds up," he tells me. "But it paid off. People talk about it." And they come back. Hungry Ghost, he says, became profitable in its second month.

But by 4 o'clock, the freelancers pack up their things and Hungry Ghost empties. As one afternoon last August became evening, Uyaroglu found himself behind the counter in his nearly deserted café and thought: This is not right. "I see people walk by. They're not stopping in because it's coffee," he recalls. "At 6 p.m., it's the perfect ambiance for beer and wine."

By this point, Uyaroglu, who emigrated from Turkey in 2000, had become something of a mini café mogul in Brooklyn, with three cafés and a lobby concession for a local arts center. He had financed his third café with a Small Business Administration loan at 8 percent interest, but it took six months to close--the government shutdown added an extra month--and he didn't want to wait another six months for the \$20,000 or so it would take to begin serving beer and wine. He didn't even consider a bank, after an early attempt to get an equipment loan ended with rejection.

Since the recession, many banks have stopped issuing small loans, even to healthy businesses. New regulatory costs, combined with already-high underwriting expenses, means there's just not that much profit in it for them. The Federal Reserve recently reported that the average small company now spends 24 hours--yes, a full day--applying for loans. Yet only 33 percent of businesses get all the credit they ask for, and 44 percent are denied loans altogether.

There have long been alternatives--including merchant-cash-advance lenders, the business world equivalents of payday lenders--for those willing to pay a steep price for being a "riskier" borrower. But last summer, a bit of Web research brought Uyaroglu to another option: Lending Club, the online company that matches people who want to borrow money with others willing to lend it. For most of its young life, the San Francisco marketplace mostly arranged consumer loans; in 2014 alone, it facilitated \$4.4 billion in financing. Many entrepreneurs finance their startups with such personal debt, rather than with the official small-business loans that Lending Club says weren't a significant part of its business before last year. But now it has jumped into the business of financing small companies, launching a pilot program. Today, Lending Club, one of the most visible and successful recent financial disrupters, is focusing on a larger group of startups, online lenders, and would-be bank alternatives, all of which are jockeying to reinvent the small-business financial world.



Lending Club was born out of boredom. Renaud Laplanche, antsy on vacation, resorted to reading his credit card bills and got inspired.

Photo: Mathew Scott

For entrepreneurs like Uyaroglu, this means new, faster ways to get loans of up to \$300,000, for terms running as long as five years (what Lending Club offers in its pilot program). The most creditworthy small-business borrowers can get what are essentially bank rates; Lending Club charges between 5.9 and 30 percent annual interest.

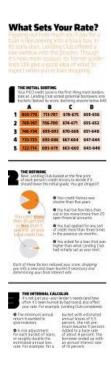
As a so-called peer-to-peer lender, Lending Club keeps its costs low enough that it can offer rates that are often better than what you pay for your credit card. While these rates have a wide range, Lending Club's average at the end of 2014 was 13.4 percent; credit card borrowers typically pay between 17 and 18 percent, says David Robertson, publisher of the Nilson Report, which tracks the industry. Noncard bank loans, including those backed by the Small Business Administration, generally cost between 3.25 and 9 percent, according to small-business-loan marketplace Biz2Credit.

For a peer-to-peer marketplace, "lender" is actually a misnomer: Instead of building branches, acquiring a stash of capital to give out, and reserving some of that money for losses on soured loans, Lending Club acts as an intermediary. It risks nothing itself, and makes its money through fees rather than interest. In December, the company went public in an offering that soon established its worth at more than \$8 billion--though what the public markets giveth, they can also quickly taketh away. The company in February revealed mounting expenses and slowing growth, disappointing investors; about \$1 billion of the Lending Club's new market cap had disappeared by mid-March.

Still, that's a relatively minor setback for a complex financial company that went from inception to IPO in less than a decade. And whatever its individual fate, Lending Club is inarguably at the forefront of a new wave of innovators, taking on the staid old financial services industry. Working out of half-finished lofts in San Francisco and New York City, a coterie of venture-funded startups have taken up the challenge of disrupting a complicated and opaque industry, and filling the remaining gap in the business-loan market. Biz2Credit, Bond Street, Dealstruck, Fundation, and Funding Circle are just a few of the firms that have been created to offer fast but bank-like (or close to it) loans to small businesses. Even Amazon, PayPal, and Square, among other Web companies that work with small merchants and closely track their sales and payment histories, now use that data to offer those clients loans.

Last summer, Uyaroglu spent about 10 minutes filling out an online application and quickly learned that he qualified for a \$30,000 loan. He opted for a one-year term at 19.9 percent annual interest and uploaded his bank statements. The next day, a representative from Lending Club called to see if he still wanted the loan. She asked Uyaroglu for a copy of his most recent tax return, and four or five days later, he had his money.

It was an OK rate--Uyaroglu was happy enough with it--but not really a great rate. So while Wall Street observers and analysts question whether Lending Club can ever make enough loans to justify its outsize public offering, small-business owners are right to ask more practical questions: Why are small-business loans so expensive, even for healthy companies? How much of a difference can be made by the faster technology and data-driven efficiency of the likes of Lending Club? And how long will it be before the increasing competition in this popular but still nascent market lowers loan prices for more small businesses?



Among the sort of people for whom disruption is a mantra, if not a business model, the Lending Club origin story makes the heart skip a beat. It was the summer of 2006, and Renaud Laplanche was on vacation. He's not really the type to take vacations, actually. But Laplanche, a French former securities lawyer, had just sold the enterprise-search software company he had founded, TripleHop, to Oracle, and he had some free time on his hands. So he planned to fill six months, maybe even a year, traveling with his family.

It wasn't long before fidgeting set in. For Laplanche--deliberate, intensively hands-on, and a professional financial nerd--that took the form of reading the fine print on the statements of his household bank accounts, something he says he wouldn't normally do. That's when he found a big discrepancy between his credit card interest rate--16.99 percent, "which I thought was really high," he says--and the rate the same bank was paying him on his savings account: less than 1 percent. In banking terms, that was a big spread. In business terms, Laplanche saw a big opportunity.

"The banking industry was either highly profitable--if all that money was going into their pockets--or highly inefficient, if that 16-point spread is all cost," he says. Surely technology could help him create a cheaper, faster way to move money around: The right online system could split the difference in that spread, offering borrowers cheaper debt than a credit card, and offering ordinary investors a better return than a savings account. He cut his vacation short and went to work immediately. In May 2007, Lending Club made its first loan.

Lending Club wasn't the first U.S. peer-to-peer lender; Prosper began making loans in 2006. But Laplanche, who rounded up some of the top celebrities of the financial and tech worlds to advise and fund his company, soon pulled ahead. Google was a big investor, as were venture firms Kleiner Perkins Caufield & Byers and Morgenthaler Ventures; board members include White House stalwart Larry Summers, former Morgan Stanley chairman John Mack, and Kleiner partner Mary Meeker. They've helped Laplanche build Lending Club into a heavyweight of small-scale lending, and furnished it with the big-data machinery to challenge traditional banks.

"Nobody has ever looked at banking as an engineering problem-;as a problem that can be solved by technology," Laplanche says.

The company's San Francisco headquarters, six floors in a nondescript building, radiate bigleague respectability. The glassed-in boardroom and the sailboat model--Laplanche was a champion yachtsman in France--that greet visitors to the executive floor say conservative financial-services corporation, but beneath the polished surfaces and behind the graceful curves beats the heart of a technology company.

When Laplanche and his deputies talk about "product," more often than not they mean software code, not loans. Lending Club's software underwrites and prices each loan and detects fraud. A third of all loan applications are never examined by human eyes, except to look for fraud. So far, the company's portfolio has performed respectably: In the last two years, for example, Lending Club's annual loss rate was between 3 and 4 percent. That's only slightly higher than the average credit card loss rate at the end of 2014, according to the Federal Reserve--not bad for an upstart in the complicated and mature world of making credit decisions.

In just eight years, Lending Club has gone from birth to IPO while arranging \$7.6 billion in financing. Now it's lending to small businesses.

All this technology has given Lending Club a big cost advantage over banks, which have to contend with much more unwieldy infrastructure and mounting expenses from new regulations. Because Lending Club is growing so quickly--and because banks do things other than make loans--comparing its operating expenses with those of the banking industry is a little tricky. But adjusting for its rapid growth, Lending Club says its annual operating costs would be about 2 percent of its outstanding loans. At credit card specialist banks (which most closely compete with Lending Club), costs were on average 8 percent of outstanding loans in 2014, according to data collected from those banks by the FDIC. Of course, Lending Club's calculation is hypothetical, and it may be undercounting some collection costs, says Marty Mosby, a banking analyst with Vining Sparks. Still, it's gotten to the point that banks themselves--about 10 of them, ranging from small community institutions to West Coast powerhouse Union Bank--now invest directly on Lending Club's platform.

That's where it gets complicated, especially as Lending Club tries to build a separate product specifically for small businesses. Those companies' loan performance "has been typically worse than that of other categories," Laplanche says.

There's also just less data available on small businesses. If you're applying for a new personal credit card, banks can check deep wells of information about your student loans, car payments, and mortgages--but "data is very fragmented in the small-business universe," says Sid Jajodia, Lending Club's vice president for small business. "For different kinds of businesses, different industry verticals, different sizes, you're going to find strengths and weaknesses in different places. Our challenge is to analyze all of that, aggregate it, use what we think makes sense in the right situation, and make a decision."

At Lending Club, this happens in two stages. Once, say, a Turkish-born coffee shop operator finishes his loan application, Lending Club instantly determines whether the financials he's presented qualify his business for a loan. If so, then it checks his personal credit history against consumer credit bureaus, and the coffee shop's against commercial ones. It's largely the same data a bank might use, when it gets around to it. Then, Lending Club applies an alchemy of

analysis about the business's size, industry, and location, and the credit model sorts the business into one of 10 grades on the risk curve--or declines it altogether.

Banks traditionally have relied on the banker's judgment about the borrower to fill in the gaps in information. Lending Club relies on a mix of automated and manual judgments; if it makes an offer that the applicant accepts, the next step is to verify the borrower's financial information, using bank statements and tax returns. Jajodia, who used to run small-business lending for Capital One, says that while most banks use statements primarily to assess the applicant's average balance, Lending Club also mines them for a wealth of more predictive information, including data on the business's cash flow.

Still, all the data in the world can't always control for the very real risks taken by entrepreneurs. "Small-business owners, if you just underwrite them for personal loans and don't underwrite the business, tend to be a riskier population," Laplanche says. "More small businesses fail than people lose their jobs."



.6 billion: Total loans Lending Club has made since its 2007 launch **billion:** Drop in banks' business loans of less than 0,000 since 2008

Photo: Victor Prado

Small businesses are also riskier than bigger companies, for obvious reasons. Even minor events "can cause really big problems at a small business," says Sam Graziano, co-founder and CEO of Fundation, an online small-business lender based in New York City. "Like when an employee is stealing from them. Or they lose one big contract, and they're done. There are just so many different things that can happen that a bigger business can deal with because they have the resources. But when these little things happen to small businesses, they can be catastrophic."

Every month, Lending Club extracts a \$2,700 payment from Murat Uyaroglu, debited automatically from his bank account. After taking a 1 percent cut, Lending Club forwards the payment to Arcadia Funds, an investment firm in the Boston area run by Andrew Hallowell. Understanding that side of the transaction is the next step to understanding why small-business loans can be so expensive, despite all the recent innovation.

If online lenders remake the American banking system, or at least provide a new avenue for small businesses to get loans, it will be partly because of Arcadia and the dozens of other funds that have saturated Lending Club, Prosper, and all the other new lenders with money in the past two or three years. Laplanche's company may have started as a sort of precursor to Kickstarter or GoFundMe, letting ordinary Web users invest a few hundred bucks in a stranger's car-repair loan, but Lending Club's peers are now significantly bigger and wealthier than the average crowdfunding amateur. Banks, hedge funds, wealth-management firms looking to bulk up their rich clients' retirement portfolios, and other such investors now account for more than two-thirds of all the funding going through Lending Club. (As of March, Arcadia has purchased over \$200 million in loans through the company.)

Hallowell wasn't the first fund manager to buy Lending Club loans, but he was the first to borrow bank money to do it. (In finance jargon, this is "using leverage.") He borrows as much as \$2 for every dollar he raises from investors, and then tries to boost his returns by scrutinizing the data Lending Club makes available on its website about its loans.

"More small businesses fail than people lose their jobs," Laplanche says.

To Laplanche, the Lending Club platform is a mechanism for fairness, for both borrowers and lenders. But money funneled through two levels of profit-seeking is not cheap money. You can see, then, the problem this poses for borrowers. Hallowell wants to give his investors a 15 percent return; but after he collects fees from his Lending Club borrowers, he first has to pay back the share owed to his lending banks. From what's left, he subtracts the fund's various other expenses, including his management fees (2 percent of the original amount his investors gave him) and 20 percent of the profit he made for them. Hallowell estimates that his Lending Club loans need to pay Arcadia on average at least 9 percent interest--and that doesn't include interest to cover losses or Lending Club's fee.

Without the leverage, Hallowell would need borrowers to pay even more. Brendan Ross, a fund manager from L.A. who buys only small-business loans and does not use leverage, says a fund similar to his would need to buy loans with an average interest rate of 20 percent to return 12 percent to investors. (Ross does not buy from Lending Club.) By contrast, it's much, much cheaper for banks to raise money--fraction-of-a-percent cheap, whether for deposits or for their short-term loans to one another.

"A bank can go and get money at 25 basis points," says Ross. "The fact that investors need a higher return than the Federal Reserve puts everyone in a situation where the small businesses are going to have to pay the cost of funds, plus the cost of my operations, and the cost of all the different operations involved in figuring out whether they're creditworthy."

This adds to the challenge for the would-be financial disrupters--but it's also where the opportunity appears for the next startups that want to throw themselves at the challenge of building a better small-business financing system. In eight short years, the early marketplaces proved that investor-financed loans can work, laying the groundwork for the next generation to refine and perfect the system.

While Lending Club and Prosper have opened the doors to investor-provided financing, newer startups must prove themselves to fund managers. That means they likely have to pay more, at

least initially; Lending Club and Prosper, after all, proved their models by having individual Web users take the first risk. Today, for example, OnDeck Capital is probably the largest online, nonbank small-business lender--last year it made \$1.2 billion in loans, and it went public just a week after Lending Club's IPO. But when OnDeck started looking for institutional funding for its business loans, the best rate it could get for financing, from a hedge fund, was 18 percent. "We originally tried to build the business at 36 percent APR, and we couldn't," says CEO Noah Breslow.

The cost of financing a loan doesn't take into account the relative risk associated with giving that money out. Lenders typically do that by figuring out how much they have to charge to recoup their capital costs and how likely they are to lose money on the loan. The higher the risk, the higher the premium a borrower gets charged. And since a lender can't really predict losses with complete certainty, it has to build in some cushion to protect investors, in case the predictions fall short. Even then, it has to offer investors an additional reward for taking on more risk-because if riskier loans didn't provide higher returns than prime loans, who would buy them?

"Small-business owners are extremely busy, and they won't shop carefully for cheaper loans. It's too much work," says one fund manager.

Initially, Lending Club set the risk premium for its consumer loans by simply doubling the assumed default rate. The company won't say what it does now, but interviews with other small-business lenders suggest that strategy is sound for borrowers that are considered relatively safe bets.

So consider again OnDeck. By the end of 2014, its cost of capital had fallen to about 6 percent-half of what it had been two years earlier. Finding customers had gotten cheaper, too, standing at about 6 percent of the average loan. But its annual loan default rate was nearly 11 percent, or close to three times Lending Club's. Double, or even triple, that and add it to the earlier costs, and OnDeck needed to charge at least 34 percent, or perhaps even 45 percent, annually just to cover these costs. Its average APR at that point was 51 percent, according to Breslow--down from 66 percent at the beginning of 2013. While still high, that lower rate shows a marked effect of time, experience, and better market conditions.

What, then, will lower interest rates for small-business owners? Banks are unlikely to do it; even if they found a way to become more efficient, a slew of new regulations have made it difficult for them to start taking bigger risks on borrowers.

The long-term solution is increased competition, as more companies--startups in the business of lending, and investors who want to fund the loans--enter the market. It will be helped as more small businesses successfully repay their loans, as the economy improves, and as credit models get better at weeding out risk. That's the best sort of chain reaction, and there's already evidence that it's working at many of these lenders. At Lending Club, for example, better loan performance and increased investor demand led the company to drop average interest rates for consumers by 1 percent last year and another 20 basis points at the beginning of 2015. It has also cut interest rates by 1 percent for small-business borrowers.

Laplanche sees lower rates as inevitable. "I think as investors trust us more and more, their perception of risk is going down," he says. "That's allowing us to make lower-interest-rate loans." Lower interest rates then attract more borrowers, "so you have this really positive, reinforcing, virtuous cycle."

Of course, these are great times to be in the small-business-loan business--and neither Lending Club, which was getting off the ground during the last financial crisis, nor any of its newer competitors have yet been fully tested by an economic downturn. And it's possible that those most resistant to lower interest rates might be, ironically, small businesses themselves.

"Small-business owners are extremely busy, and they just won't shop carefully for cheaper loans," says Ross. "It's too much work. They're going to trade their time for yield."

Just ask Murat Uyaroglu. Two months after taking out his Lending Club loan, he went back to the trough. His very first Brooklyn coffee shop, named Prospect Perk, seemed ever more diminished compared with the sleek, expanding Hungry Ghost universe. "Every time I went there, I liked the coffee and the service, but the design, the ambiance, bothered me," he says. "You've got to change the whole thing."

Thinking, rightly, that Lending Club would not lend him more money so soon, he turned instead to OnDeck, which had lent him money once before, and borrowed \$100,000 for 18 months. It cost him \$30,000, at what Uyaroglu assumed was the same rate he had gotten from Lending Club. It was actually more expensive than that. (OnDeck, like many short-term lenders, prefers to present its fees as cents on the dollar, or factors, rather than as APRs. Factors almost always appear to be lower than APRs on loans of under two years' term.)

But Uyaroglu shrugged off the higher cost of this loan. "Regardless of what it is, I'll tell you why it doesn't matter if I'm paying \$30,000 to them," he says as we sit in his \$1,300 chairs. He upgraded nearly everything at Prospect Perk, he tells me, from the espresso machines to the benches outside, and rechristened it as the fourth Hungry Ghost. Immediately after the makeover, sales went up dramatically.

"Our first month as a Hungry Ghost, in January, is the highest gross sales of any month since we opened as Prospect Perk," he explains. Even if he could have gotten a better rate elsewhere, "because of that painless, nearly overnight loan that I got, I am paying that off, and then have some to put in my pockets." That sort of attitude might sound like an excuse to give up on the problem of building a faster, cheaper small-business loan. But it's also a wide-open opportunity for the Lending Clubs of the future.