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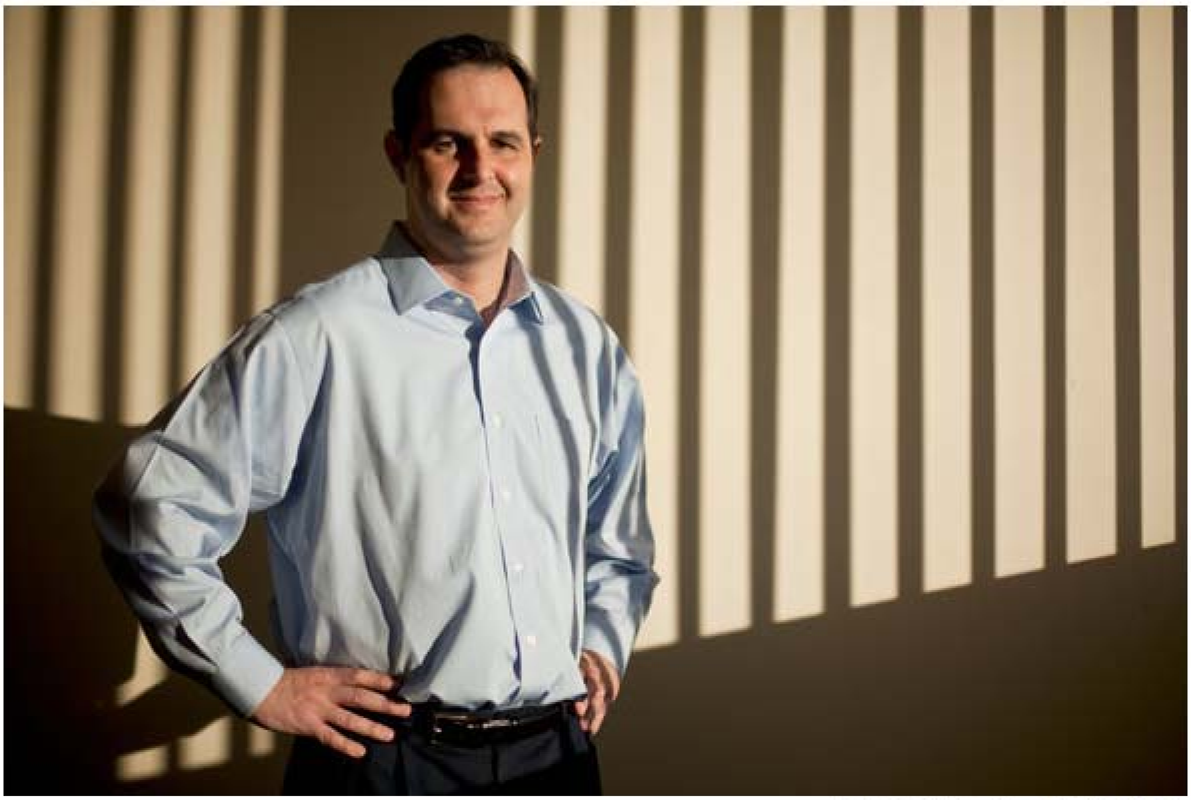
Not Banks, but Still Lending Money and Drawing Investors

By RANDALL SMITH



Peter DaSilva for The New York Times

Renaud Laplanche is the chief executive of Lending Club, which hopes to sell shares to the public next year.

In one sense, much of Internet commerce is largely a matchmaking service, connecting people looking for relationships, taxis or spare bedrooms. One of the hottest areas is the market for personal loans, which is attracting money from venture capital investors, spurred by the fast growth of the largest online platform, Lending Club, and the paper profits for its early backers.

In their simplest form, these marketplaces link borrowers who want to refinance high-interest credit card debt of 20 percent or more with investors looking to beat paltry bank savings account yields of less than 1 percent.

At Lending Club, borrowers obtain three- or five-year personal loans and pay annual interest of about 14.5 percent, depending on their credit scores, which can lift it to as much as 30 percent, with fees. Investors can earn interest rates of about 8.5 percent, the company says. The difference from the average comes from defaults, which cut annual returns by 3.5 percent, and the company's annual fees of 2.5 percent.

Some of Lending Club's earliest investors, including Norwest Venture Partners, Canaan Partners and Morgenthaler Ventures, are showing paper profits of more than 10 times their investment, based on Lending Club's most recent valuation of $1.55 billion in an investment led by Google in May. Lending Club hopes to complete an initial public offering next year.

That success has drawn the interest of venture capital firms looking for similar results.

"Investing in the networks that light up the sharing economy" for items like rooms and rides "certainly looks like a good idea," Fred Wilson, a managing partner of Union Square Ventures, said in a post on his Web site in July. Union Square invested in Lending Club in 2011 and has put money into multiple platforms. Last year, it backed Funding Circle, which offers small business loans in Britain. This year, it financed the personal-loan marketplace Auxmoney in Germany.

"There is a platform proliferation out there," said Frank Rotman of QED Investors, a group of former executives of Capital One Financial that has invested in four platforms. "Usually that happens when you see one company succeed and people say they want to find the next one. Right now, everyone is trying to find the next Lending Club. They don't want to feel like they missed the opportunity."

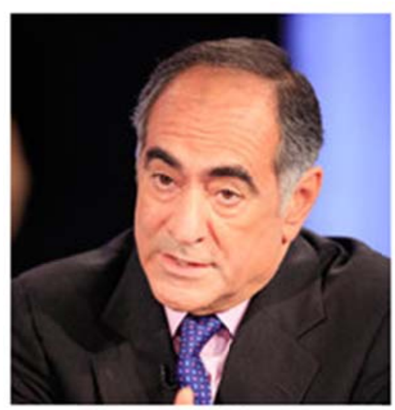
Asa Mathat/All Things Digital, via Reuters

Mary Meeker, a partner at Kleiner Perkins Caufield & Byers, joined the board of Lending Club after the firm became an investor.

The number of significant lending platforms has already grown to roughly 50 worldwide, according to Disruption Credit, an investment firm. The main personal loan platforms in the United States are Lending Club and Prosper Marketplace. On Deck and Kabbage offer small-business lending. Overseas, Zopa and RateSetter offer consumer lending in Britain, as does SocietyOne in Australia. And student-financing platforms include Social Finance, CommonBond, Pave and Upstart.

Disruption Credit's chief executive, Michael Parekh, says such platforms can disrupt Wall Street and traditional banks much like Google has taken on old-style media companies and Amazon.com has taken business from brick-and-mortar retailers. Disruption and other experts cite a vast $2.8 trillion consumer credit market up for grabs.

Lending Club, which just passed the $2 billion mark in total loans made, already has plans to expand into small-business and student loans, and may pursue credit cards, insurance and mortgages. It may also expand globally.



Mark Lennihan/Associated Press

John Mack, a former chief executive of Morgan Stanley, is also a director of Lending Club.

In addition to its original base of individual investors, Lending Club has attracted the participation of a few community banks as well as institutional funds that invest in the loans. It also attracted a later-stage investment in 2012, at about one-third the current value, from the venture firm Kleiner Perkins Caufield & Byers, which has a partner, Mary Meeker, on Lending Club's board. Other directors include John J. Mack, a former chief executive of Morgan Stanley, and Lawrence H. Summers, a former Treasury secretary. Kleiner's China fund is also backing CreditEase, an online small-business and consumer lender in China.

If Lending Club can complete an I.P.O. on schedule next year, "I believe this will be the financial-tech version of the Facebook I.P.O., a coming-of-age event just like Facebook was for social media," said Dan Ciporin, general partner of Canaan Partners, Lending Club's second-largest shareholder, with a 15 percent stake.

Lending Club expects revenue could roughly triple, to $100 million in 2013 from $36 million in 2012, and could grow to $400 million by 2015. One Wall Street banker said other fast-growing online services like LinkedIn and Priceline.com traded at 7 to 10 times revenue expected for the following year. At that rate, he says, Lending Club could be worth more than $3 billion in an I.P.O. next year.

"I think this is viewed by venture capitalists as incredibly disruptive and rapidly scalable," said Ron Suber, head of institutional sales at Prosper Marketplace.

Pat Grady, a partner at Prosper's chief venture backer, Sequoia Capital, said big banks might be hobbled by their "legacy infrastructure" and "incumbent inertia." He added, "In some ways, the sky's the limit. There's nothing that says the banks of yesteryear have to be the banks of tomorrow."

At a presentation in June at the inaugural Lendit conference for the nascent sector in New York, Lending Club's founder and chief executive, Renaud Laplanche, compared its rapid embrace by customers to the adoption of electricity, color television, stoves and washing machines, saying he plans to "transform the banking system."

Some platforms are adept at gleaning online data about their customers. Borrowers, for example, must agree to allow Lending Club to obtain data from their employers' payroll processors. And the small-business lender On Deck has developed methods for evaluating borrowers based on dozens of online sources.

But some investors still have doubts.

One skeptical venture investor says such lending sites have flourished in an environment of a pullback by banks from unsecured consumer lending, an improving economy and a steep decline in interest rates on other investments, starting with savings accounts. Other experts note that banks have a big advantage in rock-bottom financing costs.

"There's been an explosion of new companies using the Internet to originate loans," said Josh Koplewicz, founder of Thayer Street Partners, an investment firm that focuses on technology and financial services. "The barriers to entry are low. There are people setting up shop with a couple hundred thousand dollars." But aside from a few big names like Lending Club, he says, it may be difficult to create enterprise value without some edge in access to borrowers.

Indeed, some venture firms' investments have already shown paper losses. For example, the stakes of venture firms including Accel Partners and Benchmark, which invested in Prosper Marketplace from 2005 to 2010, fell in value in January when Sequoia rebooted the company with a new round of financing and a new management team.

Prosper, which started offering loans in 2006, just before Lending Club, had offered higher rates and riskier loans, which led to investor losses in the 2008 market collapse. Prosper also clashed with securities regulators over whether its offerings should be subject to disclosure rules.

Both Prosper and Lending Club temporarily curtailed their loan offerings in 2008 after the Securities and Exchange Commission required that loans offered to average investors be registered publicly; Prosper recently reached an agreement to settle a class-action investor lawsuit over the losses. Amid the economic slump, Zopa in Britain abandoned its own costly push into the United States. And some fledgling entrants like Loanio and Pertuity Direct shut down.

Even after meeting the S.E.C.'s requirements, Lending Club and its rivals have had run-ins with regulators. Lending Club can offer its loans to investors in only 26 states but thinks those limits would melt away after an I.P.O. Both Florida and Missouri fined the company $100,000 each last year for selling unregistered securities because Lending Club had allowed its registrations there to lapse.

In June, Ohio securities regulators filed charges against SoMoLend, an online small-business lender, accusing it of securities fraud and unregistered securities sales. SoMoLend, which declined to comment on pending talks with the regulators and on a hearing set for October, has halted transactions with individual investors in the state.

Some Lending Club investors and executives are hedging their bets, taking some chips off the table even before an I.P.O. Both Canaan and Morgenthaler sold some of their shares in a $125 million stock sale in May. About 30 Lending Club employees, including Mr. Laplanche, sold an average of less than 5 percent of their stock as well. Insiders also sold in a recent On Deck financing.

At the moment, the wind of the market is at Lending Club's back. With broad United States market indexes up more than 18 percent this year, social media and social commerce stocks have been surging even more.

Facebook, up 46 percent this year, recently regained its I.P.O. price after 14 months below that level. The real estate marketplace Zillow has tripled this year, and the business network LinkedIn and business-review site Yelp have doubled. Even the discount-deal service Groupon, which replaced its chief executive after its shares plunged 87 percent from the I.P.O. price, has risen 79 percent this year.

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