It Should Be Obvious Now that Marketplace Lending Is Unsustainable

By Todd H. Baker
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If I was your stockbroker and I told you to invest in a business with the following characteristics, what would you think?

The company I'm pitching to you has revenues that rise and fall as much as 50% or more on a quarter-to-quarter basis. Its quarterly earnings and losses are equally volatile. Almost all its revenue comes from new product sales — it has very little continuing revenue. Operating expenses generally increase a little more slowly than revenue when sales are rising, but when sales fall, expenses keep increasing anyway because of accounting charges for layoffs and office closures when management downsizes.

Management can't plan ahead because the company sells most of its products to a few large customers. Those customers dictate sales volume and product pricing and their purchases determine whether the company makes or loses money in any given period. Management's only lever for controlling the company's earnings volatility is to try to guess how much and at what price those customers may buy in the future. The company increases or decreases personnel and marketing expenses based on that guess.

The company also has a large ongoing technology investment program that it can't afford to cut much if it wants to compete. Oh, and the company isn't growing — sales in the most recent quarter were flat compared to the same quarter two years earlier — and it is only marginally profitable even when things are going well.

The company I just described is Prosper Marketplace, a fintech "unicorn" with a billion-plus private market valuation and the granddaddy of the marketplace lenders. Prosper reported second quarter 2016 results in a 10-Q filing last week that included a $35 million net loss and a $37 million cash burn on a 56% quarter-to quarter reduction in loan originations. The Prosper announcement followed fellow marketplace lender Lending Club's equally dismal quarterly earnings report earlier this month.

MPLs like Prosper transfer loan revenue and credit risk to loan investors at origination, so they earn nothing from loans held on balance sheet. Almost all MPL revenue is generated from "gain on sale" fees earned from new loan sales. This dependence on origination volume and gain-on-sale margins makes MPL results exquisitely sensitive to macro and micro trends in investor demand and risk appetite. Small market disruptions and credit performance changes can have an outsize impact.

This past quarter, Prosper's management got a firsthand look at just how unsustainable the MPL gain-on-sale business model really is, when investor demand dried up, loan pricing became uncertain and bad publicity hit the sector. The experience should lead the Prosper board to reconsider the company's core strategy if the lender is to rebound and the MPL sector as a whole faces continued headwinds.

Companies like Prosper and Lending Club have done a fantastic job revolutionizing the front end of the consumer lending experience — and in doing so have created real value for some borrowers — but their vision of a "disintermediated" loan marketplace is proving itself unable to handle even minor financial market bumps without running off the road. It's time to face facts — the pure "marketplace lending" model just isn't working. MPLs need to shift to a more sustainable mode — either as banks or as nonbank balance-sheet lenders — before the end of the current credit cycle brings on a real shakeout and the MPL experiment becomes a financial failure.

There was some good news coming out of the second-quarter report. Prosper's management, unlike Lending Club's, didn't try to prop up originations too much with costly loan buyer "incentives," and it acted quickly to cut personnel and other expenses to reflect its current reality of slow growth and limited funding. But with sharply lower originations and no continuing earnings from a balance sheet, Prosper's revenue fell through the floor.

Unfortunately there is no reward in this world for good behavior. Prosper's expenses also rose by 12% due in part to restructuring charges. The accounting for aggressive downsizing is a bear that bites hard (and repeatedly) so the expense hits will keep coming for the next quarter at least before the world can see the run-rate impact.

The company is also using up its cash at a fast clip (only $28 million in cash at quarter end) and although it has $55 million in unpledged available-for-sale securities in reserve, it may need to find some new sources of capital pretty soon, especially if it ties up more liquid assets to satisfy lenders. That will likely be a very expensive proposition given recent results.

Prosper management is trying to shore up its origination volume with commitments from institutional buyers and warehouse lenders. But these funders are not really legally committed to buy loans or advance more money to Prosper if markets or credit goes sideways. The likely short-term outcome of these efforts is more predictable funding, but at a higher cost. The longer-term impact is more worrisome — Prosper's funders will have a significant level of control over the company's origination volume, revenue and gain-on-sale margin.

There is another view on the viability of MPLs. Lending Club's $2 billion-plus market capitalization shows that many people still believe that the sector's recent problems are temporary and that the MPL model can work to create shareholder value. But history shows that when a high stock price is coupled with consistently poor fundamentals, as is the case

there, there is a lot to lose. A core requirement for a lender is to be able to make money consistently. MPLs haven't shown the ability to do that, and they can't ignore this weakness forever by putting on a fintech label. Lending Club has lost a cumulative $115 million over the last four and a half years (Prosper has lost a cumulative $125 million over the same period) and nothing suggests that will change anytime soon.

The path ahead is clear if boards, venture investors and management want to salvage something before the string runs out. Stable funding is everything for a lender, and the best place to find that is to fund lending directly with bank deposits. If buying, becoming or selling to a bank is not an option (so far banks seem content to let the MPLs implode), then creating a moderately leveraged finance company with a real balance sheet should help stabilize results, at least until the next credit downturn. While this won't result in the type of equity valuation dreamed of by the MPLs' tech boosters, it will provide something real for the venture and institutional investors who put up the equity to fund companies like Prosper.

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