Online Lending : The Boom To Come

$ONDK	OnDeck Capital
$LC	BULLISH +400%
	$8 → $40

LendingClub and OnDeck Capital have grown big enough to access Wall Street funding, and growing consumer awareness will help them attract new customers. Their revenues and margins are about to shoot up.

March 25, 2016

Executive Summary

Online lending platforms are starting to get some wind in their sails from media coverage. This amounts to free publicity, which will help them attract customers beyond their traditional marketing techniques (such as direct mail).

Online lending volumes have grown past a level where loan securitization starts to make sense for the big Wall Street banks. The companies have a good track record of their lending books, and will have no trouble attracting institutional interest. This will enable online lending platforms to access cheap and limitless funding.

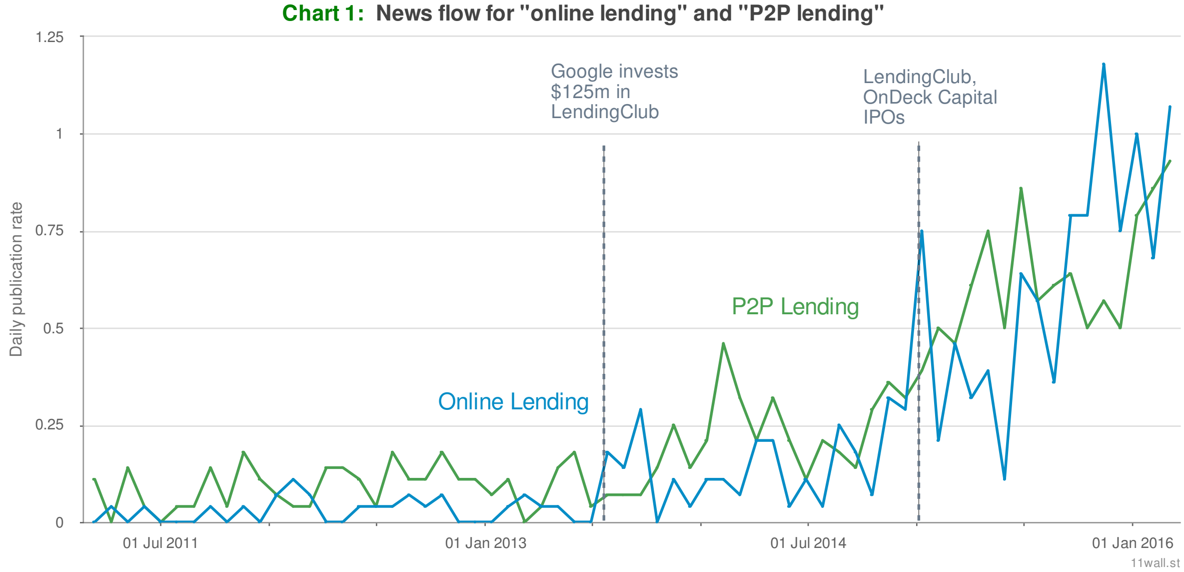
The combination of both trends: more borrowers, and easy funding, is about to disrupt their existing business model, and propel their revenues to the Moon. We believe the stock prices of the two listed lenders, LendingClub and OnDeck capital, grossly undervalue the probability of this scenario.

Analysis

Online lending businesses are getting free publicity from rising media coverage

Public awareness for online lending has been rising over the last three years **(Chart 1)**.

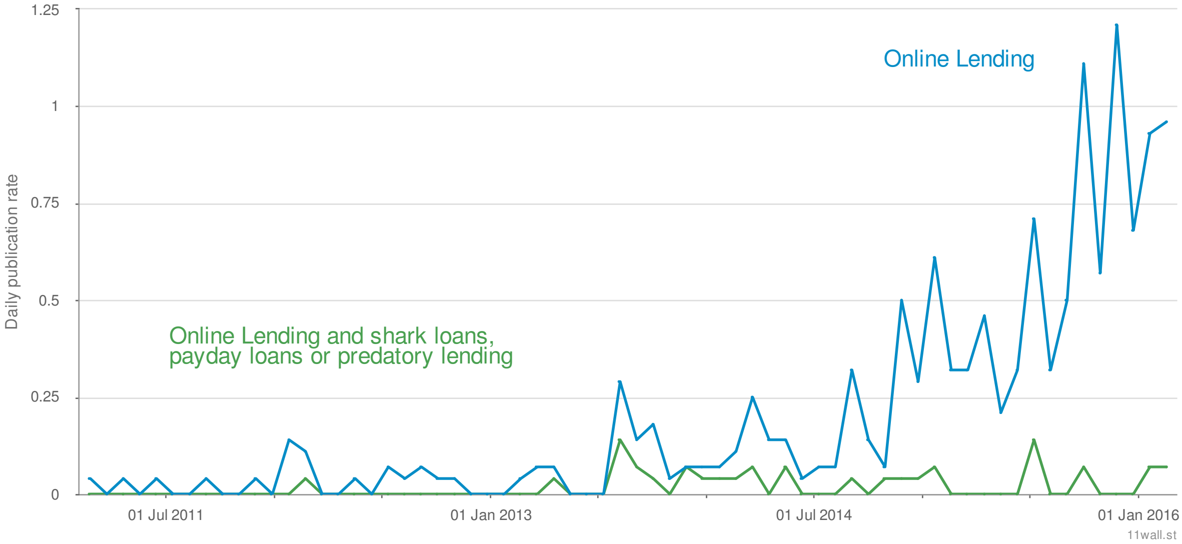
Chart 1: News flow for "online lending" and "P2P lending"



Although the business has been around for over a decade, the 2014 IPOs of LendingClub (personal loans) and OnDeck Capital (small business loans) have given the practice a more institutionalized status.

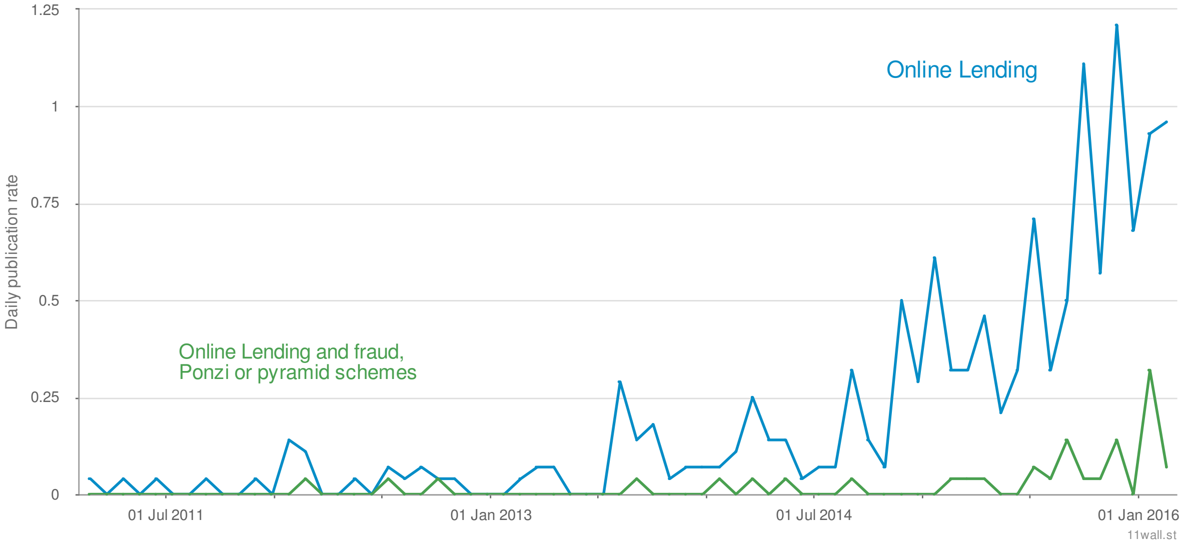
Online lending has managed to grow while distancing itself from the negative image of payday loans and shark loans. An investment in LendingClub by Google back in 2012 has further helped legitimize this business **(Chart 2)**.

Chart 2: News flow for « online lending », and « online lending » in the context of payday, predatory & shark loans



Online lending has recently suffered two bouts of bad publicity **(Chart 3)**. In December 2015, it became known that one of the lenders, Prosper, had facilitated a loan to Syed Rizwan Farook, one of the San Bernardino shooters. Then, in February, a massive $7.6B Ponzi scheme masquerading as P2P lending collapsed in China.

Chart 3: News flow for « online lending », and « online lending » in the context of fraud, Ponzi & pyramid schemes

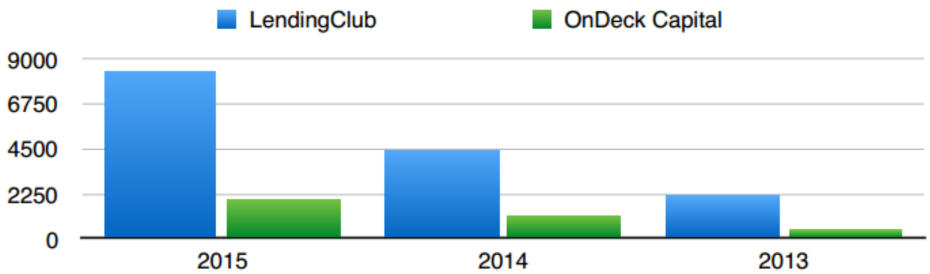


For both of these events, however, media coverage has focused on the specific cases, and hasn't suggested a wider problem, or any consequences for the better-regulated, US-based platforms. The possibility that a US-listed online lender is actually a Ponzi scheme is remote: every loan is filed with the SEC (albeit in a succinct form), and auditors contact directly a random subset of borrowers to check that they actually exist.

Lending volumes have grown rapidly, with a good track record

The market for online loans has been growing rapidly **(Chart 4)**. We have based our analyses on the SEC filings of LendingClub and OnDeck Capital. LendingClub functions as a "peer-to-peer" (P2P) platform, enabling retail investors to choose from a batch of borrowers seeking a loan, whom to invest with. OnDeck Capital has a more institutionalized approach, lending to businesses, and funding the loans by selling them to institutional investors. LendingClub provides long-term (3 to 5 year) loans at rates between 6% and 25%, while OnDeck focuses on shorter loans at much higher interest rates (average rate for 2015: 37%, as per its 10-K).

Chart 4: Loan originations, in millions (source: SEC 10-K filings)



The default and charge-off rates for both issuers have been stable over the last years **(Charts 5, 6 & 7)**. Unfortunately for our analysis, both companies started their activities in late 2007, so they couldn't have a reference default rate for loans issued in 2007, the worst year for issued loan performance in recent history.

Chart 5: Net Cumulative Lifetime Charge-Off Ratios, all loans, OnDeck Capital (source: 10-K for FY2015)

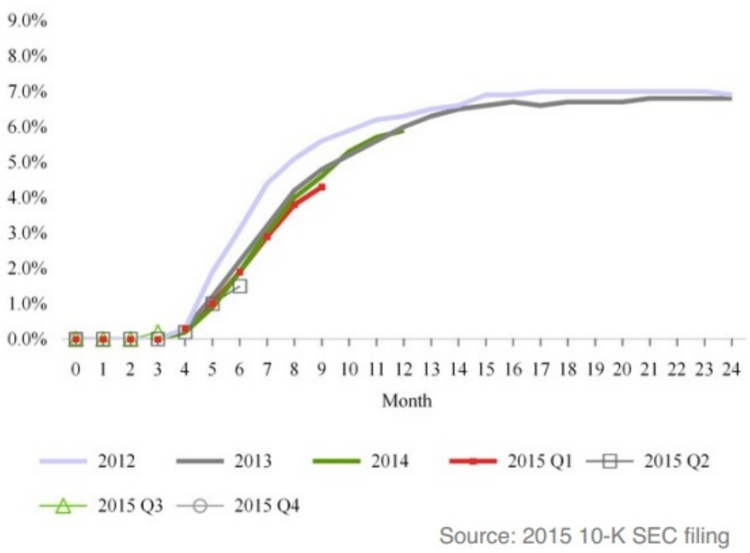


Chart 6: Charge-Off Ratios by year, 3 year loans, LendingClub (source: 10-K for FY 2015)

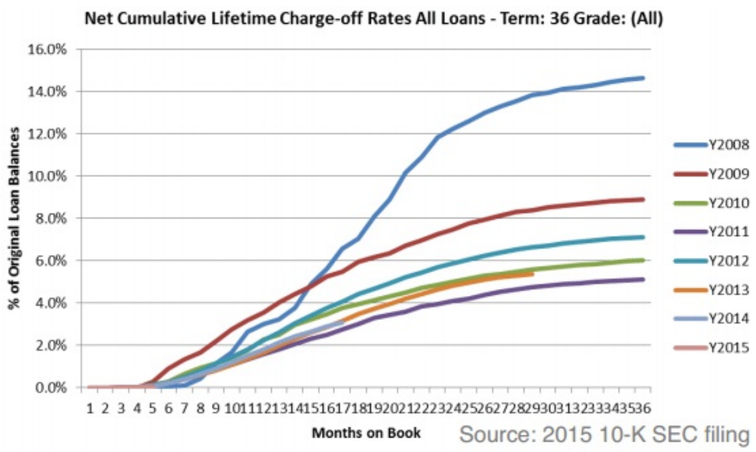
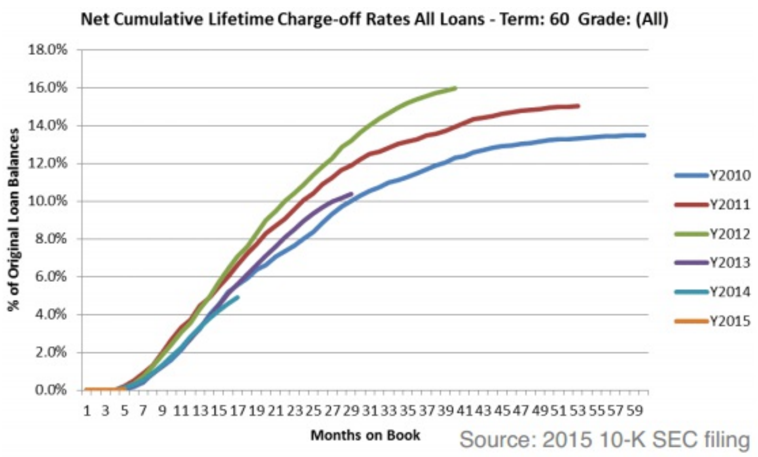


Chart 7: Charge-Off Ratios by year, 5 year loans, LendingClub (source: 10-K for FY 2015)



Both companies account for loan charge-offs on a year-of-issue basis, which is a welcome move. Aggregating them all together would have made for a prettier picture: past defaults would have been offset by the growing amount of total loans. Instead, we have a clear and accurate image of the actual performance of their loan books. Their model of having algorithms crunch the applicants' profiles, bypassing costly human interaction, has been validated empirically.

In general, we have failed to find discrepancies in their accounting for loan losses, or in their revenue recognition policy.

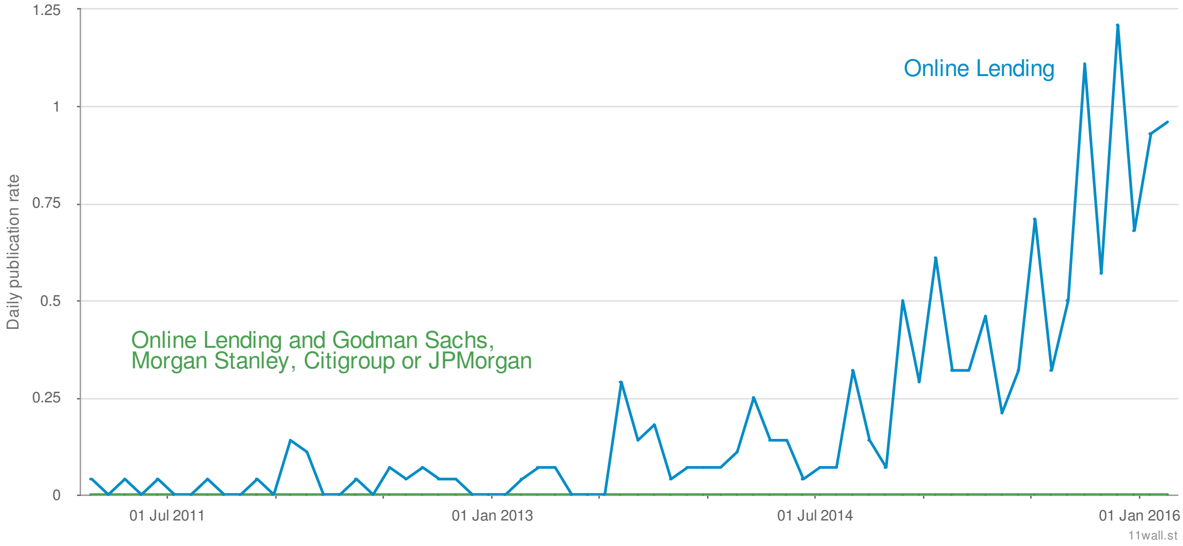
The rates both companies charge for the loans reward handsomely the risk. Current loans seeking financing at LendingClub are commanding average rates of 10.4% for 3-year loans and 17.7% for 5-year loans (we aggregated the loans listed in the latest prospectus supplement filed by the company at the SEC, for a total outstanding amount of $49M). OnDeck Capital, as mentioned before, managed to get rates close to 37% in 2015.

Loan securitization is already happening, and Wall Street is paying attention

Online lending companies' loan books have been growing. They have reached a critical point when securitization starts to make sense. Citigroup sold $337M of bonds backed by Prosper loans in July 2015, commanding Moody's ratings of A3 ($231M tranche A), Baa3 ($86M tranche B) and Ba3 ($59M tranche C).

Should this securitization channel build up (and we don't see why not), online lenders would have virtually limitless access to capital. The big banks themselves have realized the new market that's being created, and become increasingly involved **(Chart 8)**.

Chart 8: News flow for « online lending », and « online lending » in the context of big Wall Street banks



Goldman Sachs in particular, is trying to set up its own online lending platform, dubbed "Mosaic". We see this as "too little, too late": the existing platforms have been around since 2007, and they have built their processes and brands through years of efforts, investing and research. A much better fit for the banks would be to admit that they won't be able to compete with the lenders on their own turf: user experience and automatic credit profile evaluation. The banks could, however, set up a lucrative business securitizing the loans, and act as intermediaries.

This is a set up a "winner takes all" situation: the first online lender to reach a sufficient volume for its loans to be securitized, will be the first to access Wall Street funding, and will be able to offer more loans, on better terms, to its customers, thus annihilating competition.

The advent of securitization of online lending loans, and the creation of a new asset class, could be a replay of the mortgage securitization boom. Hedge funds in particular should show increasing interest in the riskier tranches of the new bonds. A growing credit market would be welcome by regulators and politicians as well, creating a new, self-reinforcing paradigm.

Lower marketing costs and access to cheap funding is about to disrupt the business model of online lending

The main issue that online lenders are facing is: finding new customers, on the borrower side as well as on the lender side.

Loan securitization will provide cheaper funding, without the need to find thousands of small investors to bundle together.

Furthermore, rising media coverage will help online lending companies in building brand recognition and customer awareness. This free publicity will contribute in reigning in their main expense: sales and marketing **(Charts 9 & 10)**. Direct mail can only get you so far (that's one of their current customer acquisition strategies).

Chart 9: **Income Statement breakdown, $ millions (source: SEC 10-K filings)**

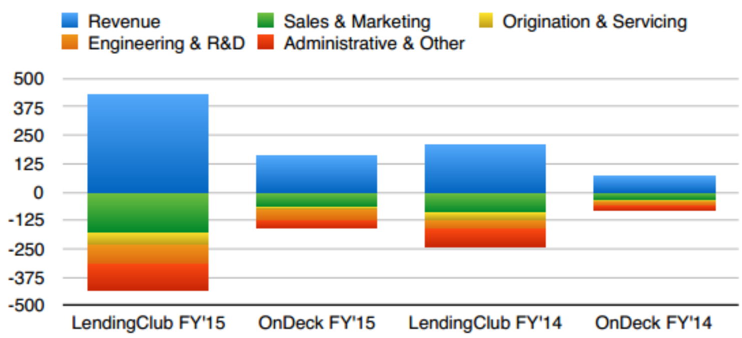
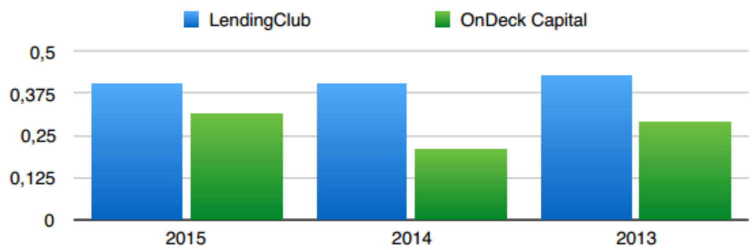


Chart 10: **Marketing & Sales as a percentage of total revenues (source: SEC 10-K filings)**



The stocks of LendingClub and OnDeck Capital have performed badly since their IPOs, down roughly two thirds, in a climate that's been generally negative for startups. We believe that they shouldn't be valued on their current organic growth assumptions. The two stocks are actually call options on a new consumer finance product, a direct competitor to credit card debt ($733 billion outstanding in the US, as of 2015) and small business loans ($595 billion).

Roadmap & Playbook

Even if the securitization phenomenon doesn't gain traction, we believe that growing media coverage will be enough to attract new customers, reduce marketing costs and push profits into the green.

Both $LC and $ONDK are currently trading at around $8. We believe that the pricing-in of the new business model based on securitization would create a 2-3 year bull run for the stocks, with revenues growing tenfold, and marketing expenses as a percentage of revenues dropping. On this assumption, we'd buy both stocks (with a bigger allocation to LendingClub due to its market leader status), looking to cash out at $40 per share.

Should this projected trend play out really well, online lending would grab (or add to) a substantial share of the credit card & small business loan market. A mere 20% of these markets adds up to $300B of outstanding loans ($30B to $60B of revenue). Reduced marketing costs and economies of scale attained thanks to automatized processing of loan applications can easily push gross margins into the 10%-20% range. Under this scenario, both stocks would easily reach $100.

An acquisition by any of the big banks is a very real possibility as well.

Probability	Event	Early signs
50%	Increasing media coverage of online lending attracts customers, reduces marketing & sales costs, while securitization solves the financing problem. The biggest online lenders see their loan volume skyrocket.	• Media coverage keeps increasing • Goldman Sachs scraps its Mosaic project • New securitizations of online lender loans, institutional investors show interest for the new asset class. • Hedge funds start investing in online lender loans.
20%	Securitization of online loans fails to gain traction, but media coverage attracts more customers. Lending volume grows at a steady pace.	• No new instances of securitization. • Media coverage keeps growing.
20%	Loan volume growth stalls, the market remains fragmented among a big number of competitors. Profits remain elusive.	• Media coverage dies out. • Hedge funds start investing in online lender loans.Wall Street banks set up their own online lending platforms.
10%	The industry crashes, due to new regulations, instances of fraud, or runaway loan default rates.	• Instances of fraud & identity theft. • Customer complaints, lawsuits.

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