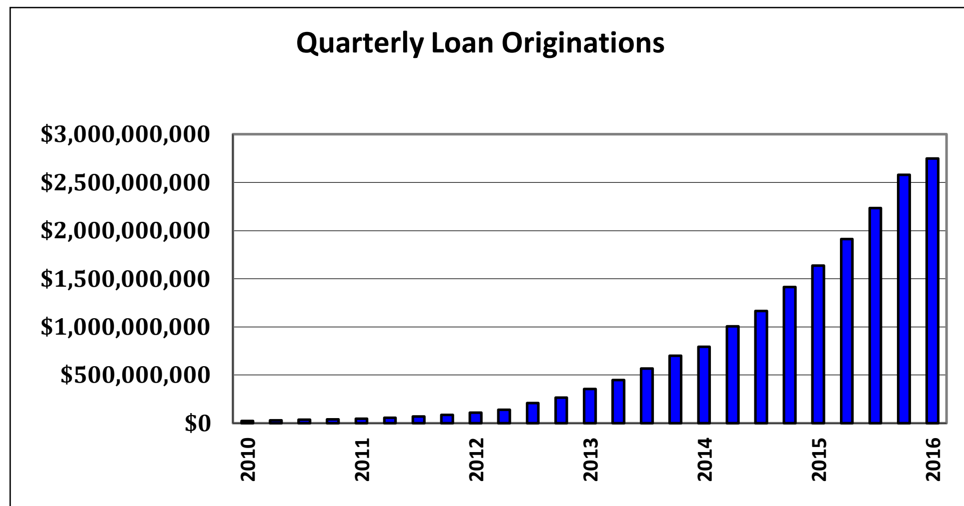
Overview

Lending Club is a leading player in the relatively new field of marketplace lending. Marketplace lending (sometimes referred to as peer-to-peer lending) involves a two-sided marketplace bringing together borrowers and lenders. Lending Club qualifies the borrower, sets the interest rate, and funds and services the loan. To the borrowers, this offers easier access to credit, at a lower interest rate. To the lenders (individuals, banks, insurance companies, hedge funds, etc.), this offers higher net returns in a new asset class. Lending Club, as the marketplace, carries no credit risk and earns money from a percentage of the loan proceeds up-front as well as from servicing fees.

Marketplace lending subdivides into many niches – student loans, mortgages, auto loans, medical financing, small business, etc. At present, the largest and most lucrative segment is unsecured consumer debt, Lending Club's main focus. The market for these types of loans is relatively young and growing rapidly, and Lending Club is the leader in this space.

Growth

Founded in 2007, Lending Club exhibited rapid growth. They had steady quarter-over-quarter growth in loan originations every quarter, from ~$8.2 million in Q1 2009 to ~$2.75 billion in Q1 2016. They turned cash-flow positive in 2013, had their initial public offering in December 2014, and turned GAAP-earnings positive in Q3 2015, as they continued to exhibit expanded margins and operating leverage from increased loan originations. Lending Club continued to experience substantial growth through the end of 2015 and Q1 2016, even as the broader online lending industry started to show signs of weakness and some competitors faltered.



However, despite the rapid growth experienced over 2015, the stock slid consistently from its post-IPO high of approximately $28 to a low of $7.10 at the close on May 6th 2016. Although we assess the post-IPO price of $28 to have been irrationally exuberant, the stock's continued descent in the face of steady execution and improving fundamentals was, in our opinion, an overreaction to the downside, leaving the stock undervalued.

Scandal and Aftermath

On May 9th, together with an excellent earnings report, Lending Club surprised the markets with the immediate resignation of Renaud Laplanche, the founder and CEO, and the firing of three top executives, due to an internal investigation into improprieties. Specifically, Jefferies (an investment bank who was working on the first securitization of Lending Club loans) was knowingly sold $22 million of loans that did

not fit their specific criteria. (The loans were the correct credit profile and price, but Jefferies had requested specific disclosures be made to borrowers and should have only been sold loans with application dates after the requested disclosure changes were implemented.) To make matters worse, $3 million of the loans had their application date falsified to match Jefferies' criteria.

The issue was discovered *internally* by Lending Club themselves and escalated to the CEO and the Board. The Board took decisive action. The three executives at fault were dismissed without severance pay. Although Laplanche himself was not implicated in the investigation (in fact, he launched it), the Board felt that he was not completely forthright with them during the investigation. In addition, it was discovered that Laplanche had recommended to the Board that Lending Club invest a small sum in Cirrix Capital without disclosing that he personally was a limited partner with Cirrix. As a result, the Board demanded and received his resignation.

The shockwaves from the scandal were felt immediately, both on the stock and the business, and indeed, the entire industry. The stock dropped more than 50% in a week, from $7.10 to a low of $3.50. At the same time, many institutional investors pulled back or ceased investing in Lending Club loans, drying up the funding necessary for them to continue loan originations at the same pace. Jefferies and Goldman Sachs announced a halt to their securitization efforts, and a number of banks announced a halt to their lending activities. A company like Lending Club lives and breathes based on investor trust and without investor trust there simply cannot be a two-sided marketplace between lenders and borrowers.

On June 28th, Lending Club held their annual meeting. They shared the final results from their sweeping internal audit and gave their outlook going forward. Three points stood out from the meeting. Firstly, with Q2 basically over, Lending Club guided Q2 originations to be down about one third from Q1 originations.

Secondly, after they spoke with hundreds of investors, Lending Club said that virtually all want to continue in some capacity, with varying levels of new due diligence required. Many have already returned, albeit at reduced levels, and all classes of investors (retail, hedge funds, banks, etc.) have returned. One particular asset manager (unnamed, but reported to be Stone Ridge Asset Management) finished their re-underwriting process and bought $200 million of loans since May 9th, with plans to buy $1 billion over 2016 and more in 2017.

Thirdly, Lending Club said that Q2 will include about $9 million in investor incentives (both institutional and retail) as a charge against revenues. They expect to continue these investor incentives into Q3 and no longer need them in Q4, and they plan to resume revenue and EBITDA growth in the first half of 2017. In addition, Lending Club is laying off 179 volume-based positions, 12% of their workforce.

Analysis

The scandal was a sharp blow to the business and will materially dampen company prospects going forward. Nevertheless, we are convinced that the market overreaction created a unique buying opportunity. Lending Club is now selling at a steep discount from what was already an overly depressed price. At the low of $3.50, Lending Club had a market cap of just $1.4 billion with $868 million in cash and securities and zero debt. The company as a whole was being valued at the ludicrously low figure of ~$509 million. Although the scandal and its aftermath will definitely depress growth and profitability temporarily, we do not see Lending Club as facing an existential risk, and we believe they will survive this and come out stronger in the long term.

The scandal itself must be put in perspective. The issues were internally discovered, were relatively minor (non-credit, non-price), were tiny in comparison with loan volume ($22 million out of $2.75 billion for Q1), and the CEO was not involved. There was a strong board, and swift, decisive action was taken. There have been no leaks or reports of poisonous culture. An independent accounting firm was hired to undertake a full audit of all loans and other aspects of the company, and no similar issues were found.

But more important than the events themselves is the loan investors' reactions to the events. Many signs point to the damage being serious but manageable. As previously mentioned, Lending Club guided Q2 originations to be down about one third from Q1. That equates to ~$1.8 billion in loan originations, down just over 4% from Q2 2015. This is not great when compared to the 68% growth in Q1, but it is not catastrophic either. It is important to note that more than 40% of Q2 had passed when the scandal broke on May 9th, so a large portion of that $1.8 billion was already booked pre-scandal. Taking that into account, and modeling a sharp decrease with the scandal and slow recovery thereafter, we conservatively estimate that the present run rate is down by as much as 40% compared to pre-scandal run rates. We do not consider that to fatally undermine Lending Club's business, and we expect loan originations to rebound relatively quickly within the next 18 months or so.

The underlying business model remains alive and well. Borrowers receive easier access to credit at a lower rate, and investors receive higher returns in a new asset class. As long as Lending Club continues to provide healthy risk-adjusted returns and assuage investor concerns, investors will gradually return. Indeed, they are doing so already. Lending Club and other industry players have indicated that investors are slowly returning. Media reports have also indicated that there remains intense investor interest in Lending Club loans. In fact, Bloomberg reported on July 14th that Jefferies is back to gauging investor interest in the securitization deal that precipitated the scandal. On July 20th, Reuters reported that Jefferies has in fact found sufficient investor interest and is well on the way to selling the full allotted amount.

Although some falsely compare this to a run on the bank, Lending Club is not a bank and does not have any debt. Lending Club is in control of much of their operating expenses and is pulling back on direct marketing to borrowers and other volume-based expenses, including the aforementioned reduction of 12% of their workforce. This actually compares favorably to the 28% that competitor Prosper laid off before the scandal and the 40% that competitor Avant has announced it is laying off.

Paradoxically, the scandal may actually strengthen Lending Club over the long term. The scandal sent shockwaves throughout the industry, affecting all their competitors as well. The nature of such things is that the weakest players are the most affected, leaving the stronger ones to thrive even more. In the end, the scandal may weaken some of their competitors fatally and leave Lending Club, with their leadership position and fortress-like balance sheet, stronger and better than before.

We believe that at these depressed stock prices, risk is muted and upside potential is enormous. Focus Capital Management initiated a position on May 16th at a price of $3.70 and has an overall average price of ~$4.00. We believe that over 1-3 years, we are likely to see a 2x-3x return, with significant potential for more. The essential business model remains strong, and Lending Club remains the leader in a fast-growing space which, despite the temporary slowdown, will resume growth and overcome the present challenges. Eventually, this will be a forgotten episode, and Lending Club's rising loan originations, revenues, and profits will yield significant returns for the patient long-term investor.