FINTECH ONE-ON-ONE PODCAST – GUNES KULALIGIL

Welcome to the Fintech One-on-One Podcast. This is Peter Renton, Chairman & Co-Founder of Fintech Nexus.

I've been doing these shows since 2013 which makes this the longest-running one-on-one interview show in all of fintech, thank you for joining me on this journey. If you like this podcast, you should check out our sister shows, PitchIt, the Fintech Startups Podcast with Todd Anderson and Fintech Coffee Break with Isabelle Castro or you can listen to everything we produce by subscribing to the Fintech Nexus podcast channel.

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Before we get started, I want to talk about our flagship event, Fintech Nexus USA, happening in New York City on May 10th and 11th. The world of finance continues to change at a rapid pace, but we will be separating the wheat from the chaff covering only the most important topics for you over two action-packed days. More than 10,000 one-on-one meetings will take place and the biggest names in fintech will be on our keynote stage. You know, you need to be there so go ahead and register at fintechnexus.com and use the discount code "podcast" for 15% off.

Peter Renton: Today on the show we are talking marketplace lending, specifically securitization of marketplace lending deals. I'm delighted to welcome Gunes Kulaligil, he is the Structured Finance Co-Lead at Stout, they are an investment bank and advisory firm. I wanted to get Gunes on the show, he's written a couple of articles for us at Fintech Nexus News which I will link to in the show notes. He has got a really good perspective, really follows the deals very closely in the marketplace lending space, he's been doing this quite a long time, and so we wanted to get him on a show to talk about the state of the industry today, the state of securitization, how and why 2022 was record year. We talk about the impact of increased interest rates, we talk about demand and supply, we did an explainer about how a securitization deal is structured, we talked about pre-payments and much more. It was a fascinating discussion; hope you enjoy the show.

Welcome to the podcast, Gunes!

Gunes Kulaligil: Thank you for having me, Peter.

Peter: Alright. Let's kick it off by giving the listeners a little bit of background about yourself, tell us some of the highlights of your career to date.

Gunes: I've been in the structured finance business for about 20 years or so. The definition of structured finance and what it is that we do changed over those two decades, but I've generally been involved in lending, securitization, investing and trading securitized products and special to finance assets. I've actually started my career back at Fannie Mae early 2000's, as you know, the mortgage giant in the US so learned the ins and outs of the mortgage business and the structured finance business, in general.

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I then moved to various Bear Stearns Asset Management in 2005, I was there until 2008, 2009 up until the crisis. I've also had similar roles at Fortress, all on the buy side investing and risk analyzing and various other roles within structured finance. After Fortress, I actually moved to the sell side, I led the structured finance group at Houlihan Lokey for about six to seven years. After that, I launched my own valuation advisory firm called Methodical in 2018 and Methodical was acquired by Stout in 2022 so we are now part of Stout, me and my partners, and we're growing the special data structured finance business in the bank.

Peter: Okay. So then, what is your core focus, tell us what you are focused on at Stout today.

Gunes: I'd call it the structured finance business, but if you think about it, it's a bit of a misnomer because when you say structured finance people mostly think about securitization, securitized products, mortgaged-backed securities and asset-backed securities. We, of course, cover those products, but I think, by definition, structured finance is overlapping with specialty finance, fintech lending-type assets quite often so we cover those as well.

What I do is actually quite simple, two service offerings. The first service offering is valuation work so every asset that we're going to discuss today, almost all I should say not every, is considered a level 3 asset from an accounting perspective which means these are illiquid, esoteric, and hard to value assets. There are no trades you can refer to so, as you know, these are higher yielding assets for the most part so that when a hedge fund invests in it, a third party needs to do the valuation of these assets on a monthly or quarterly basis as investors go in and out of these funds, somebody needs to strike the NAV.

So, that's part of what we do, we do this for securitized products, mortgage-backed securities, asset-backed securities, we also do whole loan investors. Not every investor will be investing in bonds or securitized products, there's a bunch of funds who invest in individual loan portfolios, there are also investments in servicing rights, there’s many different ways to invest in this asset class and we do valuation work for all kinds of investors including hedge funds, obviously. But that also includes, you know, some banks, some insurance companies and some trusts and what have you. So, that's half of our business, the other half of our business is, you know, in general, specialty finance and structured finance, is a pretty illiquid and I would say, a pretty fragmented space from a (inaudible) perspective.

Given the fragmentation in the industry, we're actually doing some loan transaction advisory work. What that means is if we take one step back and look into the, you know, financing tool book of a specialty lender, there's securitization, there's warehouse lines, there's forward flow facilities from alternative investors, right. But it's a very fragmented space and there's a lot of room for brokering some of these trades and connecting specialty finance lenders with pockets of financing available for them so they can go ahead and originate more products. So, that is the second line of business we have that is a loan transaction advisory business.

We cover secured, unsecured and business loans on the unsecured consumer front, obviously, marketplace lending which is what we're going to focus on today, but we also cover sub-prime model, POS lending, solar, buy now, pay later, those types of specialty finance assets as well as residential and commercial which we're not going to get into today. But these are really old, higher yielding and higher risk assets that hedge funds mostly invest in so we do the valuation work for them and we also

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help the platforms when they're looking for financing to grow their origination or when they're looking to sell loan portfolios we assist them, with connecting with buyers.

Peter: Right, got you, okay. As you said, we are going to talk about marketplace lending, we're going to focus on that today. Maybe we could start off with just telling the listeners when you first started following marketplace lending, what got you interested in it?

Gunes: I was on vacation in Mexico, believe it or not, I was at Houlihan at that time and I got a call from the office, it was about a decade ago, I think 2013, this company called SoFi, at the time was basically just a couple of years old and they were looking for some valuation work and that was my initial introduction to marketplace lending was with SoFi portfolios. But if you think about it, that was 2013/2014 when this sector really became, I don't want to say, a mainstay, but became more in the spotlight.

Prior to that, if you recall, a lot of the alternative investors were really trying to invest in distressed investments all the way from 2008/2009 crisis. So, from that perspective this marketplace lending offering in early 2010s was a very refreshing offering, something new, something not distressed and something interesting so that's when I got into valuing and also transacting in the space.

Peter: Right. Actually, from memory, I think SoFi did their first securitization in 2013, if I remember rightly, it's a private deal I think, and it was a big news in the space.

Gunes: I think you're right, I think you're right. That's when actually there was, you know, with those securitizations there was a lot more institutional eyes looking into this asset class, you know, investing in their residual bonds or investing in seniors so I think that was kind of the coming of age for marketplace lending and that was about a decade ago.

Peter: Right, right. So then, let's fast forward to today, you follow this industry pretty closely now, how would you describe the state of marketplace lending today?

Gunes: I think the word is transitory really because our economy is in a transitory stage anyway, but I mean transitory in a good way as it applies to marketplace lending. We've written a few articles for your publication, as you know, and I mentioned that there are two, that marketplace lending has been called the canary in the coal mine for many years that anytime there is any kind of distress in the economy or any kind of softening in consumer credit, the theory was the first shoe to drop is marketplace lending, i.e. unsecured consumer loans that will be the first default.

So, you know, and then there was this theory that it was never a tested asset class, it was untested, right. So, true or not, it was not the biggest asset class, if you think about it, I mean, we looked at a bunch of securitizations for the piece that we've written for you and that was only about $60 Billion, that covered most major originators, right. So, it wasn't necessarily the biggest space, the most tested space because if you look into something like autos or student loans there's literally billions and billions more of this history and data to work with. So, it was always considered untested, but I think at this point, as we pointed out, I mean, the first deal of Lending Club was 2010 or even earlier, at this point it's been around for 13/14 years, right. You know, people still criticize that hey, it hasn't really seen a cycle like 2008, a recessionary cycle where consumer credit softens, that may be true.

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We were actually thinking that, you know, throughout the pandemic, as you can imagine, our theory was hey, any kind of prime or near-prime unsecured consumer loan borrower...if marketplace lending is indeed the canary in the coal mine, we should see really elevated defaults and delinquencies and things like that. But, as we all know, that didn't happen because with all the stimulus payments the borrowers have received from the government, and this especially applies to lowering the credit spectrum, i.e. sub-prime or near-prime borrowers, they took those payments and actually made payments on their unsecured consumer loans. So, we've actually seen improvement in delinquencies, improvement in losses in some of the sub-prime deals throughout the pandemic.

My point being is, would the industry participants, would they call it a test, can we now call it a tested asset class? You know, the beauty is in the eyes of the beholder, but if something's been around for 15 years and it's been working for 15 years, I don't want to call it untested anymore. I think, for better or worse, I think we can say marketplace lending has definitely come of age and just looking into who's investing in what shape or form, I would say it's becoming a more attractive institutional asset class and I think less people care if it's tested, untested, whether it's a canary or not.

Peter: Right, right, yeah. You know, I've been investing now for 14 years, since 2009, was when I first started, never had a down year which I think is something that I can't say for many of my investments. But, anyway, I want to talk about 2022 and I'll link to the article that you recently wrote to us in the show notes because one of the things that surprised me about that was the volume in 2022, particularly across the 8 companies, the 8 major issuers, it was significantly higher than the 2021 and significantly higher than any other year so what's driving this increased demand?

Gunes: 2022 was indeed a record year for marketplace lending so a few things. First of all, the demand for unsecured consumer loans is not going away, right, so unsecured consumer loan demand is strong. And if you look into who’s supplying this, you don’t really see commercial banks rushing to provide this financing, right, so it’s really mostly coming from, you know, the type of loans, at least we’re talking about, is coming from these marketplace lenders.

As a matter of fact, this gap, i.e., the lack of funding for unsecured consumer product will actually probably get worse after what happened to SVB, meaning if there’s more bank consolidation, if more smaller banks exit the space, right, if there’s more big money, money center banks we’ll probably even see less funding available by banks for the unsecured consumer loan borrowers, right.

And also, it was indeed a ton of origination in 2022. I don’t want to necessarily call it as surprising because if you look into who’s done securitization and the type of the product they’re securitizing, obviously, rates went up in 2022. Inflation was a problem, right, these are the types of things that really reduce issuance for many other sectors except for marketplace lending, but it’s important to also look at the impact of rates on marketplace lending, right. So, if you’re a mortgage borrower, if you can borrow at 4% versus that rate going up to 6% that really makes a big dent on your budget, right, for your monthly P&I, especially when, you know, a few hundred-thousand-dollar mortgage, right, if the rates go up from 4 to 6.

But if you look into someone like Oportun or Landmark or even OneMain, the APRs, the interest rates they lend it are 30, 25 and 23 respectively, right. So, the fact that, you know, the rates are a few

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percentage points higher doesn't necessarily dent in the origination for some of these real high APR lenders like Oportun, Landmark, and I would put Avant in there as well. So, the point being, if somebody's looking for a 25% APR loan, right, and if they cannot get it from a……you know, if they're looking for unsecured consumer loan and if they cannot get it from any other source and I don't mean these are lenders of last resort, by any means, but they will get that loan, whether that's 23% APR or 25% APR or 22% APR.

So, from that perspective, you know, the rates rallying doesn't stop the origination for this high APR product because there's plenty of excess interest to go around because you are securitizing at the cost of funds of let's say 8%, right, but the underlying product is spitting out 30% interest, right. So, there is a lot of excess interest, a lot of margin for issuer originator to be able to, you know, be economically better off from that securitization, right. So, that's one reason we didn't see the securitization volume go down for marketplace lending with the high APRs. If you look into the mortgage world, you know, with the rates going up, no better refi and origination was down and therefore the securitization was down. So, it's really a function of origination being high drives, you know, securitization volumes being high, but also, it's important to keep in mind, securitization is not the only take-out, securitization is not the only way to monetize these portfolios, there's warehouse lines, there's, you know, selling it outright as a portfolio to a buyer, right.

So, if we see record securitization volumes for any product that means also securitization was indeed the best execution for that asset class that year compared to previous year. What that means is there were buyers, institutional buyers, what that means is cost of funds despite being higher compared to previous years was not prohibitive, right. So, all those facts came together to enable issuance and a record year for marketplace lending and, you know, looking into this year, I think we're seeing similar trends where issuance, so far, this year, you know, we're at Q1 but is par with last year. For a lot of other sectors, mortgages, autos, student loans, you're going to see 20, 30, 40% less issuance compared to the same period last year so I think this is actually going to be a good year for marketplace lending, marketplace securitizations as well.

Peter: Right, right. There's also, I mean, some of the major players have not been in the market for a while, like Prosper has not been in the market for, I don't know how long, years, it feels like. Lending Club is obviously keeping a lot of stuff on their balance sheet now they're a bank, they used to be players in the late 2010's that were in market regularly.

But, anyway, I want to actually switch to the other end of the market because one thing I've been really curious about is, you talked about SoFi, you know, Marlette's another one, these are prime borrowers and I'm curious about the senior tranches in those securitizations. I mean, they can't be paying very much, what about when you compare it to what you can get now with the government, with treasuries, are the spreads still enough to get people interested in the senior tranches of some of those deals?

Gunes: Yes. So, I think it's important to keep in mind who plays in those senior tranches, right, it's institutional money managers, the AAA investors care about rating and duration, they care less about what's under the hood. So, if it's a 6-month weighted average like bonds, it's going to pay off in a few months, right, so they care a lot less what's under the hood. What I mean, what I also want to emphasize is that the deals that are coming into market, they have very significant credit

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enhancement. For example, Bankers Healthcare put out a deal, I think it's their last 2023 deal their AAA tranche hit 50% credit enhancement, right.

Peter: Can you explain what that means, the 50% credit enhancement?

Gunes: Basically, the securitization is you have a portfolio that is producing a cash flow, in this case a marketplace lending portfolio where borrowers are paying principal and interest monthly. All securitization does is it takes those cash flows and structures those cash flows to create tranches, let's say, A tranche, B tranche and C tranche, right, $100 Million book. You can say $50 Million A, $30 Million B, $20 Million C, right, so that's your senior, mezz and sub, all it does is senior bonds have lower returns and lower risk, shorter lives, they get paid and they get out of the way, right.

Mezzanine takes on more risk and requires more return and obviously these more subordinate bonds like residuals have higher yields, it could be 20/25% yields and the duration or the weighted average life, i.e. the number of years your dollar's outstanding and exposed to risk, that's the weighted average life, that could be ten years for some of these more riskier assets. So, it's really, securitization gives access to different parts of the capital structure on the same portfolio, on the same consumer portfolio to different investors.

So, going back to your question, you know, who's buying AAA's and why? So, the BlackRock double lines, PIMCOs of the world are investors in AAA rated assets from marketplace lending portfolios which you can actually look up from 13F filings. So, these are all short duration AAA funds. Some of them are income funds, they're just looking for that short duration, but marketplace lending also offers residual trades and some subordinates where, you know, especially for the hedge funds who really feel like they know the credit under the securitization and they have an edge in calculating expected losses and things like that, those assets are available yielding at 20, you know, north of 20% in some cases.

So, your original question, is this still a good investment instead of treasuries, you know, why not buy a 2 or 5-year treasury, there's still a spread, I mean, there's still 50, 150 basis points spread you can earn on a pretty short product, right. I mean, some of the yields we're looking at, are you know, are closer to 5.5/6% so not the type of yield you can get from treasuries and these are very short assets. It pays off in six months and it's got, you know, 30/40% credit enhancement, meaning when the losses hit, you're not going to take the losses, the bonds that are subordinate to you take the losses first.

So, in the case of our, you know, AAA rated bond with 50% credit enhancement, what that means is 50% of all the borrowers in the pool would have to default with 100% loss severity with not a single dollar recovered for your bond to take a loss. So, not an impossible scenario, but a very unlikely scenario, right, so that's what I meant by the credit enhancement available.

Peter: Yeah, appreciate that, it would have to be the end of the world almost for that sort of thing to happen. I want to talk about the credit box, like I've talked to a few lenders, I was just in San Francisco last month, sat down with many of the leaders in the marketplace lending space and many of them talked about tightening credit boxes. Are you seeing that in the deals coming to market this year?

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Gunes: Yes. We are seeing tighter underwriting criteria to the extent issuers are relying on FICOs or other credit metrics that are definitely being tightened. We are seeing the weighted average coupon in these deals, i.e. the APR being charged to the borrower is also going higher, but that is not limited to a marketplace lending space. This is just flight to quality, every investor in every corner of the market I think is doing that.

Flight to quality means in this context, at least, maybe more near prime or prime deals, it could also mean, you know, trying to move higher in the capital structure from an investor's perspective, you know, maybe away from the mezz to more senior positions. But, you know, this is also creating investment opportunities as well, right, there is a flight to higher up in the capital structure.

Peter: Right, right. So, one of the lenders I was talking to said that they hadn't been in market for a while and they're thinking about doing it in the latter half of this year, do you expect demand to increase in the second half of the year as more supply comes onboard?

Gunes: I'll give you a bifurcated answer for that. I think for the senior part of the capital structure, the demand will be there, right. As we've talked about, those investors tend to be a bit more agnostic, i.e. they may as well be invested in CMBS or RMBS or ABS AAA, as AAA's a AAA right, so I think that demand will be there on top of the capital structure, right. But if you look into some of the subordinate investors or, you know, the borrowers who are retaining the residual, the residual is the equity tranche, the bottom tranche, i.e. the first loss piece, the first borrower defaults, it comes out of the residual, obviously, not even subordinate or mezz, right.

So, it's really what those investors have in mind is really what's going to drive the issuance, right, because if there is not enough demand from those investors for the subordinate, i.e. the risky tranches then the securitization doesn't get done. So, that is just a function of getting compensated for that risk especially for the subordinate investors and giving them, you know, a bit more protection, whether that means issuer retaining a bigger residual which means there is less risk for the issued bonds, right. So, it's a little bit of adjusting the deal until, you know, you find market clearing levels, but the one thing that's going for marketplace lending is APR is high enough that, you know, you can still do these deals.

If you look into some of the latest marketplace lending deals, the senior stack coupons or I should say the yields were 6/7/8%, maybe goes up to 9 for some deals, fine, that's the cost of funds, let's call it 9%. Your APR's 25 so there is still 15% excess interest to account for any miscalculation and losses or to compensate issuer, originator, what have you for their effort in putting together the securitization. So, as long as there's demand for the subordinate investors, I think deals are going to get done. Now, those subordinate investors, i.e., if we had this conversation before the SVB situation, I would say that demand will also be there.

How did SVB change things? I think there's going to be some distressed portfolios sitting in the market, right, and not from SVB or any failed bank, but, you know, SVB just highlighted the amount of distress that's real and that's out there, right. So, when these types of things happen, usually your alternative investor will take a step back and say hey look, do I want to maybe wait for a distressed opportunity where I can buy something 60 cents on the dollar and make an immediate 80% return, whatever, right. Or, do I want to play in some of the numerous securitizations like marketplace lending

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where you may invest and, you know, get like 10%/12% return, lever it up to 15% if you can get that even, right.

So, I guess, the point is there's you know, the same buyers who invest in marketplace lending also invest in distressed deals and I do think that they may actually be more willing to wait for some kind of distressed deals right now after the SVB blow up. Deals are going to get juicy I think, Peter, that's all I'm saying, right, it's like hey, you want this 8% yield that's got a little bit of credit enhancement, there are unsecured borrowers behind it, you're not getting it a real deep discount or, you know, get something at a deep discount from a distressed sale.

Peter: Yeah, understood, understood. So, I want to move on to pre-payments because we've seen some unusual trends in pre-payments. I know that when all the stimulus was coming out during the height of the pandemic there were lots of pre-payments happening. Now that interest rates are going up, I imagine this has dropped off dramatically, right?

Gunes: Yes. Pre-payments are down, they are indeed down dramatically, and I think, you know, there's two reasons for that. High interest rates, definitely one reason, I mean, high interest rates takes pre-payments down for any product including marketplace lending, but the other thing is, and this is not always easy to track, but with the credit box getting tighter your ability to refinance with another lender is decreased and that's why we're also seeing how pre-payments go down as well. So, not only the rates are higher but the credit box is tighter so you're not able to necessarily refi with another borrower so that's what we're seeing now.

What we saw throughout the pandemic was actually also very interesting. If you look into either pre-pays or things like analyzed net losses, there's actually a theme, there's a trend between different platforms, right. You have SoFi who as you know lends to HENRYs, High Earners, Not Rich Yet, well, that was at least how they started ten years ago, I'm sure they're rich now (Peter laughs) so they are lending to prime borrowers and their default rates are, you know, general cumulative net loss rates are 2%, around 2%, sub 2%. Throughout the pandemic and way before the pandemic, it's always been there, it's not like the SoFi losses improved in the pandemic because the borrowers got stimulus checks, right, because these are not the borrowers that actually need or use those, or have a need for stimulus checks.

But if you look into the other end of the spectrum, you know, you have Upstart, for example, with net losses were around maybe 10%, 8/10% before the pandemic, we've seen to your point, pre-payments or paying down loans, we've seen the default rates on those almost converge with SoFi. So, your prime and sub-prime borrowers, from a credit perspective, were performing pretty similar in like late 2021 and that was just the function of the sub-prime borrowers getting stimulus checks from the government and being under lockdown, not able to travel, not able to do anything. They literally just paid down those loans, not just marketplace lending loans, same applies to mortgages as well.

But that was a short lived trend because I would say, like maybe late 2021 when the stimulus payments disappeared and by the way, keep in mind this is before Ukraine, before any kind of deep recession talks or anything like that. We've actually seen the annualized net loss rates on marketplace lending go up back then in late 2021 and I think this is again just the function of no more stimulus checks, back to real life, right.

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And the other thing is throughout the pandemic when all those sub-prime borrowers were making timely payments with the stimulus payments, that also led to FICO inflation. Not that marketplace lenders always rely on FICO, I mean, they all have their underwriting models that doesn't necessarily rely on FICO but it's something to consider. I would say, many sub-prime borrowers in the pandemic actually became near-prime, right, just by paying down loans, but that's artificial, right. You know, you're just one payment, one missed payment away from being a sub-prime borrower, right, so I think that's FICO inflation and what happened in the pandemic and what it meant for credit quality and credit performance really needs to be studied before jumping into conclusions by looking at, you know, data.

Peter: Right, right, yeah, got it. So, we're running out of time, I want to get to one more question and when you're looking at all these deals and you sort of look out through the rest of this year into 2024, I'm curious about what you think of the unsecured consumer lending asset class. Obviously, there's a lot of talk about a recession, we don't know where interest rates are going to end up, but I'd love to kind of at least get your perspective as how you think about it, how will the marketplace lending industry perform over the rest of this year and into 2024?

Gunes: I expect a performance similar to last year which was a good amount of issuance, yes, some deterioration in credit performance, right, and we've seen that last year. I think we're going to see further deterioration of credit performance, especially for sub-prime. But, you know, keep in mind that this is all priced-in, this is all in the APR, this is all in the structure and I think the sector used the last 10/15 years to iron out all these issues so that it becomes a viable investment, right.

So, I do think we're going to see healthy issuance, the distress or credit deterioration to a certain extent will continue, sponsorship will matter a lot, repeat issuers, bigger names, names that have been around are going to do better and I do think there's going to be some consolidation from some of the smaller and weaker peers joining their larger peers, but the demand is there. As long as the demand from the consumers is there, the market, the sector will do fine and I don't see anyone other than marketplace lenders rushing to, you know, lend to these borrower, right.

Peter: Right.

Gunes: And, you know, I don't want to call out any names but it's not an easy space to operate. There's been some recent exits from the space, some highly publicized names, I mean, just, you know, being big and bad doesn't make you successful in the space, you have to be nimble and kind of creative and I think that's what the industry is doing, exactly that.

Peter: Right. Well, that's a good place to end it on, Gunes, I appreciate your insights today. Thank you very much for coming on the show.

Gunes: Thank you very much, a pleasure!

Peter: Well, I hope you enjoyed the show, thank you so much for listening. Please go ahead and give the show a review on the podcast platform of your choice and go tell your friends and colleagues about it.

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

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