BLACKMOON
FINANCIAL GROUP

RETAIL DISCOUNT

I NEW BREED OF MARKETPLACES

Raising working capital has always been quite a difficult endeavor for a balance sheet lender focused on a non-prime segment. There are several ways to get working capital. For example equity investment is usually bundled with a debt investment. Another source of debt funding is private investment from HNWI. Those companies that scaled enough managed to get a securitized line of credit from a specialized company. The very few floated public bonds.

These four sources, namely PE&VCs, HNWIs, specialized debt-funds and bond investors, were essentially an exhausting list of available sources of working capital. Therefore recent emergence of two European companies that marketed loans issued by such balance sheet lenders to the retail investors was quite an interesting move in the industry.

These two companies are Mintos and Twino. According to Mintos[1] “Mintos is a peer-to-peer lending marketplace that connects investors with borrowers of various loan originators”. According to Twino[2] “TWINO is a marketplace for unsecured consumer loans from Poland, Denmark and Georgia”. These companies position themselves as marketplaces in a pure sense of this word, since the underlying is issued by another originator and the companies do not market these loans to the borrowers. It’s important to keep in mind that unlike traditional marketplaces the loans are already issued and granted to the borrowers, so it is essentially a secondary market for originators.

There is a twist however since Twino is a wholly owned subsidiary of Finabay, a group of payday lending companies active in Latvia, Poland, Czech Republic, Russia, Georgia and Denmark and sells exclusively the loans originated by the group. As for Mintos, the company started up as a peer-to-peer platform for mortgage loans in Latvia and still markets mortgage loans, issued by affiliated company under the brand of Hipocredit.

[1] https://www.mintos.com/en/about-us/about-us/

[2] https://www.twino.eu/about.html

One of the most interesting things about Mintos and Twino is an interest rate offered to the investors for personal loans, i.e. non-prime payday loans and cash installments. As of 9th of February 2016 every loan available for the investment on Twino was priced at 12.9% per annum[3]. Quite similarly Mintos offered investors 12.5% per annum for their exposure to this asset class.

Another important feature is a guarantee from the loan originator (Creamfinance and Finabay for Mintos and Twino respectively) to buyback all delinquent loans from the investor at a price equal to principal plus accrued interest.

COMPANY PROFILE

Creamfinance is an online consumer lending company focused primarily on payday lending in Poland, Latvia, Czech Republic and Georgia. According to the company's website the company was founded in Latvia in 2012 and has EUR 25M run rate revenue[4].

Finabay is an online consumer lending company focused primarily on payday lending in Poland, Latvia, Czech Republic, Russia, Georgia, Denmark and expanding to Mexico. According to the company's website the company was founded in Latvia in 2009 and expects to receive EUR 27.7M revenue in Latvia, Poland and Georgia in 2015[5].

REQUIRED RETURN, ECONOMIC PERSPECTIVE

Actually the presence of this buyback guarantee is the only reason why this asset could be priced below 13.0% per annum given that the underlying payday loans have three-digit APR, loss rate in teens combined with a ultra-short duration, since without this provision and with same pricing the investors were very likely to experience negative returns.

On the other hand such pricing combined with a buyback guarantee from the originator makes such investment essentially a loan directly to the company, since the investor takes the risk not of the underlying but of the originator.

In this perspective such a rate of return seems inadequate for such an investment.

[3] Except for one loan issued in Jan 2015 which offered 11.6% interest rate but had only EUR 7.77 available for investment

[4] Source: factsheet at corporate website

[5] Source: Twino website

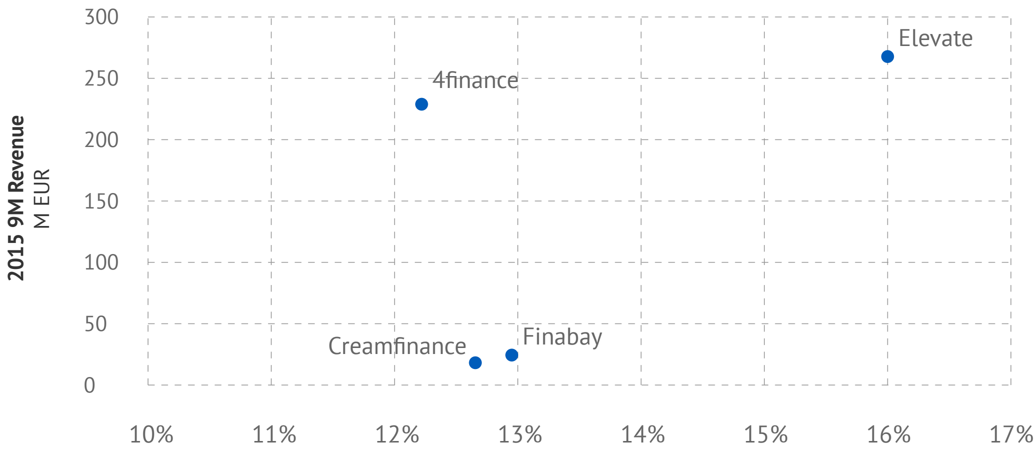
According to the multi-factor CAPM (capital asset pricing model) the required return of the asset is a function of the market risk premium, size premium and company specific risk premium:

$$E(R_i)=R_f+\beta(RP_m)+RP_s+RP_u$$

Assuming that Fin-tech non-prime consumer lenders have a similar sensitivity to the market risk, i.e. the same beta, one should expect that smaller companies would have a higher required rate of return.

CHART

Size vs Rate of return[6]



[6] Size is measured as revenue for 9 months of 2015.
Sources. 4finance: Revenue – company's 9 month interim report, rate of return – Bloomberg yield quote on last trade for USD 200M bonds on Irish Stock Exchange. Finabay: Revenue – 2015 forecast provided at TWINO adjusted for 9 month period, rate of return – loans available for investment at Twino; Creamfinance: Revenue – factsheet at corporate website adjusted for 9 month period, rate of return – loans available for investment at Mintos; Elevate: Revenue – S-1 filing converted at 1.12 EURUSD rate, rate of return – S-1 filing.

COMPANY PROFILE

4finance is an online consumer lending company focused on payday loans and cash installments in Argentina, Armenia, Bulgaria, Czech Republic, Denmark, Finland, Georgia, Latvia, Lithuania, Mexico, Poland, Romania, Spain, Sweden and the United States. The company was established in 2008, has EUR 229.3M in 9 months' revenue, listed public bonds with a face value of USD 200M on Irish Stock Exchange and SEK 375M on Nasdaq Stockholm, and holds B3 rating from Moody's and BB- rating from S&P.

Elevate is an online consumer lending company focused on payday loans and cash installments in the United States and the United Kingdom. The company was spun off Think Finance in 2014, which in turn was founded in 2001. Among company's equity investors are Technology Crossover Ventures and Sequoia Capital. According to the pre-IPO S-1 filing the company's revenue was USD 229.3M in 9 months of 2015.

Nevertheless the evidence shows that less scaled companies raised money through marketplaces at less than 1% premium to yield to maturity of 4finance senior bonds listed on the Irish Stock Exchange with B3 rating from Moody's and BB- rating from S&P and at a considerable discount as compared to Victory Park senior over-collateralized debt facility to Elevate.

COMPARATIVE ANALYSIS

One could argue that it is a value proposition of a marketplace to offer better interest rate to the borrowers that are consumer-lending companies in this case. But it has never been a value proposition of a marketplace to do so at cost of the investors. Each of 4finance and Elevate offer better terms to the investors.

First of all 4finance bonds are senior to any other debt of the company, that means the bondholders will be first to get their capital back in case of 4finance financial difficulties. Bond placement was run by a notable investment bank, Credit Suisse, that produced extensive investment memorandum on company's business and strategy, and the bonds were rated by two of three global major rating agencies. Moreover bond placement comes with covenants on the amount of leverage the company could get with a put option for the investors should these covenants be breached. Additionally 4finance regularly publishes interim reports and audited financial statements and constantly communicates with the investors. Finally the majority of the bondholders are institutional investors that have better research capabilities than an average retail investor.

Elevate and Victory Park Capital deal is even more advantageous for the investor. The credit facility is senior to any other debt. The loan is granted to a special purpose vehicle not the company, with a guarantee and lien, transparency and control of the lender. The funds are not used to cover operational expenses of the borrower but solely for the purpose of funding the loans issued to the customers. Moreover the SPV is over-collateralized. That is the fair value of the portfolio substantially exceeds the amount lent by Victory Park. The covenant is dynamic and as a rule is set in 75-85% rage of the portfolio value. As for the information rights, Victory Park conducted a throughout due diligence before the investment, company's management is obliged to provide weekly updates to the investor and Victory Park research team reviews covenants as well as the portfolio structure and performance on the ongoing basis.

Investment opportunities offered through Twino and Mintos marketplaces don't provide such benefits and credit enhancement for the investors to justify less than 13% rate of return. Marketplaces provide neither relevant statistics on the performance of the underlying like historical charge-off curves or cash on cash vintages nor the necessary information on the customers that took the loan like debt to income ratio, loan count, credit history, occupation, etc. like other marketplaces generally do.

Despite the fact that both Twino and Mintos publish originators' financials admitting that ultimately it is the company's credit risk not the underlying, this data will not suffice for proper research of the originators' financial position.

Information on Twino "includes FINABAY group operations in Latvia, Poland and Georgia"[7]. That is only 3 out of 6 countries of operations, which one could not claim to be a consolidated financial statement. Same is true for Mintos, since only data for Creamfinance Georgia is provided.

Secondly this information is very high-level. Neither marketplace publishes cash flow statement of the originator, which is necessary to assess ability of the company to honor the buyback covenant. In addition data on Mintos provides no information on the originator's balance sheet structure. Both platforms provide aggregated profit and loss statement down to EBITDA (earnings before interest, taxes, depreciation and amortization), which is not an IFRS measure and is meaningless for a financial institution since interest expenses are part of the cost of doing business.

Finally the financial information is unaudited. Therefore investors have to put their trust into marketplaces to conduct independent research and not to be prone to conflict of interests, which one could expect to be, since platforms' revenue comes from the originators they partner with. This potential conflict of interest is even more pronounced for Twino, since the company is a subsidiary of Finabay.

Therefore one could conclude that from the information perspective investors on Twino and Mintos are disadvantaged as compared with the investors of 4finance or Elevate.

Same is true for the bankruptcy provisions, since the loans which could be considered as a pledge for the investments through Twino and Mintos, are still retained by loan originators. And there is no guarantee that these companies have no senior or preferred borrowings. Should the buyback guarantee be not honored by the Originator the investors will experience negative returns since low interest rate combined with ultra-short duration on performing claims will not compensate for the losses of non-performing ones.

To sum up it seems that consumer-lending companies with substantially smaller balance sheets are able to raise working capital at comparable or even more favorable rates with little to no credit enhancements and special or information rights to the investors.

[7] Source: Twino website

RETAIL IS THE ANSWER

Essentially investments facilitated by Twino and Mintos are private balance sheet loans to alternative lenders and these marketpaces could be considered as platforms for enterprise lending in the niche of Fin-tech companies, rather than consumer lending marketplaces.

The only explanation for such a risk-return mispricing is the fact that 4finance and Elevate investors are sophisticated institutional ones while Twino and Mintos target EU retail investors.

Given near-zero interest rates in euro zone, quite modest growth rates in the region and poor performance of stock and bond market retail investors are left with little options to allocate their assets.

CHART

1 year European stock and bond index performance[8]

EURO STOXX 50 equity index
3.05% 1 yr return

Bloomberg EUR Investment Grade European Corporate Bond Index
-0.39% 1yr return

[8] Source: Bloomberg

Therefore Mintos and Twino have a good value proposition for the retail investors. In 2015 the companies facilitated EUR 8.9M of balance sheet loans to payday lending companies. It is important to highlight however that given ultra-short duration of these loans total committed capital is smaller, due to high turnover and constant reinvestment.

CONCLUSION

Investment opportunities with a buyback option from loan originators facilitated on Mintos and Twino marketplaces are essentially balance sheet loans to these alternative lenders packaged in the form of peer-to-peer consumer lending. Given the size of companies and little information on the originators these investment opportunities don't seem to provide investors with sufficient return to compensate for the risk being taken. Nevertheless unsophisticated investors take these risks given the long-lasting period of near-zero rates of return for their investments.

On the other hand these consumer lending companies are advantaged since they are able to raise capital at less cost as compared with the options they could get from more traditional sources like PE&VCs, HNWIs or specialized debt-funds.

This situation suggests the presence of the retail discount. Which is inefficiency according to the capital asset pricing model since sophisticated investors would not opt to a more risky investment without additional expected return to compensate for this risk.

Therefore one could expect that with current pricing, risk management and information policies these newly emerged marketplaces would attract only unsophisticated private investors, while institutional ones would require additional return and more advanced investment structures for their allocation to such asset class.