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Lending Club should become a bank as fast as it can

by: Guest writer

This guest post is by Todd Baker, a senior fellow at the Mossavar-Rahmani Center for Business and Government at the John F. Kennedy School at Harvard University and managing principal of Broadmoor Consulting LLC.

Lending Club's Q3 2016 earnings call was a strange affair. Despite a second consecutive quarter of losses and a year-on-year loan volume decline, the stock actually rose 15 per cent after the call before eventually returning to its pre-announcement level in the weeks that followed. Today it's still worth over $2.3bn, which has led many investors to scratch their heads and wonder how this company can sustain a valuation that seems so at odds with its fundamentals.

The fragility of "true" marketplace lenders like Lending Club was displayed for all to see earlier this year when market conditions suddenly shifted, originations plummeted and a scandal involving Lending Club's CEO hit the papers. Marketplace lenders (sometimes referred to as P2P or online lenders) transfer loan revenue and credit risk to loan investors at origination, so they earn nothing from loans held on balance sheet. Almost all their revenue is generated from "gain on sale" fees earned from new loan sales, putting them on a perpetual origination/volume hamster wheel. Their business model is completely dependent on loan investor demand and risk appetite, which makes them exquisitely sensitive to small market disruptions and credit performance changes that can turn gains into losses and threaten their ability to generate any revenue at all.

What, then, could possibly lead investors to continue to value Lending Club so highly?

I for one was flummoxed, so I decided to conduct a simple experiment. I would work backwards to determine how much Lending Club would need to earn to justify today's valuation using a traditional price-to-earnings based approach. Then I would look at what Lending Club's financial performance and market value would likely be if it were to become a bank.

The takeaway? Lending Club should become a bank as fast as it can in order to reap the economic benefits of its loans and secure a more stable funding base. And, in the meantime, there are changes it can and should be making to increase resiliency and create the foundation for a sustainable and profitable business.

Does Lending Club's valuation make sense?

The first order of business was to determine if Lending Club's business could support its current valuation. I ran the valuation based on the annualised quarterly earnings run rate for Lending Club in Q3 2018 (2 years from now) so as to allow ample time for the company to turn things around after the recent management turmoil. I assumed a P/E for Lending Club of between 6-8x, which is a generous range for a gain on sale-dependent, liquidity-constrained lender without a balance sheet. For simplicity's sake, I focused the analysis on the 7x middle of the range. (The best comparable for a marketplace lender like Lending Club is probably a mortgage banker like PennyMac Financial, which has a forward P/E of around 5.5x.)

According to my simplified view, Lending Club would need an annualised net income run rate of $329m (at a 7x P/E) by Q3 2018 to justify its current $2.3bn valuation.

Lending Club's sales & marketing and origination & servicing expenses have oscillated around 50 per cent of its operating revenue for the last two years, so I made a management-friendly assumption that those two items would continue at that level for the next two years. I also assumed that loan gain on sale margins (reported in the transaction fees revenue line) and servicing revenue margins would stay at their current levels due to competition, the credit cycle and loan investor conservatism. The composition of Lending Club's loan servicing portfolio was assumed not to change, with servicing revenues moving in step with loan originations.

I calculated that if Lending Club doubled its loan originations to $4bn a quarter by Q3 2018, it would generate $224m in operating revenue (twice the current level). With sales & marketing and origination & servicing expense taking up 50 per cent of operating revenues, that would leave $112m in operating revenue to cover all other expenses and generate any profit.

During Q3 2016, Lending Club's other expenses — which include engineering, product development and general and administrative costs — totalled $88m. I made a really aggressive assumption that, despite doubling its quarterly origination rate, it could hold all other expenses flat at Q3 2016 levels on an absolute basis. Lending Club would then show pre-tax quarterly income of $24m, or $16m in net income at an assumed 33 per cent tax rate. Multiply that by four and you get $64m in annualised net income, which translates into an expected market cap of $448m at a 7x P/E. That's a far cry from today's $2.3bn market cap.

If Lending Club were able to quadruple originations to $8bn a quarter by Q3 2016, with the same aggressive assumptions, quarterly net income would be $93m. That would translate into a market cap of $2.6bn at a 7x P/E, which is around 13 per cent above the company's current market cap, although the difference amounts to nothing for shareholders absent dividends in the interim.**

The message seems pretty clear. Lending Club would need to aggressively grow originations over the next 24 months, while margins and other expenses stay flat, to justify the current price for the stock. Lending Club is having a hard time finding buyers to fund $8bn in annual originations today — it's wishful thinking to think management can increase that to $32bn in two years at high enough margins to make it all work, especially when total unsecured consumer online lending in the US is likely to be around $12bn in total for 2016.

There's an old adage that value in a lender is found in its liabilities, not its assets. Cheap and stable funding creates economic value in financial services, while good or bad lending can only improve or detract from that value. That's why banks, with their deposits, will be around for the foreseeable future. So shouldn't Lending Club be a bank?

Lending Club's basic economics look like this today: it originates and sells loans for around a 5 per cent effective net premium ($100m in transaction fees on $2bn in loans originated in 3Q 16.) If you amortise those fees over the approximately 4-year average loan term you get 1.25 per cent per annum in transaction fees on loans, plus 75-80 bps in annual servicing fees, or a little more than 2 per cent in annual revenue on managed loan balances.

Unsurprisingly, a bank would make a lot more money if it originated and held Lending Club-type loans on its balance sheet. It's pretty basic math — a 14 per cent loan (the Lending Club average) held at a 1 per cent bank cost of funds leaves a 13 per cent interest margin before credit losses every year over the time it holds the loan. If we factor in 6 per cent annual credit losses (Lending Club's current portfolio loss rate) a bank would get 7 per cent in annual net interest margin from holding those loans. By contrast, Lending Club earns a 2 per cent "margin" from its fees. The company's loan investors take almost all the value of the economic value for themselves.*

Marketplace lenders have to hold capital too

Yes, a bank is legally required to hold capital against loans, but it's still a lot of spread income. And let's not kid ourselves — Lending Club has to hold plenty of capital to satisfy investors today (around 20 per cent of its managed assets). When you compare Lending Club's 2 per cent annual revenue on loans to a bank's 7 per cent credit-adjusted annual revenue the point is blindingly clear — Lending Club's business would be better off in a bank

What would "Lending Club Bank" be worth? If Lending Club were to increase originations modestly over time and build a $10bn balance sheet funded by core deposits, it should be able to generate at least a 2 per cent return on average assets or at least $200m in annual run rate earnings. Multiply that by a 15x typical bank P/E ratio and you come up with a valuation of $3bn. That's more than 30 per cent above what the company is worth today. Additional balance sheet growth over time would only add to value.

Despite what many think, Lending Club operates much like a bank today. Lending Club is subject to, and complying fully with, the full panoply of federal and state consumer lending laws such as TILA, ECOA etc. Its loans are currently originated by a regulated bank

(WebBank) which makes LendingClub adhere to “bank-like” levels of risk management and compliance. Lending Club has plenty of capital (20 per cent of managed assets) to support a banking operation and balance sheet growth. And Lending Club would have easy access to its loan customers for deposit marketing.

Of course there are some real issues. Lending Club’s business is highly concentrated in one product — consumer installment lending — and some of its higher-risk loans could be problematic for regulators. Asset growth above a certain annual level in any bank can also be problematic. But Lending Club could continue to sell or securitise some loans to control these risks, albeit at a higher cost than holding them on balance sheet. And bank regulators today seem quite interested in bringing online lenders into the fold.

When you can’t beat them, join them

Despite these concerns, industry observers think that Lending Club could become a bank if it really wanted to. But there would be costs to this path. Lending Club would probably have to restrain balance sheet growth for the next several years, particularly in higher-risk loans. It might also have to agree to broaden its product offerings, while bearing the miscellaneous burdens and costs that go along with being a bank. That would delay for some time realisation of the full financial benefit of bank deposit funding, but not necessarily restrict volume growth, as Lending Club could continue to sell loans to its existing investor community as its balance sheet grew to accommodate more originations over time. The transition would be messy and protracted, as it often is when a non-bank moves into regulated banking. Clear communications with equity investors would be critical to keeping the focus on the future configuration of the business as a bank.

For Lending Club’s management, job number one should be converting into a bank as soon as possible. That means submitting a credible business plan that shows the regulators that management understands that growth and yield goals need to be balanced against an appropriate risk appetite. A strong marketing plan will also be needed to gather necessary deposits and support customer growth. And Lending Club should pursue a bank acquisition to speed up the process and lessen concentration issues if the right partner can be found.

Time to admit the current model doesn’t work

But there are plenty of changes that can and should happen immediately. The first step should be abandoning the cherished idea that true marketplace lending is a viable model. That should be easier to do now that Lending Club's ousted founder, Renaud Laplanche is reportedly setting up a competitor with a "hybrid" balance sheet model where some loans are held on balance sheet while others are securitised or sold.

Next, Lending Club should use some of its $800m cash hoard to hold loans and start earning spread income. Most other online lenders are already doing this. By building its balance sheet, Lending Club will be in a better position to weather temporary market disruptions and take advantage of less expensive securitisation funding. Securitisation will also broaden the base of institutional investors that can invest in Lending Club's loan products — many today can only invest in rated securities.

Lastly, Lending Club should try to pick up the pieces of any faltering competitors — Prosper comes to mind — to build volume inorganically.

If Lending Club does all these things with determination and speed, it may emerge from the other end of the process as a lean, tech-driven consumer bank with a healthy stock price, strong funding, solid growth and a profitable business model. If it doesn't, equity markets and loan investors will eventually figure out that the marketplace lending Emperor has no clothes and take their money elsewhere.

*Another way to look at this question is to compare LendingClub's effective cost of funds to a bank's. LendingClub gives up to its investor/funders the entire yield on loans minus 2% in annual fees. That makes LendingClub's credit-adjusted cost of funds 12% (14% minus 2%). This compares to a 7% credit-adjusted cost of funds (1% bank cost of funds plus 6% annual losses absorbed) for a bank.

**Toggling the combined sales & marketing and origination & servicing expenses below 50% of operating revenue (while maintaining revenue margins and holding other expenses flat) would reduce the origination growth necessary to reach current market cap, but not by much. If LendingClub tripled quarterly originations by Q3 2018 to $6 billion, but only spent 45% of operating revenue on sales & marketing and origination & servicing, it would have annualized net income of $168 million and a market cap of $1.18 billion. That's still far short of today's value. Changes in origination margins would have a similar impact.