Small Business Lending in the Digital Age

Dealstruck

lendio

Small Business Lending Enters a New Era

Small businesses (SMB) in the US have faced their share of ups and downs, but they continue to be the backbone of the American economy, responsible for 65% of new jobs created since 1995.[1] In order to support growth in this vital sector, a new industry has arisen to assist small business owners in their quest for expansion capital. Relatively new to the financial world, these companies are known as alternative small business lenders.

Alternative lending began in 1994, when the U.S. Department of the Treasury implemented a program to certify Community Development Financial Institutions (CDFIs). The agency's goal was to provide funding to underserved small business owners and, since its inception, has awarded over $1.7 billion to local CDFIs to provide SMB financing in their communities and an additional $33 billion in New Market Tax Credits.[2] This however, still left an extraordinary number of small businesses that didn't qualify for CDFI financing.

In addition, since the banking crisis in 2008, U.S. banks and the Small Business Administration (SBA) have significantly tightened requirements for approval of small business loans. Currently, the approval rate for these traditional SMB loans hovers around 20%, leaving thousands of small business owners in need of affordable financing.

Today, alternative online lenders are a champion for these small business owners, giving them access to funds to manage everyday finances, pay their employees, purchase and maintain inventory, and — most importantly — grow.

In the following pages, we will define the small business lending industry and explain how the industry has changed over time. We will also offer predictions for the future of this burgeoning market.

Thank you for helping us to build a new avenue for small businesses to obtain the capital needed for growth. After all, small business powers the nation.

Sincerely,

Ethan Senturia, CEO
Dealstruck

Brock Blake, CEO
Lendio

[1] Jason Nazar, *16 Surprising Statistics About Small Businesses*, http://www.forbes.com (September 9, 2013).
[2] Community Development Financial Institutions Fund, http://www.cdfifund.gov/about/Pages/default.aspx.

TABLE OF CONTENTS

CHAPTER 1

SMALL BUSINESS LENDING IS UNIQUELY COMPLEX

Small Business Lending is Uniquely Complex: Consumer vs. Small Business

Banks and the Small Business Administration (SBA) offer the lowest interest rates and most favorable terms to the SMB market, but their documentation requirements and funding timelines for loan consideration can be onerous.

- Consumer lending can typically be underwritten with two pieces of data
  - ☑ Personal credit score
  - ☑ Personal income information

- SMB lending requires an exhaustive list of documents which can be overwhelming for a small business owner
  - ☑ Personal credit score
  - ☑ Financial projections
  - ☑ Profit and loss statements
  - ☑ Bank statements
  - ☑ Business plans
  - ☑ Personal and business tax return
  - ☑ And more

Further complicating the process is the fact that banks are challenged to devise uniform underwriting policies for small businesses since they cover a wide spectrum of industries with diverse needs and business cycles. And that makes the process even slower. Many SMBs are in need of financing quickly and the banks are not able to accommodate their need for access to funds with short turnaround time. As Brock Blake, CEO of Lendio points out, "business owners are incredibly busy and don't have time to wait 60 to 90 days for a bank to approve and fund their loans."

It has become clear over the past few years that there is a need for easier access to fair business financing for this key sector of the economy. As a result, there are now many additional types of SMB loan products and lenders in the market to meet the demands of small business.

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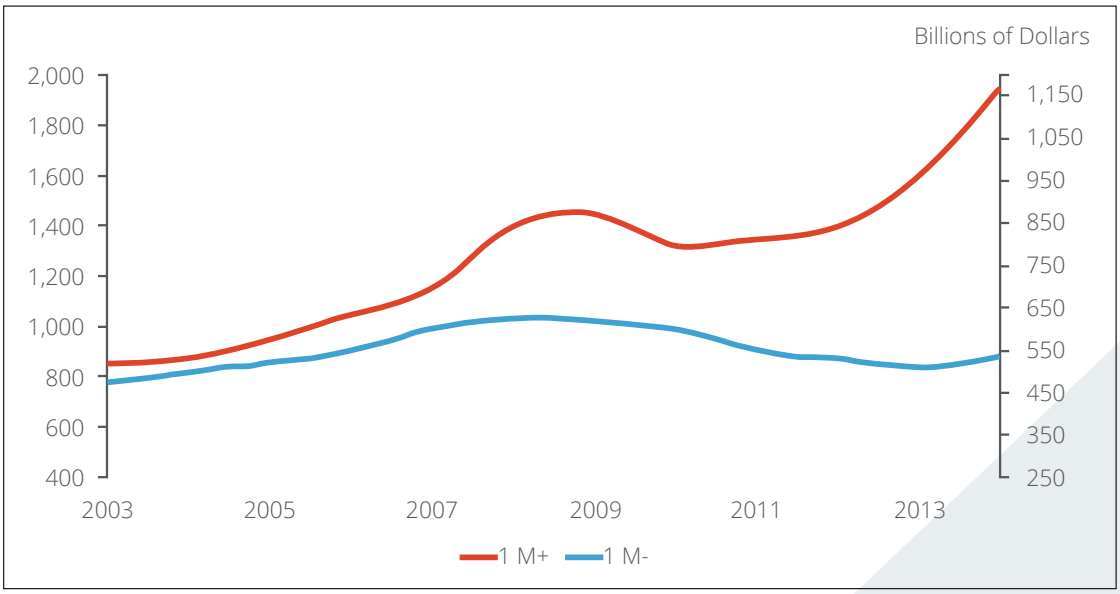
CHAPTER 2
STATE OF SUPPLY

State of Supply

Where has all the money gone?

Since the early 2000s, banks have increased focus on larger commercial loans of more than $1 million, primarily backed by real estate. This has left thousands of small businesses with nowhere to turn.

Banks' focus continues to shift toward small business loans in excess of $1 million.



As banks have backed away from business loans under $1 million since the financial crisis of 2008, loans in this category are down a striking 20%.[3] "With banks moving upstream, it's created a significant funding gap in the market for Main Street business owners. Fortunately, many marketplace lenders have created new loan products that are stepping in to fill the void" says Blake.

There are a variety of reasons banks have moved in this direction.

- ☑ Larger loan amounts have a similar cost to approve and service, and are therefore more profitable
- ☑ Increased regulation in small business lending with the inclusion of Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requiring banks to increase data collection on small business applicants, increasing cost and paperwork

[3] Karen Gordon Mills, Brayden McCarthy, State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game, Harvard Business School Working Paper 15-004, July 22, 2014.

- ☑ Insufficient technology to streamline the online SMB loan process which would increase efficiency and profitability
- ☑ Brick and mortar banks face higher operational costs

As a result of the banks increasing their focus on larger loans, there is an opening in the market that online lenders now fill. According to Dealstruck CEO, Ethan Senturia, "the financing options offered to small businesses have never been as plentiful as they are today. There is unprecedented opportunity for small businesses to grow and thrive."

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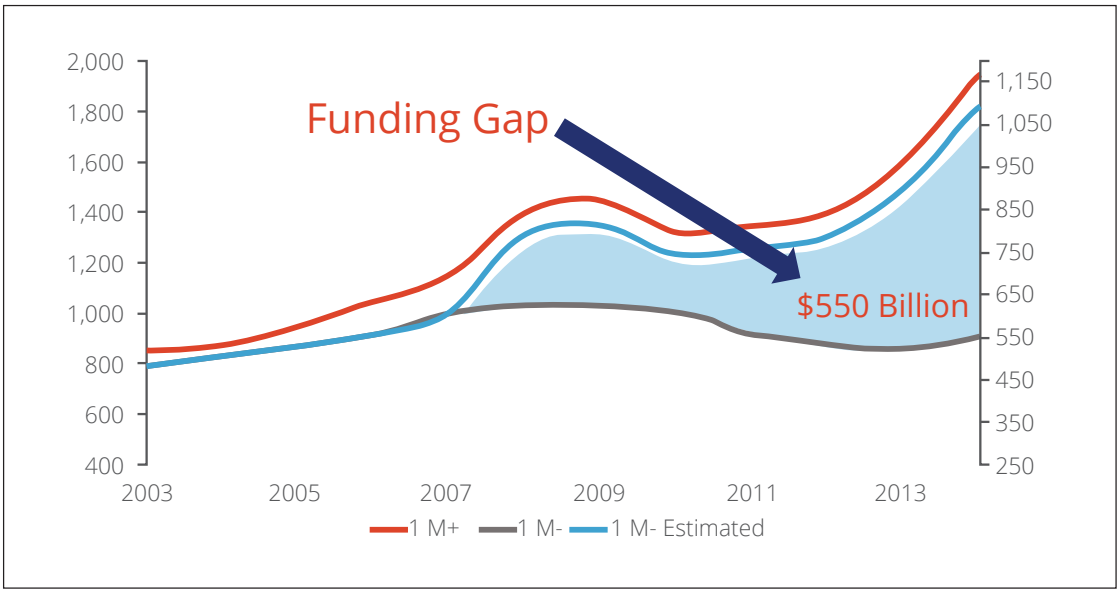
As banks have moved to loans greater than $1 million, a large funding gap has appeared that opened the door to alternative lenders.



There are key differences between alternative lenders and banks. And these new lenders have advantages and disadvantages like anything else.

- Advantages:
  - ☑ Focus on Main Street businesses by providing loans under $1 million
  - ☑ Innovative technology that allows for more automated risk assessment and streamlines the approval process, significantly decreasing time to funding
  - ☑ Little regulation, as these lenders fall outside of current regulatory scrutiny
  - ☑ Simple business model focusing on SMB lending only, with no other bank services (like deposits)

- Disadvantages:
  - ☑ Cost of capital for banks is nearly zero; alternative lenders are typically funded by investors looking for high yields
  - ☑ No "built-in" customer base; banks already have deposit customers to target
  - ☑ Need increased access to data; banks already have visibility into customers' deposit accounts and other financial information

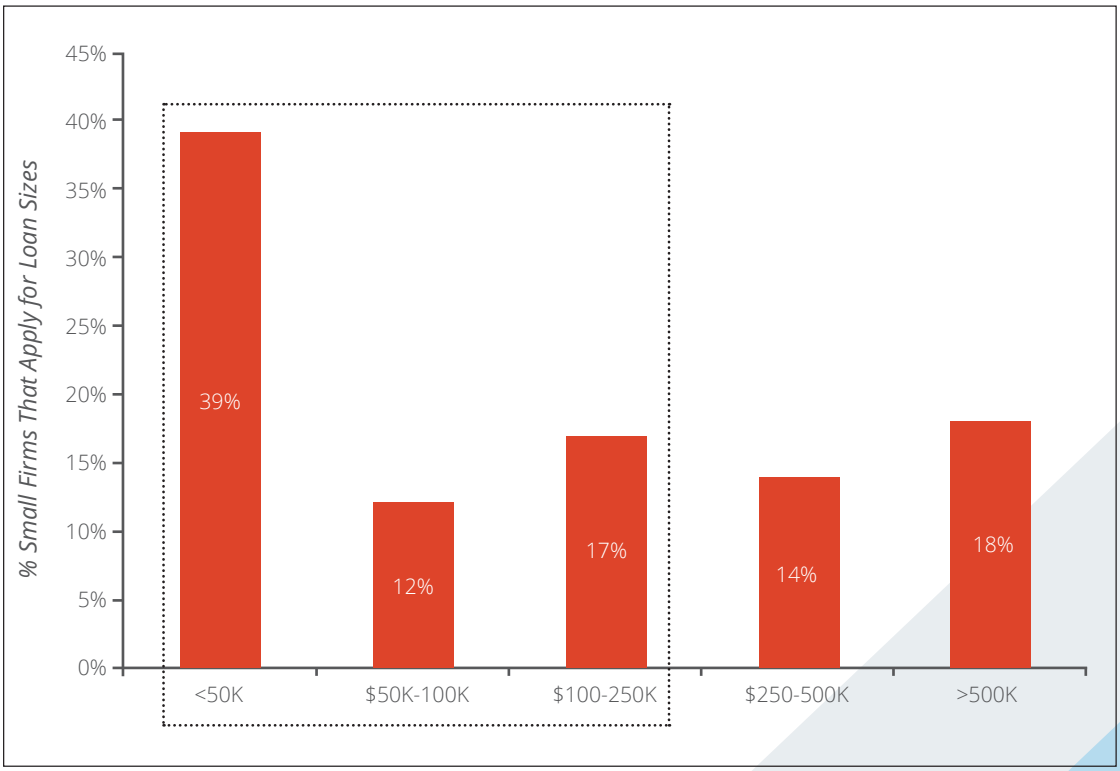
CHAPTER 3
STATE OF DEMAND

State of Demand

Is there a market for these "smaller" loans?

While large financial institutions are more likely to offer loans in excess of $1 million, 70% of small businesses are actually looking for less than $250,000.

The majority (70%) of SMBs are looking for $250,000 or less in financing.

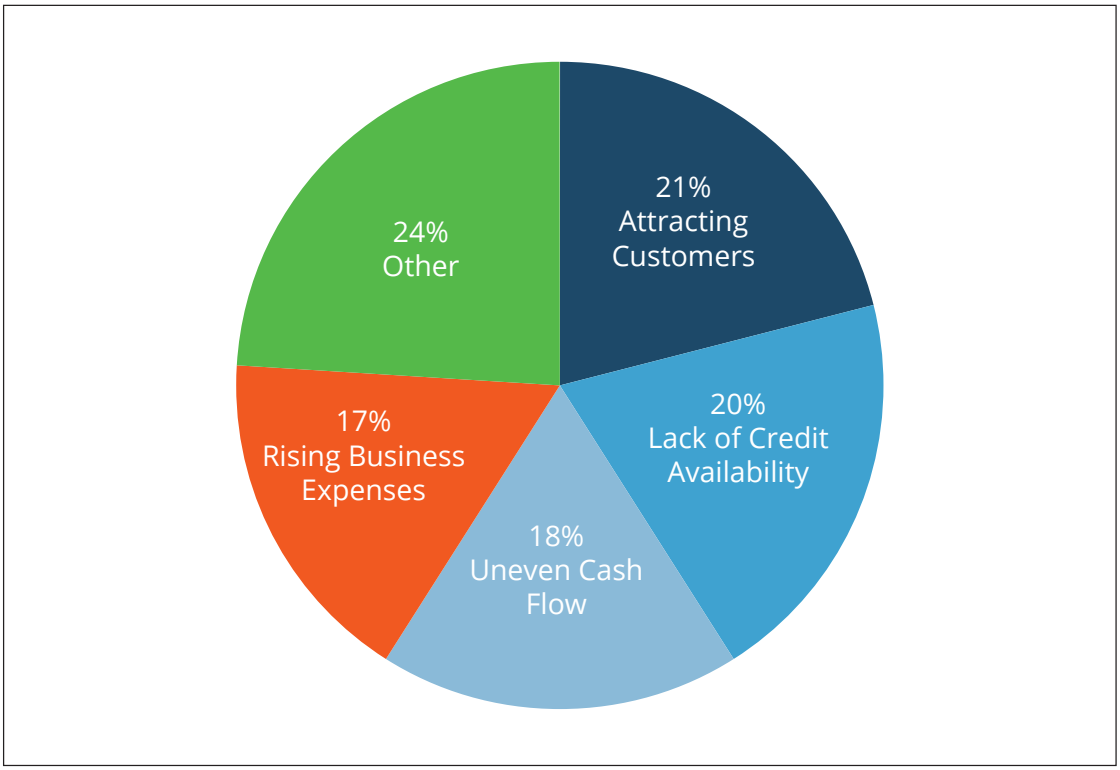


Source: Federal Reserve (New York) *Fall 2013 Small Business Credit Survey*.[4]

[4] Federal Reserve Bank of New York, Fall 2013 Small Business Credit Survey, (http://www.newyorkfed.org/smallbusiness/Fall2013/).

Results from the Spring 2014 Small Business Credit Survey by the Federal Reserve Bank of New York[5] show that small business face four major growth challenges and a fifth "other" unspecified category.

Small businesses report a number of challenges to their growth, with well over half of those issues are addressable with proper SMB financing.



Source: Federal Reserve (New York) *Spring 2014 Small Business Credit Survey*

In 2013, 40% of survey respondents had applied for credit. Of those, slightly more than half were looking for less than $100K, and nearly a third sought capital to expand or make business investments. Unfortunately, 18% were too discouraged to apply, often out of fear of rejection or worry that business financing would be too expensive.

Results from the 2014 Joint Small Business Credit Survey[6] show that large banks are a dominant credit source. Online lenders are spread across firm segments and not yet favored by any one

[5] Federal Reserve Bank of New York, Spring 2014 Small Business Credit Survey, (http://www.newyorkfed.org/smallbusiness/Spring2014/).

[6] Federal Reserve Bank of New York, Joint Small Business Credit Survey, 2014 (http://www.newyorkfed.org/smallbusiness/joint-small-business-credit-survey-2014.html).

industry in particular, as small businesses still primarily turn to large national and regional banks for financing. Approval rates were highest at regional banks, both large and small, and online lenders. Of firms that applied to a small regional or community bank, 59% were approved for at least some of the financing sought.

Large banks have seen improvements in small business lending in 2015, with approval rates up more than 11% over 2014. However, this still means that only slightly better than one in five small business loans were approved.[7]

In the first half of 2014, nearly one in five applicants sought credit from an online lender, and more than half were looking for $100,000 or less. About 40% of those seeking credit said the primary purpose was to expand business, which is the top reason for borrowing across all revenue segments. "While the local bank is still the first stop for many small business owners looking for financing, the trend is starting to shift as borrowers seek alternative sources of capital," says Senturia.

Businesses face different challenges at different points in their lifecycles. Startups are concerned with getting their enterprises off the ground, while more mature businesses are dealing with hiring and retention of quality employees, and the increased operating expenses that come with growth. However, one common challenge every stage of business surveyed reported as being of concern is cash flow.[8]

[7] Ed Lieber, *Small Business Lending Increases for Six Straight Months*, SmallBizTrends.com, May 28, 2015 (http://smallbiztrends.com/2015/05/biz2credit-small-business-lending-index-june-2015.html).

[8] Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia, Joint Small Business Credit Survey Report, 2014 (http://www.newyorkfed.org/smallbusiness/joint-small-business-credit-survey-2014.html).

CHALLENGES FACED BY SMALL BUSINESSES CHANGE AS THE COMPANIES MATURE

<5 years in business

STARTUPS

- Lack of credit availability
- Difficulty attracting new customers
- Uneven cash flow

Profitable with increased revenues

GROWERS

- Uneven cash flow
- Lack of credit availability
- Difficulty hiring and/or retaining employees

>5 years in business, 10+ employees, holds debt

MATURE

- Uneven cash flow
- Increased costs of running business
- Lack of credit availability

CHAPTER 4
STATE OF FUNDING

State of Funding

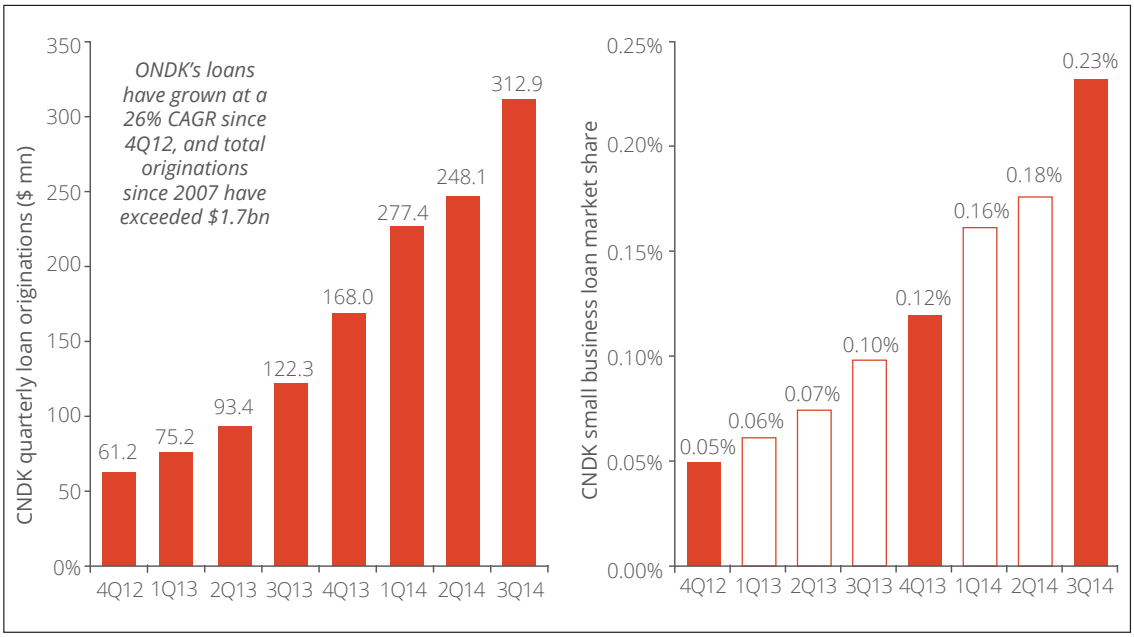
Alternative lenders are gaining attention from investors.

Alternative, online lenders offer highly-attractive investment products and are generating a great deal of interest in the marketplace.

Investment Vehicle	Current Yield
3-Year U.S. Treasury Note	0.93%
5-Year U.S. Treasury Note	1.50%
High Rated Bonds	~2%
Junk Bonds	~6%
Online Lending	7% - 14%

OnDeck, one of the first publicly traded companies in the alternative online lending space, is growing at a staggering pace, which is indicative of the alternative online lending space as a whole.

OnDeck Market Share



Sources: Company Data, Goldman Sachs Global Investment Research

Valuations Any Banker Would Love

The two lenders are selling at Internet-like premiums to their forward earnings estimates.

Company/Ticker	Recent Price	Market Value (bil)	2016E Rev (mil)	EPS 2016E	Book Val Per Shr Mar' 15	Market Value/ Rev	Price/ '16 EPS	Price/ Book Value
Lending Club/LC	$18.40	$7.9	$600	$0.02	$2.03	13.0	920	9.1
On Deck Capital/ONDK	14.80	1.2	400	0.20	4.17	3.0	74	3.5

Sources: Company Filings, Bloomberg[9]

[9] Bill Alpert, *Lending Club and On Deck Stocks Too Rich to Buy,* Barrons.com, June 6, 2015 (http://www.barrons.com/articles/lending-club-and-on-deck-stocks-too-rich-to-buy-1433557220).

CHAPTER 5
STATE OF PERFORMANCE

State of Performance

Investor expectations are not always in line with the reality of the business.

With the growing popularity of alternative lending, some forerunners have gone public through Initial Public Offerings (IPOs). OnDeck and Lending Club, despite early investor enthusiasm, have been underperforming in relation to the market, creating a growing concern for these big players in the industry.

Here lies a disconnect between investor understanding of the industry and the reality of the business. Many investors are only now starting to understand the complexities of alternative online lending. As the learning process continues, stock valuation will continue to shift. It is important to acknowledge that these are leaders in the space and despite the fluctuations of Wall Street, the underlying businesses continue to grow.

Senturia states that regardless of the ups and downs the market has seen in valuations of some alternative lenders, the industry is rapidly expanding, "these sources of SMB capital are growing and are here to stay."

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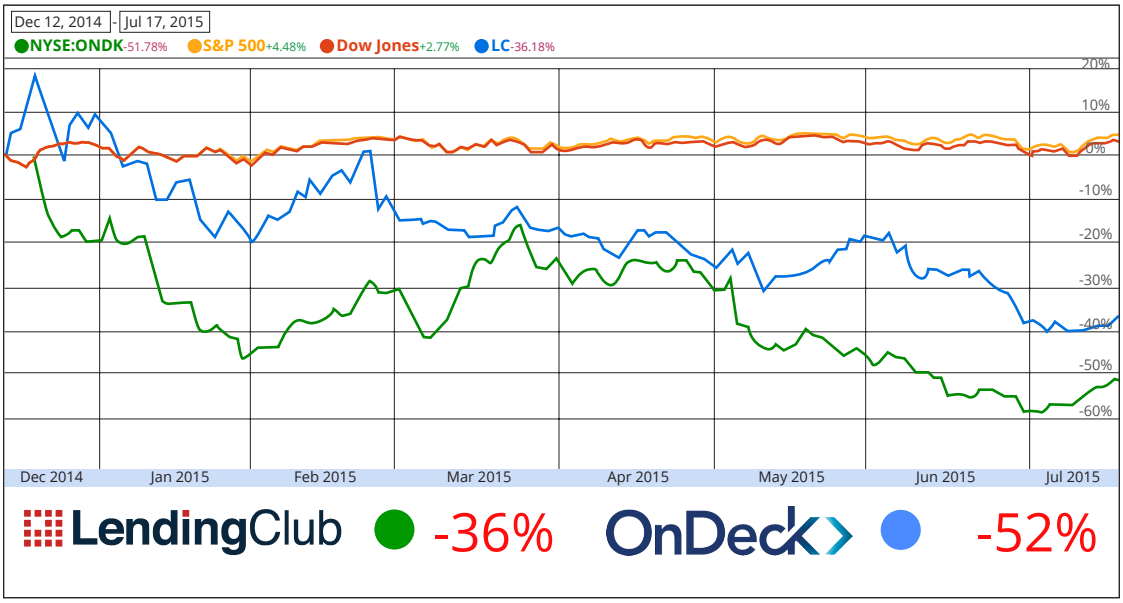
Both OnDeck and Lending Club saw a great deal of investor excitement at their IPOs but stock prices have failed to stay at those levels as investors are still learning the realities of the alternative lending business.



CHAPTER 6
STATE OF REGULATION

State of Regulation

Will the Wild West of alternative lending stay that way?

In an attempt to better understand the alternative online lending industry, the U.S. Department of the Treasury recently issued a Request for Information (RFI) about "Online Marketplace Lending," likely the first step on a path to a much larger conversation, potentially with a number of other agencies that could have regulatory oversight.

As Senturia sees it, the current interest taken by Treasury is an indicator that regulators are sitting up and taking notice as something new started to happen in finance. He believes that as they are seeing activity around this new lending industry sector, the Treasury is recognizing it as a sign that alternative lenders are a meaningful and viable provider of capital to key markets that are driving the economy, namely SMBs.

Thoughtful regulation to ensure operators are performing with honesty and transparency is a good thing. And good players are stepping up to the plate to take a proactive stance regarding fair and transparent lending practices, executed ethically and with integrity. Fortunately for the small business lending market, the key lenders and marketplaces in the industry have used a blueprint of best practices that were established and implemented in the consumer lending space.

Blake notes that until now, the online lending industry has been fairly unregulated. Fortunately, many of the online marketplace lenders have studied the regulatory history of consumer lending and have sought to be proactive in their lending practices. Unfortunately, however, there is a segment of lenders and brokers that is taking advantage of the current regulatory environment by using business practices that are deceiving and/or damaging to the borrower. When increased regulation occurs, Blake hopes that governing agencies will offer reasonable policies that will encourage best-in-class business practices (to weed out the bad actors) without damaging the innovation and growth in the industry. Furthermore, Lendio highly recommends that any new or additional regulations come from the Federal level, rather than through a state-by-state patchwork of laws that will impose inconsistent and costly regulations on the online lenders.

CHAPTER 7
STATE OF THE FUTURE

State of the Future

Based on observations of the alternative lending space, we predict six major changes in the future.

- ☑ **More options:** There will be more business loan products and providers, but they will be more accessible and easier to navigate for small business owners.
- ☑ **Increased speed**: Instead of days, weeks, or months, funding will be streamlined and occur within minutes.
- ☑ **Increased trust**: The public will have a better understanding of the small business lending landscape with improved transparency. Lenders will have a greater customer focus.
- ☑ **Increased Regulation**: If the market can self-regulate and quickly innovate, government agencies and the U.S. Department of the Treasury may not find a need to regulate outright.
- ☑ **Increased underwriting innovation**: New data sources/sharing and predictive analytics/machine learning will streamline processes and make the loan approval process much easier for both borrower and lender.
- ☑ **Banks and alternative lenders collaborating**: Given how the different categories of players in the industry complement each other and fill gaps in the market, partnerships are likely to occur. The potential synergy through collaboration will benefit the consumer in the rising interest rate environment.

Lendio projects that the demand for alternative online loans will definitely increase in the future. Today, there is still relatively low awareness by the Main Street business owner. In fact, most business owners still approach their banks when seeking loans - even when they believe that the banks will decline their requests. As awareness in the market increases, we will begin to see that trend shift which will result in increased demand for marketplace loans.

Dealstruck posits that, despite the ups and downs that will always exist in the U.S. economy, the forces that are driving growth in the alternative online lending space are reaching a critical mass and the term "alternative" will soon no longer apply. The lenders in this space are growing, providing billions in capital to small business owners who were historically shut out of the traditional SMB lending market. This component of the lending system that is here to stay.

CHAPTER 8
IN CLOSING

In Closing

Each SMB is different and each has unique business needs. Fortunately, there are many types of credit products to meet growing demand, including term loans and lines of credit.

Banks have an increased focus on providing small business loans greater than $1 million. However, the vast majority of small businesses looking for credit are seeking $250,000 or less. Alternative lenders have filled that gap with more flexible products and approval processes, but at higher costs than banks.

The alternative lending landscape has grown dramatically in recent years. OnDeck and Lending Club have emerged as forerunners, taking much of the market and attention. Since their respective IPOs, the stocks have underperformed, despite continued rapid growth in the underlying business, and are not meeting investor expectations despite the growth in the businesses themselves.

There is increased attention being paid to the industry in the finance and regulatory sectors and as a result, the U.S. Department of the Treasury has issued an RFI on online (alternative) lending. Given recent events, we anticipate that the online marketplace will come under greater scrutiny in the future.

We are confident that small businesses will continue to have more lending options with shorter approval times as a result of the technology improvements and streamlined application processes spearheaded by alternative lenders.

"Banks opened the door to alternative lenders during the post-recession "Credit Crunch." Non-bank lenders did not just stick their foot in the door, they slammed it open. The result has been faster approvals, greater competition for qualified borrowers, and better rates and terms for small business owners." Forbes.com[10]

[10] Rohit Arora, How Banks Lost Ground To Alternative Funders In Small Business Finance, October 15, 2015, (http://www.forbes.com/sites/rohitarora/2015/10/17/how-banks-lost-ground-to-alternative-funders-in-small-business-finance/).

Any Questions?

Thank you and please feel free to contact us.

Dealstruck
press@dealstruck.com

Lendio
press@lendio.com

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