Privcap/ Report

Q1 2021 | Dealmaker Roundup

Specialty Finance Turbo-Charged by FinTech

- The expansive definition of specialty finance
- Innovations driven by financial technology
- Point-of-sale breakthroughs
- Mistakes made by PE investors

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Specialty Finance Turbo-Charged by FinTech

This report is based on an edited transcript of a recent Privcap podcast.
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Privcap: Why don't we start with a definition of "specialty finance," because it means different things to different people.

Jim Chester, KBW: When we talk about specialty finance, typically we're talking about originators of capital solutions who either provide these to consumers or to businesses. Traditionally, we think about specialty finance companies being outside of a regulated financial institution, like a bank. But that's not always the case. Companies are not only making loans - sometimes they're doing leases, sometimes they're doing purchases of a future receivable or some type of an advance against a future asset.

Specialty finance companies, since they typically don't have deposits, they either have to fund themselves in some wholesale manner. They can either originate their assets and, if they hold them on the balance sheet, they need to fund them with lines of credit from banks or credit funds, or they need to access alternative sources of mezzanine capital, or even private equity, to support their growth.

Hersh Shah, RSM: I would just add that more and more plays in the FinTech world are now becoming specialty finance, or specialty finance companies are now describing themselves as FinTech companies. So lending through an online model or through cell phone model, or lending through some algorithmic origination or Ais, that's where I've seen an overlap with specialty finance.

Brandon Hollis, RSM: Jim captured it when we said lending institutions that don't have access to deposits. There's also definitely a FinTech layer to this. We've definitely seen an outgrowth of partnerships between what might be considered traditional financial services, including specialty finance companies, and technology companies to develop these pretty innovative FinTech solutions.

Privcap: It sounds like FinTech is a big driver of growth in specialty finance today.

Chester: The main attraction for FinTech companies to participate in specialty finance is basically the ability to add convenience and speed to a process and also bring additional information into the specialty finance world to help manage risk.

From an origination standpoint, being able to access applications online, being able to access credit applications through your mobile phone, increases convenience for potential borrowers or parties that need the capital. It also increases the speed with which the providers of funding can adjudicate that opportunity. From an underwriting standpoint, from the finance company's perspective, it allows them to access much greater levels of

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information. That could be directly on a loan application from a potential borrower, or they can also access third-party data very quickly so they can call out using third-party providers to get much more information, to help them underwrite a specific request and to help them manage overall risk much more efficiently.

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Shah: We are in a post-COVID world, where people are working a lot more from home. Previously, there was traditional point-of-sale financing, which is also specialty finance. So, you go into a BestBuy and you want to buy a TV. That's where you're making that loan application. Now you want to buy a TV online and suddenly a button pops up asking if you want to finance this TV via the website. So, that is where you see an evolution, away from in-person financing in a store. You go to the Peloton website and there's an option to use Affirm to make your payment. Those are elements of FinTech that have really overlapped with specialty finance and a big growth in originations.

Hollis: One thing that's driving it is the change in the way in which consumers want to interact with their lender, with their financial services provider. Part of it is a generational shift towards the millennial generation and the power of the millennial in the marketplace in general. There is a desire for easy access to their lender, the ability to access on demand a bundle of products where they can go to one provider and achieve multiple different services. So, all of these factors in the changing of the underlying consumer have really put specialty finance in a place where they can maximize those opportunities through integration of technology in new and different ways.

There's always a place in the market for the standalone brick-and-mortar location for a certain market. But where the growth is and where the opportunities are to expand is in the FinTech-enabled side of the market, whether it's through a partnership with a technology company or developing the technology solution themselves, that's really where specialty finance companies will drive growth going forward. The current COVID environment really exacerbated and highlighted that trend. We were heading there anyway, and it got accelerated a little bit over the last year.

Shah: Five to seven years back, payday lending was very popular. Now, we are seeing that payday lending in some cases or by some private equity groups is considered taboo. They don't want to lend there, they don't want to invest if there's a lot of state regulations. But now, we have FinTech companies who are providing an advance for one day. So, if you're going to go to work today, but you need to get gas in your car and want an advance right now, the company is able to give you an advance for that day's salary, which is a big evolution from going into a store, proving that you have a job and then getting one week's salary and paying an extremely high interest rate.

Hollis: Hersh hit on something interesting with the regulatory environment. If you have a technology-enabled solution for delivering your products and services, you're much more nimble to be able to respond to changes in the regulatory environment, as opposed to being confined to a traditional brick-and-mortar type environment.

Privcap: When a private equity firm is seeking to invest in a specialty finance company, what are some of the most important underwriting considerations?

Shah: Traditionally, the model was, how many stores were you able to open? How fast can you originate? Now, there's so much competition within the specialty

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finance space and you really have to be able to prove you can do something different. You need to be able to say that you have a different product offering. You can't just offer a traditional specialty finance product. You need a product which is not just about lending money, but also additional value. Many companies are trying to attract the younger generation. So, private equity groups want to go to their investment committees and say they've got something different.

The other difference is there has been a decreased sense of taboo around specialty finance, which was at its height around the 2008-2009 era, when there was a credit crisis. Some of the larger players actually exited the specialty finance business because they did not want to be labeled as high interest-charging companies.

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–Brandon Hollis, RSM

Chester: If you're evaluating a company, you really need to understand how they're underwriting new opportunities. What is their methodology for evaluating credit, not only on the front, but how do they manage risk in a portfolio on the backend? That requires detailed analysis of the annual loss metrics of the business. For every dollar that they put out, what is the ultimate loss that they experience? We call that a static loss-curve analysis. You also need to make sure you understand how they're pricing the capital they put out the door, to make sure that they're getting a good return on the capital. In many cases, you may be dealing with a finance company that has relatively high losses, certainly higher than a bank, which is pretty common in the specialty finance world. But are they pricing their products appropriately for that level of risk? We sometimes refer to that as the risk-adjusted return on the investment. And that's a very important consideration.

When you think about analyzing these companies and investing in these companies, you need to make sure that the company's ability to fund its loan growth is efficient and there's enough flexibility and diversity in the capital structure, so you're not reliant on one source of capital. If that source of capital wakes up one morning and decides they don't like providing financing to a specialty finance company, you don't want to have all your eggs in one funding basket.

Shah: In specialty finance, traditionally there are a lot of companies or private equity groups who are looking to buy. But with the growth in originations and the growth in volumes, you also are seeing securitizations of portfolios. And, when you're seeing portfolios being securitized, the level of diligence changes. You need to make sure that you are doing enough to check the levels of support, and testing to make sure that there is really a portfolio which can be collateralized for somebody else. So, it's just not your traditional quality-of-earnings at that point. You have to go and do almost a field audit to make sure that they have a file that can be collateralized in the event that the platform goes under.

Privcap: Are there any particular sub-sectors within specialty finance that are receiving a lot of attention from private equity firms right now?

Chester: Anything in point-of-sale financing is very hot right now, including on the retail side, the buy-now, pay-later business model is very much in vogue. So, companies like Affirm, which finances retail purchases. The example of Peloton is one of the bigger providers of buy now, pay later. The other sector that's gotten a lot of attention on the point-of-sale side is home improvement. Post-COVID, people are staying in their homes, realizing they need to make more investment there, and using financing tools to help make those investments. That's become very hot segment. Vehicle finance is hot at the point-of-sale, but more specifically around power sports.

Hollis: I would add one other sector that we've seen a little bit of activity in is clean energy financing — things like solar installations for homes and commercial establishments, energy-efficient lighting installations.

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Privcap: Interesting. In the case of solar energy, would the loan be secured against the panels themselves? And if the person can't pay it back, the panels get reclaimed off the roof?

Chester: Basically, the lender does have a security interest in the panels, but it's not practical to foreclose on the panels at the top of the house. In most cases, they have the ability to shut off the solar panels, which decreases the energy efficiency on the property. So there's an incentive for the borrower to keep paying because they want those solar panels to keep running.

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Privcap: Have you seen any common misperceptions or mistakes that are made in specialty finance because the investors don't fundamentally understand the sector?

Shah: We sometimes get traditional private equity groups who are signing an LOI based on an EBITDA multiple, which is really weird, especially in specialty finance, because cash is the inventory. You cannot say that there's no cost of capital. So, using EBITDA as a metric versus EBT, which is a traditional metric, or pre-tax income versus pre-tax income after taxes and interests.

The other mistake is, how do you think about the closing net assets in the portfolio? You could, for example, look at traditional specialty finance businesses, which would have the lowest originations in the first quarter because of tax refunds versus the highest originations in the fourth quarter, because of holiday season lending. Those could be missing from a portfolio perspective in the LOI early in the process, and could become a deal breaker.

Chester: One mistake that I've seen is investors potentially focusing too much on origination growth, more on the top-line growth. For most businesses, that's going to be the key driver of earnings and profitability, and it's an important factor in a specialty finance company. But if you are not maintaining strict controls on your originations and maintaining your credit standards, you can very quickly get yourself in trouble and have much greater losses than you anticipated if you loosen your historical standards. And that can be a real risk factor for these businesses. So, analyzing the portfolio, the credit metrics and the loss potential of the portfolio is critical in connection with the growth. We like to say, focus on safe growth, not just growth at any cost.

Shah: Just focusing in on two or three years in specialty finance doesn't really work. When you're looking at a portfolio, you want to look at five to seven years of the portfolio. You want to see how many cycles the portfolio has gone through.

So, if you are just looking at the portfolio from 2012 to 2020 or 2015 to 2020, you will miss out what happens after a housing crisis, like 2008. As Jim mentioned, it's really the portfolio that you are interested in.

Privcap: If you could describe the characteristics of a specialty finance company that is going to thrive going forward, what would those characteristics be? And if you were to talk about the kinds of groups that are going to struggle and perhaps be eclipsed in the coming environment, who would those be?

Hollis: The companies that will thrive will have made an investment in technology, developing multiple ways of delivering the product to the consumer. They will truly understand who their consumer is, what they want and how they want to engage with their lender, and they will develop solutions that meet those consumer demands. Companies need to stay nimble enough to respond to changes in the regulatory environment. There's always change in a regulatory environment, so those that stay abreast of those changes will succeed as well.

The other characteristic that will help companies thrive will be those that understand the importance of utilizing alternative data for underwriting. There's so much data available on consumers, and being able to maximize the use of that data to make smart decisions to define the credit criteria, is important.

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Shah: Many specialty finance companies are asking, what else can be financed out there? Five years back, I did not know that you could finance a funeral. With specialty finance, you can not only finance a funeral, you can finance your inheritance. If you're going to get an inheritance in 12 months, four months, you can finance that. Companies are always changing the products offerings.

Privcap: Is there a land grab going on with regard to different forms of financing?

Shah: Right now, private equity groups and investors are all looking to invest in fixed income-type products, and specialty finance is a fixed income-type of product. Because if your portfolio is pretty homogenous, you know what yield you're going to get on it. So, private equity investors are looking at this space, and with lower interest rates you get in a really nice spread. If you've got good underwriting, a good platform or good model, then there's a steady yield. I would not say that there's necessarily a land grab because not everybody or not all private equity groups are savvy enough to understand the space. But there are funds out there who have a strategy around specialty finance or financial services, and those are the ones who we see are acting on it.

Chester: I agree. The firms that are knowledgeable about specialty finance know what pockets of the economy to invest in. They've really been able to differentiate themselves based on their history and their knowledge. I don't think there's necessarily a land grab in a broad sense, but what I would say is that companies that specialize in certain niches that are large enough from an addressable market standpoint can generate meaningful, quality growth, and be in a position to manage the portfolio from a risk perspective. And those are the companies that have done exceptionally well.

Privcap: Brandon, what makes you excited to be active in the specialty finance space going forward?

Hollis: The potential for innovation and development of new markets really excites me. Traditionally, there was a misconception that this sector is there to serve the underbanked or the unbanked, and to charge really high rates, and be predatory lenders. But that's not the sector today. There's lots of opportunities to finance different things across the credit spectrum with innovation and technology in play.

Shah: I would really like to see is what's going to happen around cryptocurrencies and, if they do become prevalent, what will the specialty finance market do to utilize that market? Also, how is specialty finance going to be able to lend across borders? Right now, you're just lending in the United States, but how would a person sitting in the US be able to lend money to somebody in Europe or in Asia? I think that would really open it up. ■

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