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Financials

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P2P Lenders

Prosper's Suber and Lee on How Barriers to Entry Shield Their Company and Lending Club from Upstarts

While much of the attention on the peer-to-peer (P2P) lending space has been focused on Buy-rated Lending Club (LC, PT - $31) since its initial public offering last month, the industry's other major player, Prosper Marketplace, has continued its rapid growth. In 2014, $1.6bn in loan originations were facilitated by Prosper's platform, including $205mm in December.

Prosper was the first P2P lender in the U.S., as it was founded in February 2006, shortly before LC. The company managed through a difficult few years during the financial crisis, including a cease and desist order from the SEC, a class action lawsuit brought by noteholders and high delinquency rates due in large part to few restrictions on borrower eligibility. However, Prosper relaunched its business in 2009 with stricter lending criteria, and the company's growth accelerated after Aaron and Steve Vermut and Ron Suber took over management in early 2013.

During the course of a discussion with Suber, now Prosper's president, and Macy Lee, the company's CFO since April, this week, the two executives touched on the reasons they believed LC and Prosper will not have any serious competition any time soon, the keys to continued growth, and Prosper's prospects for an IPO later this year.

One of the main criticisms of LC's premium valuation since its debut as a public company was that its success would attract competitors beyond Prosper, which would flatten its growth trajectory. However, Suber and Lee believe the critics are forgetting how difficult it had been for LC and Prosper to pass muster with the SEC, particularly with regard to securitization and the issuance of platform notes.

“People are underestimating what it takes to do this,” Suber said. Lee added that beyond the onerous regulatory hurdles a would-be competitor would need to overcome, another barrier was the need to develop a pricing, credit and risk model - a task that took Prosper years to accomplish as it fine-tuned its analytic capabilities. “It’s not something that can be done overnight,” she said.

Beyond the establishment of its marketplace, Prosper also needed to gain the trust and confidence of borrowers and investors. And in spite of its early difficulties, the company has raised about $200mm in capital since its founding. Meanwhile, plenty of venture-stage companies trying to break into the P2P industry have failed to launch or struggled to drive meaningful revenues despite drawing significant attention to their efforts.

"It takes lot more than branding and marketing to have an actual business that can scale,” Suber said.

Suber said Prosper's management team had a positive relationship with that of LC in large part because they both understood that the magnitude of the opportunity would be more than sufficient for both companies to thrive. He added that Prosper viewed the size of its total addressable market as $3bn.

“Our competition isn’t each other or the banks. It’s what we call ‘EAU’ – education, awareness and understanding,” Suber said. He pointed to a dozen different means through which Prosper seeks to increase EAU, including direct mail, digital marketing, partnerships, co-branding, bloggers, radio and terrestrial advertising and social media. Prosper's management team made 47 presentations during 2014, many of which can be viewed on YouTube, he said.

Suber acknowledged that LC's IPO had significantly improved Prosper's prospects for its own potential public offering, which is widely anticipated to occur later this year. In addition to the benefit that an IPO could bring the company in terms of bringing attention to its brand and drawing additional focus to the benefits of P2P lending, Suber said the capital raised would expand its options with regard to both growing its core business and pursuing M&A opportunities.

Appendix

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Our price target of $31 is based on 0.8x the company's FY16E total loan originations of $13.7bn discounted back at 10%.

Risks

Increase in defaults on loans facilitated through LC's marketplace could negatively impact return on investment for investors in those loans, which could result in a decline in investment in the marketplace. Additionally, changes in the regulatory environment surrounding peer to peer loans could negatively impact Lending Club's ability to originate new peer to peer loans.

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