Peer-to-Peer Lending Investor Guide

Innovating an Ancient Credit Model

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2 OPENING STATEMENT

Peer-to-peer lending (P2P) is still growing at a rapid rate. Roughly 200,000 retail investors have benefited from the stable, attractive returns on offer with the industry surpassing £10 billion in cumulative lending. In the first half of 2017 the market experienced a 59% market growth rate when compared to the same period in 2016. An impressive figure considering the industry reached £3.2 billion of lending in 2016 alone.

The reasons for growth are clear: attractive, predictable investor returns which are shielded from stock market volatility; and downside protection through security provisions and the opportunity to diversify a portfolio with an alternative investment which was previously only available to institutional investors. The fundamentals of this asset class are extremely strong and so differentiated that we have no doubt that exceptional growth will continue in the years to come.

On the borrower side, a superior experience has driven droves of borrowers to P2P platforms which lend across a range of lending sub-sectors including consumer, business and property. The value of P2P lies with the ability of platforms to originate good quality borrowers and present these borrowers to yield hungry investors. In its purist form, P2P is a direct loan contract, known as a P2P agreement, between the lender and borrower. The role of a P2P platform is to facilitate this agreement by originating loans and matching borrowers to lenders.

The UK regulator - the FCA - has to be credited in part with the growth of P2P. Although the history of regulation within the P2P market has been relatively short, dating back to 2014, the FCA has established a framework for this asset class to flourish. In April 2016, a new ISA, the Innovate Finance ISA (IFISA), was launched allowing investors to hold their P2P investments within a tax-efficient ISA wrapper. At the same time, financial advisers were given permission to advise on 'P2P agreements'. Regulation has been incredibly powerful in evolving the market. To put this into perspective, the UK P2P market now represents approximately 85% of the entire European market.

It's worth noting that it was a UK business, Zopa, that invented P2P back in 2005. The industry as a whole is a true example of British innovation where the government has supported adequately to encourage private sector growth.

However, with market growth comes complexity. This is particularly true for investors attempting to appraise the wide range of investment opportunities on offer. We've written this guide to help people understand P2P, how P2P might fit within their investment portfolio and to provide best practices for accessing the market. A special thanks to Samantha McBride for pulling this guide together and Jordan Stodart for reviewing previous drafts. Really good team effort so thanks.

Iain Niblock – CEO of Orca Money

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3 THE BASICS

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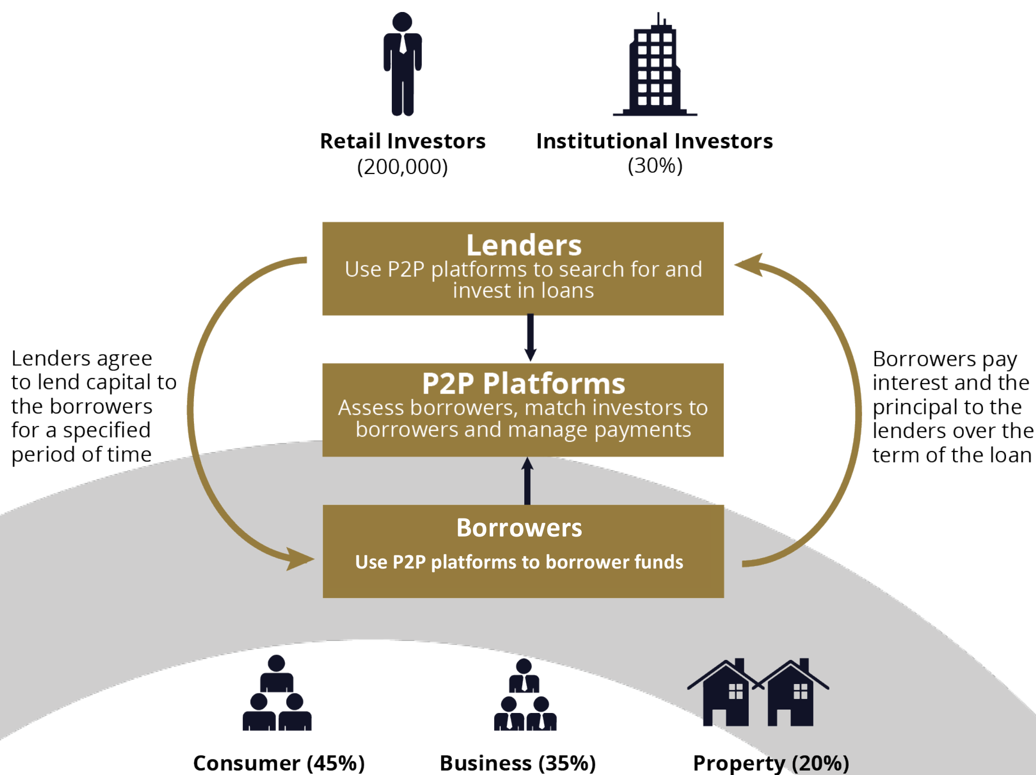
What is P2P?

Peer-to-peer lending (or “P2P”) is a method of debt-financing which connects borrowers directly with lenders across an online platform. This process is designed to be the most efficient form of lending by cutting out the middlemen, namely the banks, in the process.

P2P involves three parties: the lender, the borrower and the P2P platform. Similar to any other loan agreement, the lender is responsible for lending capital over the term of the loan, while the borrower commits to repaying this capital plus interest in accordance with the loan agreement. The P2P platform helps to facilitate the transaction by performing a credit assessment on the borrower and matching borrowers to lenders more efficiently and more rapidly than would have been the case in years gone by.

How P2P Works[1]



Source: Orca Research.

P2P is, at the same time, the very latest and the oldest form of credit.

The latest, because without digital technology and the consequent ability to transact business instantaneously across any distance amongst large numbers of people, there would be no P2P sector. The oldest, because long before there were banks or finance brokers, people with money to spare lent it to those in need of it for whatever reason – business

[1] Note: Numbers are approximations, based on Orca Research (August 2017).

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or personal. Critically, while replicating the time-hallowed practice of one-person lending to another, P2P platforms use contemporary technology to allow such lending without any prior knowledge of the borrower. Instead of lenders being restricted to lending to their neighbours, they can now theoretically lend to anyone in the world.

This ancient-yet-modern credit model landed in the UK in 2005, with the arrival of the Zopa platform. Since then, the rate of growth has been impressive, to put it mildly.

The UK Landscape

To celebrate the P2P market surpassing the cumulative lending milestone back in July 2017, mapping out where the UK landscape stands today[2]. An ecosystem of technology businesses is evolving around the P2P market, both aiding borrower and lender origination. For example, Orca helps educate retail investors and financial advisers with independent due diligence and, on the borrower side, we have seen a wave of partnerships with new banking apps such as Revolut and Pariti referring borrowers to P2P platforms.

UK ALTERNATIVE LENDING ECOSYSTEM

2 For more information about this infographic, or to find the most up to date version, visit Orca's website: https://www.orcamoney.com/uk-alternative-lending-ecosystem.

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Source: Orca Research.

P2P is a beautiful financial innovation which delivers true value to both investors and borrowers. There is no sign of this changing and, with this, we expect that the industry will continue to grow, albeit at more sustainable levels than we have seen so far, and the ecosystem around it will continue to flourish.

Who are the Borrowers?[3]

Consumer Lending

The pioneer of the UK P2P industry, Zopa, operates in the consumer lending space and originated the first consumer loan back in 2005. The consumer lending sub-sector represents the largest of the three, at approximately 45% of the overall P2P market. Consumer loans are granted for a variety of purposes, including car finance, home improvements, debt consolidation and weddings. Typical loan sizes are between £250 and £30,000.

Consumer Lending Providers

Provider	Cumulative Total	2016 Total
Zopa	£2,529m	£688m
RateSetter	£2,010m	£665m
Funding Secure	£140m	£53m
Lending Works	£76m	£21m
Total Consumer Lending	£4,755m	£1,426m
As a % of Total P2P Lending	46%	44%

Source: Orca Research.
Note: As at August 2017.

An issue that this sub-sector is currently facing surrounds loan origination. In fact, Zopa, the largest lender in the consumer lending space, is currently closed to new retail investors due to insufficient loan supply[4]. To mitigate this issue, platforms have sought to strike up high-profile partnerships to increase public awareness and attract high quality borrowers. For example, Zopa have formed a partnership with Airbnb, which enables borrowers on the Zopa platform to include income from their Airbnb rentals when they apply for loans. In addition, the partnership aims to help borrowers pay down their loans quicker by hosting on the Airbnb platform.

[3] Data is correct as at August 2017. To find daily updated data, you can visit Orca's Website: https://www.orcamoney.com/industry or for more in-depth analysis of individual P2P platforms you can visit Orca's Analytics Service: https://platform.orcamoney.com/.

[4] The Zopa platform is closed to new retail investors as at August 2017. Potential investors can monitor the situation and register their interest on the Zopa website: https://www.zopa.com/lending.

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Business Lending

Funding Circle, which operates in the business lending space, launched in the UK in 2010 and has grown significantly since then to become the largest P2P platform in the UK market. Business lending as a sub-sector has also grown significantly and now represents approximately 35% of the overall P2P market. P2P has proven particularly popular with manufacturing and engineering companies as well as those in transport, utilities, finance and retail. Loan sizes can vary quite significantly. Funding Circle, for example, offers small business funding from around £5,000 and up to around £350,000. Other platforms offer loans to businesses in the millions.

Business Lending Providers

Provider	Cumulative Total	2016 Total
Funding Circle	£2,571m	£823m
Assetz Capital	£304m	£108m
ThinCats	£245m	£63m
Folk2Folk	£168m	£51m
MoneyThing	£69m	£35m
Abundance Generation	£53m	£35m
ArchOver	£42m	£16m
Funding Knight	£31m	£3m
Ablrate	£25m	£12m
Crowdstacker	£17m	£15m
LendingCrowd	£15m	£5m
Rebuilding Society	£12m	£2m
Total Business Lending	£3,554m	£1,167m
As a % of Total P2P Lending	34%	36%

Source: Orca Research.
Note: As at August 2017.

Property Lending

Property lending accounts for the remaining 20% of the P2P market, with a number of platforms operating in this space such as LendInvest and Lendy. There are a variety of financing models and products in property lending, ranging from short-term bridging finance to longer-term commercial and residential mortgages, and construction and development.

Property Lending Providers

Provider	Cumulative Total	2016 Total
LendInvest	£999m	£355m
Wellesley & Co	£502m	£60m
Lendy	£327m	£163m
Octopus Choice	£134m	£49m
Proplend	£71m	£1m
Landbay	£50m	£11m
Relendex	£12m	£1m
Total Property Lending	£2,096m	£642m
As a % of Total P2P Lending	20%	20%

Source: Orca Research.
Note: As at August 2017.

Who are the Lenders?

Retail Involvement

The majority of lenders in the UK P2P market are individual investors. We estimate that there are around 200,000 retail investors currently lending in the UK.

It's fairly normal for institutional involvement to remain lower in the early stages of a new sector. Firstly, new sectors are simply not large enough for institutions to invest in, as institutions often require the ability to write large tickets, in the tens of millions, while also ensuring that they do not represent too large a proportion of a particular provider/platform due to the risk of concentration. Secondly, until the sector gains the stamp of approval from the regulators and has a decent track record, those in charge of an institution's wealth are simply unwilling to put their necks on the line for it. Instead, they'd rather invest in well-known, blue chip asset classes which their peers are all invested in too.

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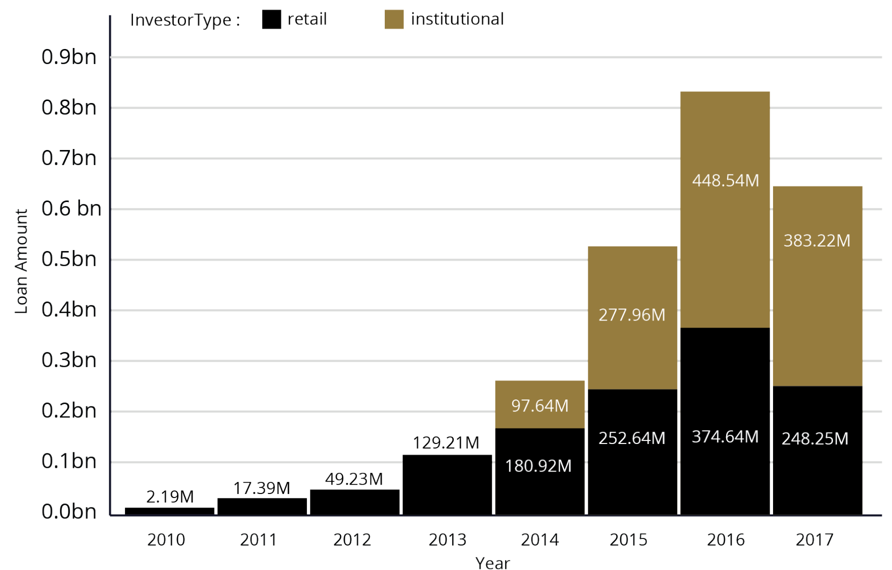
There's much less chance someone will get fired for those investments if they get into trouble. Thirdly, the P2P ecosystem is still in its early stages, which means that access to independent research and adequate due diligence tools is largely unavailable.

There are some drawbacks of institutional involvement in P2P to be aware of. The main concern is the potential conflicts of interest that may arise, which could see institutions cherry-picking the best deals from platforms to the detriment of retail investors. Indeed, the FCA has also highlighted this concern and will likely be monitoring the situation closely in the future.



Source: Funding Circle Loan Book, Orca Analysis.

While there may be some concerns, growing institutional involvement, on balance, should be seen as a positive sign for the P2P sector. As long as P2P participants remain well-versed on the risks involved and the FCA implements the necessary rules, institutional involvement could be a great thing for borrowers, lenders and the wider ecosystem alike. Institutions mean more capital for lending and an increased demand for robustness in the credit and business models involved, which in turn helps to grow the sector and stabilise the businesses of the platforms. Institutions also increase awareness with other investor groups, thus helping even more capital to flow into the sector. As platforms become larger and more profitable, we could also see cost savings passed on to investors.

The British Business Bank

One of the key milestones for institutional involvement in P2P was the involvement of the British Business Bank. The British Business Bank is a UK Government-owned economic development bank established to increase the supply of credit to small and medium enterprises as well as providing business advice services. It has so far invested more than £100m through a number of P2P platforms, with the majority invested through Funding Circle and further capital invested through Zopa, RateSetter and Market Invoice.

Investment Trusts

There are a number of listed investment trusts, including P2P Global Investments, VPC Specialty Lending and Ranger Direct Lending, which have proven to be a popular structure with institutional investors. Institutions have been attracted to these trusts thanks to their promise of high yields in this low yield environment and the belief that the teams involved have the skills to construct the best performing portfolios. A drawback of these trusts being listed is that their price can fluctate significantly away from NAV, causing large performance impacts; for example, in 2016 many began to trade at a large discount to NAV (>20%), having previously traded at a premium.

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The Growth of P2P

12 years after the first loan was originated on the Zopa platform, P2P has grown significantly, surpassing the £10bn cumulative lending milestone in July 2017. Although Zopa has been in operation since March 2005, it was not until Funding Circle and RateSetter joined the party in 2010 that the asset class saw its explosive growth.

Samir Desai, CEO of Funding Circle, has previously described how three powerful trends have created a perfect environment for P2P to grow.

(1) Post 2008, financial institutions' appetite for lending reduced
(2) and, as a result, the Bank of England cut interest rates to a record low, leaving investors starved of yield.
(3) At the same time, Internet Marketplaces like Uber and Airbnb disrupted massive traditional industries.

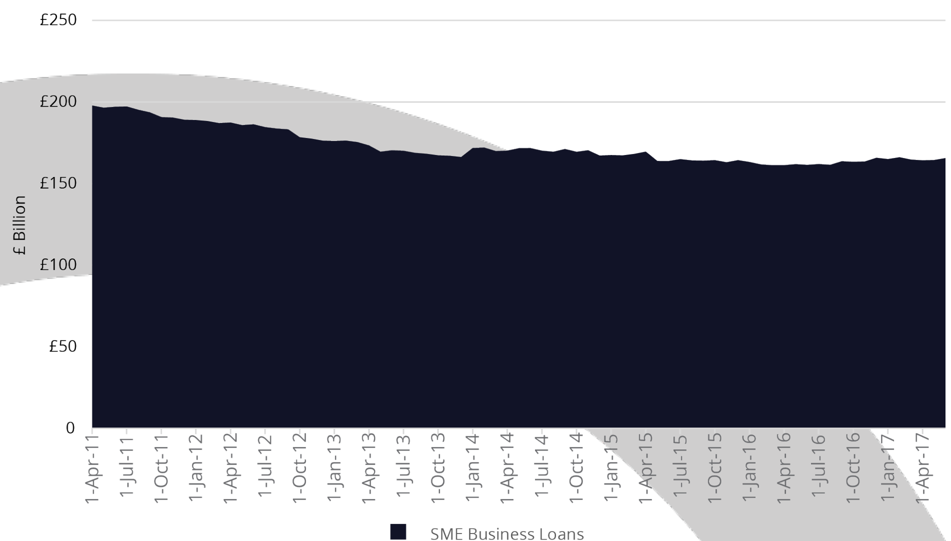
We believe that there is a fourth trend which spurred growth in the P2P sector – (4) consumers distrust financial services, particularly when it comes to major banks.

"We're entering a Golden Age for Peer to Peer Lending" Samir Desai (CEO of Funding Circle)

We've revisited these trends to understand if market conditions still hold true today and to make predictions on what will catalyse further growth in the industry.

Mega Trend 1: The Banks Stopped Lending

Does the trend still hold true today?



Source: Bank of England

The consumer lending market, where Zopa, RateSetter and Lending Works play, has become increasingly competitive. Since 2008, we have seen a resurgence from the traditional lenders in the consumer lending market, as well as a flurry of new entrants such as Hitachi Personal Finance, Tesco Bank, Sainsbury's Bank and the AA. This increased competition, particularly for prime borrowers, has driven down investor yields in the P2P market. Good for borrowers, bad for lenders. With consumer lending accounting for 46% of the UK P2P lending market in 2016, this rise in competition is the principal reason we are seeing a slow in growth throughout the total P2P market.

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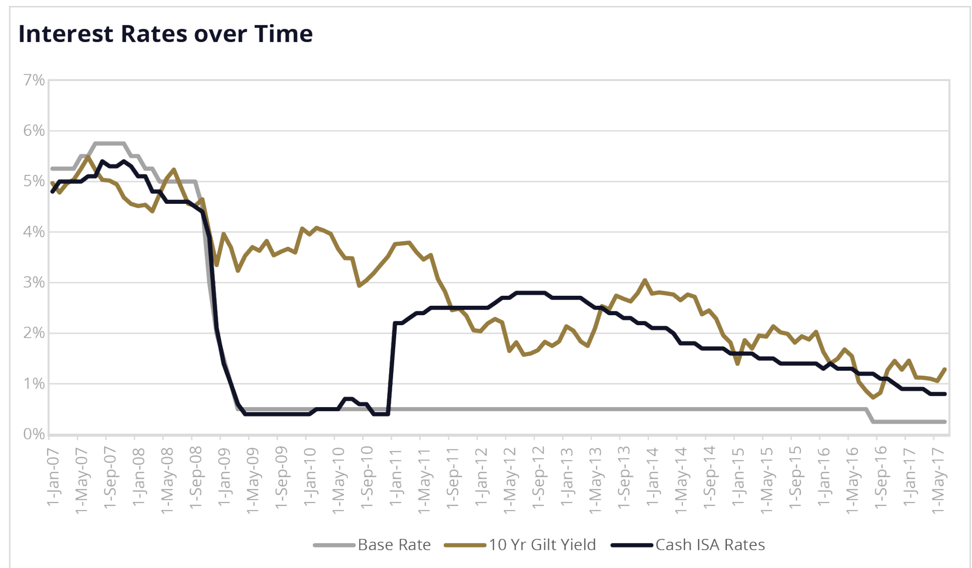
However, the business lending market has not recovered in the same way and continues to contribute to the growth of P2P. In fact, Bank of England data (right) shows that the amount of loans outstanding has continued to drop since 2011. Comparing today's conditions to 2011, there is 16% less capital outstanding within the SME lending markets. P2P business lending – in particular Funding Circle – appears to have found a niche of lending below a million pounds and on average below £100,000. This level of lending, targeting SME businesses, is below the size which attracts large financial institutions.

Mega Trend 2: Low Yield Environment

Chronically low inflation-adjusted returns on 10 year Gilts and cash ISA rates sitting below zero presents a major issue for savers, pensions and the broader fixed income industry.



Does this trend still hold true today?

Absolutely, this trend is just as prominent today than it was five years ago. While the exact timing and the levels to which rates will be risen is debatable, there is little evidence to suggest that a substantial rise in base rates, returning them to near historical levels, is on the cards for the foreseeable future.

Howard Archer, economist at the consultancy firm IHS Markit, told the Guardian in March 2017:

"While we believe the next move in interest rates will be up, we do not see this happening before 2019 and it could well be delayed further by prolonged economic and political uncertainties."

Mega Trend 3: Growth in Technology

At the turn of the millennium, the widespread adoption of home computing took off. This resulted in direct innovations within personal finance as more and more people took to their computers to manage their finances. Technology is at the core of P2P, connecting lender and borrower seamlessly on an online platform. Just like Uber disrupted the taxi market and Airbnb the hotel, P2P has disrupted traditional lending markets.

The underlying lending product, cash, offered by traditional financial institutions is no different to that of P2P platforms. Often the credit assessment process is very similar, with P2P platforms recruiting ex-bankers to manage their risk teams.

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The true differential between P2P platforms and traditional finance providers is the user experience and, specifically, the speed at which a credit decision can be made.

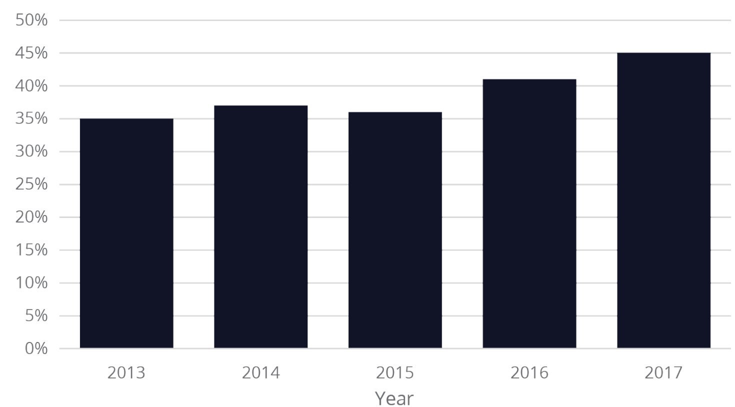
Does the trend still hold true today?

Although the user experience of the incumbants' technology is improving, legacy systems and prohibitive organisational structures prevent such large businesses from technologically excelling.

P2P platforms will continue to use technology to their advantage and this will continue to be a key differentiating factor. Fundamentally, P2P platforms offer a better experience for borrowers and lenders alike.

Mega Trend 4: Anti-Bank Sentiment

The 2008 credit crisis and subsequent scandals such as the miss-selling of PPI had led to an increasing negative sentiment and general distrust of financial services. One of the longest running surveys on consumer trust is the Edelman's Trust Barometer. In 2017, only 45% of UK consumers stated that they have trust in financial institutions.



Source: Edelman Barometer.

With such a poor level of trust throughout financial services, consumers have searched for alternatives. Funding Circle's vision statement directly appeals to this sentiment:

"We're building a better financial world. Funding Circle was created with a big idea: To revolutionise the outdated banking system and secure a better deal for everyone."

Does the trend still hold true today?

While consumer trust for financial services is growing once more, and it feels like the wide-scale bank bashing has somewhat softened, it is clear that there remains a level of sceptism when it comes to traditional finance. Indeed, while the sentiment index has grown quite significantly since its low of 21% in 2010, just 45% of consumers trusting financial services remains a remarkably low number. Consumers continue to be frustrated with their banks and, importantly, are increasingly wanting differentiated products and choices. This is leading consumers to alternative products and "challenger" companies, as it is difficult to identify differences in major banks' products, from processes to marketing, as the line-up from one institution to the next is very much the same.

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How is P2P Regulated?

The History of the FCA and P2P

The history of the FCA's regulation of peer-to-peer lending is a relatively short one; starting in April 2014 when they took over the regulation of consumer credit from the Office of Fair Trade.

Regulation of Innovative Finance ISA

The Innovative Finance ISA ("IF ISA"), launched in April 2016, allows for P2P loans to be held within a tax-efficient ISA wrapper. The IF ISA was, and still is, significant for a number of reasons: It is a shining example of the FCA's commitment to the growing P2P sector and the ISA represents a trustworthy structure and brand with broad, mass market appeal.

The Future of FCA Regulation

The total number of P2P platforms with full authorisation now stands in the twenties according to the Orca IF ISA tracker[5], which is up from just two in November 2016, and we expect the flurry of newly authorised platforms to continue through 2017. With the heavy hitters now passing the bar and further entrants getting the FCA's stamp of approval, it seems likely that the sector will continue on its growth trajectory. One area of growth expected is in IF ISAs, which, once HMRC ISA plan manager approval has been granted, can now be offered by the larger platforms thanks to their recently granted full authorisations.

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[5] For more information, visit Orca's website: https://www.orcamoney.com/innovative-finance-isa.

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Regulation is likely to continue to tighten as the sector grows and matures. Indeed, in December 2016, the FCA published its interim feedback on the call for input to the post-implementation review of its crowdfunding rules[6]. The FCA expects to publish new rules later in 2017.

Clearly the market still has some concerns when it comes to P2P, as there has been little uptake from intermediaries and, although it's increasing, institutional involvement is still relatively subdued. As a mitigating factor, the P2P ecosystem will continue to develop; independent third parties such as Orca will help to educate investors and provide the necessary transparency and tools required to conduct in-depth due diligence.

So, as long as the FCA maintains its commitment to ensuring innovation is allowed to flourish, while strengthening the sector, new rules should be welcome news to all involved.

[6] For more information, visit the FCA's research: https://www.fca.org.uk/publication/feedback/fs16-13.pdf.

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4 THE BENEFITS

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Risk-adjusted Returns

In a low-yield environment, P2P can offer stable, predictable, risk-adjusted returns. P2P investments offer average annual returns of between 5% and 6%. Investors can achieve upwards of 10% annually, depending on their appetite for risk.

Efficient Asset Class

Offering credit as an investment has been around for centuries. Credit assessment is not new. P2P providers have innovated by offering an efficient, low-cost method of accessing credit investments.

Uncorrelated

P2P investments are not listed on an exchange, meaning the performance of assets are not highly correlated to stock market volatility. P2P assets are expected to perform better during an economic downturn in comparison to equities or bonds.

Diversification

P2P lending allows investors to diversify into an alternative asset class. Some of the largest P2P providers auto-diversify investors' capital across a large number of borrowers, increasing their exposure, and reducing the risk of borrower default.

Innovative Finance ISA

The new IF ISA allows investors to hold their P2P investments in a tax-efficient ISA wrapper. P2P Providers offering the IF ISA can be found on the Orca IFISA tracker page.

Income or Growth

Investors often have the choice of taking interest payments as an income, or for these payments to be reinvested, enabling capital growth.

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5 THE RISKS

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Note: P2P is an alternative investment where funds are not covered by the Financial Services Compensation Scheme (FSCS). Ultimately, without FSCS coverage, investors' capital and interest are at risk.

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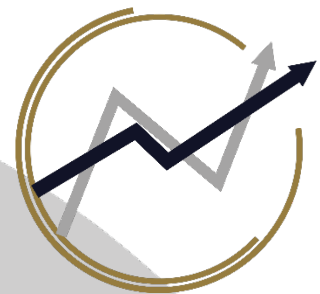
Performance Risk

- Credit Risk: Borrower default may result from a poor initial credit decision or economic factors (see market risk).

- Cash drag: P2P platforms create a marketplace of borrowers and lenders. Where an imbalance exists of more borrowers than lenders, investors' capital may sit idle waiting to be lent. This can significantly reduce returns.

Platform Risk

- Platform insolvency: Platforms may become insolvent. FCA rules dictate that platforms must have sufficient plans in place to ensure borrower repayments continue, but such an event would likely cause significant turbulence for investors.



- Fraud: Although FCA rules stipulate P2P platforms must segregate client assets from their own, Nesta reported in their 2015 the potential collapse
  of one or more of the well-known platforms due to malpractice was the
  biggest risk to the growth of the sector.

- Technology risk: The entire P2P industry is based online and a severe cyber security breach is a real risk. Cyber security was highlighted in Nesta's 2015 report as one of the key risks to the sector.

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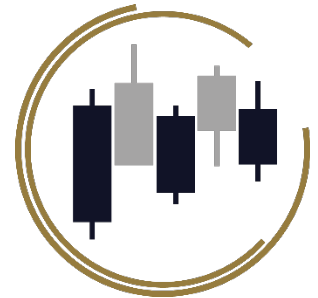
Market Risk

- Interest rates: With interest rates holding record-low levels since 2009, the P2P sector has largely grown in a low yield environment. The risk here is that P2P returns may not appear as attractive to investors as compared to other asset classes in a higher rate environment.



- Unemployment rates - consumer lending: If unemployment rates were to rise, the risk of borrower default would also rise which, in turn, would lead to diminishing investor returns. During the 2007/2008 recession, Zopa's default rates rose from 0.49% in 2007 to 5.07% in 2008[7]. However, it's well-documented that Zopa performed well through this period, with the platform printing returns of more than 5% in the entire period prior to 2014. In fact, post 2008, competition for borrowers was very low, which pushed up the weighted average borrower rates, even for prime borrowers, providing investors with superior returns.

- Property prices - property lending: If a loan backed by property moves into default, the P2P provider has the ability to sell the property held as security. Two things are important here. Firstly, how easy will it be for the property to be sold? Secondly, what value will the property or asset be sold at? Typically, P2P platforms will ensure they have sufficient loan-to-value ratios to ensure they can withstand a market down-turn.

Liquidity Risk

- Investors are contractually obliged to lend funds to borrowers over the term of the loan. The inherent nature of lending is therefore illiquid unless the loan can be sold to a new investor. Depending on the P2P platform it may be possible to sell loan commitments on a secondary market. Generally, the larger the P2P platform in terms of loan volumes, the more active or liquid the secondary market is.

[7] Orca independently analyses P2P platform loan books. For more information, visit Orca's Analytics Service: https://platform.orcamoney.com/.

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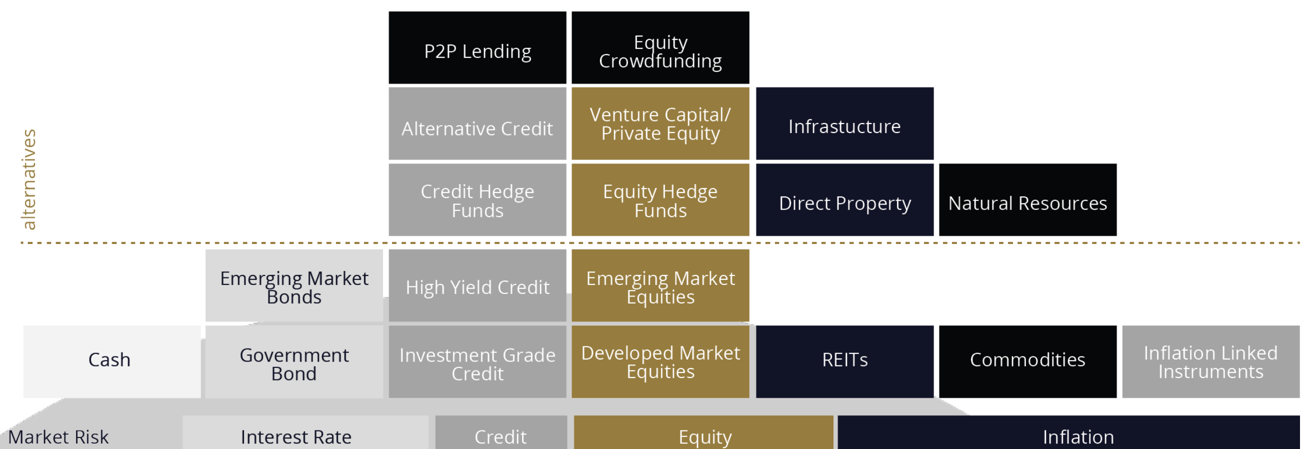
6 THE BEST PRACTICES

How to Think About Portfolio Construction: Where Does P2P Fit?

Conventional wisdom, derived from modern portfolio theory, tells us that optimal portfolios are those which are as diversified as they can possibly be. Diversification, after all, is the only way investors can reduce the risk of their portfolios without reducing the expected returns (see below section on how to think about diversification). One of the most famous applications of this in the world of institutional portfolio construction is David Swensen's Yale Model (or the Endowment Model). What's interesting is that as well as being a proponent for investing across the entire range of traditional asset classes on offer, the Endowment Model has had a growing focus on alternative asset classes.

Asset Class Map



Source : Orca

Our asset class map shows the traditional and alternative asset classes which comprise a typical, institutional, multi-asset class portfolio of this kind. P2P becomes part of the alternative credit bucket in portfolios. As an additional bonus, P2P can be relatively liquid when compared to many other alternative asset classes, which generally should allow for higher allocations.

Unfortunately, when it comes to retail investors it's difficult to access the world of alternative investments, with the exception of personal, residential property. Even for some institutions, accessing the best deals can be tricky. This has led to retail portfolios that are largely comprised of highly-liquid, cost-efficient equities and bonds, for example in a 60 / 40 percentage split. In some portfolios there may also be some exposure to commodities. With the recent advancement of technology, efficient passive investment vehicles such as ETFs and online investment platforms have provided ever easier access to this kind of portfolio. Now, this is where P2P steps into its own, as it finally provides broad access to the

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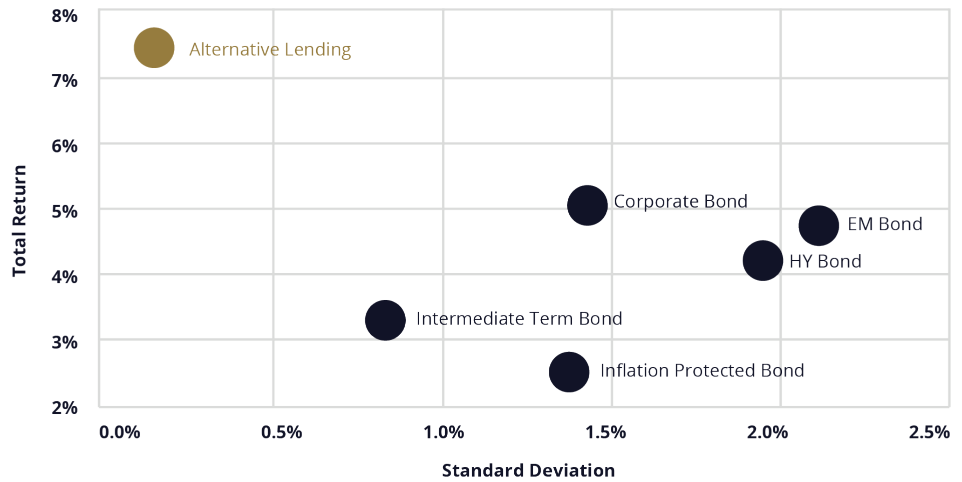
alternatives space. P2P platforms have now democratised the process of investing in alternatives and so individual investors can complement their existing traditional portfolios with higher yielding, uncorrelated alternative credit.



Source : Funding Circle, Lendit, 2016

P2P platforms are able to achieve these superior risk adjusted returns thanks to their structural efficiencies. These platforms cut out the middleman (i.e., the banks) and are operating as new FinTech businesses, which leaves them free of archaic legacy technology and operating systems.

How to Think About Diversification

In 1952 Harry Markowitz, the Nobel Prize winning economist, described diversification as the 'only free lunch' when investing. This is because diversification is the only way investors can reduce the risk characteristics of their portfolio while not reducing the portfolio's return expectations. Fast-forward 65 years and this same philosophy applies to P2P portfolios.

Whether investing through an active or passive strategy, there are two main ways to diversify a P2P portfolio. Firstly, investors should diversify their loan selection across a large number of borrowers. This mitigates the credit risk inherent in P2P investing, as one borrower defaulting will have less impact on your overall portfolio. Of course this doesn't mitigate the risk completely, as a large number of borrowers may default on their loan commitments at the same time. Secondly, investors should diversify their exposure to each P2P platform. A number of risks exist at a platform level including insolvency, fraud and security. If a platform were to fail for one of these reasons, investors may be subject to turbulence, have difficulty withdrawing their capital and may be at risk of losing some or all of their capital altogether. Diversifying your holdings across multiple P2P platforms helps to mitigate this risk.

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How to Think About Implementation

There are a number of factors to consider when chosing how to implement a P2P portfolio, including direct investing or investing through a structure.

The illiquid nature of P2P has posed an issue for large institutional investors who are used to highly liquid investments. Listed investment trusts such as P2P Global Investments and VPC Specialty Lending have resolved this issue by establishing investment trusts which invest in P2P loans.

However, such structures do not truly alter the underlying liquidity of the P2P portfolio and, due to their listed nature, exhibit a lot more volatility. While direct P2P investing is largely shielded from external market factors such as general market sentiment or interest rate movements, the prices of listed vehicles can move around quite dramatically. The large investment trusts are currently trading at large discounts to NAV. A further drawback of investing through a structure is the increased costs of active management, leading to higher fees paid by investors.

Investment Structure Benefit Breakdown

	Direct P2P Investing	Listed Investment Trusts	Non-listed Pooled Investments (Goji)
Transparency	High	Low	Low
Yield	High	Medium	Medium
Costumisation	High	Low	Low
Volatility	Low	HIgh	Low
Liquidity	Medium	HIgh	Low
Historical Performance	High	Medium	Low
Platform Diversification	Non applicable	High	High
Fees	No additional fees	Fees apply	Fees apply

In the past two years, we have also seen a number of non-listed pooled investment structures emerge which again are tasked with actively selecting loans originated by P2P platforms. Goji's Crowd Bond targeting both retail investors and financial advisers is an example of this which has the added benefit of being Innovate Finance ISA eligible. Investors in this kind of structure benefit from platform diversification, but will lack the transparency and lower costs of direct investing.

How to Think About Active vs. Passive

As discussed in the section above, investors can chose to invest directly on P2P platforms (either actively or passively) or invest through a structure which benefits from more active management.

When investing directly on P2P platforms, investors will need to make the decision whether they would like to invest actively or passively. P2P platforms such as ThinCats and Lendy require investors to actively select the loans they wish to invest in, while others such as Zopa and RateSetter automatically match capital across a large number of borrowers, creating a passive investment.

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By actively selecting loans investors can implement their own investment strategy which may yield greater returns. Although achieving alpha is possible, investors are responsible for diversifying their portfolio and managing cash drag which can be difficult and time consuming.

Passive investments allow for capital to be allocated to a range of non-specified borrowers using “autobid” functionality. As an example, Funding Circle allows investors to either actively select opportunities or invest passively; active loan selection provides a choice of loans graded between A+ to E while the autobid function automatically invests across loans graded A+ to E

How to Think About Liquidity

When it comes to P2P, liquidity is a particularly important consideration, because the underlying loans can have fairly long maturities, often up to 5 years. Many investors in P2P may forget that they are actually entering into a loan agreement as a lender, as opposed to simply investing in a certain asset. When an investor commits money to a P2P platform, they are entering into a loan agreement which is essentially a commitment to lend a certain amount of money to a certain borrower for a defined period of time. This means that you, the lender, are on the hook for that defined amount of time and have no legal right to access your capital early so long as the borrower is abiding by the terms of the loan agreement. However, many platforms have built in clever functionality which allows investors to access their money early by selling the loans on a secondary market. This often happens very quickly. Sometimes you can have early access for free and some platforms charge, so it’s important to check the specific terms of your account. It’s important to remember though that you can only sell your loans if there is someone willing to buy, and under adverse market conditions liquidity may dry up.

Investors can achieve best practice by ensuring they (a) understand the real liquidity of their portfolio, and view the early access mechanisms as a bonus, (b) size P2P within their portfolio appropriately, dependent upon their liquidity tolerance, and (c) diversify their holdings as much as possible to best-place portfolios for adverse market conditions.

Drawing an income from your investment

One way to gain access to your money is to choose to take income from your peer-to-peer loans, as opposed to re-investing any income earned or capital repayments in new loans. Many platforms which offer “autobid” functionality will allow investors to choose whether they would like interest to be automatically re-invested or paid out as income. The benefit of this method is that you gain liquidity from your investment without having to rely on other lenders and there is no additional cost.

A couple of things to be aware of when you are doing this is that (a) it can cause a cash-drag on your portfolio, due to cash sitting idle in your accounts and (b) it may increase your administrative burden, as you will need to manage your capital flows.

Early Access Accounts

Some P2P platforms offer specific products designed for early access. Typically, these accounts allow investors to withdraw their capital, under normal market conditions, almost immediately and free of charge. These products generally have lower rates associated with them. RateSetter and Assetz Capital, for example, offer early access products which offer rates of 3% and 3.75% respectively at the time of writing.

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"Under normal market conditions" is an important phrase here. While these products offer early access, under normal market conditions, the investor is still investing in loans with maturities of up to 5 years in both the RateSetter and Assetz Capital products. Therefore, the underlying liquidity of the assets has not gotten shorter and is certainly not aligned to the daily liquidity offered by the product.

Investors should view these products as having the advantage of being specifically designed for early access and so make the process easier and faster for the investor, while not charging a fee for this service. They should not be seen as a way to improve the underlying liquidity of your loan commitments.

Under adverse market conditions

As discussed, you can only access your money early so long as there are buyers or other lenders who can take on your loan obligations. This is fine under normal market conditions, but what happens under adverse market conditions? Well, it may mean that there are more people wanting to sell their loan obligations than those wishing to buy them. In this scenario, investors may need to offer discounts to encourage people to buy their loans, or may not be able to sell at all. If liquidity were to dry up and you cannot find a buyer or an alternative lender, you will be obligated to hold your loan to term.

On its own, this is not necessarily a bad thing, as the underlying loan may not be affected by the adverse market conditions and you will simply be earning interest as usual. The trouble comes because adverse market conditions may come hand in hand with an increasing number of borrowers defaulting on their loans, reducing your return expectations. To put this all into context though, P2P is not a unique asset class from this perspective. The majority of financial investments may see liquidity dry up and/or see a negative performance impact under adverse market conditions.

How to Think About Performance

As with all investments, generally, the higher the return the higher the risk. The credit performance of a P2P platform can be evaluated using both historical and current data. Fortunately, the large P2P platforms are fairly transparent with detailed statistics and loan by loan data being made available. This has allowed us at Orca to independently analyse a number of P2P platforms with the results displayed on the Orca Analytics Service[8]. Currently it's free to sign up, with no obligation on your part.

It's important to note that historical data should be reviewed with respect to the loan term. A loan issued in the first half of 2017 with a 5-year term is considered to be in its infancy and is unlikely to have defaulted. This may create the perception of artificially high returns and low default rates for loans issued in recent years. For the years that all loans are 100% complete (defaulted or repaid) we can fully review the performance of the platform in that given period.

[8] For more information, visit Orca's Analytics Service: https://platform.orcamoney.com/.

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How to Think About Operator Health

A platform risk exists in P2P. Effectively, if a platform becomes insolvent or has a large cyber breach or fraud exists, investors' capital is at risk. To mitigate this risk, in-depth due diligence needs to be conducted not just on the quality of the loans originated by the platform but on the platform itself. To mitigate this risk further, it's wise for investors to diversify across multiple P2P platforms. Detailed financials and background information on the platform directors can be found on the Orca Analytics Service.

How to Think About Borrower Supply

P2P, at its core, is a balancing act of lenders and borrowers; if there is an oversupply of investors there may not be enough borrowers to fulfil the demand. On active or manual loan selecting platforms, investors may have to wait for loans to become available and specific loans may be competitive. Cash sitting in an account waiting for lending opportunities earning no interest reduces the overall return, and the advertised rates assume cash is lent immediately.

The cost of borrowing, particularly in the consumer lending market where Zopa operates, is very low and traditional lenders are competing with the P2P platforms for borrowers. This has led to these platforms struggling to meet the investor demand. On the RateSetter platform, interest rates have suffered and on the Zopa platform new retail investors have been refused due to an oversupply of capital.

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7

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THE MYTHBUSTERS

"P2P is the last and only choice for risky borrowers"

This is categorically not true. Borrowers typically use P2P platforms due to their superior user experience, particularly the speed at which they reach lending decisions. A Centre of Economics and Business report[9] commissioned by Funding Circle reported that 72% of their borrowers found the experience of obtaining a loan to be faster than other providers they'd considered. This helps to explain why 77% of borrowers initially shopped around for finance, but 94% would come back to Funding Circle first in the future.

Research conducted by Orca found that traditional lenders have reduced their lending to SMEs[10]. The regulatory costs for a bank to lend £50,000 is the same as that of a £3 million loan. Traditional lenders are not lending to this group because it is no longer commercially viable, not because of the underlying risk profile of the borrower.

"P2P is a new fad"

The history of P2P lending has been short in comparison to the concept of lending more generally. Early loan contracts, including the concept of interest and use of security can be traced back to pawnbrokers operating in Ancient Greece. The innovation that P2P platforms have delivered lies in their use of technology, not the underling concept of lending. By bringing lending online, investors can benefit from an efficient process with no intermediary, whilst borrowers receive a quick credit decision. A long 'no' is incredibly frustrating for borrowers.

Zopa created the first P2P platform in 2005, has since endured a recession and has now lent more than £2bn. It wasn't until post-recession conditions in 2010 when RateSetter and Funding Circle joined the market that the sector began to pick up pace. We now have sufficient data and an industry track record to make informed investment decisions. P2P, as a sector, is coming of age.

"P2P is the same as equity crowdfunding"

Emerging at roughly the same time as equity crowdfunding and with funds initially sourced entirely from retail investors, or 'the crowd', P2P has often been considered to be "crowdfunding". Currently, the only body referring to P2P as crowdfunding is the FCA who continue to refer to the asset class as 'Loan-based Crowdfunding'. This is terminology that the P2P industry is steering away from.

Equity crowdfunding and peer-to-peer lending are fundamentally different. Equity crowdfunding involves people investing in early stage companies in exchange for equity. The businesses raising finance are often very early stage

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[9] For more information, visit https://static.fundingcircle.com/files/uk/information-packs/small-business-big-impact-cebr-report-315de033.pdf.

[10] For more information, visit Orca's website: https://www.orcamoney.com/blog/the-growth-of-peer-to-peer-lending.

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companies looking to raise finance to kickstart their venture. Successful investors on equity crowdfunding platforms such as Seedrs or Crowdcube can reap significant financial gain, however, the risks are high.

In comparison, peer-to-peer lending involves established businesses and credit worthy individuals borrowing funds directly from lenders. In return, interest payments provide a steady stream of income to investors.

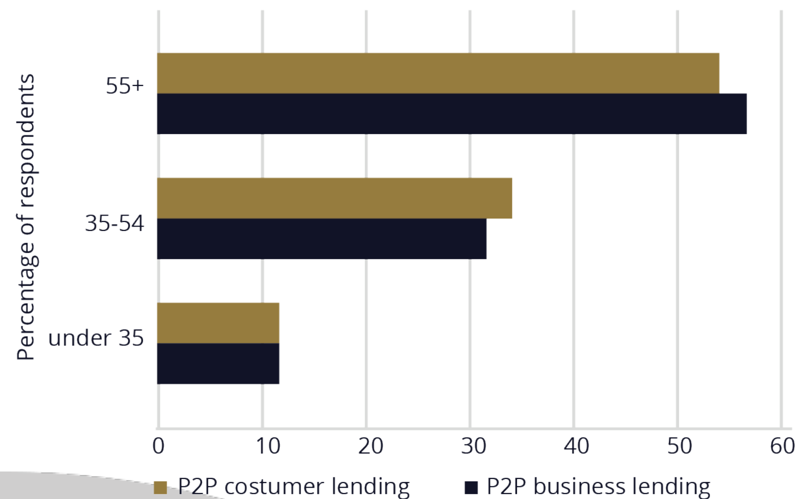
The UK equity crowdfunding market has raised £480 million1 cumulatively across 6 platforms since inception while the UK P2P market has lent more than £10 billion cumulatively[11], highlighting the difference in scale between the two asset classes.

"Only millennials invest in P2P"

It's a common misconception that P2P is reserved for the millennial generation. The assumption that technologically advanced investment solutions such as P2P and robo-advice are dominated by the 'tech savvy generation' is incorrect. Millennials alone cannot be expected to sustain growth in P2P due to the group's broad lack of affluence.

In fact, evidence by Nesta[12] shows that over 55% of investors are 55 years old and over, with only 12% of investors under 30.

While it is quick and simple to invest online, this is not the primary reason retail investors are attracted to the asset class. The stable, risk-adjusted returns first attracted enthusiastic retail investors before spreading more mainstream.



"An interest rate rise will kill the P2P industry"

If interest rates rose to pre-2008 conditions where savers could yield 5% from their Cash ISA, it's likely that the P2P market would be impacted to some degree. Media commentator Damien Fahy of MoneytotheMasses predicts that interest rates will rise to 0.5% in 2018[13], which is still a long way off significantly impacting the P2P sector.

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11 To find daily updated data, you can visit Orca's Website: https://www.orcamoney.com/industry.

12 Pushing Boundaries, by Nesta (2015): http://www.nesta.org.uk/sites/default/files/pushing_boundaries_0.pdf.

13 For more information, visit: http://moneytothemasses.com/owning-a-home/interest-rate-forecasts/latest-interest-rate-predictions-when-will-rates-rise#article-overview.

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If interest rates were to rise, the cost of borrowing and rate of returns to lenders would follow suit. In theory, the returns generated by the P2P sector should rise in tandem beyond the Cash ISA rates. It's the spread between the investor rate and the borrower rate which is important, not the Bank of England base rate.

"P2P will suffer during an economic downturn"

Zopa did endure the 2007/2008 economic crisis and default rates did rise from 0.18% in 2006 to 5.07% in 2008, however, Zopa lenders have earned returns in excess of 5% in every year prior to 2014.

If unemployment rates rose, the ability for individuals to repay their loans would be affected, similarly, if business insolvency rates rose SME defaults would also rise. The question is how big would the impact be and ultimately are lenders at risk of losing money? Landbay commissioned MIAC Acadametrics (MIAC)[14], an independent asset valuation service provider, to model how the P2P provider would perform in poor economic conditions. The results found that Landbay's expected loss rate would be 0.03% in normal economic conditions and 0.48% in poor economic conditions. Their estimates found that the returns earned by investors would fall by 0.48%, but critically investors would not have lost money. Landbay's results may be encouraging, however, this may not be representative of the overall market and investors should understand that their capital is at risk, particularly during an economic downturn.

P2P agreements do not sit on a stock exchange and, as such, are not affected by large swings in traditional markets. In simple terms, P2P has a low degree of correlation and it's predicted that P2P assets will perform better than traditional assets that are listed on an exchange during an economic downturn.

[14] For more information, visit Lanbay's website: https://landbay.co.uk/reports.

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8 CLOSING THOUGHTS

Peer-to-peer lending can offer investors strong, stable yields. One benefit that is perhaps overlooked is the diversification that P2P can offer. The performance of loans is not correlated to stock market volatility which can be particularly useful in periods of uncertainly. In the past, alternative credit investing has only been available to institutions and in this sense P2P has democratised alternative investing to the masses.

With an array of investment products on the market - advertising returns ranging from 3-19% - there is a spectrum of opportunities presented to investors. With upside, there is clearly downside risk, and the market can be complicated. Investors are not only encouraged to diversify across a large number of loans but also across multiple P2P platforms. This will diversify a P2P portfolio across a large number of borrowers, P2P platforms and loan types.

One potential solution is aggregator platforms which offer a mix of loan opportunities from different P2P platforms. This enables cross platform and cross loan diversification while still offering the non-correlated attributes of direct P2P investing. The team at Orca live and breathe peer-to-peer lending, serving both retail investors and financial advisers with in-depth, independent P2P research. Offering an aggregator investment platform is a natural evolution for Orca and something the team are currently focused on. This next phase of the Orca platform will allow investors to invest across multiple P2P platforms from the Orca site with the aim of increasing investor diversification. Initially, the platform will be launched to a limited number of investors. To be considered a first user of the Orca investment platform please email 'iain@orcamoney.com'. There are a number of spaces still available, however, the list is growing rapidly.

Thanks for reading. If you have any comments on this guide feel free to email Iain Niblock, CEO of Orca, directly at 'iain@orcamoney.com'.

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CONTACT ORCA

Orca aims to drive the mainstream adoption of peer-to-peer lending and have done so by providing independent data, research, analysis and tools to empower investors for the past 2 years.

Independence is a core value of Orca. By providing independent analysis, insight and tools, we strive to instil confidence in investors researching P2P. If you would like to contact anyone at Orca, you can find the team's details below:

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