Peer-to-Peer Investing Part I

By John B. Brooks and Erwin G. Krasnow, Esq.

Small deals are the bane of lenders' and investors' existence. "Small" can be defined as under $1 million, under $100,000 or under $50,000. They often require just as much work as larger deals, but usually without the potential for a big payoff.

Sophisticated financiers shy away from these types of deals, and small banks and lenders don't usually appreciate them, whether they're media, service, retail, manufacturing or consumer goods ventures. Oftentimes, the entrepreneur seeking funding doesn't have the tools for preparing a compelling pitch and lacks the resources for purchasing good professional advice. To make matters worse, the recession has rendered many potentially worthy – but small – projects un-financeable, other than with credit cards or friends and family money. So software, automation and signal upgrades are pushed to the side, the electronic billboard project languishes, and you make do with only two sales people instead of four. If your VISA card, friends and family are maxed out, what do you do?

You may have heard of a new phenomenon whereby people are able to lend to each other through organized online exchanges. They are commonly referred to as crowdfunding or peer-to-peer lending sites. These online portals number in the hundreds, and their missions vary, but the principle is the same. Individuals network and pool their money via the Internet. Sometimes investors are attracted by a feel-good act of extending credit to individuals and small businesses or to quirky projects and causes. Other times they may be attracted by the potential of a better return than they can get in a money market account.

In an effort to make raising capital easier for small companies and start-ups, the federal government enacted the Jumpstart Our Business Startups (JOBS) Act. A key provision of the JOBS Act amended securities laws to exempt offerings through the Internet and the social media in which the aggregate amount of securities of an issuer sold to any one investor within the previous 12-month period is $1 million or less. Individual investors can invest in these crowdfunding offerings the greater of $2,000 or 5% of their annual income or net worth, if either the annual income or net worth of the investor is less than $100,000; or 10% of the investor's annual income or net worth, if the investor's annual income or net worth is equal to or more than $100,000. The offering must be conducted through a registered broker-dealer or a newly-created class of "funding portals" subject to new Section 4A(a) of the Securities Act which requires intermediaries involved in crowdfunding transactions to satisfy certain registration and other requirements and take certain steps to protect investors.

Crowdfunding sites appear to be involved in deploying hundreds of millions of dollars to fund targeted projects, causes and technological, scientific and creative endeavors. Generally, a crowdfunding transaction involves establishing a minimum fundraising goal for a specific purpose and setting up a mechanism for holding funds in escrow, so that, if a specific goal is not met, the escrowed funds can be returned to investors. The project sponsors generally tell investors that, if the project moves forward, the anticipated returns to investors are expected to be well above those prevailing for "safe" investment such as money markets and Treasuries. Plus, the investor receives that immeasurable feel-good value of supporting a project for which he or she has a personal stake. The downside is that investors usually don't receive an equity position or security in any proprietary assets, and, of course, the level of risk in start-up enterprises generally is extremely high.

The crowdfunding space continues to evolve and expand, with targeted sites emerging to serve new constituents with larger fund raising goals, and such sites have expanded beyond small one-off projects to service young businesses. CircleUp targets consumer products companies with $1 million to $10 million in revenue. In many respects these new sites function much like an online VC portal, but the vetting process remains the same. Of course, crowdfunding, like virtually all startup investment activity, is hardly risk-free, and current SEC rules allow these ventures to operate with fewer regulatory, reporting and oversight burdens because the amounts involved are relatively small.

So, buyer beware. The success of the new crowdfunding mechanisms will likely depend on whether the result will be a lean, efficient process for early stage capital raising, or a complicated set of rules that makes crowdfunding unappealing or costly to startups and small issuers, or worse, facilitates fraud on unsophisticated investors.

In Part II of this series we'll look at another aspect of peer-to-peer lending.

Peer-to-Peer Financing, Part II

In "Peer-to-Peer Investing, Part I," Radio & Television Report, January 31, 2013, we wrote about on-line crowdfunding sites, essentially exchanges where entrepreneurs are able to connect with potential investors on investing in ventures that are far too small (or speculative) for more established financial institutions. This article will focus on another form of grass roots-type financing called peer-to-peer lending (also known as person-to-person lending or P2P).

At first glance, there would appear little difference between peer-to-peer lending and crowdfunding. In fact, there is even a third type of financing – microlending – that could be lumped into this category as well (it is not discussed in this series.) All three are Internet-enabled fundraising models where capital can be raised through online campaigns, but there are distinct differences.

Crowdfunding is a collective cooperation of people who pool their money in order to support efforts initiated by other people or organizations.

Microfinance is the provision of financial services to low-income clients who lack access to traditional banking services.

Peer-to-peer lending is primarily a for-profit lending transaction directly between as few as two individuals without the intermediary of a traditional financial institution.

In the United States, peer-to-peer lending platforms have been around for over a half dozen years. Lending Club is the leader in this space, attracting venture capital and prominent board members (such as former Treasury Secretary Lawrence Summers) enticed by its risk management, low default rates and solid returns. This article examines Lending Club's policies and results as a proxy for the industry.

Lending Club enables borrowers to create loan listings on its website by supplying details about themselves and their applications for unsecured personal loans up to $35,000 for three to five years. The company runs the borrowers' financial metrics through their risk-rating model to determine which applications are creditworthy, assigning each a credit grade that determines interest rates and fees. Investors can search the company's loan listings and select what they want to invest in based on information supplied about the borrower, the loan amount and the grade and purpose of the loan. Interest rates vary from 6.00% to 27.00%, plus origination and servicing fees.

Why are individuals and companies attracted to companies like Lending Club? Everything from debt consolidation to home improvements, major purchases, vacations and investments in small businesses (think new laptops, re-paving the parking lot or a new billboard.)

To reduce default risk, Lending Club mitigates its risk by focusing on high-credit-worthy borrowers — indeed, it declines approximately 90% of loan applications. Generally, only borrowers with FICO credit scores of 660 or higher are approved. But, like crowdfunding, this model is not without risk, as these are unsecured obligations of individuals and very small enterprises. Also, peer-to-peer lending is still in its infancy and is not yet available in every state, Also, where the peer-to-peer platform issues securities, they may be subject to state and federal registration requirements. So buyer beware.

Still, Lending Club's value proposition and risk management have been so compelling to both borrowers and lenders that it made $718 million of loans in 2012 and expects to double originations this year.

While there is no peer-to-peer financing model dedicated to broadcast and media companies, it would seem a logical fit, particularly for small loans for broadcasters locked out of the credit markets, even for small purchases. If peer financing continues to grow and avoids the pitfalls of defaults and losses, it may be only a matter of time before this model is replicated and expanded for small businesses, especially if the banking window remains closed. This may be a pathway forward to break the logjam that has kept small business in low gear for the past four years.

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