Bauerle's Bank Notes

Unfinished Business II

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We were not alone last week in thinking to compare neo-taxi company Uber with neo-bank Lending Club. This week's Barron's carries an article, "Take Out a Loan, but Don't Buy the Stocks," that weighs the investment value of Lending Club and On Deck Capital, another Internet lending enterprise that specializes in small business loans. Senior Editor and Uber fraud victim Bill Alpert wrote the piece. His May 18 account of phantom Uber rides through London was the jumping off point for our assessment of risks associated with Lending Club's business model. Since some readers were unable to access our last column due to a footnote formatting glitch, we have attached it here for your convenience Bauerles Bank Notes: Unfinished Business.

Alpert's focus, befitting a Barron's writer, is on the investment potential of Lending Club and On Deck Capital. The business opportunity is real, he argues. Valuation is another matter.

> In a world determined to use the Internet for everything but brain surgery, there's headroom for the [online banking] industry to take some share of the existing markets for credit-card debt, small-business loans, and mortgages, which account for trillions of dollars in the U.S. "We plan to enable about $7.6 billion in loans this year," says Lending Club CEO Renaud Laplanche. "That's essentially as much as our past eight years combined." Over time, Laplanche aims to offer a range of credit products, from auto loans to mortgages.
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> [E]ven at current prices, the two unprofitable online lenders trade at multiples typical of, well, Internet stocks. Lending Club's market cap of $8 billion is nearly nine times its tangible book value and 13 times the average forecast for next year's revenues, while On Deck's billion-dollar valuation is 3.5 times book and three times next year's revenue forecast.

Jamie Dimon of J.P. Morgan takes the competition seriously. "Silicon Valley is coming" to the banking industry, he says. We previously suggested the threat to existing banking businesses is threefold: erosion of volume and profit on loan and deposit business, a less costly distribution system that enables Internet banking platform companies to command a premium equity valuation, and freedom (so far) from legal regulation and its costs. These advantages are reflected in the table that ends Alpert's column. Titled "Valuations Any Banker Would Love," the table shows the companies' share prices as a multiple of earnings per share: 920 times for Lending Club and 74 times for On Deck Capital.

The last installment of this column focused on several risks of the Internet banking model. Here we look at how regional and community banks can address the competitive threat.

Embrace Diversity while Sharpening Business Focus. Not multi-ethnic diversity, although that's important too. Rather, recognize that middle market and small business customers have needs and opportunities that do not fit squarely within the matrix of bank credit policies. Successful banks have always served customers creatively in ways that nevertheless honor safety and soundness precepts. The last eight years have witnessed an ossification of credit policy as banks have responded to regulators' fears of repeating 2008. A return to common-sense-informed flexibility is essential for regional banks' lending business to prosper. Not 6x leverage; but 2-3x with covenant packages designed for good times and bad times too.

Lending Club and its kin will own the market for algorithm-driven lending. Regional and community banks must position themselves to serve those who either do not fit the algorithm or choose to live off its grid. Many industries offer examples of generalists and specialists that coexist profitably: grocers, brewers, restaurants and dry goods merchants. Banks must adapt to an environment in which competition exists in many forms.

Eliminate Pinch Points; Reinforce Safety. Jamie Dimon says Lending Club and similar neo-banking businesses succeed because they eliminate pinch points found in traditional bank relationships. A fellow bank consultant making a presentation to a group of Millenial Californians encountered an audience who said if they could not enter data into electronic forms, they were not interested in doing business. That experience made him rethink the way his company does business. Banks must do likewise.

As our last column noted, people have become accustomed to clicking through Terms of Service and other important disclosures, sometimes to their disadvantage, as Bill Alpert's Uber experience proved. Yet the perception continues that electronic financial services are not only more convenient, but just as safe as the traditional delivery model. Unlike Internet financial services companies, banks can and should sell safety as well as convenience. We take safety of our financial accounts for granted. We should not. The Internet is a haven for thieves. Many of them are domiciled outside U.S. legal jurisdiction and so cannot be brought to justice. Companies like Uber and Lending Club know it. That's likely why Uber refused to answer Alpert's question about how often fraudulent transactions like his take place. With no requirement to disclose the frequency or seriousness of fraudulent transactions, Internet financial companies are at risk of being fire departments with leaky hoses. Congress and the Federal Reserve are left to wonder whether when the alarm sounds, the firemen will have enough water pressure to douse the flames.

Don't Delay. The competitive threat of Lending Club-like businesses is a real and present danger. If Barron's is on the story, everybody knows it's a big one: bank stock investors, high net worth customers banks covet and everyone else. Years ago, market research for a $5 billion Pennsylvania bank revealed its most serious loan competition came not from the bank across the street, but from the Money Store, a consumer finance company whose ubiquitous "holy cow" media ads featured baseball Hall of Famer Phil Rizzuto. Bankers were shocked. Lending Club too is hidden in plain sight, on the Internet, the most widely used medium of communication today. Traditional banks must increase the speed at which they are converting their business model to meet the demands of the market.

In our bank consulting practice, we occasionally remind client, "In this business, you are either predator or prey; sometimes you are both in the same day." Bill Alpert's "Take Out a Loan, but Don't Buy the Stocks" is a cautionary tale no less than his earlier account of being defrauded as an Uber account holder. Regional banks retain the means and time to adapt in the face of this latest threat to their livelihood. Will they?

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