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Securing Growth Capital for Alternative Finance Companies in the COVID-19 Era

May 18, 2020 (New York, NY) - As a merchant bank, Middlemarch Partners, has raised over $1 billion of debt and equity for our alternative finance clients. From recent conversations with leading private capital investors, it is clear that the bar has been materially raised for companies that seek to secure growth capital in the immediate future.

Alternative finance companies are going to have demonstrate three capabilities if they are going to secure the confidence and the capital of investors:

- Clear command of data and an ability to communicate transparently company performance
- Capacity to manage cash flow in the near term to stabilize the business
- Ability to develop innovative growth and cost control initiatives to build value in the medium term

We wish to outline some strategies we have been sharing with our clients and portfolio companies that they can use to successfully manage through the COVID-19 pandemic and to position themselves to secure growth capital.

Clear command of data and ability to communicate transparently:

- ***Produce KPI and borrowing base reports, granular unit economics analyses, and economic scenario forecasts:*** Operators need to demonstrate they can accurately and intelligently measure their own performance. Investors need to be able to quickly discern from data whether a company is strong or weak and whether a company can adapt quickly to changing market conditions.
- ***Commit to full transparency:*** While data is necessary to demonstrate the condition of a company, management must be willing to communicate the facts honestly and proactively. Investors are looking for a team to partner with that puts all the facts on the table and is ready to work collaboratively with its lenders and investors to find solutions to problems and seize opportunities.

Capacity to manage cash flow:

- ***Reduce expenses intelligently:*** Increasing top-line growth is typically the goal of scaling companies looking to capture market share, but during this period of uncertainty, investors will be even more focused on controlling operating expenses, which may replace cash generated from top-line revenues as lenders slow origination growth. Cost-cutting efforts, such as reducing marketing expenses and maintaining a lean headcount are two recommendations to quickly reduce operating cash burn. In addition, we also recommend altering the structure of employee compensation by reducing fixed salaries and replacing some compensation with incentives tied to the business's economic performance.
- ***Focus on ensuring longer-term profitability by reducing distributions to owners*****:** In traditional times, most investors cheer for distributions, but we believe that, now more than ever, is the time to preserve cash, even if that is at the expense of current stakeholders' near-term compensation. Alternative finance companies, like many other balance sheet-driven firms, are required to deploy cash to scale originations. Dividend reductions aid in maintaining a healthy balance sheet which we believe will better position a company to scale when the pandemic subsides which will ultimately aid in future equity valuations.

Ability to develop innovative cost controls and growth initiatives:

- ***Provide borrowers with incentive to pay off loans early:*** While typically lenders prefer to maximize interest payments by keeping borrowers engaged through the full term of their loans, there are borrowers that would be open to paying-off current obligations if offered a discount. Although it may cause short-term unit economic compression, early payoffs that increase cash flow in the near term will enable alternative finance companies to better manage future defaults and senior debt obligations. Managing cash flow now better positions the company when it seeks growth capital or liquidity in the future.

- ***Modify existing products and create new product offerings:*** Unorthodox times call for innovative solutions, and we believe that alternative finance companies should be rethinking the pricing and term length of their existing product offerings. Shorter-term credits will increase payment speed and improve unit economics. Increased prices, because of the lack of capital availability, increase excess spread and provide additional cushion for potential defaults. Designing new products, such as lease products for lenders and credit-based products for leasing companies are additional sources of financing revenue and profit for lenders who typically rely on one product type to serve their clients. Similarly, lenders accustomed to offering non-secured loans may wish to extend their lending franchise to asset-based loan products as well. These new product offering may not only result in better unit economics, but they will also demonstrate an alternative lender's ability to pursue ancillary growth opportunities to its core business. Firms with multiple revenue streams will be rewarded with better deal terms when raising growth capital.
- ***Explore new origination channels:*** Many alternative lenders rely on third-party customer acquisition channel partners or marketplaces to originate new loans, but these partners tend to be expensive sources of potential borrowers. Middlemarch recommends exploring non-traditional sources of borrower leads such as forming strategic partnerships with regional banks that may have difficulty funding borrowers in a timely manner. Lenders should explore marketing relationships with affinity groups or influencers, such as industry associations, law firms, or accountants that have connectivity to their audience. Lastly, lenders should consider aligning themselves with merchants or other retail service providers, who can offer credit products to the end user at the point of sale. Finding lower cost customer acquisition channels will help reduce the impact of higher losses caused by a stressed credit environment.
- ***Establish new, recurring revenue streams:*** Most alternative finance companies tend to rely solely on interest income, but many lenders could leverage their existing infrastructure to create additional sources of revenue that are not tied to credit performance. Data analytics, outsourced underwriting, and portfolio servicing are three lines of business that alternative finance companies can employ to diversify revenue streams and to boost ROEs and ROAs. Additionally, scaled lenders could consider offering digital banking services such as corporate and consumer financial management tools, payment solutions, and digital accounts. We have already seen several small business lenders processing PPP or SBA loans to help address the unmet needs of borrowers during this time of crisis, and we anticipate innovative companies will continue to seek additional opportunities to expand their services beyond their core offerings.

Middlemarch believes that alternative finance companies play an important role in the financial health of the American economy. We want those firms best capable of thriving in today's challenging economic environment to be positioned to secure the growth capital that allows them to "pull away" from the competition as markets recover.

To be positioned to secure additional resources, alternative finance companies need to demonstrate command and control over their current book of business, an ability to manage through a hostile operating environment; and have an achievable near-term plan that positions them to grow when markets return to normal. We believe that by pursuing some of the above strategies alternative finance companies can succeed in a COVID-19 world and positions themselves to maximize their longer-term potential.