LEAN INTO LENDING

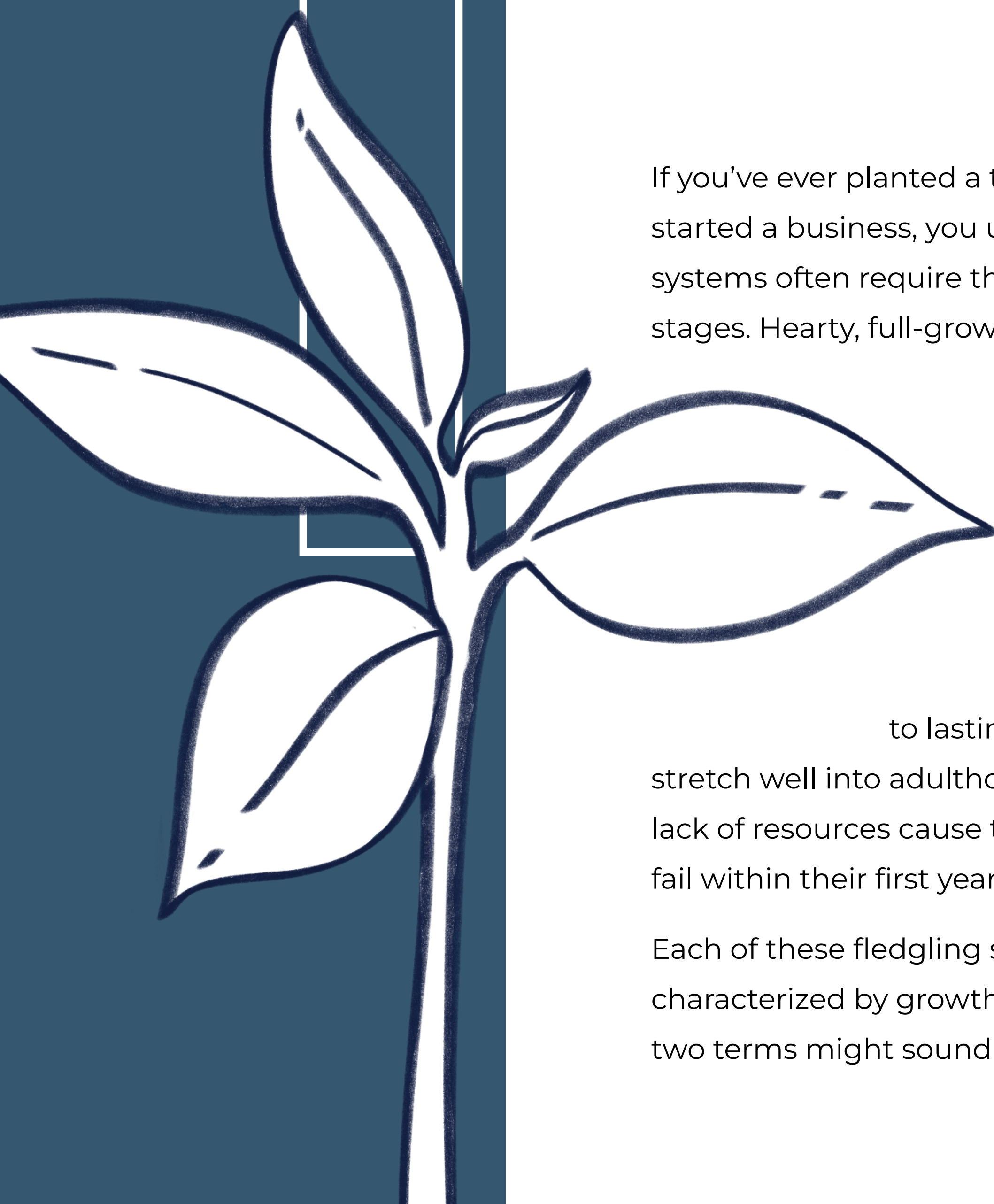
VOL. 2

WORKING WITH NEW CAPITAL

LLOYD ROBERTS

TABLE OF CONTENTS

// INTRODUCTION



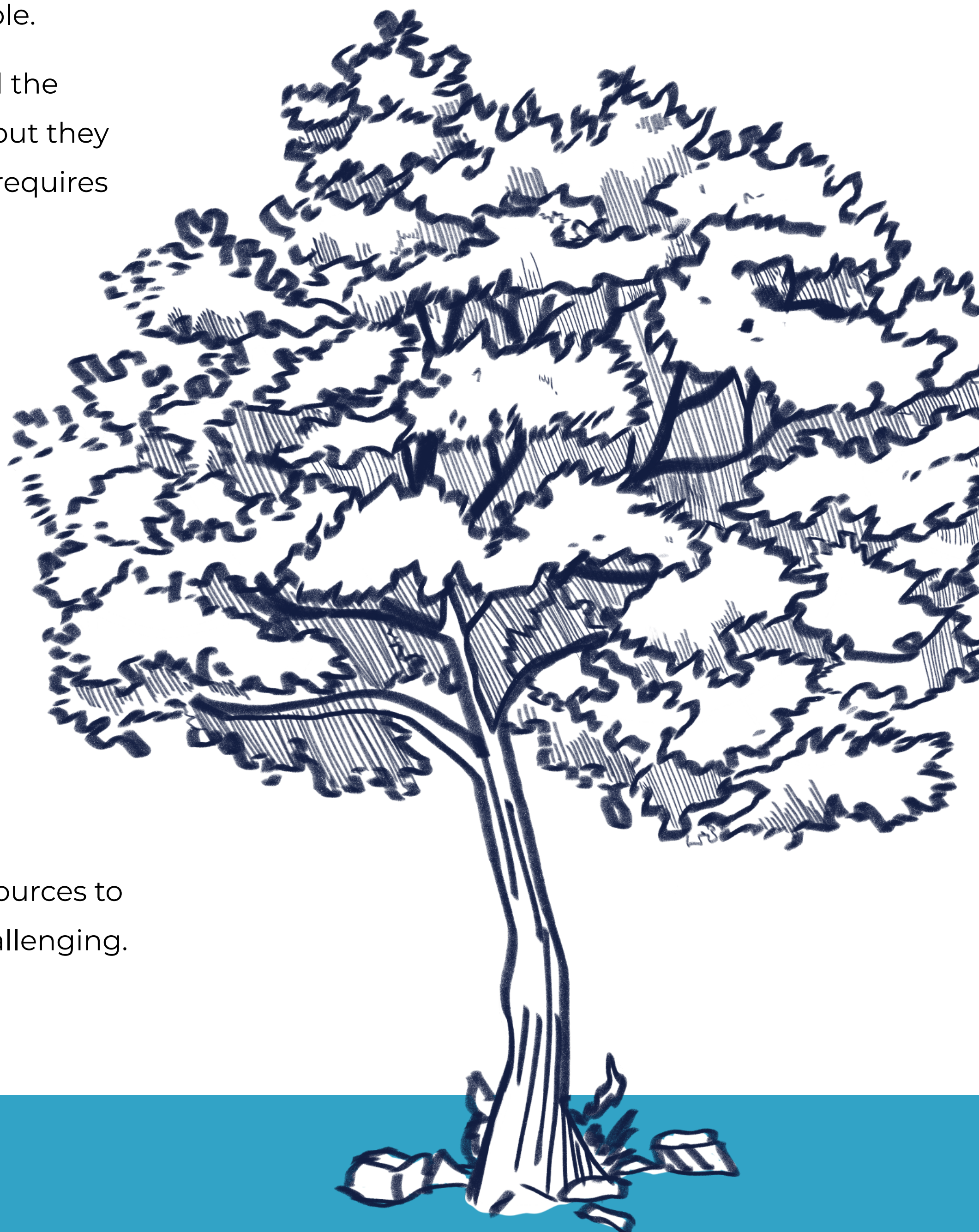
If you've ever planted a tree, raised a child, or started a business, you understand that complex systems often require the most care in their early stages. Hearty, full-grown trees might survive years of bad weather, but saplings will wither and die after a few weeks without enough water and sun. Bad food and poor exercise in your teens and 20s can lead to lasting health problems that stretch well into adulthood. Similarly in business, lack of resources cause the majority of startups to fail within their first year.

Each of these fledgling systems' early years are characterized by growth and vulnerability. The two terms might sound like opposites—growth is good, vulnerability is bad—but they're closely linked. Growth means moving into new areas and trying new things, figuring out through experience which strategies will succeed and which will fail. If a tree never stretches towards the light, its growth is stunted, but new growth is the most vulnerable.

Wise caretakers understand the importance of taking risks, but they also recognize that growth requires adequate resources. Good arborists give their trees the best soil and water, good parents give their children healthy food, and good executives ensure their company has a steady source of income as they grow.

But unless your business is profitable very early on, or you've got a pot of gold stashed away somewhere, finding the resources to grow a company can be challenging.

For lenders, growth capital usually isn't limited to money for internal operations, but includes the funds given directly to borrowers.



// IN THIS EBOOK

This volume of Lean Into Lending will focus on acquiring outside capital and using it to grow your lending operation. As with the first volume, we're writing to a diverse audience. We anticipate that the group who will be most interested in these topics are startups or other newcomers who are planning their first steps into the industry. These companies still have a lot of room to grow, and are presently the most vulnerable to shifts in the market.

But that's not to say larger, more established lenders won't find value here. Launching a new product or a branch within an organization is very similar to founding a startup: both involve a new, experimental venture that won't initially be profitable, and will instead require outside funding.

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The main difference is that a startup's funding comes from an investor, and a new project's funding comes from their company's R&D budget. In both cases, the group that provides that capital is going to have similar expectations for their investment—expectations that this eBook will help you meet and exceed.

In this volume, we'll explore:

- **Who Needs Capital?**
  Companies seek capital for different reasons. We'll discuss those reasons, and how they might impact your search.

- **The Availability of Capital.**
  The last few years have brought massive changes to the investing market. This section examines the situation today.

- **Elevated Capital Partner Expectations.**
  Much like lenders, investors have begun using data-driven approaches to predicting and measuring ROI. Here, we'll discuss the metrics they use and what you can do to measure up.

- **The Power of a Proof of Concept.**
  A profitable, data-backed proof of concept will draw investors, and can become a long-term revenue stream. This section will explores how to create a proof of concept, and how to integrate it back into your main operation.

- **Disruption in the Making.**
  An idea that can disrupt the market will draw in capital partners. We'll discuss the technological developments on the horizon that promise to shake things up.

// AVAILABILITY OF CAPITAL

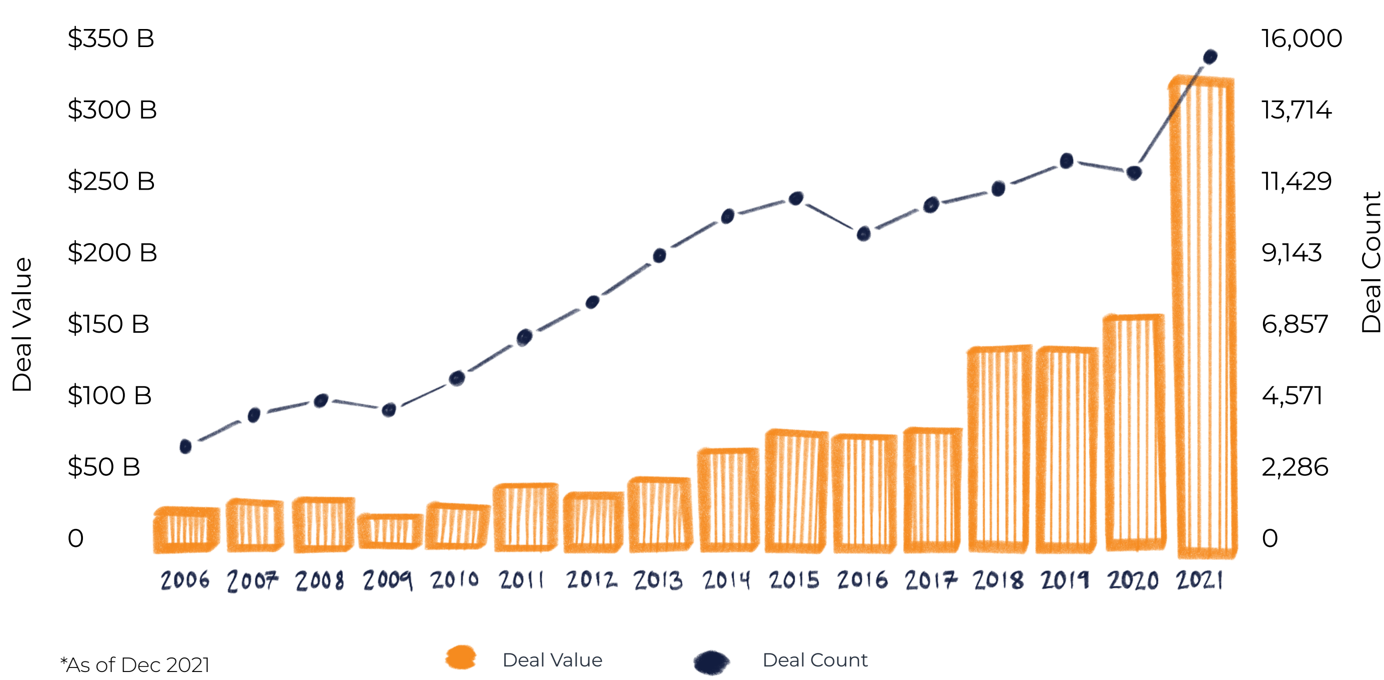
Capital investments may be a business necessity for you, but they benefit investors, too. Investors want to make money. As such, they are constantly on the lookout for new, innovative ideas in hopes that they will find the next unicorn that will make them billions. But what's the state of the market in the wake of COVID-19 and the more recent worries over inflation?

In the early days of the pandemic, the switch to remote work saw more and more firms investing in tech-forward, adaptable companies.

This resulted in a bit of a funding frenzy; venture capital investment nearly doubled between 2020 and 2021 (Mathur, 2022). Instead of businesses chasng down investors, investors were seeking out promising businesses and presenting them with pitch decks, hoping businesses would choose their investment over others.

Now, over halfway into 2022, that excitement feels like a distant memory. Just in the short time we've been writing this eBook, there have been several changes. The economic climate went from 'Things are looking good!' to 'Things have calmed down,' and then again to 'Things look a little shaky in the future.' We're seeing rising prices in energy, food, and other everyday items, and it looks

2020 / 2021 Funding Frenzy



like it will get worse before it gets better. Early in July, the Bank of England warned lenders to prepare for financial instability by buffering themselves with additional cash reserves (Reuters, 2022). We expect this to be a trend in the coming months.

As we enter a recession, funding will become more scarce—and more competitive. Lenders, however, may be buffered from the economic downturn by the nature of their business model. When a person or company faces a gap between income and expenses, they generally seek a loan to fill that gap. As the economy gets tighter, we can reasonably expect more borrowers to approach lenders for financing. Savvy investors recognize that lending is one of a handful of industries that can do well in a recession, so even with a general scarcity of new capital, it's likely that lenders with promising business models and track records of success will still be able to secure funding.

With that said, it's more important than ever that you do what you can to convince potential capital partners that your operation won't just scrape by, but reward their investment.

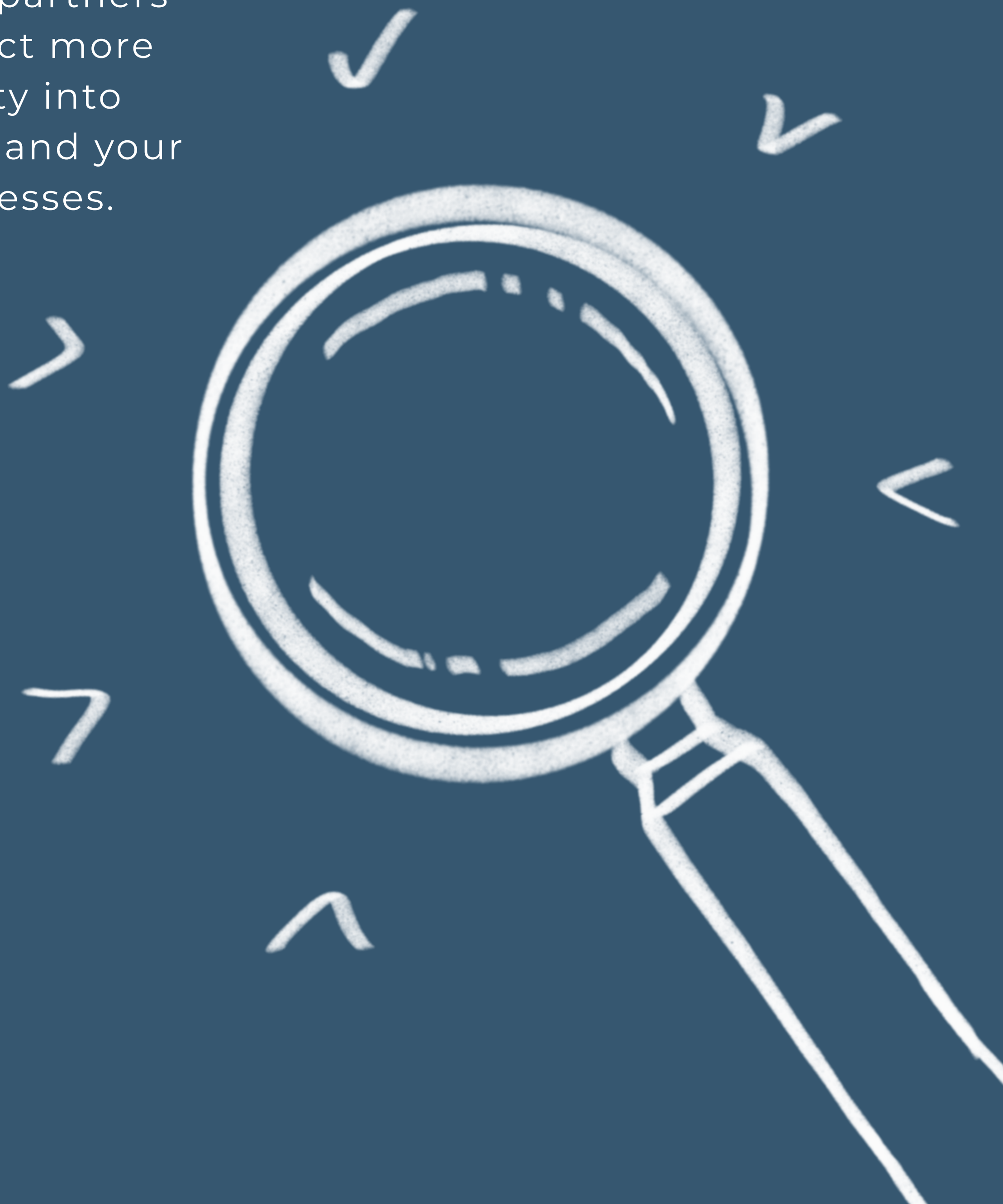
LENDING IS ONE OF A HANDFUL OF INDUSTRIES THAT CAN DO WELL IN A RECESSION.

// ELEVATED CAPITAL PARTNER EXPECTATIONS

Investors may be eager to put their money behind the next big idea, but they're also wary about putting their money in the wrong places. Heightened concern about the future of the market has led many investors to raise their expectations. In general, it's a smart idea for a company to have a certain level of visibility. It's a great way to build your brand and create trust with the public, and it gives the (hopefully correct) impression that you are an expert in your field. These are all traits that will draw in potential investors.

Visibility is especially important for maintaining investors.

As the relationship between your company and your capital partners grows, they expect more and more visibility into how you operate and your failures and successes.



In the field of lending in particular, capital partners want to scrutinize the technology lenders are using. There are a number of reasons for this. First, they want to know that the lender's choice of technology is innovative and will keep them, at the very least, on par with the competition. They also want to know that the technology will work to improve their performance and increase their loan portfolios. But mostly, they want to see the hard data in the software and ensure they're not receiving any overly optimistic numbers.

Capital partners of course want data before they make an investment, but they'll likely keep that interest throughout your partnership. In large part, it's so they can help you avoid errors they've seen in other firms they've invested in. Some investors are more involved than others, but even those with a hands-off approach will have some suggestions that can help you avoid predictable pitfalls. It's important that lenders have access to the data investors will want to see on a regular basis.

Some of the metrics capital partners really want to know include:

1. Delinquency Rate (Delinquent loans vs current loans)
2. Active Return on Investment (The actual percentage return on dollars invested)
3. Default Rate (The rate at which loans become uncollectible)
4. New Loan Issuing Rate (The number of new loans issuedeach month)
5. Portfolio Growth (The dollar-amount growth of the overall portfolio month over month)

5

// THE POWER OF PROOF OF CONCEPT

When investors put their money behind a company, they expect visibility into every aspect of their investment—from the technology powering the operation to the products offered and how they're performing. But a long, hard look at a dumpster fire isn't going to convince anyone to invest. When an investor is looking to put money into a company, (or when your own company is looking at putting their own money into a project), they're drawn to programs that have both proven results and a potential for growth.

If something has a solid track record of growth and success, you can reasonably expect more success as you scale. If a product or program has no history, then you have no indication of how consumers will respond. Before charging ahead with a new product or business model, lenders (and any business, for that matter) should develop a proof of concept: a successful, small-scale version of the program that can then be expanded.

Why is a proof of concept important? Without a strong proof of concept, your idea may end up like CNN+ or Quibi. And if you're unfamiliar with those services, that's a testament to how swiftly and magnificently they failed. Even an idea with record-level funding can crash and burn without proper planning and testing.

So how do you develop a proof of concept? Perhaps your company has been hearing a lot about new lending models, and you want to experiment. Rather than throwing all your resources into the first thing that comes to mind, research a few different options and develop small-scale programs for each. Issue a few loans, keeping the total cost low enough that it won't hurt if you lose it—the whole point here is to see how things work, so consider anything you lose an R&D cost. From there, you can see which models offer the highest and most consistent return on your investment.

REMEMBER:
FAILURE ISN'T A REGRETTABLE ACCIDENT, BUT AN INTEGRAL PART OF THE DEVELOPMENT PROCESS.

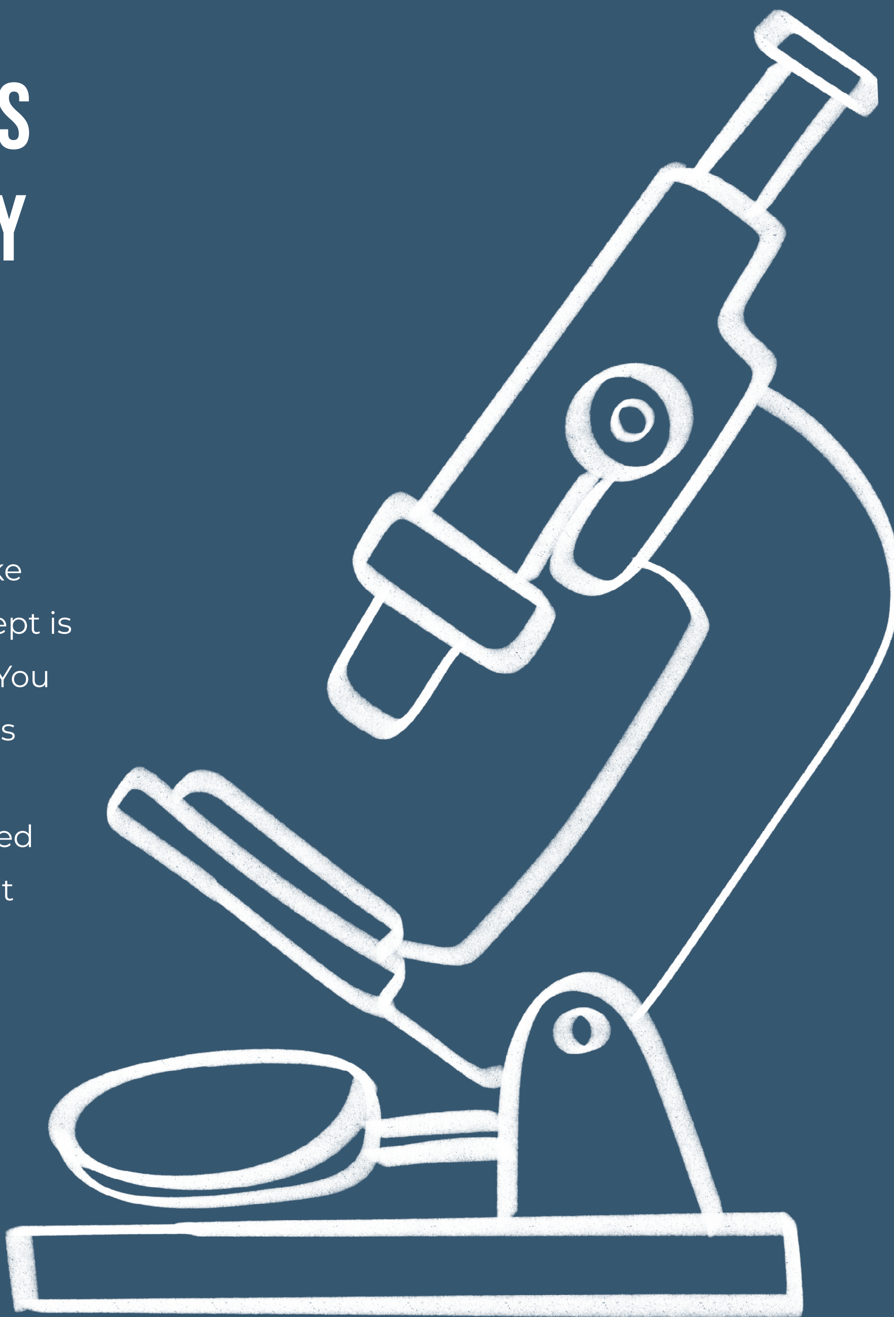
When you're running small-scale, controlled experiments, failures show you what to improve or what to scrap. If all you see are 'successes', that may mean you're not experimenting with anything new—you're playing it too safe and leaving exciting, innovative ideas untested. Trying those different models and methods will help you fail fast and small, paving the way for sound, confident investing once you've perfected your proof of concept. As you issue these experimental loans, see how consumers respond, and record your data. Do people apply for them? More importantly, do they pay you back? You can further experiment within the same type of loans, trying different collections strategies to see what draws the greatest returns.

If you're thinking that this sounds like an expensive fantasy, it might be time to upgrade your software. A lender could never have experimented like this just ten or twenty years ago. Testing different products might have required entirely different software suites, calculations, and even personnel to service them. But with modern, configuration-first software, you can create multiple products with different lifecycles and payment plans. Once the loans are issued, your software should be able to track how they perform.

GOOD TECH AND SOFTWARE EMPOWER YOU TO INNOVATE.

It puts the tools in your hands to refine what works and discard what doesn't. Your company can become a sort of lending laboratory, constantly studying and experimenting with loans as you continue to develop new products and ideas.

WE SHOULD STRESS THAT WHEN WE SAY 'EXPERIMENT', WE MEAN IT.



The biggest mistake you can make when developing a proof of concept is forgetting the scientific method. You could create a hundred or so loans with your new model. When you turn a profit, you might be tempted to call it a success. But you haven't yet proven that they're any more successful than what you were already doing. You should instead draw from a similar group of borrowers (perhaps current or previous customers who might be interested in another loan) and randomly extend them an offer for either the loan model you already use (a control) or an experimental model (with different variables). Make sure that each variable is tracked independently. It won't do you any favors to compare your current model to a new one that has a different interest rate, loan amount, payment schedule, and collection strategy; when differences in profit emerge, you won't be able to trace which variable caused them. Instead, have one model that's a control, and one model for each variable you want to test. Then, you can create additional models that pair different variables together, so you'll be able to see their cumulative effects as well.

6

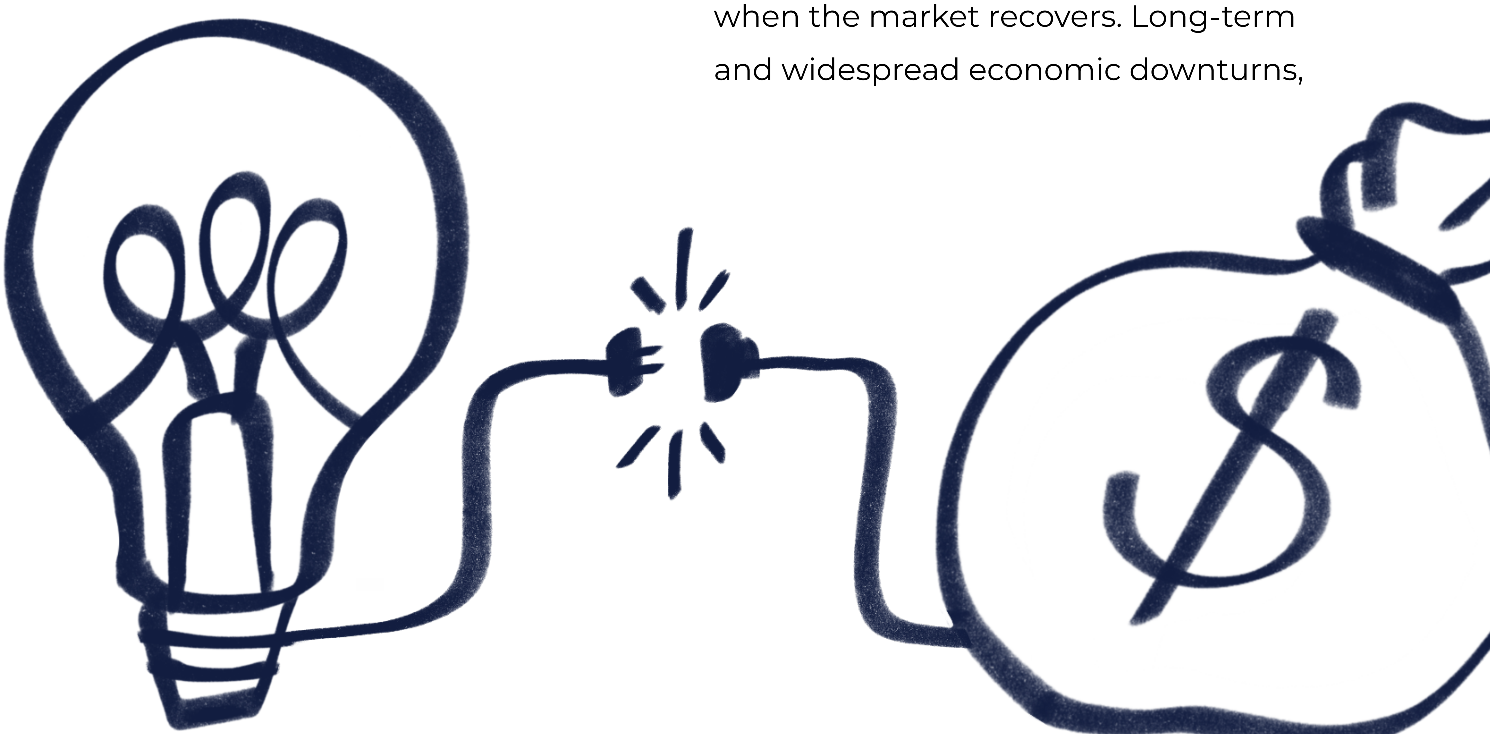
WHO NEEDS CAPITAL

In the first volume, we looked at how success in lending (as well as other industries) often depends not on product or pricing alone, but on the overall experience a company can deliver to their customers. A good customer experience, we argued, is what makes people like using your product and want to use it again in the future.

That kind of top-tier experience doesn't just happen by accident. It takes thorough research into the loan products that are already on the market and what friction points are present in those models. It takes careful deliberation when designing and developing your own solutions. Once they're ready, you might need a marketing blitz or ad campaign to draw in borrowers, and, when you get them, you'll need money to fund your loans. Finally, it takes a skilled team of servicing and collections agents who can balance the immediate need for payments with the long-term goal of outstanding customer experience. Every step of that process takes money, whether it's from an investment firm, a parent company, or more established branches of your own company.

Besides those who are building a new lending product, more established lenders will also look for outside funding. Instead of taking on capital to build an entire company infrastructure, they only look for investors who want to fund loans. Direct investment into a loan portfolio allows the lender to grow while they share the risks and rewards.

Lastly, some companies need investments to keep the operation afloat until they reach (or return to) profitability. This model is the norm among silicon valley startups, who might bridge their Series A to Series B to Series C and so on for years until their own revenue can support the company. But during the pandemic, and now the recession, some companies who were profitable have found themselves in dire straits. The lending industry can thrive amid short-term economic swings, during which it provides a great benefit to society: people borrow money when times are tough, and then pay it back when the market recovers. Long-term and widespread economic downturns,



however, will strain lenders as an increased number of borrowers default on their loans. This puts lenders in the same position their borrowers were in, seeking refuge until the financial storm blows over. Recessions and depressions do end, but in the meantime, there are more lenders competing over the same investor capital.

However, as we've explored, capital partners are raising their expectations. Very few will be interested if you approach them asking for some money you can subsist on until the economy rights itself. If lenders want to draw in investors, they need ideas that can help them grow amid a recession.

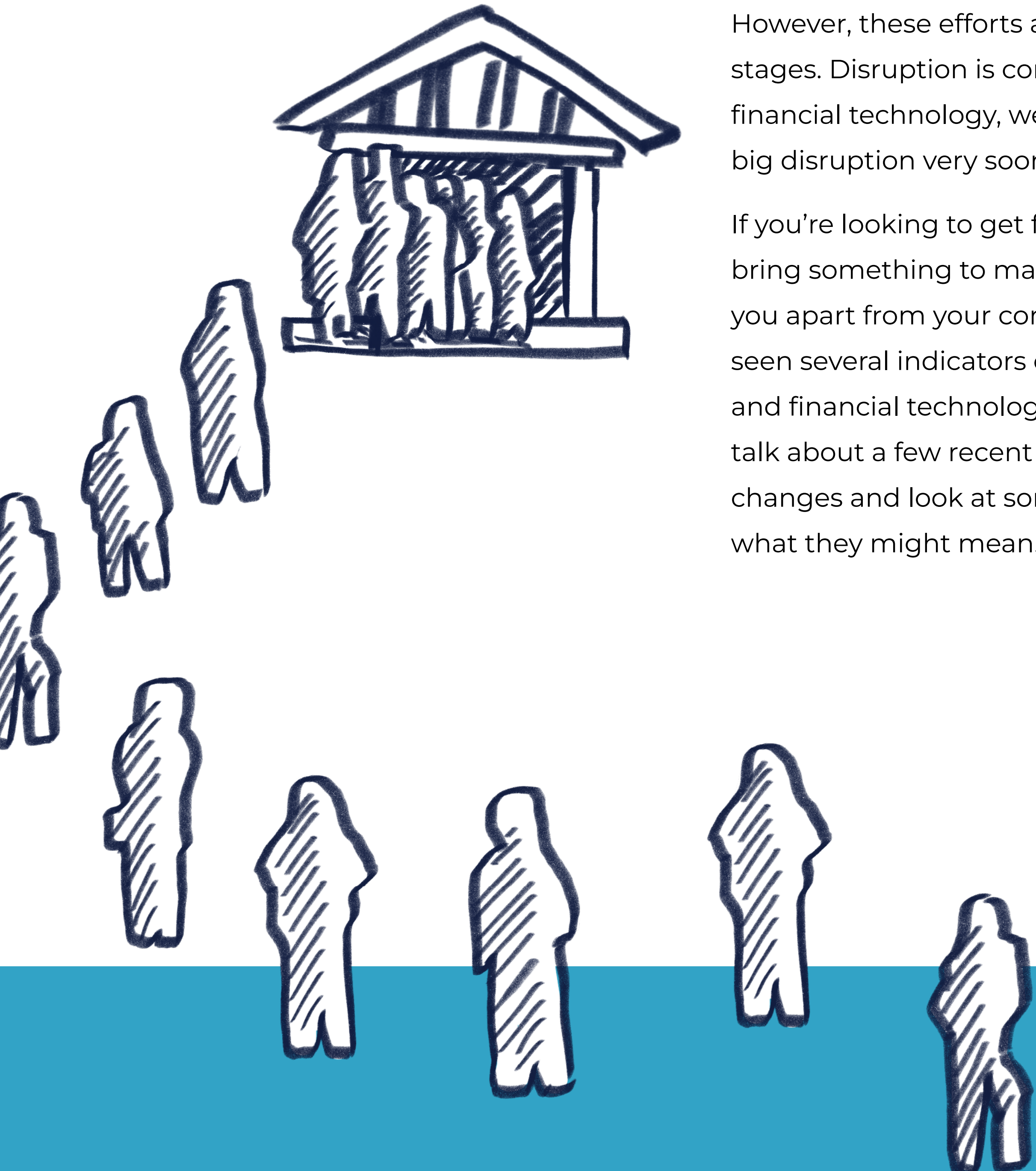
WHEN A GOOD IDEA IS TESTED WITH A PROOF OF CONCEPT, INVESTORS SEE THE POTENTIAL TO DISRUPT THE MARKET.

7

// DISRUPTION IN THE MAKING

It's worth noting that lending has traditionally been a fairly static industry. If you were to walk into a bank seeking a personal loan today, your experience wouldn't be radically different from the experience your grandparents had half a century ago. The teller might be using a nicer computer, or pulling a FICO score instead of one of its predecessors, but these advances only bring marginal gains to user experience.

However, even as banks and credit unions stagnated, other lenders capitalized on emerging technology to offer new, disruptive lending models. The growth of the internet enabled online lending to develop and spread, shaking up the traditional model of brick-and-mortar storefronts. Gone are the days when a person's only option was to stand in line, and the most convenient payment method was to send a check in the mail. And let's not even talk about the long hours on hold or being bounced around from person to person if you have a problem or question. Instead, a person today can get approved, make payments, and answer their own questions, all from their phones.



The lending landscape continues to grow and evolve at a surprising pace. Many players have entered the financial technology space with the intent to make things a little faster, easier, less expensive, or more impressive than they have been. However, these efforts are still in the early stages. Disruption is continuous, but in financial technology, we are poised to see big disruption very soon.

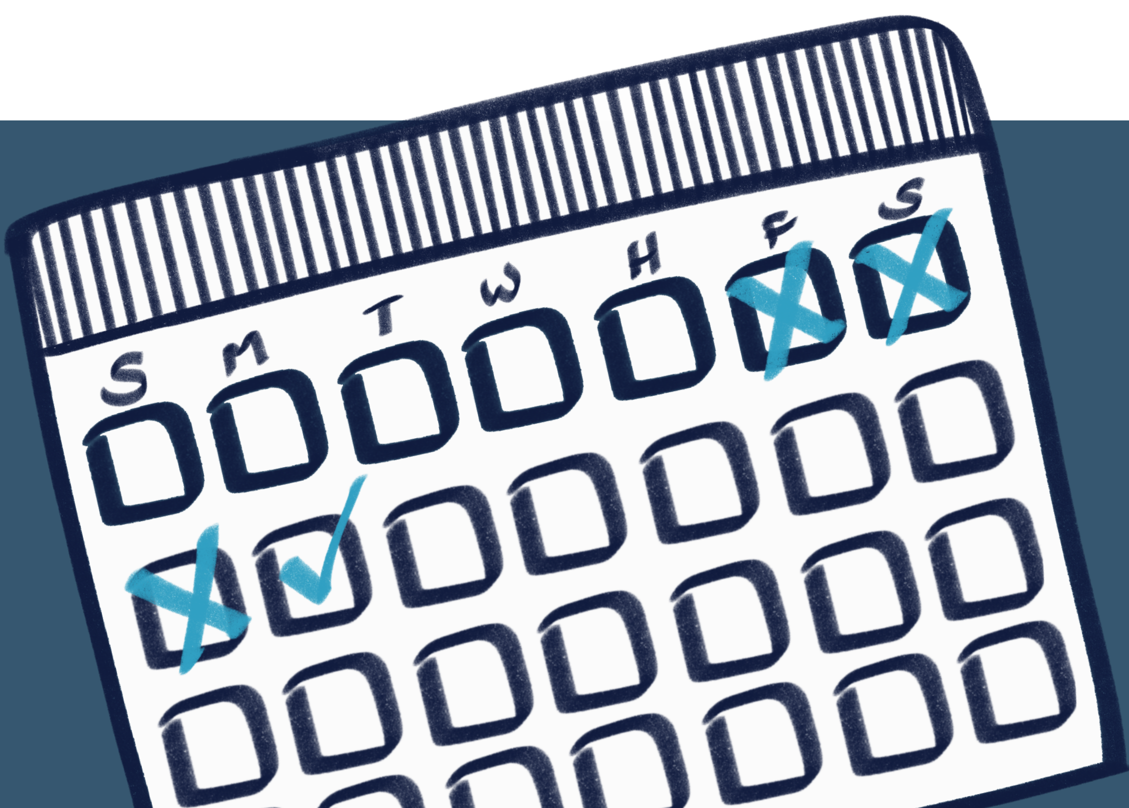
If you're looking to get funded, you should bring something to market that truly sets you apart from your competition. We've seen several indicators of where lending and financial technology are going. Let's talk about a few recent and upcoming changes and look at some examples of what they might mean.

Real-Time ACH Processing

In the US, e-check payments are handled through the Automated Clearing House, a network of banking computer systems that you can thank any time a direct deposit ends up in your bank account.

After being developed in the late 1960s, the system underwent only minor changes for decades. It was only in 2016 that the system became capable of doing same-day transactions, a major improvement from the three-to-five business days it had taken in the past. That 'same day' is still a business day, however. A transaction made at 6:30 on a Friday night might not end up in an account until Monday morning. For lenders, this doesn't just mean waiting a few days for payments to clear; delayed funding transactions leave borrowers without access to the money they want to borrow, and their emergencies won't take the weekend off.

But the Federal Reserve's upcoming FedNow system, slated for a 2023 release, will be able to process ACH payments in real time, any day of the year, without interruption. That means borrowers getting funded faster, lenders receiving payments faster, and an overall better user experience. What's more, payment processing companies will be able to speed up the additional services they offer, like verifying identities and bank accounts or pulling KYC data.



Digital Core Software

While FedNow is an exciting change to the banking network, most banks are still using software built during the Bush administration (and maybe the first Bush administration at that). Even among those who have introduced tech-forward solutions, few have taken a complete, bottom-up approach to building a better user experience from the best tech available. Thankfully, that seems to be changing.

Banking giant JP Morgan Chase recently switched their core software to a system developed by the fintech start-up Thought Machine. A few months later, Chase's UK bank switched to 10x, another fintech. These modern banking cores offer both agility and scalability, meaning that Chase can develop, test, and deploy new products faster and wider than ever before.

These systems also provide increased connectivity. That means that banking systems can more easily use third-party data or add ons. In the future, a banking core system could well be augmented with best-in-class loan origination, loan servicing, card issuing, and more. This also means that lenders who partner with banks should have a far easier time connecting their data with account data.

If the traditional banking institutions are moving their massive bureaucracies into the fintech space, non-bank lenders should take note. As banks become faster, smarter, and tech-forward, they'll be better suited to partner with private lenders and connect more data. Banking related services, like opening an account or moving money, will be quick and convenient. Lenders using bank capital may have access to more data to be able to provide better financial services.

IF BANKING INSTITUTIONS ARE CHANGING, FINANCE AND LENDING ARE GOING TO CHANGE TOO.

Software Alliances

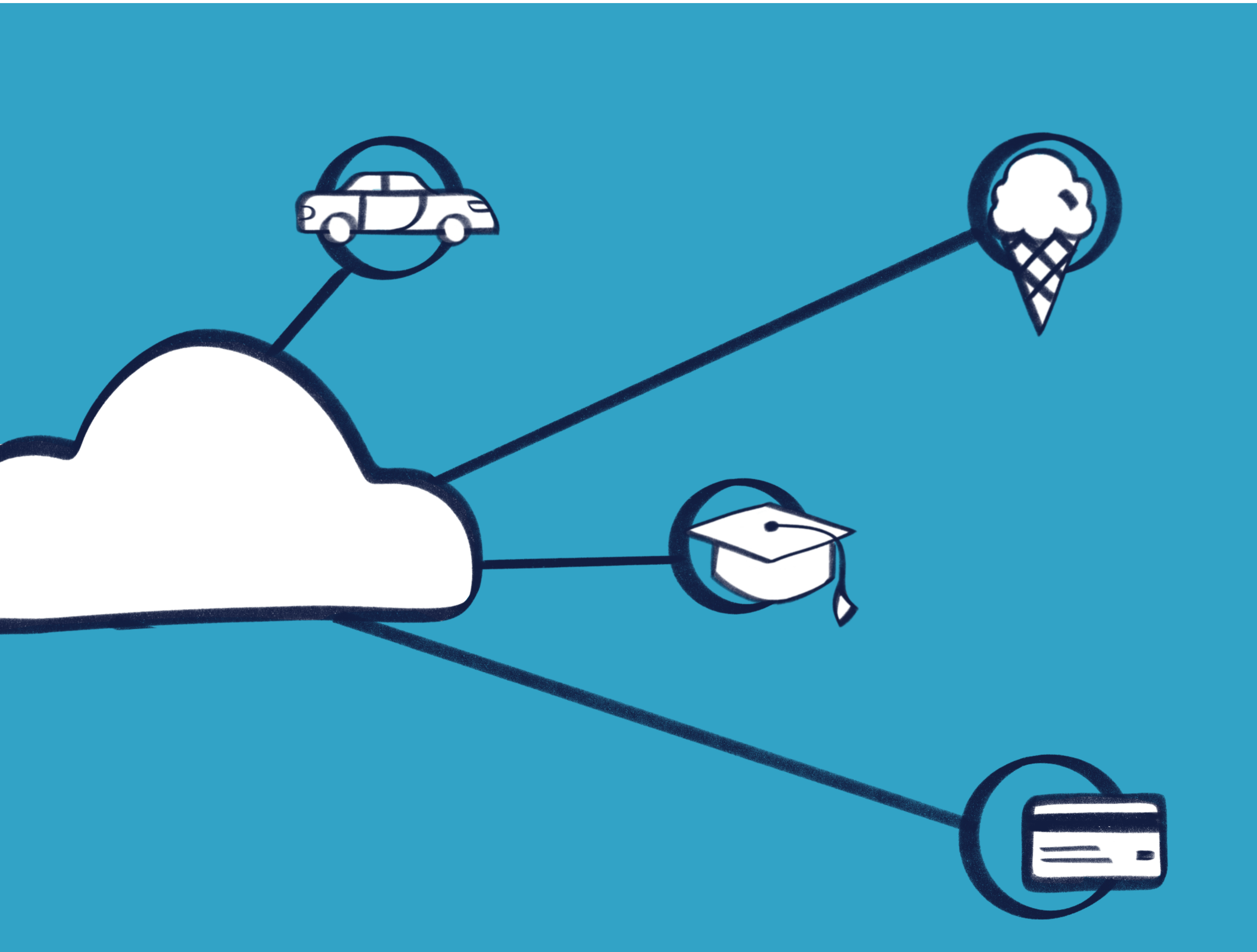
Software alliances may sound like a secret club with nefarious intentions, but in reality, this will look like connections of cloud-based services and information that haven't yet been combined. The joint data and capabilities of these services will provide extreme convenience, and industries with a history of slowly evolving technology will be the biggest benefactors.

As an example, think of the modern smart fridge. Forty years ago it's unlikely that anyone imagined a refrigerator that could tell you what was inside while you were in the grocery store. That's because remote communication, including things like cell phones and the internet, were in their earliest stages, and refrigerators had one job: keep food cold. Now, it makes sense to people that if you want to look at your home, your car, or your food, even when you're not standing next to them, you should have that option.

Software combinations will do the same thing. For example, car insurance companies that offer discounts to good students could soon pull transcripts themselves when given permission by the customer. Another example of combining data may look like this: Say you're walking through your city. Suddenly you get a notification on your phone that if you go to a new restaurant that is close by and use a specific credit card to pay, your rewards points will cover the cost of the meal. In this case, location data plus restaurant data plus financial data equals a great opportunity to give you a reward, while encouraging you to try a new place.

> **INDUSTRIES WITH A HISTORY OF SLOWLY EVOLVING TECHNOLOGY WILL BE THE BIGGEST BENEFACTORS.**

We've entered the era of connected data. Now is the time to explore what combinations might be useful. Look at lenders who are trying to optimize collections. Already, we're seeing data being used to predict when borrowers will have a high bank balance so payments can be timed more effectively. Education lenders could pull a student's GPA or academic transcript and use it in underwriting. Maybe credit card lenders could integrate with retailers like Amazon and Target who let couples post their wedding registry, offering friends better rewards when they buy gifts. If they're integrated with location and weather services, they could offer customers a free ice cream from a store in their ZIP code on a hot day. For lenders, the combination of data and services will help drive niche loans and customer loyalty, and may even create new revenue streams.



Cryptocurrency and New Collateral

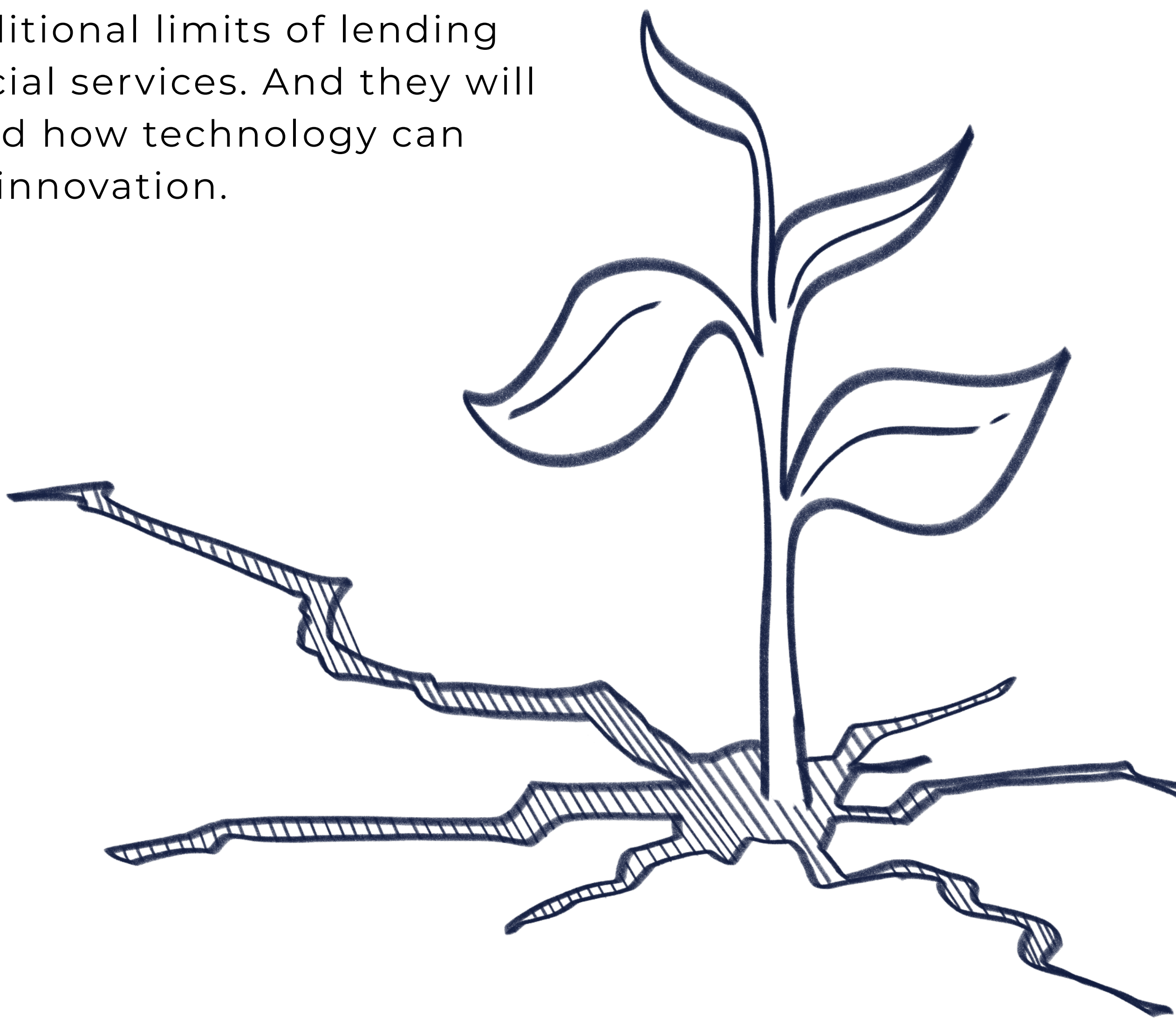
At this point, cryptocurrencies like Bitcoin and Ethereum are hardly novel; waves of celebrity-minted NFTs and the frequent ups and downs in the market tend to keep crypto in the news cycle. And yet, these blockchain currencies are used more like stocks than actual currency. Few lenders will accept cryptocurrency payments, and those who do often specialize in it, even letting borrowers take out a loan against their crypto as collateral.

But as more and more traditional institutions accept crypto, it will inevitably become more mainstream. El Salvador made headlines in 2021 when they adopted Bitcoin as legal tender. In the US, several states have written regulations concerning cryptocurrency, and the SEC has considered regulating at the federal level as well. Crypto's days as a virtual Wild West may be drawing to a close, but a regulated, stable crypto landscape could draw in businesses and consumers who would've previously steered clear.

The basic model that crypto lending uses—borrowing against an asset you own—has been around for years in the form of pawn and title loans or home equity lines of credit (HELOC). Still, borrowing against owned property carries a bit of stigma, with most borrowers seeing pawn or title financing as loans of last resort. But that judgment doesn't hold up to scrutiny. Permanently selling an asset (and potentially paying taxes on earnings) is often less appealing than accessing the asset's value through a loan. The popularity of crypto loans may lead lenders to take a closer look at borrowing against other owned assets. Securing a loan with collateral is a win-win: It lowers risk for the lender, so they can in turn lower the interest rates. Consequently, we may soon see lower-interest loans and lines of credit open against different kinds of collateral, catering to different borrowers.

AND WITHOUT A DOUBT, THERE WILL BE MORE DISRUPTIONS.

While it's impossible to predict exactly what's coming, we do know the type of people and companies who will make those changes. They'll understand what borrowers want. They won't stop at the traditional limits of lending and financial services. And they will understand how technology can empower innovation.



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// CONCLUSION

The pandemic and now the recession have spurred a world of financial uncertainty. Lending, an industry that can typically survive recessions, is buffered from economic troubles, but not wholly immune. Now more than ever, lenders need to take advantage of powerful, disruptive technologies and develop products that can draw in more borrowers and offer them a better customer experience.

We can't expect new lending products and models to emerge fully formed. It takes time for new ideas to take shape, moving from a concept to a blueprint to a prototype and finally a revenue earner. During that period of growth, the idea and the people supporting it will inevitably face vulnerability, but they can overcome that vulnerability with an infusion of capital. New capital might come from inside your organization, like an R&D department investigating new lending practices. In other cases, it might come from an outside investor. Whether the source is inside or outside of your organization, they'll likely have the same concerns and expectations.

Capital partners want visibility into your lending operation. They want to see the numbers, and they want to see the tech and software that's powering your enterprise. But what will really excite them is a solid proof of concept, a new loan product that you've tested and proved with real-world borrowers. Showing that it can work in practice, a working proof of concept will convince capital partners that your ideas can earn them money. Those partners will be willing to fund loans with your product, and seeing success there, they'll be more likely to fund your next proof of concept and the company's continued growth.

If you're unsure about where or how to develop new ideas, don't worry—you're not alone. Like we said earlier, no one can predict the future with perfect certainty. But they can change their mindset, learning to spot opportunities for innovation where others might see a stagnant market.

Developing that innovative mindset might take some work. We'd like to invite you to read the third and final installment of Lean into Lending, Be the Innovator.

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