PODCAST TRANSCRIPTION SESSION NO. 136-DON DAVIS

Welcome to the Lend Academy Podcast, Episode No. 136. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of LendIt,

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Peter Renton: Today on the show, I am delighted to have Don Davis. He is the Co-Founder and Managing Partner at Prime Meridian. Now Prime Meridian are an investment management firm focused on the marketplace lending space, they've been around for many years and in fact I had Don on the podcast back in 2014.

It's been almost four years since then so I wanted to get him back on the show to talk about how he has been able to grow his company, how he's been able to diversify his offerings and what his thoughts are on the space today, the marketplace lending space has changed a lot, we talk about that. We talk about the due diligence he does on new platforms, we talk about the pullback in 2016 and how he was able to survive and thrive during that time and we talk about what the future holds. It was a fascinating interview, I hope you enjoy the show.

Welcome back to the podcast, Don.

Don Davis: Thank you, great to be here.

Peter: Okay, so I went back and looked, it's been almost four years; it was April of 2014 when we last had you on so a lot of people probably don't know a lot about you so maybe you can start off by giving us a little bit of background about yourself.

Don: Yeah, sure. So I've been involved in finance, in one form or another, for the past 20 plus years. More recently in 2004, I founded Novus Investments which was an alternative investment management firm and we were registered as a CTA as well as an Introducing Broker since we allocated to other managers as well. In 2008, the one strategy that I managed and traded produced a positive double digit return for our investors and by 2012, I had been ranked the number one CTA in the US for total performance.

Peter: Nice!

Don: Thank you...three times over a five and seven year period. Everything was going great, I mean we were doing well, killing it, except for the fact that we had two clearing firms we worked with that suddenly went bankrupt, which as you can imagine makes things a bit difficult.

Peter: Right.

Don: But in hindsight, the timing was good as I already had a watchful eye on the burgeoning P2P marketplace lending space and the pivot has worked out quite well and here I am today.

Peter: Alright, so then when exactly did you start PMI and tell us about how marketplace lending got on your radar.

Don: Yeah, so I had been watching it closely with great interest prior to the launch and also while I was running Novus, my partner, Val Katayev, was very active in peer to peer lending being one of the very first lending investors at Prosper in March of 2006.

Peter: Wow, that is early.

Don: Yeah, it was two weeks after they opened up for business.

Peter: Right.

Don: He saw an article in the The New York Times…it was either The New York Times or Wall Street Journal and he opened up an account immediately, but he built up a sizable portfolio. It held up incredibly well during the Great Recession and then a few years later, after he had another successful exit from one of his businesses, he was looking to get involved in this space in a more meaningful way so we eventually hooked up and became partners.

Prime Meridian was started in April 2012, Val started off as an early investor in our first fund and then he later bought in as a more material partner and active member. As far as why the firm was started, you know, it was started because I'm a believer in the industry, first and foremost, and I sensed that there was great potential to build a scalable business over time and also to provide an attractive alternative for our investors.

Peter: Yeah, me too. I've been a big believer from day one as well. So back when we had you on four years ago, I think you just had the one fund and now it seems like you've expanded your offerings. Tell us a little bit about the expansion of your company over the last four years.

Don: Yeah, so by intention, you know, we have built up a family of four different strategies and that was by design. You know, I think that great businesses of all industries are led by great people, managing great products and you've got to have the right process, of course, as well. So it wasn't just about having a single fund for us from day one, this was really a vision that we had early on is, let's show that we can demonstrate, that we can produce something successful and that works and let's build off of that success and build up different product lines for different investor needs.

And so our funds are limited to accredited and qualified investors so we can't naturally go into too much detail, but we do cover all the major verticals including consumer, small business and real estate. You know, one of our funds is leveraged by intention for investors that are very comfortable with the space and they want a leveraged return. The other funds are intentionally unlevered so zero leverage, just sort of a clean transparent diversified fund in each of the major verticals.

Peter: Okay, so then can you share the scale you guys are at? What is your total assets under management today?

Don: Our total AUM is approximately $650 million today and that's all in marketplace loans in the industry, our minimum investment is $500K, you know, again, it's accredited and qualified investors and that AUM has grown quite a bit since the last time we did the podcast,

Peter: Yes, it has indeed. So then can you just give us a sense of the type of investors that are coming into your fund and how that's changed over the last four years. Is it high net worth individuals, I mean, who are the people coming into your fund?

Don: Sure, so as our AUM continues to grow, naturally so does the average size of our investor, hence, in the early days it was the individual high net worth investors and some smaller registered investment advisors. These days it's the family offices, the fund of funds and institutions that we are mostly talking to. We have large asset managers around the world, single, multi-family offices, fund of funds, institutions, you name it.

Peter: So I'm curious about how your conversations with these investors has changed. Here we are early 2018, the industry has been around for over a decade and a lot of people know about the major players in this space so how would you say...when you're talking with potential investors, how has the conversation changed today from what it was like, you know, two or three years ago?

Don: Well first off, investors have gotten much more educated and sophisticated on this space, which I appreciate. It often makes conversations easier because those are the conversations I like to have. Sometimes though it does make things more inefficient and difficult because a lot of investors out there are getting fed bad information and false narratives and one example of that is that the underwriting has gotten worse in 2017 at major consumer platforms...

Peter: Right.

Don: …which simply isn't true. The data point that some of these investors are being fed by some people out there is they'll show the index, let's say of like a Prosper or Lending Club in 2015 and 2016, you know, the index which has the index return and the index default rate and the loss curves and then they show that index for Prosper and Lending Club for 2017. What you see is you see delinquencies and the default rate is a little bit higher in the loss curve in 2017, but here is the part that they're missing, that is that the components of the index have changed.

Peter: Right.

Don: So if you remember, I think in 2015/2016, Prosper for example, 40% of the index was A's and AA's. Super prime borrowers made up 40% of the passive index and that's because some of their big investors wanted that. Now it's a little bit more evenly distributed with less AA's and A's so now the index is a little bit more diversified so you have a higher WAC, weighted average coupon and you have a little bit higher delinquency and default, but the net return is also higher. That's how I think investors can take a statistic and be misled into a false narrative if they're not getting the whole story.

Peter: Right, right, we've certainly seen that. I write about my own personal returns every quarter and they're not where they were a couple of years ago although we're starting to see some of the later 2017 vintages actually seem to be doing better. I think part of it is they've increased, as you said…like in 2015, we all remember it was just a crazy time back then when there was just so much investor money sloshing around the industry that they felt like they could...as you said, Prosper had all this demand for this low interest paper and so interest rates came down.

You've been around for a long time, 2012, 2013, I mean, you could get double digit returns, I wouldn't say easily but they were certainly available. I think back then...we're not going to go back to that anytime soon because they've reduced their rates and then they've increased them again. Now it's probably back to a more fair level, would you say?

Don: It depends on how you define fair (Peter laughs), but yes, I would agree in large part with everything you said, correct.

Peter: So then can you share the names of the platforms that you're investing on today? You mentioned the three different verticals, can you share some names?

Don: Yeah sure, absolutely. So on the consumer side, we work with the three majors, Lending Club, Prosper and we do a little bit with SoFi on their consumer loans, not on student loans. Those are the three biggest consumer originators in the US.

In small business, some of the names we work with are Biz2Credit. Lending Club Small Business, Funding Circle. So those are some of the firms we work with there. On real estate it's Sharestates, Patch of Land, LendingHome, Money360 are some of the names we're working with there and we are always on the lookout for other platforms as well.

You know, from day one, we never wanted to be a guinea pig for anybody's platform (Peter laughs), we don't like really small ones, we don't like some of these small balance sheet lenders out there especially which I think bring in different types of risks, you know, you have a much higher tail risk when you're working with some of those types of lenders. So we prefer really strong marketplace lenders with strong balance sheets, really strong management that also have strong growth.

Peter: So then just on that, that is an interesting point, how would you...obviously you've brought on new platforms over time, you talked about some of the larger names, but they weren't all around a long time ago so I'm curious about the process that you go through. You gave a little bit of a hint there, but can you go into a little more depth about what you do to due diligence a new platform.

Don: Yeah, so, you know, again, just segue off of what I said, it's really just getting to know the management inside out, we want to know the management's background. They need to have underwriters, a strong underwriting experience, they need to have a background in what they're doing today. You had a lot of smart people enter the industry on the originator side and on the fund management side over the years. I could testify, a lot of very smart people, I will definitely testify to that, but they all had varying backgrounds. Some were just someone who worked in the tech industry or some worked in this industry, so they had one area of success in their life but they didn't have a lot of experience at maybe being a fund manager or being an originator or being an underwriter.

So I talked about that I think early on at some of the LendIt conferences and so forth, on panels that I had some concerns about some of the people entering the space that if they don't have a lot of the right experience or the right team that at some point I think that's going to lead to some issues and problems. So one of the things is that, you know, who's doing the underwriting and what's their background, what have you been doing the last 10/20 years? It seems so elementary, but again, you'd be surprised at some of the answers to those questions with some of these originators.

So we want to know the background, there has to be a lot of depth and expertise there, they have to be solid, they have to have a really strong balance sheet. I don't want to do business with anyone that I think might be going under in the next six months. They have to have institutional internal controls or at least be halfway there with very strong internal controls, you know, who's their auditor, they have to be willing to work with our auditor for look through testing.

In the early days, that was a little more difficult than it is today and with some of the smaller guys that sometimes can be cumbersome so they have to be willing to do that and they have to pass our look through testing. So there's really just a checklist that we have just like investors will have a checklist on doing due diligence on us, we have that with these platforms and they really have to check all the boxes. At the same time, I do want to add that we can't be too picky or perfect with our due diligence requirements because if we were that way in 2012, we wouldn't have even launched. (laughs)

Peter: (laughs) Right.

Don: I mean, the real big issue in 2011 and 2012 for me was really on platform risk and on, you know, do you have bankruptcy remote segregation of assets with a backup servicer because I had very real experience with two clearing firms going under and so I was pretty nervous about that type of tail risk.

I remember one of the first questions I asked former CEO, Renaud Laplanche, at Lending Club is what happens to our clients' assets when you guys go under. This was in 2011 and he said, well we don't plan on going under (Peter laughs) and of course, I said, well neither did Lehmann and neither did Bear Stearns and neither did MF Global, nobody plans on going under. So I said, well when you have the answer to that question I think we'll start doing business and it was in 2012, actually Prosper was the first...

Peter: I remember that.

Don: ...to launch bankruptcy remote segregation. They rolled in all the existing notes into that and that's when we felt comfortable, that's why we started off with Prosper only in the beginning for that reason.

Peter: Yeah, I remember that, that was back in the day when Prosper…you could tell who was investing on the platform, not names, but everyone had a screen name. You could see who were the large investors and what they were investing in. It was a fascinating time.

Don: Yeah, oh yeah, we used to do some reverse engineering to see how we were performing compared to the competition.

Peter: Right, right. There were only about three or four institutional investors back in those days, then they removed the screen names and all the transparency which was probably fair enough, but it used to be fun looking at all of the different loans and strategies that people were adopting, it was fascinating. Anyway, we digress.

Don: Right.

Peter: So I want to talk about...like there's been some consolidation. I think I remember hearing you talk about it on one of the LendIt panels a couple of years ago that...I'm sure you've done due diligence on some of these platforms that have gone out of business and I'm just curious about the...I mean, it's not surprising, we all knew that there was too much money going into some of these ideas that probably should never have been funded in the first place, but then what would you say are some of the common themes that led to some of these platforms' demise? I mean, is there something that we can all learn here from like....you talk about your due diligence process, that you said no to a platform, what are some of the things that maybe people can sort of glean from your knowledge about why companies go out of business?

Don: So first off, I'll start off by saying and I think you were at the conference with me just a few months ago, Peter, I remember seeing you, but I was on a panel. We talked about this and I think it's a good intro. You know, First Associates had said publicly that over the past 12 months they have taken over backup servicing on nine different originators. Now of those nine originators, just over the past 12 months, nine originators have failed that they had to take over servicing for. Of those nine, one of them was a small marketplace lender and the other eight were balance sheet lenders.

So first and foremost, that was kind of a thesis that I think that I had right a few years ago as I was talking about that. There were a lot of intelligent people that were disagreeing saying, oh, the balance sheet lenders that have skin in the game...they're better underwriters, they're better to do business with than marketplace lenders. The problem is, first and foremost, what causes a lot of companies to go out of business is leverage, excessive leverage and therein lies the problem with a lot of these balance sheet lenders is that they're using excessive leverage.

So there are balance sheet lenders out there that are using 100% leverage, I mean, they have none of their own skin in the game and it's all borrowed skin that they're paying very high interest rates on to just leverage the book. The ones that do have skin, it's a very small piece, usually maybe 5% at most that I've seen. So excessive leverage, that's what caused MF Global to go under, that's what caused Lehmann to go under, it's what caused Bear Stearns to go under, it's what caused Long Term Capital Management to go under back in 1998 so I think that is the biggest issue right there.

And then with the others, with the one marketplace lender, I just think with marketplace lending the challenge is…so the benefits to balance sheet lending is that you can…whatever is going to happen, I think it's going to happen quickly so it's easier to make a profit because you're taking all of the return and you're leveraging the return.

So if you're very disciplined at money management and you're very disciplined at living beneath your means and managing your expenses and you grow, you can make good profits in short order, but you're at a higher risk. With marketplace lending it takes much longer and much more resources to scale, right, so you're losing money for long periods of time because your margins are thinner, but I think it's easier to survive.

Peter: Right.

Don: As you can see in 2016, we had the headaches with Lending Club, Prosper and so forth. In fact, if you think about it the three largest originators in consumer, all three have had their CEOs ousted in the last 18 months.

Peter: Right, right that's very true.

Don: Right, all three of them, in my opinion, are going to be around for many years and so that just goes to show you they survived, but if you have a balance sheet lender that maybe has the CEO ousted...like there was a very large balance sheet lender that did, usually they're in trouble. So on the marketplace lending side if you're too small and you're just not growing fast enough then, you know, that's where I think you're going to get pressure and the one that went under, I think that's exactly what happened.

Part of our due diligence we did on them in just really, in the months before they went under, before it was known they were going to go under, you know, I just...everything was looking okay, but I just…it was more of a qualitative type of due diligence where I sensed there was some desperation there and I think when people get desperate, the end is near.

Peter: Yeah right, makes sense. So I want to talk about...you mentioned the pullback in 2016, even before the Renaud Laplanche exit from Lending Club, there was definitely some pullback on the investor side. How was that for you guys? I imagine you had some nervous investors after the Renaud Laplanche episode, but how was that time period for you?

Don: So customer service certainly spiked up.

Peter: Right.

Don: Our hours of customer service went up significantly after that. There had to be lots of discussions, emails, you know, investor letters and individual emails and individual phone calls and conference calls. So that goes up during times like that and really the biggest concern was are they going out of business and how's that going to affect my investment with you and is it going to have any impact on the loans and how are things performing and what does the next three months/six months look like.

You know, those I think were some of the common and naturally, rightfully so and so all of the customer service went up. We really didn't get many redemptions at all, you know, on a percentage basis it was very, very little, low single digits in redemptions and even better than that was we had a lot of new deposits coming in.

I think part of what has helped us too is there has been some consolidation in the industry and there were some other funds out there that struck gold, and some of them went out of business and so because of that, you know, I think when you have fewer funds remaining then I think there's fewer places for investors to allocate. So that I think actually helped us pick up our AUM growth after that happened.

Peter: Sure, so I want to get your view of the marketplace lending space today, I mean, we've come a long way, but it hasn't been a smooth ride. We had the go-go days of 2015 and then the pullback in 2016 and 2017 was more sort of focus on profitability and getting your house in order so where are we today? Give us your sort of take on where the industry is today.

Don: Yeah, I think I'm optimistic on the industry, I have been since day one, I was mildly optimistic in 2011/2012, by 2014/2015, when everybody was giddy, I was mildly optimistic (Peter laughs), I was probably one of the least optimistic people in 2014/2015 and then after 2016, when people started getting less optimistic, I'm still really the same, but it’s for different reasons.

First and foremost, I'm not married to any industry, I'm not married to any asset class or any strategy. It's really if a strategy is totally not working or the industry is falling apart or doesn't look good, you know, then it's time to pivot and do something different for our investors or change the strategy so we don't see that. Just because returns have drifted, just because you've had some vintages in late 2015/2016 that underperformed, the vintages before that and after that, that doesn't make the asset class bad. Just because you've had some issues with one company or another that doesn't make the industry or the asset class bad.

So overall when we look at this industry and we compare it to...on a relative basis, it's still very attractive, we still think it gives a very attractive alternative to other fixed income investments out there so we really like the industry a lot. That being said, you know, over time great fund managers do need to evolve, you do need to always be on the lookout for where is the industry evolving and what's the next niche and what's the next vertical and so we definitely have lots of those talks and discussions internally about how we can always be one step ahead of the game.

Peter: So on that, what areas do you like most and what do you like least, shall we say.

Don: So over the past...you know and this is one of our newer funds, it covers the real estate vertical so that's an area that we've had some interest in for a few years. We watched it very closely for about a year before launching, that vertical I like a lot. I think it's very interesting, it's a little bit different than some of the other verticals in how it operates and the type of borrowers and the type of loans, etc. so that's one I like a lot.

Even then though, what we're seeing in this current market is that as LIBOR is on the rise and fed funds are on the rise, you see consumer rates going up, but in some of the other verticals, like small business and real estate, we don't see that happening. We see yields either holding tight or even drifting down because of investor demand and so even though I like that space a lot, we keep a watchful eye, we have lots of discussions with the originators on that because I think one thing that a lot of originators miss that is most important for long term success, in my opinion, is that it's all about borrower experience and investor return.

I think that most originators, even the big names, forget that; borrower experience and investor return, because the vast majority of borrowers, they want the best experience, the best service, they want the fastest turnaround and if the interest rates are a point or two higher or lower, I don't think it's a show stopper for the vast majority of borrowers.

Peter: Right.

Don: But for investors, it's about investor return, you know, so if you can have the right return for the investors and have outstanding borrower experience that's going to be I think a long term success story for originators that are focused on that. And I think sometimes, originators they just look only at how can we facilitate more volume in the easiest, fastest way which usually means lowering returns.

Peter: Right.

Don: And so one of my concerns is that we do not want to see any of the real estate originators make the same mistakes that the consumer originators did…

Peter: Yes.

Don: ...you know, a couple of years ago. So that's what I like the most, but I have some concerns on that topic.

Least I would say student loans, I probably like the least; maybe some of the auto paper. You know, some parts of auto are interesting to me, and some parts I don't like a lot like if you're buying a brand new car as a prime borrower. I don't think that's very interesting at all and student loans, we've never had an interest in.

Peter: Right, right, and that's just because of the yields, I presume?

Don: Yeah, well it's yield and also it's tail risk and, again, tail risk is what I think a lot of investors overlook and so you may have, many, many, many years of low defaults and low delinquencies, it looks wonderful on paper, but tail risk is very difficult to quantify based on looking at statistics. I think there's a lot of tail risk in student loans because with student loans...you know, there are people out there, very smart people out there, very successful investors that say...that have said publicly that student loans are in a bubble and have been and it’s a disaster waiting to happen.

And so it's very heavily politicized, politicians talk about it all the time, about giving students a break and extending their payments and giving them holidays and doing whatever it takes to never let them default and so as an investor I just think that's a big tail risk, it's kind of sloppiness, it's a different type of treatment than most of the other forms of credit and it's low returns to boot.

Peter: Right.

Don: Not my type of product.

Peter: Understood, understood. So we're almost out of time, but a couple of more questions I want to ask. I noticed you were on the Inc. 5000 list of fastest growing private companies in America last year and obviously you've grown tremendously since our last conversation, so what are the things that you can point to that have helped you grow your business the way you have.

Don: Thank you, yeah, and we also, I want to point out we also made the Bay Area, San Francisco as well. We were number 14 on the top 100 San Francisco list which is very humbling and exciting as well.

Peter: Congratulations!

Don: Thank you, like Salesforce and other big names here in the Bay Area have graced the pages of that list before. And, again, we were on the Inc. 5000, as you mentioned, and this is of all industries, all companies, all industries in the country and in the Bay area. As far as what I can point to, you know, it's having the right team, first and foremost, having the right team. We have great people that all work very hard and we all share the same goals and we have great products in this space, we're very dedicated and focused on this space, we do a great job of portfolio management and risk management, so I think we've done a good job for our investors and we work hard just getting the message out there.

From day one, early on, and you've been the same way and I think I've learned from some of the others in the industry as well, but it's about education for us. So when I'm out there, you know, speaking at a conference, or out there participating at LendIt, for example, I'm not thinking, okay, how many lead cards did I get and who's signing up for the fund today. I'm thinking about, I love what I do, I'm having fun, it's education, it's information and it's just putting ourselves out there. So I think by doing that regularly, year in and year out, we gained a lot of exposure and that exposure has helped us grow pretty significantly as well.

Peter: Okay, so final question then, what's next for you guys? What's your vision for Prime Meridian going forward?

Don: Yeah, so we have a couple of exciting things in the works for 2018 and don't want to give exactly what it is at this time, but I would say, you know, keep your eyes out for another potential fund launch later this year which is going to be something very unique and very different than what we're doing right now and totally uncorrelated, but yet still in the credit space. So I think that's going to be very, very exciting and it's just a way to evolve as a company and as a firm and continue to build upon our great brand and add additional product lines for our investors and expect continued growth.

We're also investing significantly in machine learning technology to continue to have next generation analytics and predictive modeling on all of our funds, and all of our verticals and so we have some interesting things going on right there. You know, we're always looking to stay one step ahead of the game and how we can have an edge and as a reminder, you know, we are active managers, we don't just buy passively and randomly from whatever the originators decide to originate and so between those two things I think it's going to be an exciting year and we expect continued growth. Based on our pipeline and our projections, we're expecting to hit $1 billion AUM by Q3/Q4 this year which will be very exciting.

Peter: Okay, it will be exciting. I'm very curious to find out some of those things. Anyway, it's always great to chat with you, Don, thanks for coming on the show.

Don: Thank you, great chatting with you.

Peter: Okay, see you.

Don: Bye.

Peter: Bye.

I just want to go back to that point that Don made earlier about the two most important things, borrower experience and investor returns, and I really feel like we have created this industry that's incredibly complex and there's so much going on and when it all boils down to it. it's a two sided equation, you've got the borrowers and you've got the investors.

If borrower experience is not great and that includes interest rates and how you kind of interact with the borrower during the application process...if that isn't great, you're not going to be able to thrive and at the same time if investor returns go down then you're not going to be able to attract new capital and it's really as simple as that. The companies that are continuing to thrive are those that do well on both sides of the equation.

Anyway on that note, I will sign off. I very much appreciate your listening and I'll catch you next time. Bye.

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