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INSIDE

Alternative Finance: It All Begins with Customer Acquisition

Commentary & Analysis by Sasha Grutman, Middlemarch Partners

Being a successful lender requires firms to do a few things exceptionally well — acquire potentially profitable customers at the right price; select borrowers whose risk of default appears manageable; make sure those borrowers pay their loans; and source lending capital at a cost that allows a lender to make money.

As a financial services-focused merchant banker, we've learned that very few firms do these four things well. But the firms that do source, underwrite, and collect well are rewarded handsomely. They grow quickly. They have large margins. They secure the lowest-cost capital. And ultimately they are the companies that get acquired at rich premiums.

While each of these key capabilities are important, we have observed that today's online consumer and commercial lenders have frequently elected to acquire customers from 3rd party lead generators or other sales intermediaries rather than establish direct relationships with potential borrowers. These lenders have chosen to pursue what appear to be "easy" customer acquisition strategies that deliver large volumes of potential customers at what appear to be reasonable—or at least acceptable—prices. But the truth is most consumer and small business lenders are sub optimizing their long-term success by relying on convenient yet expensive third-party solutions to customer acquisition. And it turns out that customer acquisition is the area where online and marketplace lenders outspend their bank counterparts by a 2:1 margin. (See Chart 1.) If online lenders are to gain a sustainable advantage against bank lenders, whose cost of capital is extraordinarily low relative to non-bank lenders, the online players are going to have to drive their customer acquisition costs much lower than they are now.

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TOP 5 RANKING FOR SEARCH TERM "WORKING CAPITAL LOANS"

Average # monthly searches: 1,300
Cost per click: $55.96

Top 5 Paid Traffic:

SnapCap
VelociFund
NationalFunding
Fundera
SmartBizLoans

Top 5 Organic (Free) Traffic

Kabbage
NationalFunding
UnitedCapitalSource
Balboa Capital
Fundera

Source: SEMRush

Massachusetts "True Lender" Case Another Crucible for Bank-Fintech Relationships

By Steve Evans

A Massachusetts usury lawsuit filed against Kabbage and partner Celtic Bank will test the legal liabilities of fintech-bank collaborations in a closely watched case that could get in front of a jury next year.

Filed in mid-October, plaintiff Alice Indelicato, who owns outdoor clothing company NRO Boston, says she was victimized by an alleged "rent-a-bank" scheme in which Kabbage partnered with Celtic Bank to get around the state's usury laws. Interest rates on business loans are capped at 20 percent in Massachusetts. Celtic holds an industrial bank charter in Utah, which does not have a usury limit on interest rates. Kabbage is based in Atlanta.

At issue is whether the fintech or the bank is the "true lender." As a fed-

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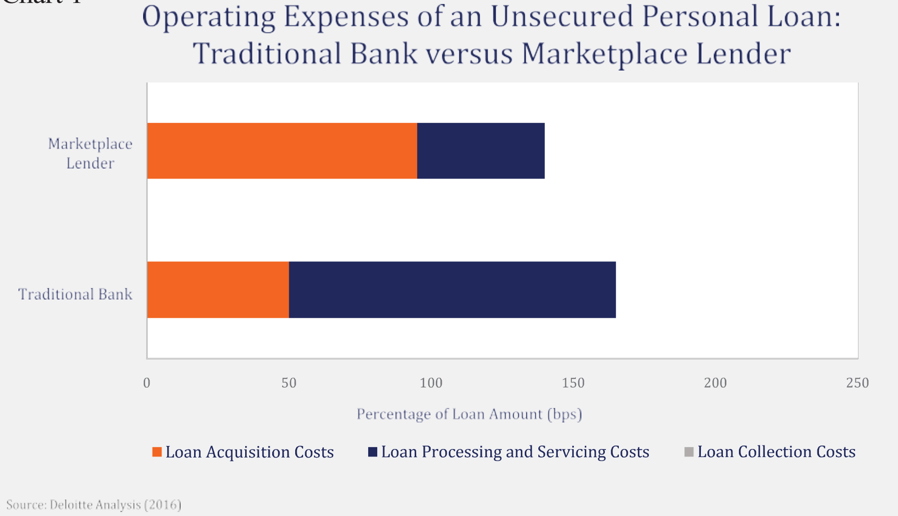
Continued from front page

Chart 1



Multiple Roles to Play

It's hard to be an online lender. You have to be good at a great many things, including customer acquisition. Pay-per-click rates, lead generation costs, and activation rates all have to be considered—often within seconds of becoming aware of a potential borrower. And lenders still have to worry about their underwriting algorithms, regulatory compliance, customer service levels, defaults, and reactivation rates. So it is no wonder that lenders often would prefer to outsource customer acquisition to firms that appear to be able to focus on it more efficiently than a lender can.

And it isn't just lenders who seem to favor outsourcing customer acquisition. Private equity investors and debt providers want alternative finance companies to grow as rapidly as possible. They reinforce the idea that customer sources that can supply customers quickly should be favored so long as they build volumes that will allow companies to achieve critical mass and draw down more debt capital to fuel their lending. This has, in turn, led to increased demand for leads and consequently a marked increase in the costs of those leads from the lead generation firms that supply them. (See Chart 2.)

So lenders are under a lot of pressure to make loans to high quality custom- ers as fast as possible. Top-line growth is clearly very important and the cost of acquisition is simply not lenders' top concern.

Add to this dynamic some operators that financial services firms have never considered competitors have instead emerged as Phantom Menaces. For example, who thought Amazon would become one of the largest small business lenders in America? Amazon has quietly lent over $3 billion to its partners that sell merchandise on Amazon. Care to guess what the customer acquisition cost is for these borrowers? Close to zero. Amazon has realized that it has nearly perfect information to make lending decisions. Plus, it holds borrowers' inventory as collateral. Smart, non-financial services companies are beginning to realize they can tap into the expanding world of alternative finance by leveraging their large customer bases and lending to them.

Where Costly Problems Occur

Middlemarch Partners has witnessed many examples of how this focus on customer acquisition at any price has cost companies dearly and, in some cases, been a fatal strategy. The most common damaging customer acquisition strategies include:

- Unsustainable costs
  - Consumer lenders have overpaid for leads from lead generation firms and consequently produced initial loans that are not profitable and relationships with borrowers that require multiple loans to achieve client profitability.
  - Many commercial lenders have become reliant on intermediaries like independent sales organizations ("ISOs") that have permanent

Chart 2

commission tails on borrowers. This means renewal loans don't have lower marketing costs associated with them.

- Chasing new/misunderstood customer types
  - Some consumer lenders pursued borrowers whose acquisition costs did not justify their potential for profits. These lenders lost a lot of money chasing borrowers they were not accustomed to serving.
  - Small business lenders have unsuccessfully tried to copy other lenders' marketing strategies. Copycats have discovered their underwriting models fail as they chased borrowers that that they did not fully understand.
- Banking on customer retention in a world without loyalty
  - Consumers often do not have a very strong relationship with their lenders. The borrowers apply to a lead generator's brand and are served by a lender that "bought them on the internet."
  - Small business borrowers are encouraged by intermediaries like ISOs (who earn fees for introducing borrowers to new lenders) to switch lenders rather than establish long-term relationships with a lender.

And if these pitfalls were not enough, direct lenders have to be cognizant that marketplaces are uniquely positioned to make establishing strong relationships with potential borrowers very challenging for direct lenders. Unlike alternative finance lenders that are mono-line in nature (i.e., focus on a single product type like short-term consumer loans, mortgage loans, or equipment leases), these marketplaces can position themselves as enabling multi-line lending as they can source direct lenders to facilitate whatever loan type a borrower is looking for. So firms like LendingTree are well positioned to cross-sell a consumer who has historically taken out a mortgage through LendingTree to consider an auto loan or a consumer credit offering sourced by LendingTree from the many direct lenders who are vying for borrowers through LendingTree's marketplace process.

At Middlemarch we want to challenge our clients and potential clients to become more innovative customer acquirers. We believe that lenders' ability to raise growth capital, be it debt or equity, will be significantly affected by their ability to demonstrate true differentiation in customer acquisition. We want to share a variety of strategies that we encourage lenders to consider that can help them reduce customer acquisition costs; increase access to unique, hard-to-reach customer types; and enhance their brand reputation and customer retention levels. Here are some innovative acquisition approaches:

- Get closer to borrowers by reaching out to them directly
  - One of our small business lender clients markets to Pandora listeners who turn out often to be entrepreneurs who will respond to loan offers while listening to music.
  - Another small business lender client avoids ISOs and does all marketing via large-scale direct mail efforts that target very specific business verticals which are well-suited to the loans this lender offers.
- Find and serve hard to reach borrowers
  - Another small business lender client has avoided the crowded merchant cash advance market and instead targets manufacturing, logistics and agricultural borrowers who seek out much larger loans than MCA lenders typically offer.
  - Smart consumer lenders have partnered with retailers who have many clients with poor credit but have few loan options to choose from. They offer them a range of products traditional short-term loans and leases to address their financing needs.
- Create cross selling partnerships with other financial service providers/lenders who serve customers your firm would like to serve
  - A small business lender client has partnered with lease financing providers who do not offer working capital loans. Often lease clients need working capital loans and are happy to get cross-sold a loan when taking out a lease.
  - In the consumer space, we have seen Avant Credit partner with JG Wentworth to offer consumers who have received structured settlements loans that help facilitate earlier access to their funds.
- Build partnerships with other businesses which have customers that could benefit from your loan products
  - SoFi has partnered with small business employers to offer "SoFi at Work" loans to employees of those firms as a benefit offered by their employer.
  - Evergreen Home Loans has developed a partnership with the Teachers Union of Seattle to offer consumer mortgages to teachers.

Most emerging alternative lenders will not be able to build scale in direct marketing for quite some time. And organic marketing programs will distract the marketing "machine" from running at its highest marketing RPM by fueling itself with third-party leads. Near-term volumes may be more challenging to achieve while building these proprietary direct marketing programs. But the payoff is in the longer term. Direct marketing will build greater brand loyalty with lenders' best customers as they respond to efforts to appeal directly to them on a proactive basis.

We encourage lenders to challenge their status quo customer acquisition strategies. The path of least resistance of buying leads and absorbing high marketing costs is unlikely to be sustainable in the long term. Markets are maturing and competition breeds loan pricing pressure which in turn either puts pressure on margins or forces companies to rethink their cost structures to unearth potential incremental profitability.

Customer acquisition in general has been about building volume in a growing non-bank market for consumer and small business lending. But as the non-bank market matures and as banks come back to compete for borrowers, there needs to be a greater focus on driving down marketing costs while increasing the effectiveness of customer acquisition strategies.

Unconventional competitors, like Amazon, are entering the market with advantages like huge captive customer bases for selling their financial products. And innovative conventional lenders are trying to reinvent their cost structures through new customer acquisition strategies that lower costs and increase borrower loyalty. Alternative lenders' very ability to grow and raise capital may rest on their ability to demonstrate that they are better than other lenders in their sectors.

At Middlemarch we believe that consumer and commercial lenders who develop unique and cost-advantaged customer acquisition strategies will be best positioned to be the winners as these markets evolve, shakeout, and ultimately mature.

Sasha Grutman is a co-founder of Middlemarch Partners, a merchant bank that focuses on advising and investing in high-growth financial services and business services companies.

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