EVOLUTION
CAPITAL MANAGEMENT

HOW TO INVEST IN MARKETPLACE LENDING

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EVOLUTION CAPITAL MANAGEMENT RESEARCH

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This thought piece provides a framework for how to approach investing in the marketplace lending space and what considerations should be taken into account to ensure an investor is creating a portfolio with the desired risk-return profile. The two primary decisions an investor must make are 1) how to access the market, and 2) what investment approach to take. There is no one right answer to these questions, but having an understanding of what options are available and what the benefits and drawbacks of those options are should serve potential investors well.

I. OVERVIEW

Creativity and innovation flourishes in marketplace lending, as originators of debt and managers of capital seek optimal loan and securities structures to provide to investors. Beginning with a fractional note offering to retail investors and thus far concluding with structured and rated securitizations, this industry has come far in its product development.

There are a variety of methods for investing in this asset class, differing in a number of ways to suit investor preferences and requirements. Those preferences are generally bucketed into the following categories: size of investment, qualification of the investor, risk tolerance, liquidity, volatility, accessibility, oversight, valuation, currency, servicing, taxation, and regulatory capital requirements.

Example Investment Method Matrix

Investment Method	Minimum Investment Size	Investor Qualification	Liquidity
Fractional Notes	As little as $25	None	Moderate
Public Funds	~$1K-$10K	None	Moderate
Private Funds	~$25K-100K	Accredited	Moderate
Securitization Bonds	$3M-$5M+	Qualified Institution	Moderate-High
Whole Loans	$5M+	Varies	Low

Investors must also consider how to access the loan supply, what approach to take once that access is acquired, and other factors in setting up an investment strategy.

II. ACCESS

There are **generally three methodologies for investing in this asset class.** The first is to **do it yourself** (“DIY”). Although this is the cheapest solution, it assumes the most risk and personal work. The second method would be to outsource parts of the investment oversight to a manager, while maintaining control in some form, specifically through a **Separately Managed Account** (“SMA”). This often requires deep pockets, but can lead to optimal customized results. The third and final option is to **allocate your capital entirely to a manager** with expertise in this asset class.

A. DO IT YOURSELF

The DIY model exists in the most basic form through the **direct purchase of fractionalized note investments from the lending platforms.** However, fractional interests expose investors to a loss of control of the underlying loans, and thus most institutional investors shy away from this option, especially if the investor is allocating enough capital to achieve portfolio diversification through other methods.

Beyond fractional interests, the DIY model involves either **purchasing securitization bonds or whole loans,** which are both only available for large institutional investors. Thus far in this industry, securitization bonds have come heavily protected with significant credit enhancements and credit bureau ratings. These bonds also provide value to banks and insurance companies with regulatory capital constraints. Finally, the bonds allow for some liquidity, most likely via the broker who initially sold the bonds in the first place. However, all of this **security and liquidity comes at a cost.** Current yields on bonds, while more stable than whole loans or other investment methods, will *almost* always be lower than the underlying assets themselves. Meanwhile, the complexity of the expected cash flows and credit risk on these bonds can be difficult for investors who are not experienced in the ABS market.

Whole loan purchases offer significantly more opportunities for control, including the ability to lever and/or securitize. Whole loan purchases require a negotiated Loan Purchase Agreement and Loan Servicing Agreement with the originating platform. Although well-negotiated agreements can provide extensive benefits, these agreements are trending towards boilerplate and standardized terms. Furthermore, despite the control and absolute yield on the underlying asset that whole loan purchases can offer, **it can be quite expensive to set up and maintain a secure whole loan purchase program.** Investors must consider custody solutions and a never-ending list of legal and regulatory issues with outright ownership.

B. SEPARATELY MANAGED ACCOUNTS

Investors who wish to maintain some control over their assets while limiting costs can often negotiate with asset managers for a Separately Managed Account solution. **The intent of an SMA is to use a manager's expertise in a strategy or asset class while segregating assets outside of a co-mingled fund structure.** SMAs may also allow for certain amounts of control or insight from the investor itself into the direction of the strategy.

Accessing the market through an SMA can capitalize on a manager's market experience, network, and resources. Importantly, because that account is "separate," it may not need certain components of oversight that a co-mingled fund may require, such as annual audits, administration, or valuation. This **can reduce expenses normally associated with managed funds.**

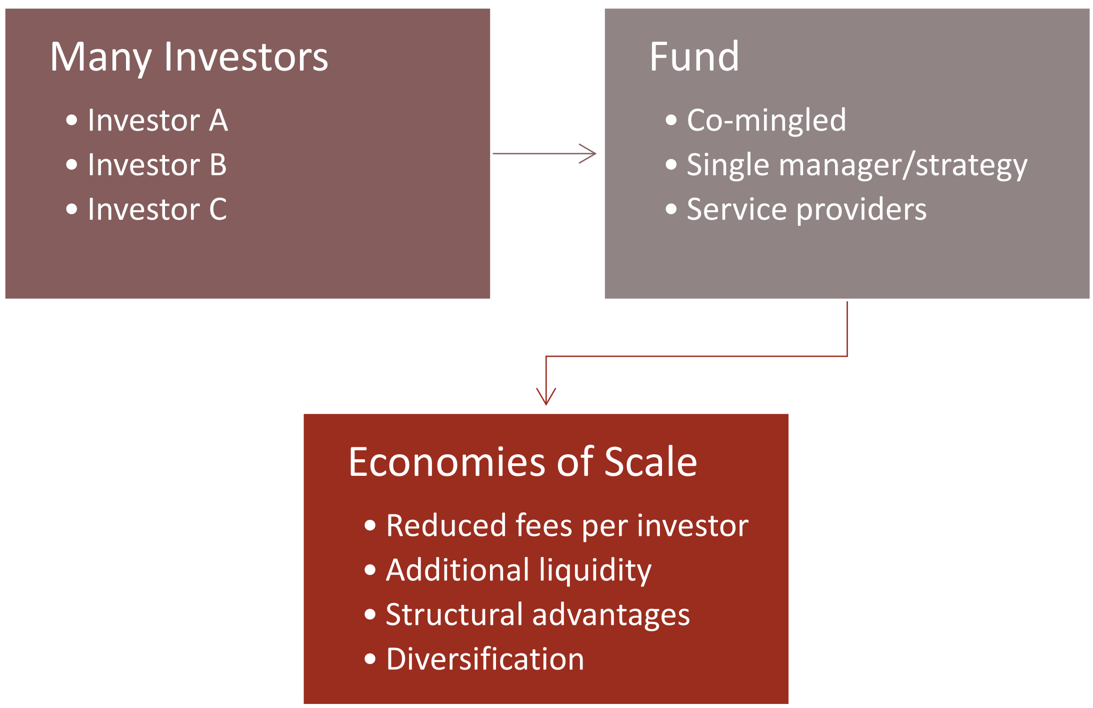
While an SMA is a common structure among hedge funds in the equity world, it is important to consider the issues this structure brings about with less liquid assets. Unlike stocks and bonds, each underlying asset in a portfolio of whole loans is different. So, while the strategy may remain similar, a separately managed account **may look different than a fund run by the same manager using the same strategy.**

Finally, because of the illiquid nature of these loans, leverage comes with more constraints – and thus at a greater expense – than would be required for an equity portfolio. Consequently, due to the expense of setting up leverage facilities, **levered SMAs usually require a high minimum investment size to be economically viable.**

C. FUNDS

Funds come in many forms, but with a **general idea of co-mingling investor capital to achieve diversification and economies of scale when investing in a single strategy.** Most funds in the marketplace lending industry are private funds, however there are now publicly listed and/or sold funds in both the United States and United Kingdom.

Funds almost always provide more liquidity than available with DIY or SMA investment methods. At worst, they should be able to provide the same liquidity. This liquidity will come at a market price or valuation price, which should be well understood prior to any fund investment.



The risk-return profile of funds can vary significantly and it is important to understand each manager's strategy when comparing funds. Strategies can vary by asset class, platforms, leverage, loan selection, and a variety of other approaches. Accordingly, the volatility of returns will follow suit.

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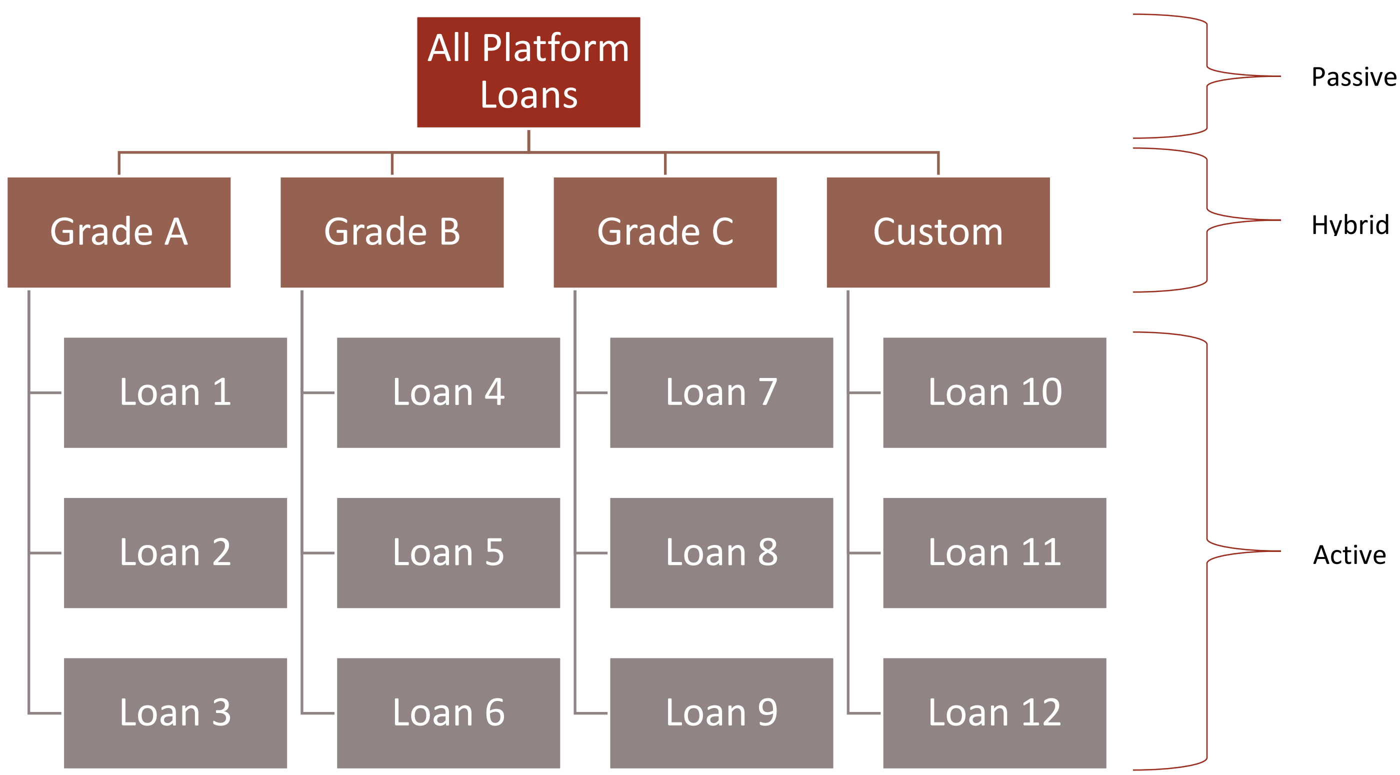
Significant advantages can come from proper fund structuring. First, service providers such as administrators, auditors, custodians, valuation agents, lawyers, banks, and tax preparers can provide incredible value toward protecting investors from risk. These **service provider expenses can also be drastically reduced as funds grow in size with pooled investment.** Second, managers can strategically structure funds to manage for a variety of constraints this industry brings with it, including valuation, taxation, and leverage. Finally, **managers should provide a significant amount of oversight of the portfolio,** especially on the underwriting, operations, and servicing. Keeping a close eye on changes to credit and underwriting by originating platforms, on the cash flow and reporting of loan payments, and on the servicing of the underlying loans cannot be undervalued when working with startup originating platforms in this industry.

III. APPROACH

No matter the investment vehicle, at some level there are whole or fractional loan purchases taking place that eventually flow through to your investment of choice. **There are three investment strategy approaches unique to marketplace lending loan purchases: passive investment, active investment, and a hybrid of the two.** These approaches are frequently discussed and debated as investors and originating platforms vie for investment control. Since loans are independent and non-interchangeable, they must be allocated or selected in a manner that allows for fairness and investment oversight.



A. PASSIVE LOAN ALLOCATION

A passive loan strategy involves a random allocation methodology by the platform in determining which loans go to which investors. In theory, random allocations should provide each loan buyer a truly random sampling of the loans being originated in a given period of time. This sampling should be reviewed and reconciled on a weekly or monthly basis to make sure negative selection is not occurring outside of certain margins of error.

While allocation fairness is the most scrutinized concern, changes to originator underwriting methodologies will also drive significant problems if left unchecked. Origination, underwriting, and pricing can be tweaked constantly by the originator across thousands of variables. With a passive allocation, investors must require extreme transparency from originating platforms to monitor ongoing credit changes. This should be tracked and reconciled with high frequency at both the portfolio and platform level.

B. ACTIVE LOAN SELECTION

Active loan selection is preferred by most sophisticated managers, allowing another layer of oversight on the initial underwriting. **Active selection allows, via a variety of methods, for loan buyers to actively and independently select which individual loans they wish to purchase from among all of those originated by the platform.**

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The challenge for originating platforms is in building a large and diverse investor base, often including their own balance sheet, which is willing to purchase the entire volume of loans originated. **Without this diverse investor base, certain types of loans may be avoided** and the platform may either be on the hook for those loans or might lose credibility by not funding a loan promised to the end borrower.

However, with a true individual loan selection marketplace, **the efficiencies that come from markets provide extensive value to the platform in the long run.** First, it helps define the true desired rates of return of the market as underqualified loans may not fund. Second, these market dynamics allow platforms to iterate on underwriting faster than trying to do it solely themselves. The crowd can provide extensive wisdom.

C. HYBRID SELECTION

There are a variety of hybrid loan selection models that often work well for platforms working to scale. The first and **most common option would be to allow investors to accept passive allocations from pre-defined credit buckets or grades.** While the investor is still exposed to variations on underwriting within these grades, they at least come with some level of confidence around more refined risk-return profiles.

A more advanced hybrid approach is for platforms to allow investors to define a "buy box." This essentially allows an investor to define their own credit bucket, but to accept a random distribution of loans that fall within that bucket. These buy boxes are generally limited to credit filters, through which an investor may decide to filter out all borrowers above or below certain credit scores, loan sizes, borrower attributes, and other credit metrics.

While not a perfect market option for investors, **maintaining certain pre-selected filters allows for a good amount of control against loose underwriting.**

IV. OTHER CONSIDERATIONS

When determining what method of access and investment approach to take in the marketplace lending industry, one must consider a variety of other issues that can affect the end investment results.

Two important considerations up front are in which asset class and which platforms to invest. As discussed in the previously published "What Is Marketplace Lending?" thought piece, unsecured consumer debt, student debt, small business debt, and real estate round out the four primary asset classes today. Each of these offers a **variety of risks and benefits, from collateral security to loan size diversification to history and track records.** Each risk must be considered carefully before determining with which platform to work within that asset class. With hundreds of platforms starting up, it can be **important to set some high-level parameters of platform history length, originated volume, or product type** before an investor or manager can narrow down choices and begin diligence. There should also be confidence that the platform will still be around in a few years to service those loans purchased, so **platform financial stability is a significant factor in platform diligence.**

As diligence and discussions begin with platforms, the notion of forward-flow arrangements will surely be floated. **Securing future investment capital and origination volume can seem opportune from both sides, but these type of arrangements come with significant risk.** Similar caution must be taken when adding leverage. Financing with any term on it will come with strict covenants and adherence requirements. But, when used together, forward flow and term financing can attempt to lock in favorable terms that come with longer-term capital.

> *"...when used together, forward flow and term financing can attempt to lock in favorable terms that come with longer-term capital."*

Diversification among platforms can quickly lead away from adding alpha toward an industry-wide beta strategy. If desired, **platform diversification – especially across asset classes - can mute volatility** more than almost anything else. However, platform diversification can quickly become risky if an asset manager loses the ability to monitor each originating platform with utmost scrutiny. A portfolio of many platforms bears the risk of the most risky platform within that portfolio, because one platform blow-up can wreak havoc on volatility and stability.

> *"A portfolio of many platforms bears the risk of the most risky platform within that portfolio…"*

Finally, taxation should be considered with each asset class, platform, fund vehicle, or bond structure. **Ultimately, investors should compare after-tax returns on every method of investment.** Differences in bank origination, seasoning, or even fund accounting can shift the after-tax returns significantly for both onshore and offshore investors. **Unfortunately, there are many ambiguities on tax law in this new and changing asset class, and legal opinions vary widely. All investors are encouraged to seek independent tax counsel prior to investing.**

V. CONCLUSION

Walking into this asset class without guidance and due diligence can be a risky endeavor. Fortunately, the marketplace lending investment space has grown significantly in the past few years. **Asset managers with deep industry expertise have begun to serve the largest and most sophisticated of institutional capital.** Service providers have matured in every aspect of the market, with competition finally driving pricing down and innovation up.

The process to invest in marketplace lending stems from first determining a method of access before strategizing about or accepting a given approach. With each of these two decisions, a variety of significant considerations must be taken into account. **There is no perfect way to invest and no absolute winner, but navigating smartly with proper advisers and educated managers is the best way to manage risk.**