BLACKMOON
FINANCIAL GROUP

THE RISE OF THE COMPOSITE LENDING BUSINESS MODEL

EXECUTIVE SUMMARY

Alternative lending has become an important part of the financial landscape. Two major lending business models in this industry are marketplace and balance sheet lending, which mainly differ in the distribution of risk and the amount of return. Composite lending is an emerging model that brings benefits of marketplace lending to balance sheet loan originators. Blackmoon Financial Group offers a composite lending product that combines the benefits of both balance sheet and marketplace lending models.

TODAY'S INVESTMENT ENVIRONMENT

The popularity of the alternative lending industry has grown significantly in recent years. Two prominent lending business models that have shown little convergence in this industry thus far are marketplace lending and balance sheet lending.

MARKETPLACE LENDING FOR LOWER RISK

In the marketplace lending model, lending companies sell loan portfolios to third party investors in exchange for collection of a service fee throughout the loan's duration, and optionally an upfront origination fee. This transfers associated risk of loan default to investors, but it reduces the overall return by sacrificing interest rate spread of the portfolio. These sales bring in new capital, allowing the lending companies to originate more loans without being constrained by capital adequacy and leverage ratios.

Marketplace lending companies typically focus on near prime unsecured consumer loans, prime student and medical loans, small and medium enterprise (SME) loans, and real estate property financing—all which have long durations. The origins of the focus on this type of loans dates back to 2008 when home equity line of credit (HELOC) and credit card APRs were dramatically reprised upward while bank consumer lending became virtually non-existent, a phenomenon brilliantly described by Frank Rotman[1].

With the benefits of marketplace lending come complications stemming from its dependence on commitments from venture capital (VC) firms. Because marketplace lending deals with low margin, substantial capital investments from VC firms are required to sustain operations until the company reaches breakeven point. And as this lending model typically focuses on loans with long durations, lengthy VC commitments lasting five years or more are required to achieve the desired results.

BALANCE SHEET LENDING FOR HIGHER RETURN

The second major alternative lending business model is balance sheet lending. In this model, loan originators retain the portfolio so as to collect the interest rate spread over the lifetime of the loans. This increases the return and provides cash flow, but the balance sheet lenders retain full exposure to the risks associated with loan defaults.

Balance sheet lenders tend to focus on specialized lending, such as subprime payday loans, cash installments, POS loans, merchant cash advances, and factoring. Loans of this type are usually short in duration with a focus on current profitability.

Expected cash flow attributable to the originator is generally greater for balance sheet loans than for marketplace lending, allowing balance sheet lenders access to profit for business growth rather than relying on VC commitments. However, balance sheet lenders experiencing capital inadequacies must raise additional operating capital through investments from third party investors.

MARKETPLACE LENDING TAKES THE LEAD

For a variety of reasons, marketplace lending more readily attracts mainstream investors.

Loans on balance sheet lenders' are highly illiquid and very risky for third-party investors. This is in part because there is no way to assess the company's good standing and the quality of the asset base on a continual basis. As a result, the cost of such capital is high, frequently exceeding 15% p.a. in US dollars and Euros[2].

Another issue for balance sheet lenders is the fact that the market is not familiar with the specialized lending in their portfolios, and therefore not comfortable with the asset class they create. Because of this lack of understanding, investors tend to compare balance sheet lenders with banks due to perceived similarities of business models, which may lead investors to draw incorrect conclusions (see sidebar).

The more challenging task is assessment of the underlying assets in the balance sheet lending portfolio. Unlike prime loans, the short-term near-prime and subprime loans favored by balance sheet lenders are daunting for investors to evaluate using a classical approach based on default rates, since early repayments, delinquencies, and frequent restructuring dramatically affect the performance of the portfolio.

COMPARING BALANCE SHEET LENDERS WITH BANKS

Investors who do not grasp the complexity of the balance sheet portfolio may compare the lender with a bank and draw incorrect conclusions. For example, the company 4finance (4finance.com), one of the largest balance sheet lenders in the EU placing public bonds, has a non-performing loan to total gross portfolio ratio of 35.8% as of 30 September 2015. This figure is well below 5% the majority of EU banks according to IMF Global Stability Report. This is a result of the short-term nature of the 4finance loan portfolio, which consists primarily of loans with 30-day durations, while non-performing loans are accumulated for several years.

Another issue facing balance sheet lending companies is business scalability. The marketplace and balance sheet lending models both must generate capital to fund the ever-growing market demands for loans and to scale their businesses, yet marketplace scalability is path-dependent. Companies in each lending model need historical loan statistics to demonstrate proven results—a track record—to potential new institutional investors, but to create these statistics, they need initial investors. Once a company collects enough statistics and attracts institutional money it will experience hockey-stick growth in originations. To reach this point, marketplace lenders must spend money from early investors, while balance sheet lenders may use their own equity for this purpose.

Marketplace lending firms were literally founded to acquire new investors to scale their growth. Balance sheet lenders retain their earnings, enabling the expansion into new segments and markets; however, few balance sheet lenders have scaled their operations sufficiently to raise debt through securitizations or off-balance sheets. This is mainly due to costly set-up and the lack of specialized investors.

Given all these challenges, mainstream investors shy away from balance sheet lenders in favor of the more conventional assets originated through marketplace lending.

THE COMPOSITE LENDING MODEL

The composite lending model put forward by Blackmoon Financial Group combines the benefits of balance sheet and marketplace lending models, providing flexibility and scalability, high operating margins, and impressive valuation multiples. This brings investors a unique and compelling asset class in terms of risk and return. In this model, a portion of the portfolio is retained on the balance sheet funded by the company's capital, while the other part is financed by outside investors on the principles of the marketplace. The composite lending model gives investors access to the assets created by alternative lending companies, irrespective of their business models, their technical availability, or the investors' API (application program interface).

The Blackmoon mission is to provide this composite lending model in a marketplace-lending-as-a-service platform for balance sheet lenders around the world. To that

end, Blackmoon developed a rich offering of tools to make their system both comprehensive and easy to use, including business processes, proprietary integration technologies and API, data processing and mapping modules, asset assessors, monitoring and business intelligence systems.

THE TECHNOLOGY

Blackmoon's investment interfaces and reporting systems allow balance sheet lenders to stream loan applications to their third party institutional investors in real-time, without incurring high IT or management personnel costs. The Blackmoon API was designed for easy implementation by the lenders' own IT personnel, with detailed documentation publicly available on the Blackmoon website.

Integrating Blackmoon's marketplace module into a current system adds no latency to the loan applicants' user experience. Data transferred through the Blackmoon API is automatically standardized and evaluated using a low latency loan assessors specially created for each originator. These loan assessors automatically choose the loans that may be funded with institutional investors' funds deposited with the loan originator. The entire data exchange, standardization, and assessment process takes less than a second.

It is very important for those in the alternative lending marketplace to build solid cooperation with investors and to proactively attract early adopters so as to create a track record. Blackmoon provides loan originators with established assessment techniques and a network of investors who are committed to invest in the loan portfolios originated by using Blackmoon's platform. Blackmoon provides them with independent analytical and monitoring solutions and loan pricing models to avoid potential conflicts of interest, ensuring the pure marketplace lending approach is executed based on full transparency and informed decisions.

THE ASSETS VALUATION

On top of the principal generated by a newly originated loan, the loan originator also receives the origination fee as a consideration for future cash flows projected to be generated by this asset. This fee accounts for the high APR usually inherent with the products originated by balance sheet lenders.

This origination fee is automatically evaluated based on the risk and cash flow profile of each particular asset, which is a process comparable to a risk group classification provided by marketplace lenders. This fee allows for the purchasing of a wide spectrum of the loan originator's inventory, provided that the expected net present value of the loan is greater than zero.

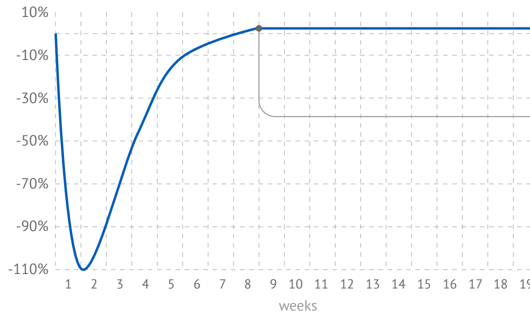
Since a larger amount of money (principal plus fees) is exchanged for the same cash flows (repayments), the cost of capital for the loan originator will be in line with alternative sources of funding. To ensure this, the loan originator is also given a call option on the portfolio of loans. This option can be executed once the return on the portfolio reaches a specified rate of return, as shown in Figure 1 below.

FIGURE 1
Illustrative cash flow for the parties

CASH-FLOW
FOR BLACKMOON

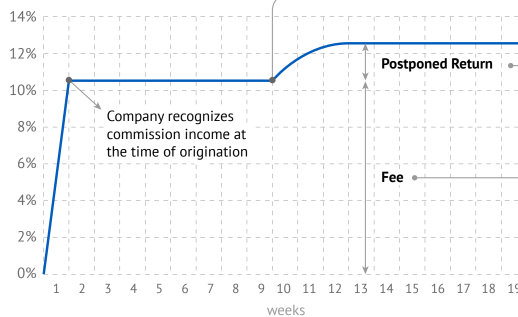
Assumptions

- the portfolio is formed during 7 days
- 100% equals to the principal of the portfolio



Once the target return on the sold portfolio is hit, the company executes call option on the cohort and collects any surplus cash flows. Blackmoon informs the originator, when the condition is met.

CASH-FLOW
FOR THE ORIGINATOR



Proprietary forecasting algorithms allow Blackmoon to maximize the portion of loan's NPV which is paid to the platform upfront. Therefore the Originator gets majority of the loan value at the moment of sale and only a small portion as a postponed return.

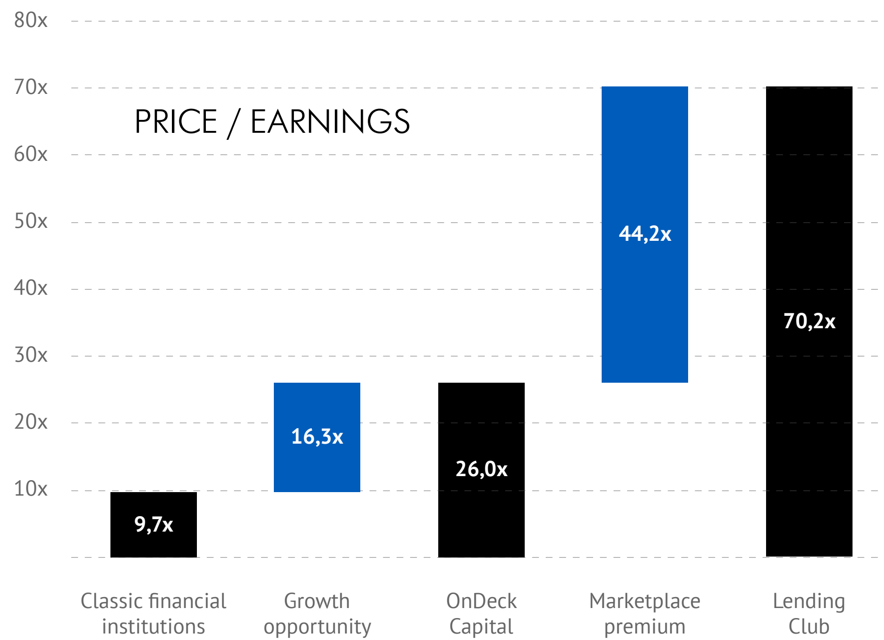
THE ASSETS VALUATION

On top of the principal generated by a newly originated loan, the loan originator also receives the origination fee as a consideration for future cash flows projected to be generated by this asset. This fee accounts for the high APR usually inherent with the products originated by balance sheet lenders.

Companies choosing this approach are more able to boost originations using fresh funds, decrease balance sheet risk exposure, and remain in compliance with leverage covenants. At the same time, these companies dramatically improve cash flow due to fees paid at the time of the origination, yet still retain the flexibility and profitability of the balance sheet lending model.

Apart from diversifying and broadening capital sources, another advantage to balance sheet lenders using the composite lending approach is higher valuations, since equity investors tend to favor marketplace lenders more than balance sheet lenders in terms of price to earnings multiples, as shown in Figure 2, below.

FIGURE 2
Valuation premium



Source: Capital IQ, Blackmoon

SERVICES FROM BLACKMOON FINANCIAL GROUP

Blackmoon works with loan originators and lenders from around the world. The company provides investors with holistic investment management capabilities through proprietary scoring and valuation models, automated real-time loan acquisition, legal and IT environments, and investment interfaces that streamline the investment process. Blackmoon acts as a service provider for institutional investors such as private equity fund and asset managers, providing open exposure to the assets originated by balance sheet lenders.

With the goal of serving as a one-stop shop for investors wishing to access the alternative finance market segment, Blackmoon also integrates with marketplace lenders. It applies its expertise and infrastructure to acquire loans that match the chosen investment criteria of its investors. In the event marketplace lenders do not have the technology that allows automated loan selection, Blackmoon provides the originator with the API and other necessary solutions.

SUMMARY

The composite lending model offered by Blackmoon Financial Group brings the lower-risk benefits of marketplace lending to companies operating under the balance sheet lending model. The Blackmoon solution includes innovative processes and technologies, including a low-latency API that can easily be integrated into lending companies' own systems.

ABOUT BLACKMOON FINANCIAL GROUP

Blackmoon Financial Group was founded in 2014 to deliver innovative solutions in alternative lending. For investors, Blackmoon offers high-yield consumer loan portfolios in Europe and the CIS with a proprietary technology solution, risk analysis toolkit, and technical support. For loan originators, Blackmoon provides access to a consistent, high-tech off-balance sheet funding source that locks in profits at the time of loan issuance, and preserves flexible pricing and product policy for the originator.

For more information about Blackmoon Financial Group, please visit us online at www.blackmoonfg.com or contact us at info@blackmoonfg.com.

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[1] The Hourglass Effect: A Decade of Displacement, by Frank Rottman. QED Investors. http://qedinvestors.com/wp-content/uploads/2015/04/the-hourglass-effect.pdf

[2] Elevate – https://www.sec.gov/Archives/edgar/data/1651094/000119312515371673/d83122ds1.htm
4finance – http://4finance.com/wp-content/uploads/2015/11/4finance-report-on9M2015-results.pdf
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