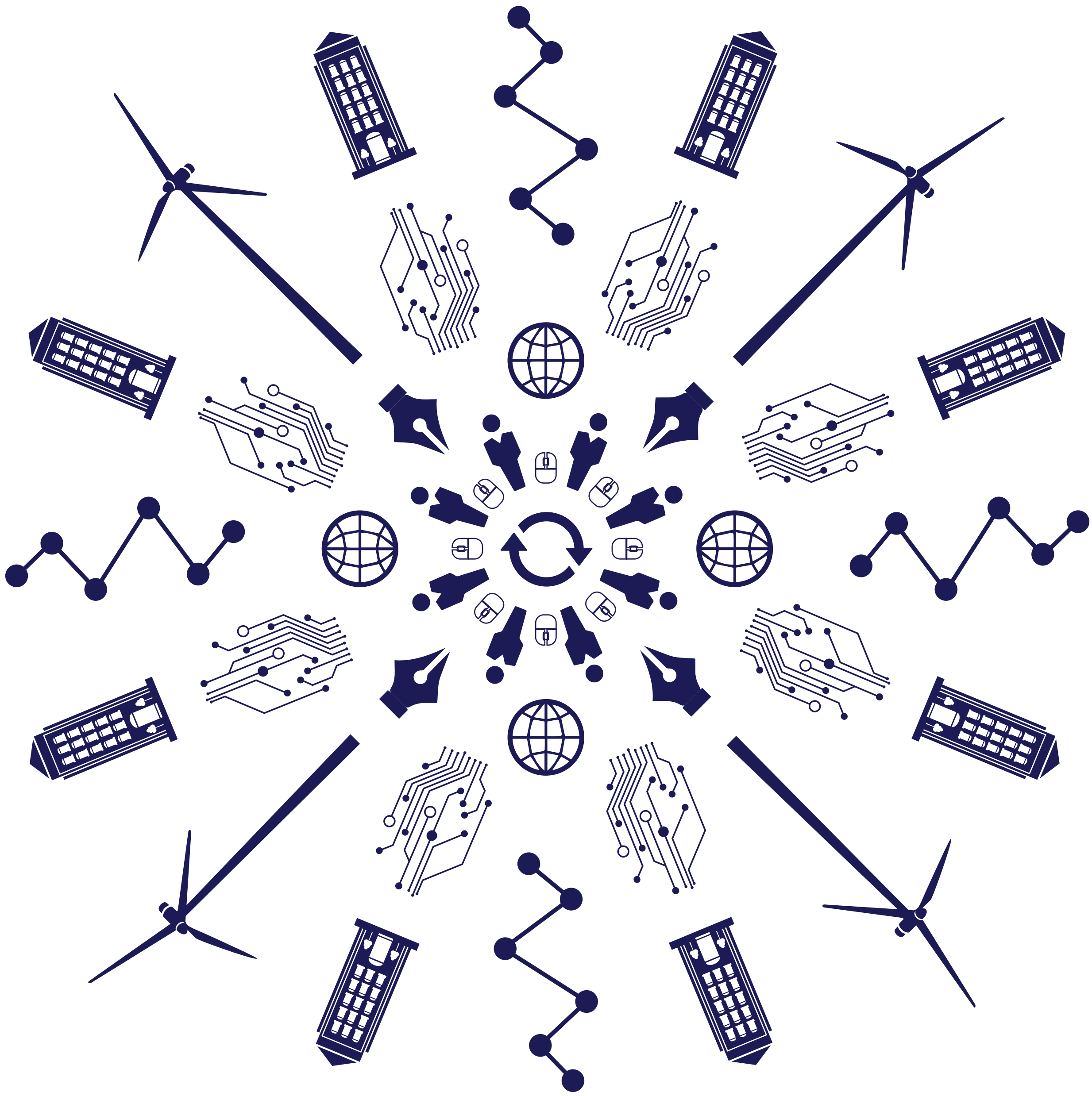
AiR 15/16

ALTERNATIVE INVESTMENT REPORT



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ALTERNATIVE FINANCE 2015/2016

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PUBLICATION

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FOREWORD

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Welcome to the first alternative finance industry report, written for retail financial services professionals.

Writing this report has been a lot like trying to hit a moving target because the world of alternative finance changes fast and there are so many developments: new platforms, products and innovations; new statistics, records and research; wraps, regulations and tax treatment... the list goes on, making it difficult to get your arms around the whole-of-market and develop a full understanding of the sector.

This might not be an issue for the two categories of investor who have been attracted to alternative finance so far: small retail investors who are early adopters and big institutions that have the resources to carry out thorough research before deploying their capital. However, we think that it IS an issue for retail financial services professionals: regulated advisers, SIPP, SSAS and ISA providers, wealth managers, compliance firms, accountants, tax specialists and sophisticated investors.

There is a huge amount of wealth that sits in this retail financial services bucket and there will be big benefits for both investors and the alternative finance industry if that wealth can be deployed by alternative finance – but there are unique challenges to overcome before that can happen.

Anyone operating in professional retail financial services is heavily regulated and has treating clients fairly and consumer protection at the heart of everything they do. They won't 'dabble' with their clients' money. Furthermore, they don't have the resources to do the research that is required to allow them to enter the asset class with confidence. This report has been written with this group in mind. We want to provide an accurate summary of where the alternative finance industry is today, how it got there and where it might be headed. We look beyond the volumes deployed by the platforms and outline the various models on offer and assess the risks and benefits associated with them. We discuss how to conduct due diligence on alternative finance, what to look for and what questions to ask. We solicit the opinion of industry insiders and forward thinking advisers – both optimists and sceptics. We look at regulation and what that has done to the market, and we consider how this asset class will start to fit into the retail financial services landscape.

Guy Tolhurst
Managing Director
Intelligent Partnership

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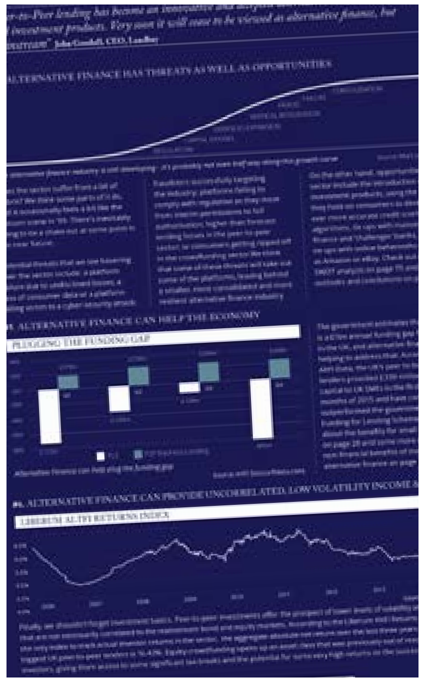

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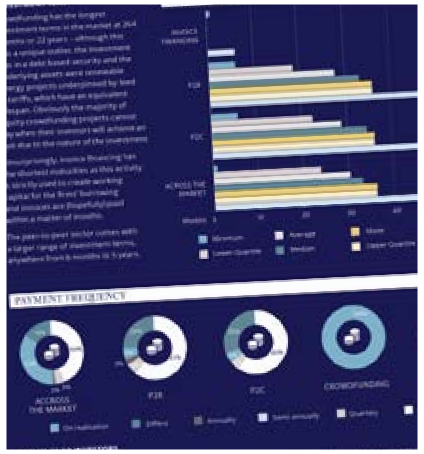

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ALTERNATIVE INVESTMENT REPORT

* Please note: unless otherwise stated, all charts and graphs have been provided by Intelligent Partnership

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AMPS

FSC www.fsc.org MIX Paper from responsible sources FSC® C008007

FSC is a non-profit international organisation established to promote the responsible management of the world's forests. Products carrying the FSC label are independently certified to ensure consumers that they come from forests that are managed to meet the social, economic and ecological needs of present and future generations, and other controlled sources.

OVERVIEW

Our intention is not to provide the kind of market statistics that AltFi Data does (although we do leverage some of their work), or to produce the kind of academic papers that NESTA and the University of Cambridge do (although they are a crucial resource for us). Our intention is to view the asset class through the eyes of retail financial services professionals and provide some of the answers they will require if they are to successfully engage with alternative finance.

The report doesn't have to be read cover to cover, from start to finish - it's not a novel and you can get just as much value from it by dipping in and out of sections that take your fancy. For those of you who like to get a really quick summary of what we have to say, the key findings are on page 10, the executive summary is on page 8 and the conclusions and outlook are on page 74.

However, the report does follow a logical order - we'll start at the beginning by defining just what alternative finance is, where it sprang from and where it's at today. We've tried to structure the report so that we start off at a very high level, and then go into each topic in a little bit more depth as the report goes on. So even if you are starting from a position of no prior knowledge at all (we know from talking to advisers that this is exactly where some of them are at) the report will still be readable and useful. And if you already know the basics, there's also some in-depth analysis for you to get your teeth into. (Note for newcomers: there's also a glossary at the back if you find yourself getting confused by some of the terminology).

We'll go on to assess some of the benefits and risks of investing in alternative finance and take a deep dive into the surprisingly diverse alternative investment universe - there is a huge variety of business models and USPs out there and one of the myths we want to dispel for our readers is that all the platforms are the same.

We'll also look at some of the big developments that are happening right now and have really big implications for how alternative finance develops - from ISA and SIPP acceptance, to high street bank referral schemes and the influx of institutional money. We'll give our view of what we think is good and bad about all of these exciting changes.

There's a section that looks at things specifically from the point of view of investors and advisers, and we think about the practical steps they can take if they want to get involved in the sector. Frankly, it's not an easy task for advisers to invest their clients' money in alternative finance at the moment, but we reckon that more and more of their clients are going to hear about it, and it's going to be an asset class that more and more of them will invest in. Advisers need to be wary of clients developing satellite portfolios in alternative assets that are not part of their assets under influence, as they won't form part of any valuation of the adviser's business. As a minimum advisers should ensure they have a working knowledge of the sector so that they can discuss it with confidence.

As with all of our reports, we've been out there and surveyed the opinions of some of the big stakeholders - in this case we conducted one survey to establish the levels of awareness of alternative finance amongst advisers and another survey to see just what the alternative finance platforms thought of advisers. We also carried out "meta studies" (looked at the other available research) of investors and potential SME investee companies and finally surveyed SIPP operators to complete the picture.

Finally, our market analysis is what drives a lot of our commentary - we take a thorough look at the platforms and products that are out there to build a complete picture of what comprises the market for investors right now, and we share that with you in the market analysis section.

And that's basically it 37,000 words over 80 pages with lots of explanatory charts and diagrams thrown in. If it's all new to you, by the end of the report you'll have a great understanding of where this industry stands today and what it means for you. And if you're a veteran of the scene, it will summarise some key issues all in one nice handy document, and hopefully present some new research and ideas for you.

By the way - we're focusing on UK based platforms here. We touch on overseas alternative finance markets, and some of our UK platforms are branching out internationally (and given the online nature of alternative finance, it easy for investors to access overseas platforms), but this report is all about the platforms UK investors can invest in right now, based here.

ACKNOWLEDGEMENTS

We couldn't do this without the help and support of a number of third parties who have contributed to writing this report. Their contributions range from inputting into the scope, sharing data, giving us their insights into the market, providing copy and peer reviewing drafts. Their input is invaluable, but needless to say any errors or omissions are down to us.

SO A BIG THANK YOU TO:

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Alternative Funding Network

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altfi

knowledge peers

altfi DATA

pwc

ANGEL NEWS

Thistle Initiatives

Bovill

UKCF UK Crowdfunding

LONDON FINTECH PODCAST

UNIVERSITY OF CAMBRIDGE

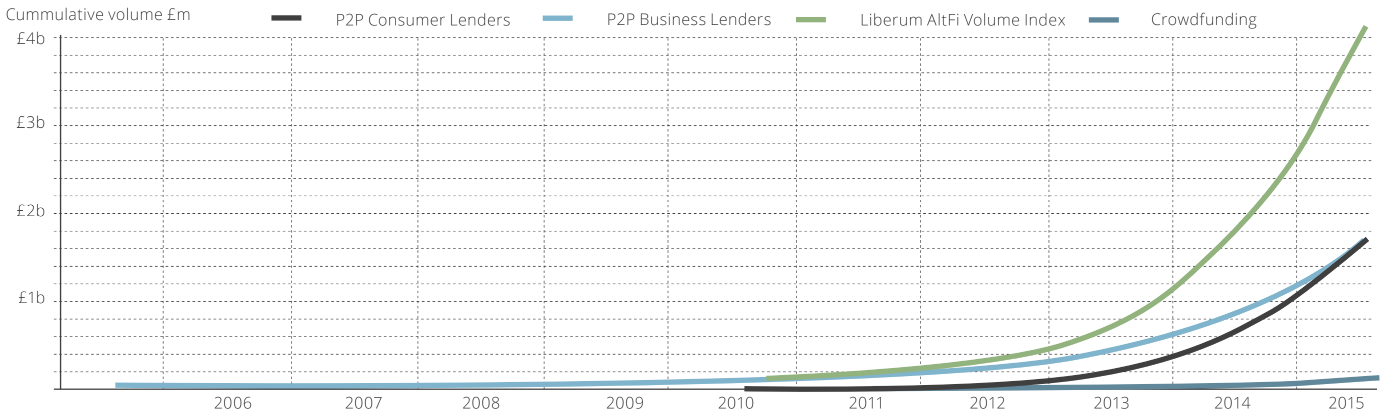
EXECUTIVE SUMMARY

OK, enough preamble - let's get down to brass tacks. What have we found out?

#1. ALTERNATIVE FINANCE IS GROWING FAST

Well, you probably already know that even though alternative finance accounts for a very small percentage of the retail lending, business lending and equity fundraising markets, it's growing fast: the market doubled in size year on year from £267 million in 2012 to £666 million in 2013 to £1.74 billion in 2014 (Source: 'Understanding Alternative Finance', NESTA and the University of Cambridge). AltFi Data measures the cumulative total amount of money deployed by the peer-to-peer lending market at over £4 billion and by the crowdfunding market at over £100 million. And this is not a trend that is slowing down - take a look at the growth curve on the chart below. There's more on the growth of the market on page 28.

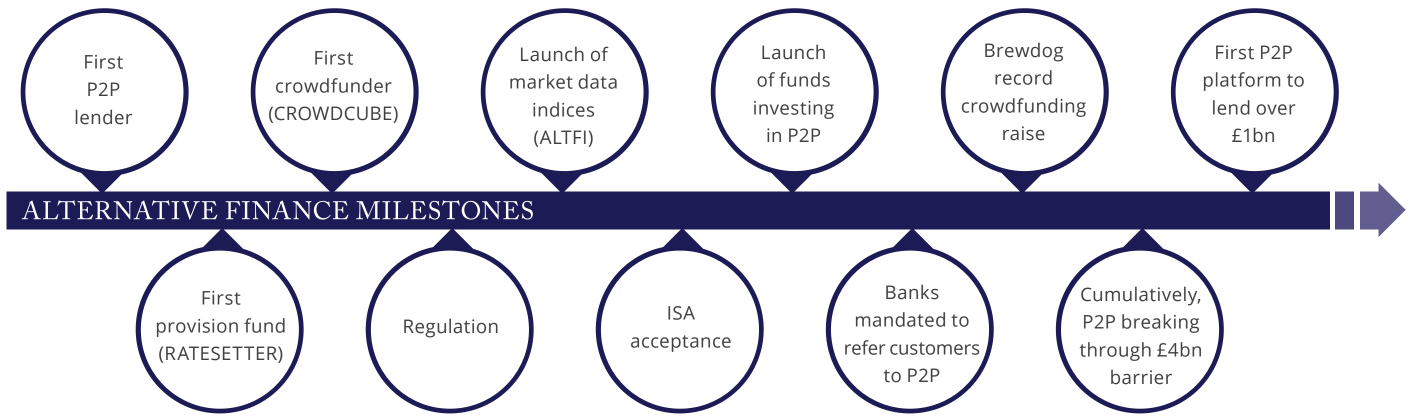
LIBERUM ALTFI VOLUME INDICES (2006-2015)



Volumes in the Alternative finance market have grown exponentially Source: AltFi Data 2015

#2. ALTERNATIVE FINANCE IS MATURING

As the sector is growing, it is also maturing. We think that key milestones such as the bank referral scheme, SIPP and ISA acceptance, institutional investment, creation of retail investment products, regulation and the deployment of taxpayers' money via alternative finance are all indications of a maturing market. However, each of these developments also brings their own unique challenges with them and it's not clear to us that all of the platforms really appreciate that there are a lot of potential pitfalls ahead. We discuss these developments on page 9.

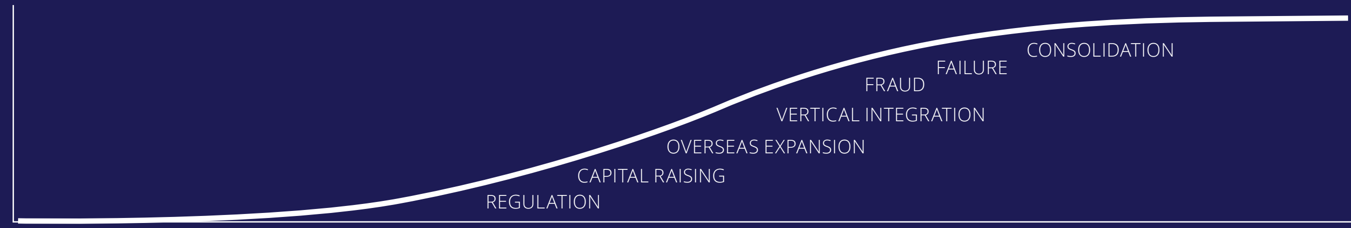


#3. ALTERNATIVE FINANCE IS NOT A HOMOGENOUS ASSET CLASS

This is not a homogeneous asset class. There are over a dozen different operating models in the market and as well as generalist funding platforms there are five specialists. We think that this diversity is excellent and the sign of a healthy market that has something to offer everybody. However, each variation has its own risks and rewards making it harder to get your arms around the whole-of-market, which is a problem for advisers. We go through the various models and what we believe the pros and cons of each are on page 38, we discuss the risks and benefits of the sector on page 31 and we suggest a due diligence process on page 48.

"Peer-to-Peer lending has become an innovative and accepted alternative to traditional savings and investment products. Very soon it will cease to be viewed as alternative finance, but mainstream" **John Goodall, Landbay**

#4. ALTERNATIVE FINANCE HAS THREATS AS WELL AS OPPORTUNITIES



The alternative finance industry is still developing - it's probably not even half way along this growth curve Source: Mark James, PwC

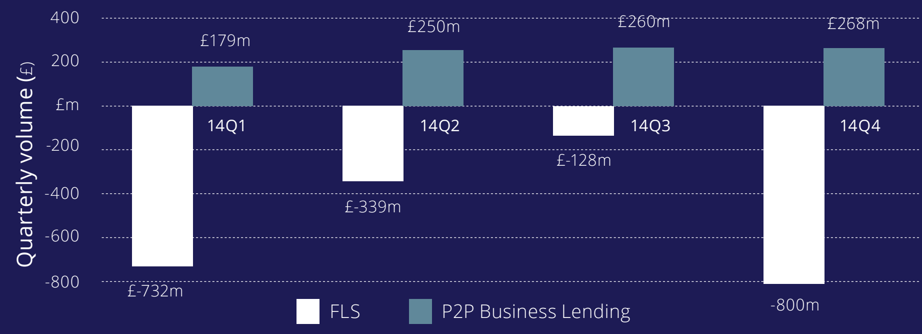
Does the sector suffer from a bit of hubris? We think some parts of it do, and it occasionally feels a bit like the dotcom scene in '99. There's inevitably going to be a shake out at some point in the near future.

Potential threats that we see hovering over the sector include: a platform failure due to undisclosed losses; a loss of consumer data or a platform falling victim to a cyber-security attack; fraudsters successfully targeting the industry; platforms failing to comply with regulation as they move from interim permissions to full authorisation; higher than forecast lending losses in the peer-to-peer sector; or consumers getting ripped off in the crowdfunding sector. We think that some of these threats will take out some of the platforms, leaving behind a smaller, more consolidated and more resilient alternative finance industry.

On the other hand, opportunities for the sector include the introduction of retail investment products, using the 'big data' they hold on consumers to develop ever more accurate credit scoring algorithms, tie ups with mainstream finance and 'challenger' banks, and tie ups with online behemoths such as Amazon or eBay. Check out our SWOT analysis on page 75 and our outlooks and conclusions on page 74.

#5. ALTERNATIVE FINANCE CAN HELP THE ECONOMY

PLUGGING THE FUNDING GAP



Alternative Finance can help plug the funding gap

Source: AltFi Data (alfidata.com)

The government estimates that there is a £1bn annual funding gap for SMEs in the UK, and alternative finance is helping to address that. According to AltFi Data, the UK's peer to business lenders provided £339 million of capital to UK SMEs in the first three months of 2015 and have consistently outperformed the government's Funding for Lending Scheme. Read more about the benefits for small businesses on page 28 and some more of the non-financial benefits of investing in alternative finance on page 18.

#6. ALTERNATIVE FINANCE CAN PROVIDE UNCORRELATED, LOW VOLATILITY INCOME & GROWTH

LIBERUM ALTFI RETURNS INDEX (2006-2015)

Source: AltFi Data 2015

Finally, we shouldn't forget investment basics. Peer-to-peer investments offer the prospect of lower levels of volatility and higher yields that are not necessarily correlated to the mainstream bond and equity markets. According to the Liberum AltFi Returns Index (LARI) – the only index to track actual investor returns in the sector, the aggregate absolute net return over the last three years from the three biggest UK peer-to-peer lenders is 18.05%. Equity crowdfunding opens up an asset class that was previously out of reach for many retail investors, giving them access to some significant tax breaks and the potential for some very high returns on the successful investments.

KEY FINDINGS

In the **UK**, alternative finance has originated over **£4.6bn** of **investments** to date

Total investments in 2015: **£2.29bn**

18.05% is the **aggregate absolute return** over the last 3 years from the 3 biggest UK peer-to-peer lenders (as at 30 September 2015)

Crowdfunding has originated £145m

£145m

Peer-to-peer lending has originated £4.8bn

£4.8bn

Nº OF PLATFORMS

INVOICE FINANCING	2
CROWD-FUNDING	33
P2P	55

P2P MARKET
(NOV 2015)

ZOPA	24%
FUNDING CIRCLE	19%
RATESETTER	18%

PEER-TO-PEER PLATFORMS offer **forecast yields** ranging from **4% - 15%** a year and **terms** from **6 months** to **5 years**

CROWDFUNDING MARKET
(NOV 2015)

CROWDCUBE	36%
SYNDICATE ROOM	19%
CROWDBNK	3%

CROWDFUNDING offers investors **low cost access** to tax reliefs in the form of **EIS** and **SEIS** benefits

CROWDFUNDING offers access to **AIM** and **ISDX listed shares**, which can be held in ISAs and qualify for relief from inheritance tax

There are **3 funds** investing in alternative finance listed on the London Stock Exchange

BRITISH BUSINESS BANK has already deployed over **£200m** in the alternative finance market

93% of the **advisers** we surveyed were not aware that **alternative finance platforms are regulated**

73% of platforms either plan to **market to advisers** in the future, or do so already

If you only read this far, we'd still like to think that it's been useful and informative for you and you can see what we're trying to achieve here - we want one single, comprehensive and well researched overview of this emerging asset class that looks at things from the perspective of the advisers and financial services professionals who serve retail investment consumers. If you read on we'll flesh out this picture for you, so that by the end of the report you can talk to your clients knowledgeably and with confidence.

OVERVIEW

THE ALT FI UNIVERSE

In this section we'll define exactly what we mean by alternative finance and identify the sub-sectors that sit underneath this umbrella term, and then after a brief run through the history of the sector we'll give you some stats to show you where it's at today and who's investing.

WHAT IS ALTERNATIVE FINANCE?

Alternative finance is an umbrella term that covers a range of very different models for deploying capital to people who need it. The distinctions between these models are important and we'll cover them in more detail later on in the report, but the majority* share four important features:

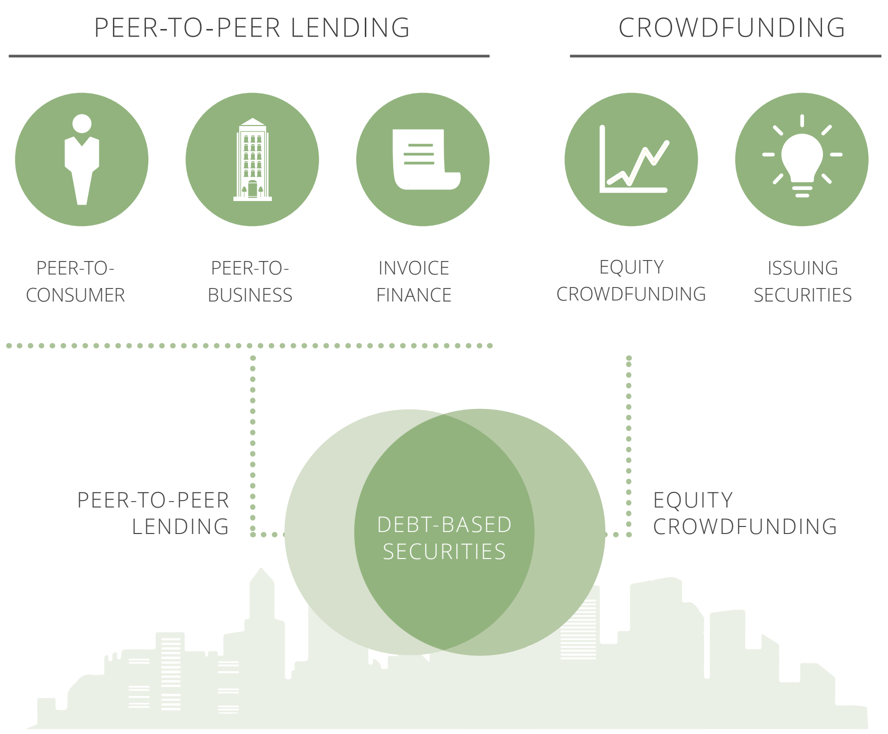
- The platform operators are 'digital' businesses -their model is web-based
- They are not banks or other traditional financial services institution
- They leverage the scale of online platforms to secure lots of lenders and investors at low cost
- They are not investors themselves - they help their members invest their own money

*There are exceptions, but we're sticking to general statements in the name of keeping things simple at this early stage in the report! We'll deal with the exceptions in later sections.

TAXONOMY #1
Breaking Down Alternative Finance

Right at the top, there is a clear distinction between platforms who are facilitating lending, and those that are facilitating investment in equity. Lending activity is referred to as peer-to-peer-lending (P2P) or marketplace lending, and can be broken down into peer-to-business, peer-to-consumer and invoice financing. Equity fundraising is referred to as crowdfunding and includes a sub sector that issues debt based securities as well as company shares.

WHERE DO "DEBT BASED SECURITIES" FIT IN?



Some commentators classify debt based securities as crowdfunding, some as lending

Unhelpfully, the FCA used different terminology in its policy statement on alternative finance PS14/04. It had crowdfunding as its umbrella term, and classified the market into loan based crowdfunding and investment based crowdfunding.

The term marketplace lender needs explaining. It's used interchangeably with peer-to-peer lending and has been a more US-centric term because the market there has a much heavier weighting to institutions rather than individuals. With more institutional money now coming into the UK alternative finance industry, more and more platforms are referring to themselves as marketplace lenders. This is probably a good development as the term peer-to-peer lending implies something different to what is actually happening on lending platforms where institutions are also playing. An even more nuanced definition would be:

- **Peer-to-peer lending:** consumers and institutions are the lenders
- **Marketplace lending:** institutions are the lenders
- **Balance sheet lending:** the platform is the lender

So it's important to understand exactly what the platforms do: most do not take on the risk of the loans or equity investments themselves. They originate deals for either retail consumers or institutions, or both. They have a variety of ways of doing this, which we will examine later in the report. Very few lend their own money, but this might change in the future – if inflows from lenders slow down (as they must do eventually), platforms might need the capability to lend their own (or more likely, their owners') money.

And the lending platforms are not banks. The platforms undertake some of the activities that have traditionally been the sole preserve of banks, but that's as far as it goes. Any marketing that suggests they are an alternative to banks (from the lender's point of view) needs examining carefully.

"2016 is a great time to start investing in the peer-to-peer lending industry – as the market continues to mature, investors can conduct due diligence on the platforms' track records, credit processes and lending discipline; giving investors greater confidence over the sustainability of returns" **Stephen Findlay, BondMason**

SUMMARY OF ALTERNATIVE FINANCE MODELS

DEBT				EQUITY
INVOICE FINANCING	PEER-TO-PEER LENDING		DEBT SECURITIES	
	P2C	P2B		
Individuals buy invoices at a discount, then sell them back to firms at a profit	Individuals lend money to other individuals to earn interest and their capital back	Individuals lend money to business to earn interest and their capital back	Individuals buy security, normally a form of bond, to earn interest and their capital back	Individuals buy shares in early stage business for capital growth or dividends

Breaking down alternative finance

Source: P2PFA (2015)

WHAT ARE THE MOTIVATIONS OF THE PLATFORMS?

The platforms' motivations range from a genuine desire to give a better deal to consumers, to giving a better deal to SMEs and early stage companies, to trying to plug a funding gap in a particular sector. (But don't doubt that there are some "me too" opportunists in there as well now that the sector is starting to take off).

GETTING A BETTER DEAL FOR CONSUMERS?

From the consumers' point of view, they have never had access to markets where interest rates are set, or access to affordable opportunities to invest in early stage companies before. To access the yield from issuing credit they had to accept an asymmetric relationship that favoured their bank. And to invest large sums they had to go through expensive fund managers to access the potential returns from investing in early stage companies.

Now this report isn't an anti-bank/anti-fund management polemic: both of those conventional ways of accessing these asset classes have great advantages, and we'll highlight the differences between them and the new world of alternative finance in the risks section later on. But the alternative finance industry has been able to democratise finance and open up asset classes to retail investors. This is important. Whatever other weaknesses there might be with alternative finance models, and whatever headwinds and occasional storms will have to be overcome in the future; this is a fundamental change for the better and should be supported by the regulator and government, applauded by consumers and carefully noted by incumbents.

TAKING ON THE BANKS?

It's also worth pointing out that despite some of the "anti-bank" rhetoric the sector dispenses, the more mature platforms are not anti-bank. They understand that there are important differences in the risks to the lender (the risk is WITH the lender, NOT the bank) and their objective is only to offer an alternative asset class for consumers, not to somehow replace banks.

Alternative finance doesn't disintermediate the banks: all of the money stays within the banking system one way or another. What peer-to-peer lending does do is compete with banks' lending departments. In the equity crowdfunding space the platforms are usually looking at smaller deals than conventional venture capital funds. If they are competing with anybody for deals, it is with angel investors. However, the lending and investing parts of financial services feel like an industry that is ripe for disruption:

- Fewer than 1 in 3 customers trust their bank (PWC)
- UK retail investors pay nearly 60% more for their investments than in the US (True & Fair)
- Despite computerisation and colossal economies of scale the cost of intermediation in finance has remained the same for the last 130 years (Thomas Philippon, Professor of Finance at the Stern School of Business).

So while alternative finance does compete with incumbent lending and investing institutions what it is doing is bringing about fundamental changes in how consumers can access markets -but we don't buy any anti-bank/anti fund management rhetoric. Rightly or wrongly, Barclays and HSBC are not about to go the same way as HMV and Our Price because of digital disruption...

PLUGGING THE FUNDING GAP?

The government estimates that there is a £1 billion annual funding gap for SMEs that needs to be plugged. This is significant for the UK: at the start of 2014, small firms accounted for 99.3% of all private sector businesses, 47.8% of private sector employment and 33.2% of private sector turnover. Small and medium sized businesses employed 15.2 million people and had a combined turnover of £1.6 trillion. (Federation of Small Business). Unlocking the growth potential of this sector will have a big positive impact on the UK's economy.

But banks and investment funds don't really want to step in and plug this gap. The British Business Bank estimates that 500,000 SMEs are deterred or declined for finance every year.

OVERVIEW OF ALT FI

Since the financial crisis in 2008, banks have been reluctant to lend as they try and repair their balance sheets and regulation has also played its part. The Basel Accord requires banks to hold significant amounts of capital against risky assets, and lending to small firms is hard work - large firms take bigger sums of money for longer periods of time and have more assets to secure loans against, making them much more "lendable". Similarly, in the venture capital world, funds are usually looking to make bigger investments of at least £3million plus.

All of this leaves an underserved market of SMEs that alternative finance providers can step in and provide either credit or equity funding to. By using technology to drive their overheads and costs per loan down, alternative investment providers are better able to serve this market.

Finally, it's worth mentioning speed here. From the investee companies' point of view, whether they are selling equity or borrowing money, the platforms can offer a much swifter solution than traditional sources - a timing issue which can be the difference between success and failure for some small businesses.

HISTORY

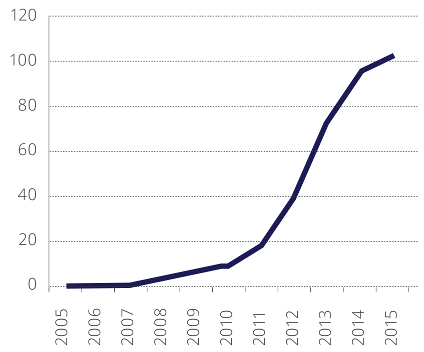
It's important not to get too carried away with the "newness" of alternative finance, or promises of disruption to the incumbent financial services industry. Facilitating the efficient allocation of capital is about as old as capitalism itself, and raising money from "the crowd" goes back at least to medieval cathedrals. Of course the on-line element is new, but even that has been traced back to the British rock group Marillion, who raised £40,000 online to fund a tour back in 1997. So the concepts behind alternative finance are not brand new.

The first peer-to-peer lending platform was Zopa, founded in 2005 - which makes it the only alternative finance provider to have operated throughout (or almost throughout) the entire business cycle. Funding Circle launched in 2010 and was the UK's first peer-to-business lending platform, and RateSetter, the first peer-to-peer lender to use a contingency fund to protect investors, also launched in 2010. These are not only the originals; they are also currently the biggest players in the UK alternative finance market.

Crowdcube is widely recognised as the first crowdfunding platform, launching in 2011 and MarketInvoice, the first invoice trading platform, launched the same year.

THE "EXCITEMENT" PHASE: 2008 - 2014

PLATFORM GROWTH



Platform growth accelerated after 2010

The two biggest drivers behind the growth of the alternative finance market were probably 'Web 2.0' and the financial market crash of 2008.

Web 2.0, along with the widespread adoption of broadband by households, got people used to the idea of forming online communities, researching and pursuing their own interests and doing much more than ever before online. The 2008 crash prompted a search for new asset classes as investors became disillusioned with the volatility of the stock market, "bankers" and the culture of "the city".

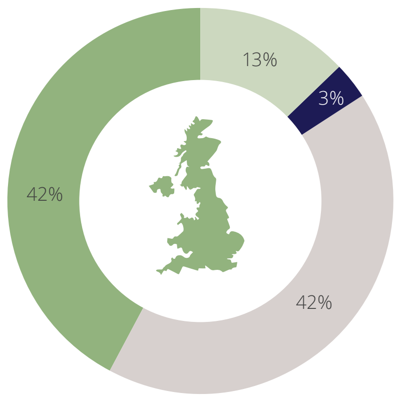
It was seemingly in this spirit - using the web to reach out to people and form communities and invest money in a more democratic or impactful way - that lots of new alternative finance platforms launched. Of course they all had the objective of making money as well, and how much they have remained in keeping with this grassroots feeling is a matter for debate, but there is no doubt that the rapid expansion of the sector has its roots in this period 2008 - 2014.

According to our research, the number of alternative finance platforms grew from 4 to 94 from 2008-2014 (2,250% growth!) and at the time of writing the number has settled at 102 platforms. During this period of rapid growth we started to see the explosion in the number of different innovations and business models as platforms innovated and looked to carve out specialist niches or unique selling propositions in the new asset class.

THE "EXECUTION" PHASE: ALTERNATIVE FINANCE TODAY

The "excitement" phase is probably over and we are now entering the "execution" phase as the industry matures and starts to enter the mainstream. We've identified 88 platforms currently operating in the UK now and according to AltFi Data over £4.8 billion of loans and investments have been originated to date.

THE UK MARKET TODAY



Source: AltFi Data , as at 10/11/2015

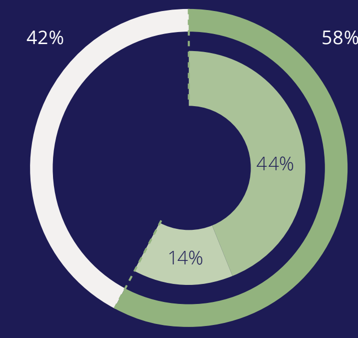
- P2P Consumer Lenders - £2,067,358,302
- P2P Business Lenders - £2,083,587,952
- Invoice Financing - £664,119,400
- Crowdfunding - £144,942,904

The makeup of the alternative finance market in the UK

"The "excitement" phase is probably over and we are now entering the "execution" phase as the industry matures and starts to enter the mainstream"

The University of Cambridge estimated that this would grow to around £4.4 billion by the end of 2015, and by October, the number was already at £4.8 billion (Understanding Alternative Finance, University of Cambridge, 2014). They support this with stats showing that awareness and usage of alternative finance is still quite low. According to surveys 42% of individuals in the UK are completely unaware of any type of alternative financing activity and only 14% have ever used an alternative finance platform. And among SMEs, 56% are unfamiliar with alternative finance and fewer than 10% had approached a platform.

CONSUMER AWARENESS

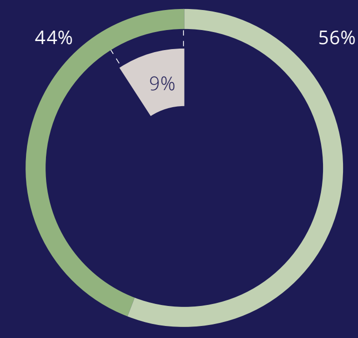


- Unaware of any type of alt fi
- Aware of some type of alt fi
- Aware of some type but have not used it
- Have used some type of alt fi

Source: University of Cambridge (2014)

The majority of consumers have not invested in alternative finance

SME AWARENESS



- Unfamiliar with any type of alt fi
- Familiar with some type of alt fi
- Have tried to use some type of alt fi

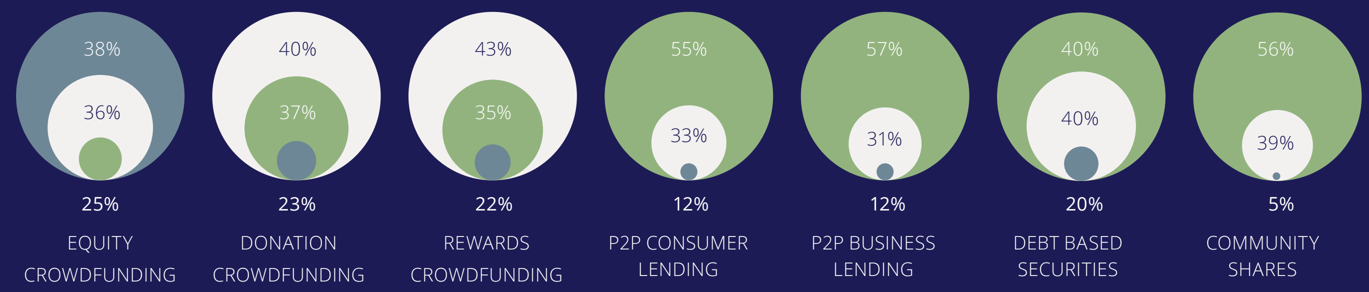
Source: University of Cambridge (2014)

The majority of SMEs have not used alternative finance

WHO'S INVESTING?

We'll deal with the influx of institutional money into the UK alternative finance industry later, but it's interesting to pause and see what kind of retail investors have been investing to date, and again the University of Cambridge have some useful research here:

AGE OF FUNDERS (2014)



Under 35 | 35-54 | 55+

Source: University of Cambridge

A broad cross-section of age ranges have invested in alternative finance, but the over 55s dominate lending, perhaps attracted by the combination of low volatility/high yield

ANNUAL INCOME OF FUNDERS (2014)

<£15,000 | £15,000-£25,000 | £25,000-£35,000 | £35,000-£50,000 | £50,000-£100,000 | £100,000-£150,000 | >£150,000

People from a broad cross-section of income brackets have invested in alternative finance

Source: University of Cambridge

The charts don't need much additional comment - clearly a wide range of age groups and income brackets are investing, and younger folks seem keener on equity crowdfunding while the more risk adverse older generation lean towards peer-to-peer lending.

And how many people are investing? Well it's not possible to generate a 100% accurate number, but AltFi Data had a good stab at it in April 2015 and came up with somewhere between 90,000 and 110,000 investors in UK peer-to-peer lending, with average portfolio sizes across the various platforms ranging from £6,000 to £125,000.

"What the platforms have done that is new, is to open up these asset classes in a way that is simpler, more transparent, cheaper and easier to access than ever before"

WHY ARE THEY INVESTING?

Yet again, the University of Cambridge have done the hard work surveying consumers.

Traditional investment motivations such as returns and diversification are still paramount across all these alternative finance sectors, but factors such as transparency, access, control and non-financial motivations also score highly.

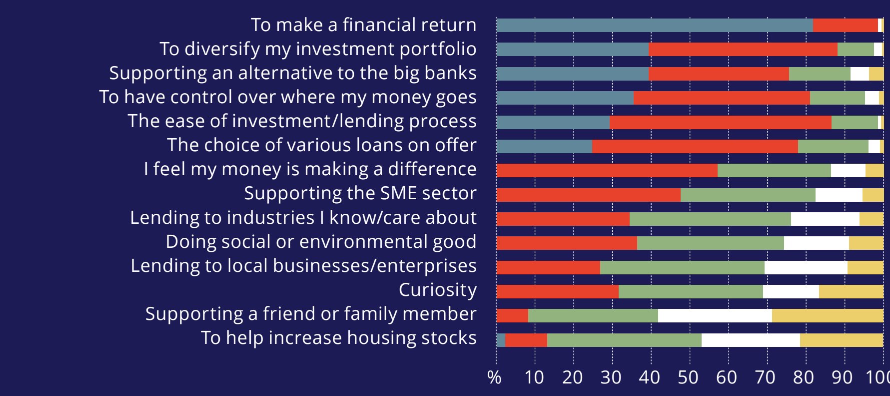
This chimes with the Great British Money Survey (commissioned by crowdfunding platform Abundance Generation) which has found that 60% of people want to know where their money is invested, 62% want to be in control of their money and chose exactly where it goes and 58% would be unhappy if their money was used for unethical activities. It also found that only 1.5% of investments offered by banks are ethical - from this perspective the appeal of alternative finance is clear.

CONCLUSIONS

Once you get past the new jargon, at its simplest level alternative finance is not doing anything new: the platforms are either lending money to businesses and consumers or buying shares in a business.

What the platforms have done that is new, is to open up these asset classes in a way that is simpler, more transparent, cheaper and easier to access than ever before. This has led to a swift influx of funds from both retail and institutional investors growing the sector to £4.4 billion in a single decade. And there is plenty of room for more growth - alternative finance accounts for a very small percentage of the retail lending, business lending and equity fundraising markets in the UK.

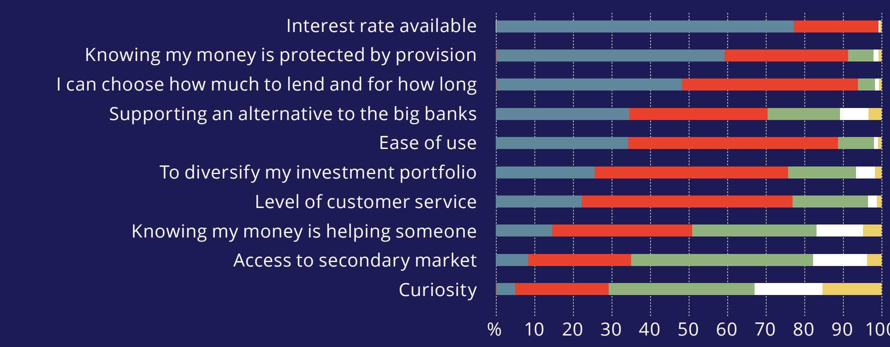
MOTIVATIONS FOR PEER-TO-BUSINESS LENDING



Financial returns are still a crucial motivation

Source: University of Cambridge (2014)

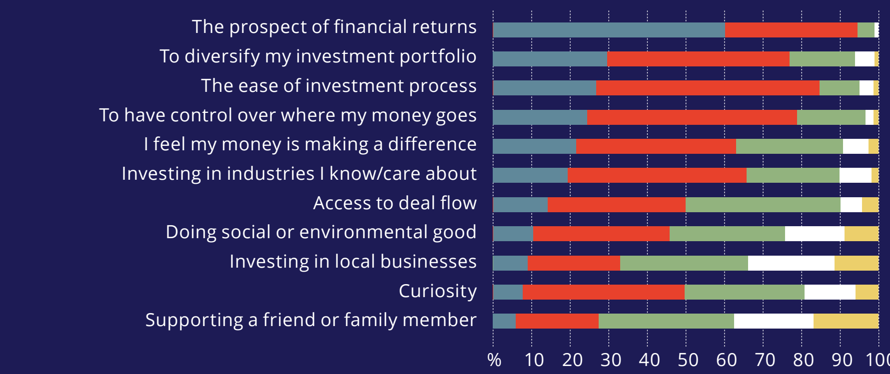
MOTIVATIONS FOR PEER-TO-CONSUMER LENDING



Source: University of Cambridge (2014)

Peer-to-consumer lending interest rates are attractive

MOTIVATIONS FOR INVESTING IN EQUITY CROWDFUNDING



Source: University of Cambridge (2014)

Even in the high risk world of equity crowdfunding, returns are still a primary motivation

Very important | Important | Neither important nor unimportant | Unimportant | Very unimportant

KEY FINDINGS

- Alternative finance covers a range of very different models
- The FCA used different terminology in PS14/04 than the taxonomy used in the industry
- Alternative finance does not necessarily disintermediate the banks, but what it does do is compete with their lending departments
- The government estimates that there is a £1 billion annual funding gap for SMEs that needs to be plugged
- During the excitement phase, the number of platforms grew from 4 to 94 from 2008-2014, a 2,250% growth

THE INVESTMENT CASE

So we've established, at a high level, what alternative finance is, where it has come from and who's investing in it. Now we're going to examine the investment case for the peer-to-peer lending and crowdfunding. We're still going to keep things at a fairly high level for now - we're not going to dive into the different models the platforms use, and we'll save looking at the sorts of things that should be part of your due diligence until a little later in the report - but we are going to look at the overall benefits and risks of investing in alternative finance.

PEER-TO-PEER LENDING

You will hopefully have gathered by now that what peer-to-peer lending platforms are really doing is opening up an asset class for consumers that promises high yields (in comparison to deposit interest rates) and low volatility.

ACCESS TO THE LENDING MARKET

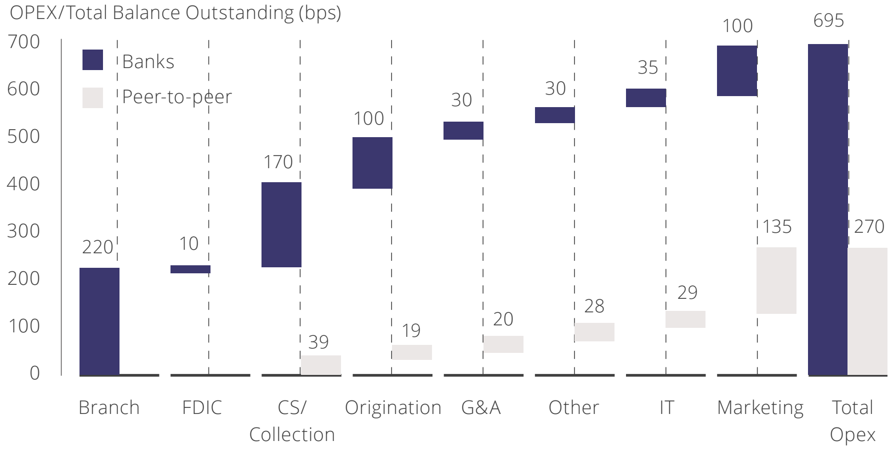
Peer-to-peer lending is no different to any other kind of lending. Investors lend a principal sum of money to a borrower - either a consumer or a business - who will pay them interest and then return the principal either at the end of a predefined period, or in a series of repayments throughout the term of the loan. Most folks are actually already exposed to this market by virtue of having a bank account - banks take in short term deposits from savers and lend them out to long term borrowers. The difference in the rate they pay to their depositors and charge to their lenders is their profit (less their not insubstantial costs).

It's this activity of the banks that peer-to-peer lending disintermediates. Consumers can now access this market directly via their chosen peer-to-peer lending platform. They can choose who they want to lend to, how much risk they want to take and what interest rates they want to earn. Instead of being in a relationship where they have very little power and their choice is basically limited to "take it or leave it" when it comes to the interest rate their bank is offering, they can now make their own decisions.

HIGHER INTEREST RATES

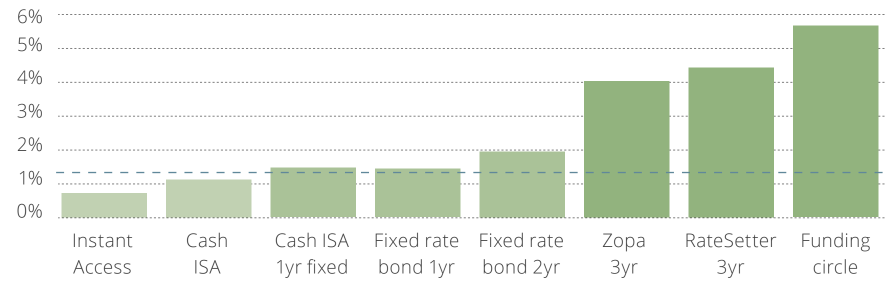
Consumers are also likely to get a better deal - lending platforms' costs are much lower than traditional banks so consumers can usually earn a higher rate of interest on their investments, as the charts below from investment bank Liberum demonstrate:

PEER-TO-PEER PLATFORMS HAVE LOWER COSTS THAN BANKS



Source: Liberum (2014)

DEPOSIT RATES VS. PEER-TO-PEER NET YIELDS



A lower cost base means that lending platforms can in theory offer a better deal to lenders and borrowers than the banks can

Source: Liberum (2014)

BUT DON'T CONFUSE SAVING AND INVESTING

So the real attraction for lenders is the prospect of earning a higher rate of interest on their cash compared to banks. But - and it is a big but in our view - peer-to-peer lending is NOT the same asset class as a bank deposit. Yes, it disintermediates the banks' lending departments and yes, it is the same activity - but in peer-to-peer lending the risk has shifted from the bank, to the lender*. If the borrowers default on the loans, than the lender will suffer the losses.

In short - it makes some sense to compare the returns on offer with bank deposits, but it is wise to treat peer-to-peer lending as an asset class in its own right. It still makes a lot of sense as an investment - high yield, low volatility, relatively liquid and uncorrelated to mainstream markets - just don't think of it as the same as cash.

We'll talk more about these risks and to what extent they can be mitigated on page 31.

To be absolutely explicit: when you make a bank deposit, you are technically an unsecured creditor of the bank. So ultimately, the risk of the bank's lending book turning out to be toxic is with the depositor. But the first £75,000 of any money you deposit with the bank is underwritten by the Financial Services Compensation Scheme, and the banks, rightly or wrongly, have been implicitly underwritten by the government since 2008.

"Crowdfunding platforms have been able to lower the minimum investment amounts, lower the transaction costs, reduce the time and effort required to source and select opportunities and cut out expensive fund managers and intermediaries"

NON-FINANCIAL BENEFITS

This is the "feel-good-factor" of putting money to work in areas that you are keen to support. That might be as simple as lending to SMEs because they are such an important part of the economy (if you've not been reading this report from start to finish, there's more on this in the previous section), or it might be specifically choosing sectors or people that you want to support, such as student finance or businesses in your local area, for non-financial reasons. As the University of Cambridge survey that we quoted earlier showed, while financial benefits are still paramount, the value that investors place on these non-financial benefits should not be underestimated.

CROWDFUNDING

Crowdfunding seems to have a knack for generating excitement and disapproval in equal measure. Investing in early stage companies is notoriously risky (estimates vary, but it's reasonable - even generous - to assume that more than half will fail), but of course successes can be spectacular. Who wouldn't want a stake, however small, in the next Google or Facebook?

ACCESS (AGAIN)

Just like peer-to-peer lending, what crowdfunding does is open up this asset class to retail investors for the first time. Previously these opportunities were the preserve of business angels, or (for the bigger opportunities) venture capital funds, but crowdfunding platforms have been able to lower the minimum investment amounts and transaction costs, lower the transaction costs, reduce the time and effort required to source and select opportunities and cut out expensive fund managers and intermediaries - all of which have opened up the asset class to ordinary retail investors. There is an argument over whether giving ordinary folks such easy access to such risky investments is a good thing, but we are in favour of the principle - why shouldn't retail investors have access to these opportunities?

TAX BREAKS

And it's not just access to the investment opportunities themselves that matters here - it's also access to the generous tax benefits that come with investing in this sector. The EIS and SEIS schemes offer relief on income, capital gains and inheritance tax (via BPR) as well as loss relief on failed investments, but to date EIS and SEIS investments have been characterised by high minimum investment amounts that put them beyond the reach of many. As long as this is the case, the tax breaks are only available for the rich. There is certainly an argument that they should be accessible to all and crowdfunding enables this.

RETURNS

A study by NESTA revealed that the returns for angel investors across a diversified portfolio is 2.2x the original investment on average (NESTA, Siding with the Angels, 2009), and of course these sorts of figures are big carrots for investors. But this comes from a small sample of experienced angel investors - the actual performance of crowdfunding investors is likely to be much, much worse than this. Nevertheless, savvy investors might be able to repeat this kind of performance.

NON-FINANCIAL BENEFITS

Over to Modwenna Rees-Mogg at Angel News:

"What many people forget is that crowdfunding is about much more than just making a financial return for many investors.

I was talking to a crowd investor the other day who had put money into Just Park. He was well aware that he was taking a punt, but as he said to me. 'I have made £1,000 renting out my front drive via Just Park. It did not seem unreasonable to invest £100 in its shares.' He likes the company. In all likelihood, over time he will make several £1,000s more by renting out his drive. In fact if Just Park can raise more money to do more marketing, he may even make more money as increasing numbers of people rent his drive. In buying shares he gets another connection point with the company and he feels good that he is helping a company that had and is making him money. This is the next stage of evolution of the Sharing Economy and we will only see it having more impact on investment over time.

Then we must consider novelty value of owning a piece of a company that you identify with. It's long been known that football fans love to own a share or two in the club they support. You feel good with a framed share certificate on your wall or tucked away in a drawer with the match brochures, scarves and sticker books. "Serious" investors need to understand that the value of a share can be more than its face or even exit value.

Rewards are an interesting aspect of crowdfunding. In time, the Brew Dog fundraising may have been seen as the peak of the crowdfunding bubble, with its £350m pre money valuation, but if you run the numbers on the beer discounts on offer to small shareholders, you can see that for a sociable draft beer drinker, buying a couple of shares will pay for itself within a year or 18 months if you quaff 4-6 pints of Punk IPA a week. If you have effectively bought your shares for £0, who cares what the valuation is?"

Source: Angel News Issue 122, May 2015

VC FUNDS

We would not be surprised if some traditional venture capital firms see the development of crowdfunding as a positive for them, rather than as competition. Very early stage firms now have more opportunity to get the funding they need to launch via crowdfunding. Yes, many will fail, but there will also be a bigger pool of survivors - who now have proof of concept and some track record – for venture capitalists to invest in. We think a far-sighted venture capitalist industry would support the development of the crowdfunding industry, but we will have to wait and see if that does come to pass.

"What many people forget is that crowdfunding is about much more than just making a financial return for many investors" **Modwenna Ress-Mog, Angel News**

BUT, BUT, BUT...

None of this makes early-stage investing any easier, and the risks around establishing the right valuation, illiquidity, lack of dividends, loss of investment and dilution are still very real. We'll talk more about these risks and to what extent they can be mitigated on page 31. But consider that perhaps crowdfunding has changed the game for good, and opened up great opportunities for a whole new generation of entrepreneurs. We'll also go into detail about debt based crowdfunding, they are a grey area between equity and debt based alternative finance that can eliminate some of the risks with equity.

CONCLUSIONS

There are two distinct investment cases for the two distinct brands of alternative finance. Both are based around providing low cost, transparent access to asset classes that were previously difficult for retail investors to get direct exposure to.

In the case of peer-to-peer lending, this means that in exchange for more risk, retail investors have a very realistic possibility of earning much better risk-adjusted returns than they are getting with cash, many bonds and other kinds of deposits.

In the case of crowdfunding, retail investors can support early stage businesses and maybe pick out some winners. The investment case is weaker, but that's mitigated by very low minimum investments, tax breaks and the fact that some people just enjoy making this kind of investment.

"Currently success in the online equity fundraising market is measured by the amount of capital raised for early-stage businesses. However, like all asset classes, the real proof of success as the market matures will be the overall return for investors. As a result, we would expect the successful alternative investment providers of the future to be those that evaluate the risk/reward profile of each opportunity, undertake extensive due diligence and can understand the potential future exit scenarios."

Jamie Beare, VentureFounders

KEY FINDINGS

- Peer-to-peer lenders have a lower cost based that means they can offer lenders a better deal
- Peer-to-peer lending is different than a bank deposit, as the risk shifts from the bank to the lender
- Crowdfunding allow investors to access valuable tax benefits offered through EIS and SEIS

ALTERNATIVE FINANCE 2015

Having set out the basic investment case for alternative finance models, now we can delve a little deeper into some of the pertinent developments in the sector. Some of these are more meaningful than others (we'll tackle them in what we believe is their order of importance), but taken together we think they are a sign of a maturing industry.

REGULATION

The FCA set its rules for regulating the sector in April 2014 (in PS14/4, which can of course be downloaded from their website), and the UK Crowdfunding Association (UKCFA) provided a good summary of what is and is not regulated in the chart below.

The paper is short enough to read quickly, but in summary the FCA proposed that peer-to-peer platforms came under the existing regime of core FCA provisions including conduct of business rules (in particular, around disclosure and promotions), minimum capital requirements, client money protection rules, dispute resolution rules and a requirement for firms to take reasonable steps to ensure existing loans continue to be administered if the firm goes out of business.

The FCA felt that equity crowdfunding was much more risky and therefore proposed that firms offering such investments on crowdfunding platforms (or using other media) promote only to certain types of investor. These are:

- Professional clients
- Retail clients who are advised
- Retail clients classified as corporate finance contacts or venture capital contacts
- Retail clients certified as sophisticated or high net worth
- Retail clients who confirm that they will not invest more than 10% of their net investible assets in these products
- In addition, where no advice was provided firms have to carry out an appropriateness test.

In addition, in February 2016 the FCA published a review into the regulation of the crowdfunding industry and highlighted issues including:

- Firms "cherry-picking" information displayed to investors, which could lead to "potentially misleading or unrealistically optimistic impression of the investment"
- Platforms "downplaying" certain important information such as risk warnings
- Firms displaying "insufficient information in promotions about the taxation of investments"

The FCA is particularly concerned given that 62% of equity crowdfunding investors surveyed by NESTA and the University of Cambridge (Nesta 2014) described themselves as retail investors with no previous investment experience of early stage or venture capital investment. It feels it is imperative "that firms provide investors with appropriate information, in a comprehensive form, so that they are reasonably able to understand the nature and risks of the investment and, consequently, to make investment decisions on an informed basis". We think the big deal here is the headline rates of return that some platforms advertise - these are not investors' likely rates of return, they are the best achievable. They're based on less-than-realistic default rates and calculated before charges and tax.

However, the alternative finance industry has broadly welcomed regulation - indeed, it actively lobbied for it - recognising that it would be a milestone that signalled a maturing industry and would give more confidence to potential investors. The consensus view from both within the

THE ALTERNATIVE FINANCE REGULATORY ECOSYSTEM

REWARDS	DEBT				EQUITY
	Invoice financing	Peer-to-peer lending		Debt securities	
		P2C	P2B		
Individuals give money in return for a reward, recognition, product or service	Individuals buy invoices at a discount, then sell them back to firms at a profit	Individuals lend money to other individuals to earn interest and their capital back	Individuals lend money to businesses to earn interest and their capital back	Individuals buy a security, normally a form of bond, to earn interest and their capital back	Individuals buy shares in early stage businesses for capital growth or dividends
No financial return so not regulated by the FCA	Not regulated by the FCA	These fall under the new regulated activity of operating an electronic system in relation to lending		A regulated activity the FCA includes in investment based crowdfunding	A regulated activity the FCA includes in investment based crowdfunding

The FCA separates alternative finance into loan based crowdfunding and investment based crowdfunding

Source: P2PFA, Alt Fi Data, University of Cambridge (2015)

"ISAs should be a good fit for alternative finance, and why should ISA investors just be limited to the public markets?"

is that the FCA got the balance between protecting consumers and allowing innovation just about right. None of the platforms have gone out of business because they can't comply with the regulations (or at least, not yet. At the moment the platforms are operating on interim permissions. A handful of commentators think some of them may fall foul of the regulations when they move to full authorisation. More on that in later sections).

The FCA plans a full post-implementation review of the alternative finance market and regulatory framework in 2016.

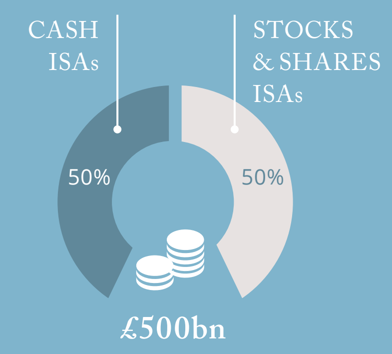
In a related issue, the FCA also published its guidance on the use of social media by financial services firms. Of course as online businesses alternative finance platforms are big users of social media. Going into the full guidance is beyond the scope of this report, but in short firms cannot treat social media differently to their communications in traditional media - a challenge when tweeting! Once again, the FCA's report is available on its website.

ISAs

ISA acceptance is number two on our list of developments. In the second budget in July 2015, the government finally responded to the consultation on making peer-to-peer loans ISA eligible and outlined how peer-to-peer in ISAs is going to happen.

ISAs hold out the prospect of a very big prize - it's estimated that there is £500bn in ISAs, split 50/50 between Cash and Stocks and Shares ISAs. They're a mass market product with a much broader client base than SIPPs - they're used by both the young and old, the rich and poor, sophisticated and unsophisticated investors. They're used to save for a rainy day, save for a deposit on a house, to accumulate wealth aggressively, to preserve wealth defensively, they're used because people don't know where else to save

ISAs



their money. If peer-to-peer lenders can capture just a small percent of the ISA market share, it could make a big difference to their volumes.

However, we think that the alternative finance platforms need to give this careful consideration. This is not the same game as tempting early adopter consumers to dabble online, or talking to institutions that are big enough and ugly enough to look after themselves. Cash ISAs are a safe asset class backed by the FSCS. Tempting people away from them and into an unproven asset class that is not backed by the FSCS could be a dangerous path to go down.

Of course, we're not saying that there isn't a case for some investors making their money work harder for them by switching from cash to alternative finance, but there is a large class of ISA investors who are very risk averse and have very little capacity for loss - tempting them into something unsuitable won't do the alternative finance industry any favours in the long run. NESTA found that 44% of those who had invested in crowdfunding and 64% of those who had invested in peer-to-peer lending had invested money that had been set aside for savings. This kind of stat will frighten the regulator, which has consumer protection as its highest priority.

Putting these considerations to one side though, ISAs should be a good fit for alternative finance, and why should ISA investors just be limited to the public markets? The uncorrelated, lower-risk-than-equities and higher-yields-than-cash-and-bonds promised by peer-to-peer lending fit well within ISAs (as would debt instruments).

The government seems to agree and the new Innovative Finance ISA ("IFISA") will be available from 6th April 2016. It will be a separate ISA from the conventional ISA that holds cash and stocks and shares. This is something that both the alternative finance industry and the ISA industry lobbied for: primarily to permit the implementation of appropriate regulation and controls over transferability and liquidity in ways that do not impact the existing ISA regime. The Tax Incentivised Savings Industry (TISA) was also concerned that allowing peer-to-peer lending in existing ISAs could lead to a rise in reporting and compliance costs. Research by the Peer-to-Peer Finance Association (P2PFA) found that the idea of a separate ISA had strong support among investors:

- 74% like the idea of keeping peer-to-peer lending in a separate lending ISA
- 81% agree that peer-to-peer lending has different characteristics to investments in a Stocks and Shares ISA
- 81% agree that a lending ISA will introduce a greater breadth of choice to the investments market
- If the third ISA type is introduced by the government, 62% of respondents will definitely invest in the product

However, we should sound a couple of notes of caution. We know from some on and off-the record conversations with providers and consultants that are working with them, that the alternative finance platforms are not up to speed with the administration issues that come with ISA acceptance. These centre around liquidity (retail investors should be able to get their hands on their money swiftly, should their circumstances change), reporting and disclosure (to HMRC). We don't think these are going to be show-stoppers, as the government is proposing to modify some of the ISA

> *"For those new to the sector it can be an extremely confusing picture, but it is important to understand the issues that need to be considered and then either do your homework or find a fund that can do it for you"* **Geoff Miller, GLI Finance**

rules to accommodate the peer-to-peer lending model, but perhaps some of the platforms are going to find turning themselves into ISA managers a bigger task than they anticipated.

It's also possible that the platforms have over-estimated the size of the prize on offer. Although there is a lot of money in ISAs, there's no reason to expect that a huge share of it is going to come rushing into the peer-to-peer lending sector. Many ISA purchases are advised, and there are big barriers to advisers recommending peer-to-peer: they struggle to understand the whole-of-the-market and make informed decisions; they are concerned about regulatory risk; it can be difficult to remunerate themselves when investing their clients in this sector. We hope that this new ISA doesn't go the way of the long-forgotten Insurance ISA, which was launched and sank without a trace.

That seems unlikely though. This is a big milestone for the peer-to-peer lending industry - there is no doubt that being able to access this new asset class through ISAs will be huge boon for peer-to-peer lending over the long term. But it might take longer and have less impact than expected. As mentioned on the next page, the new Personal Savings Allowance and bad debt relief for peer-to-peer lending income is possibly more significant right now, and takes away some of the urgency around the ISA issue for most peer-to-peer investors.

SUMMARY ON INCLUDING PEER-TO-PEER LOANS TO ISAs

In short, the key policy design decisions that the government made in response to the consultation are to:

- Create a third ISA (the Innovative Finance ISA) to accommodate peer-to-peer loans
- Modify existing ISA rules regarding legal ownership of investments for the Innovative Finance ISA, in order to accommodate the established peer-to-peer operating model
- Adapt ISA rules regarding withdrawals and transferability for the Innovative Finance ISA, so that these only apply to cash held in an Innovative Finance ISA

The government has confirmed its intention to use the proposed definition of "relevant agreements" in article 36H of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as a general basis for identifying peer-to-peer loans that will be eligible for ISA inclusion.

The government will proceed with its proposal to make advising on peer-to-peer loans a regulated activity. All firms currently authorised to advise on investments will be eligible to elect to have this authorisation automatically conferred upon them.

The FCA has not chosen to include peer-to-peer lending platforms within the scope of the FSCS. Both the FCA and the government think it is important for the regulatory framework for peer-to-peer platforms to be proportionate and the FCA does not consider that this is necessary at this time. The FCA is committed to reviewing the regulatory framework in 2016 and at that stage it will consider again whether peer-to-peer should be within the remit of the FSCS.

Nearly all peer-to-peer platforms (15 of 17) who responded said that they would consider seeking authorisation to act as an ISA manager if the government were to permit this. Platforms that responded to say that they wouldn't seek to apply for ISA manager status stated that they would look to outsource this role to a third party.

The full document can be found on *www.gov.uk*

OTHER WAYS TO GET PEER-TO-PEER LENDING IN AN ISSA

However, all of this applies to direct peer-to-peer lending. We must not forget that there are a number of closed funds listed on the London Stock Exchange that invest in peer-to-peer lending and are ISA eligible from July 1st 2015. The innovators who set these up and the Association of Investment Companies who lobbied for ISA acceptance for these trusts deserve credit here. (We've got more to say about these trusts below.)

Finally, there have been some other innovations that have taken place outside of the government consultation and industry-level work taking place to get alternative finance into ISAs.

Wellesley Listed Bond. In May 2015, peer-to-peer lender Wellesley & Co. issued an ISA eligible retail bond listed on the Irish Stock Exchange. The funds raised will be used to invest in asset backed loans and the bond pays fixed rates of return over a three or five year term.

Structuring the product in this way meant that Wellesley could give investors exposure to peer-to-peer lending via an ISA, regardless of the outcome of the consultation. However, it does alter the nature of the exposure: investors are lending money to Wellesley, who will then lend that money to their borrowers. Investors do not have direct exposure to the underlying loans as they would with conventional P2P lending. If Wellesley goes bust, investors lose - they are not contracted with the underlying borrowers.

SyndicateRoom. SyndicateRoom has begun raising money for companies listed on the ISDX. These shares are ISA qualifying, so this goes down as the first equity crowdfunding that is ISA eligible. However, the EIS/SEIS tax regime is far more attractive than ISAs when investing in smaller companies, so this is a bit of a moot point (that Syndicate Room are the first to acknowledge).

> *"Peer-to-peer lending is forecast to continue to grow rapidly as an asset class in the UK as people search for investments that give a decent yield with a relatively low level of risk"*
> **John Goodall, Landbay**

Two big changes to the way income from alternative finance investments is taxed will be implemented in April 2016.

Firstly, we will benefit from a tax-free Personal Savings Allowance of £1,000 (or £500 for higher rate taxpayers) on the interest earned on savings. The Treasury estimates that this will benefit 95% of people. Given that the average lending portfolio is £5,606 and the average interest rate is 8.8% (University of Cambridge, November 2014), this new allowance is perhaps more significant than the more-talked about ISA acceptance. (Note that this allowance does not apply to income from shares or funds).

Second, investors will be able to offset losses from failed loans against other peer-to-peer income for tax purposes, and will be able to apply for this relief on losses incurred from April 2015. This puts the platforms on an equal footing with the high street banks, but the benefit to the platform will depend upon the model they employ - platforms with contingency funds already repay investors' capital when they suffer defaults and so in theory there are no losses to offset.

In addition, depending on the outcome of a consultation, the government will probably also introduce a withholding tax regime from April 2017, meaning that tax on income will be deducted at source, so investors will no longer need to complete a self-assessment tax return, again bringing things in line with bank deposits.

INSTITUTIONS ARE DEPLOYING CAPITAL

Institutions are obviously coming into the sector in search of returns for their investors. In peer-to-peer lending they see a new asset class (or perhaps more accurately, a new way to access an asset class that was previously intermediated by banks) that can provide high yield, low(er) volatility and predictable returns. Essentially, they're looking for better risk-rated returns than they think they can find elsewhere. If they can utilise their resources and expertise to develop an understanding of the market, institutions may be well placed to take advantage of the transparency and low costs that peer-to-peer platforms provide.

It's not possible to determine exactly how much money institutions are deploying via the platforms, but AltFi Data has a good proxy: the number of whole loans that are funded. To make them more attractive to institutional investors, some of the platforms are now allowing investors to purchase a whole loan as opposed to a fraction of a loan. With their larger capital reserves and ability to assess the risk of whole loan opportunities, it's a reasonably safe assumption that whole loans are bought by institutions and fractional loans by retail investors.

AltFi Data has analysed this for one of the biggest peer-to-peer business lenders, Funding Circle.

WHAT'S WRONG WITH EQUITY CROWDFUNDING?

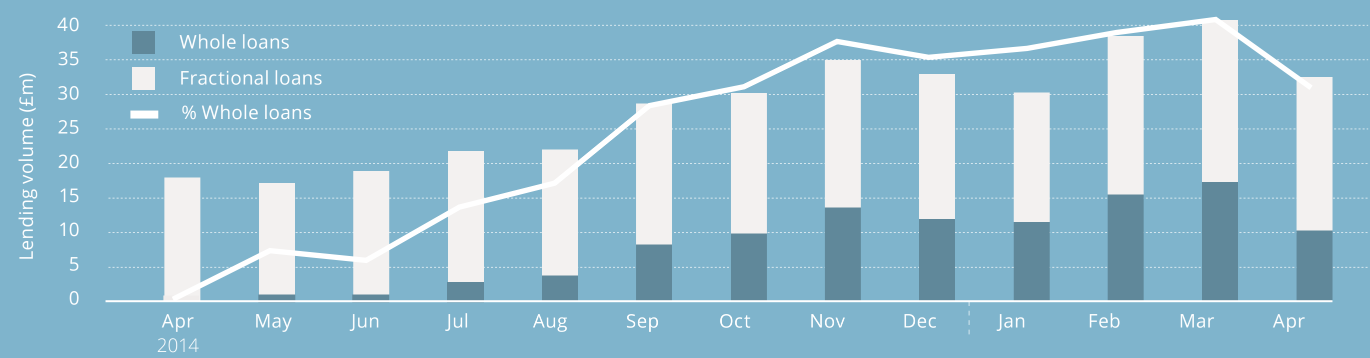
Well, absolutely nothing. It's an asset class that makes perfect sense for the right investors, but it hasn't featured very much in the discussion on SIPPs and ISAs for one principal reason: small unquoted shares already have their own regime of tax reliefs - the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS).

Recognising the additional risk of equity investments into smaller companies, the EIS/SEIS regime has generous tax reliefs to encourage investment. These include up-front income tax relief, CGT deferral, no tax on gains made within an EIS and IHT relief (via BPR). With these reliefs on offer, there is no benefit to making investments in equity crowdfunding via an ISA (where EIS/SEIS benefits would be lost). The equity crowdfunding platforms have been utilising the EIS/SEIS regime right from their inception.

However, the government has announced that it will consult on including debt securities (mini-bonds and debentures) and equity crowdfunding options in ISAs. We think that certain debt securities would be an excellent fit.

However, as it stands at the moment, unquoted shares (with the exception of AIM and ISDX shares), debentures and mini-bonds (the three securities that crowdfunding platforms offer) are not allowable in ISAs. They are all technically allowable in SIPPs, subject to the SIPP operator accepting them and being satisfied that they will not breach the rules around taxable property, unauthorised payments and trading.

WHOLE LOANS ORIGINATED BY FUNDING CIRCLE (2015)



Whole loans can be used as a proxy for institutional investment on lending platforms

Source: Alt Fi Data

"Institutions are obviously coming into the sector in search of returns for their investors. In peer-to-peer lending they see a new asset class that can provide high yield, low(er) volatility and predictable returns."

Obviously this is just a snapshot of a proxy on a single platform, but we think it is still an indication of an industry-wide trend. Interestingly, AltFi Data speculates that the falling off of whole loans since March 2015 could be because Funding Circle is actively trying to control the influx of institutional capital into its marketplace to achieve a balance with the more steadily growing retail investor base.

AltFi Data has also analysed this phenomenon on Zopa and Ratesetter – the details are available on its site in an article entitled "Is P2P Lending a Thing of the Past?"

We also have some rough, estimated data from some of the platforms themselves, courtesy of AltFi.

Looking in more depth at the emergence of dedicated retail funds and investment firms, GLI Finance, Victory Park Capital, Shepherd Capital and P2P Global Investments and are the most prominent examples to date. It's worth taking a closer look at these first-movers. (Note that all of the funds are closed funds.)

GLI Finance (GLIF.L) went through a business rethink and specifically identified the funding gap - the inability or reluctance of the banks to lend to SMEs - as an opportunity and have now reconfigured their activities to reflect that (they previously specialised in Collateralised Loan Obligations, so the move into alternative finance is a logical step). They have now built a business model based on both making equity investments into the platforms themselves, and investing into the debt the platforms originate. They work very closely with their investee companies ("strategic partners") giving them board level advice and help on core activities such as compliance, risk management and credit underwriting, as well helping them with sales and marketing and the benefit of their network of contacts. They also lobby on behalf of the alternative finance industry - for example they had a lot of input into the legislation which mandated UK banks to refer business they could not write onto other neutral finance options.

% OF INSTITUTIONAL FUNDING (as of June 2015)

abundance	0.01% institutionally funded. Ecology Building Society accounting for only 3.7% of total funds raised
Funding Circle	30% institutionally funded
LANDBAY	0% institutionally funded, but with the expectation of hitting 80% institutionally funded by the end of 2015 – owing to a secured £250m bank credit line
LendInvest	70% institutionally funded
marketinvoice	45% institutional, 55% high net worth
zopa	30% in 2015 and between 10% and 15% all time

Source: Alt Fi, as of June 2015

Obviously their intention is to see the value of their equity investments increase and make a return on the loans they have invested in at the same time. Their equity stakes give them ongoing insight into the businesses that are originating the deals that they are investing, and confidence in the way they are being managed. They have created a "head of lending" role that has oversight over all of their lending activity and they have invested in 19 strategic partners (at the time of writing - don't be surprised if they make more investments) across eight different alternative finance sectors in North America, the UK and Europe - so they have a well-diversified investment in the industry.

Victory Park Capital's Specialty Lending Investments (VSL.L) successfully floated on the London Stock Exchange in March 2015 raising £200 million. Much like GLI, it will be investing directly in both the debt (and trade receivables) originated by the platforms and in the equity of the platforms themselves. Bear in mind that the big US peer-to-peer lender, Lending Club, was valued at $5.4 billion for its IPO in 2014 - these equity stakes could prove to be very lucrative.

Shepherd Capital have been investing in the peer-to-peer space since 2010 in both the US and the UK and recently teamed up with Eiffel Investment Group to launch Eiffel eCapital. The new joint venture will invest across a number of different niches within the alternative finance spectrum, including consumer peer-to-peer loans through to more specialist small and medium sized business funding. This venture is noteworthy for the background of the players involved: Shepherd Capital is a Luxembourg based family office (managing the assets of the founder of the Yves Saint Laurent fashion empire) and Eiffel Investment Group is a French fund manager with €250 million AUM. It demonstrates the appeal to other investors such as family offices and the increasingly cross-border nature of institutional involvement in alternative finance.

Ranger Capital Group is a US investment manager that has launched a specialist fund to invest in loans originated by peer-to-peer lending platforms. What's interesting about this proposition is that it makes explicit just how they intend to outperform - by using an API (application programme

LARI PERFORMANCE (as at 30 Sept 2015)	Absolute return	Change
3 MONTH	1.61%	+0.01
1 YEAR	5.45%	+0.05
3 YEAR	18%	-0.03

interface) provided by the platforms to access loan data and then an algorithm to invest in loans that fit the investment objectives. At the moment they are only working with Prosper and Lending Club - the two big players in the US market - but this could be an indication of where P2P is heading in the future. The group also floated its Ranger Direct Lending Fund (RDL) on the London Stock Exchange in May raising £135 million.

P2P Global Investments (P2P:LON) listed on the 30th May 2014 after raising £200 million. It's managed by hedge fund firms Marshall Wallace and Eaglewood Capital Management (another peer-to-peer specialist) and buys loans from the likes of Funding Circle, Zopa and RateSetter. They declared a dividend of 16.5p per share in May and at the time of writing the share price performance has been positive. So far they are delivering what it says on the tin - in fact at the time of writing they were trading at a premium to their NAV (as are the other funds).

And finally, at the time of going to press, Funding Circle has also stated its intention to float its own fund on the stockmarket that will invest in loans on it UK and US platforms.

As for crowdfunding, rather than institutions deploying capital the more exciting development is seeing the platforms used to raise funds alongside traditional City brokerages. Sandal is a listed firm that used SyndicateRoom's platform to issue shares to the public, and Crowdcube has secured an investment from Numis, a specialist in smaller company IPOs. Oliver Hemsley, CEO and founder of Numis said. "This investment in Crowdcube will put Numis at the centre of the entire investment chain, from initial start-up capital all the way to IPO".

What we're seeing here is a blurring of the distinctions between traditional fund raising and crowdfunding, and crowdfunding investors can expect to get access to a much broader range of opportunities from much more mature companies than those that have been available to date.

WHO'S BEEN INVESTING

To date, it has mostly been city institutions investing in these funds.

Perhaps the most prominent example has been the £20 million investment by the highly rated fund manager Neil Woodford made into RateSetter in March 2015, alongside Artemis, the big name fund manager with the long running "profit hunter" advertising campaign. We've also seen investments by F&C, Invesco Perpetual, Aviva Investors, Jupiter Asset Management, City Financial and Axa Investment Managers (Source: Bloomberg). However, like much of the news flow in alternative finance, there is no need to get too excited - these are really significant milestones, but the fund managers are only investing tiny percentages of their portfolio into P2P: according to the FT, at the end of March Neil Woodford's investments into peer-to-peer comprised 1.46% of his Woodford Equity Income Fund. Are these funds good investments for retail investors? It's hard to say. On the one hand they offer the prospect of automatic diversification across loans and platforms and professional management of your money. On the other hand, they come at cost and - for now at least - it's difficult to judge if the cost is good value or not. There are currently no benchmarks being employed to measure them against, although the The Liberum AltFi Returns Index would make a good benchmark as it replicates the investor return across a fully diversified portfolio within the peer-to-peer lending sector. Another stumbling block is that not all platforms report the performance of their loan books or their passive investment products consistently - although the P2PFA is working hard to address that. Finally, it's worth noting that the financial consultancy firm Altus (among others) has stated that it believes the cost of intermediation, such as management fees is likely to be offset by P2P platforms lowering fees. Their feeling is that intermediation through funds is essential if the peer-to-peer lending sector is to reach its full potential.

For retail financial services professionals though - advisers, SIPP operators, ISA providers - these funds are retail investment products that will be much easier for them to understand, accept and recommend to their clients. With investment trusts on a bit of an upward curve after the Retail Distribution Review levelled out the playing field for trusts and OEICS, we expect these sorts of funds to play their part in taking peer-to-peer lending to the mass market.

PERFORMANCE OF DISRUPTERS

The performance of some of these listed vehicles (and many more) is captured in the LAFDI (Liberum AltFi Data Disrupters Index), a "Float Market Cap and Liquidity rank weighted index comprised of a selection of companies that are disrupting incumbent banks and financial services companies by adopting a radically new approach".

THE LIBERUM ALTFI RETURNS INDEX (2006-2015)

Source: Alt Fi.com

"The sector has been built on the back of retail investors who were either looking for a better deal or wanted to disintermediate the financial services sector (or both)"

GOLDMAN SACHS ANALYSIS OF THE ALTERNATIVE LENDING IN THE US (2015)

Type	Total market size	Market size type	% inside banking system	Amount in banking system	% in banking system at risk of leaving	Amount at banks at risk of leaving	Tot. banking profit pool at risk	Select disruptors / new entrants	Competitive advantage?
Unsecured personal lending	$843bn	Loans O/S	81%	$683bn	31%	$209bn	$4.6bn	Lending club, Prosper	Lower capital requirement, technology
Small business loans	$186bn	Loans O/S	95%	$177bn	100%	$177bn	$1.6bn	OnDeck, Kabbage	Technology (drives time, convenience)
Leveraged lending	$832bn	Loans O/S	7%	$57bn	34%	$19bn	$0.9bn	Alternative AM, BDCs	Regulatory
Student	$1,222bn	Loans O/S	5%	$65bn	100%	$65bn	$0.7bn	SoFi, Earnest, CommonBond	Regulatory, technology, convenience
Mortgage origination	$1,169bn	Annual volume	58%	$678bn	100%	$678bn	$2.1bn	Quicken, PFSI, Freedom	Regulatory, convenience
Mortgage servicing	$6,589bn	Loans O/S	73%	$4,810bn	6%	$300bn	%0.1bn	OCN, NSM, WAC	Regulatory, costs
CRE	$2,354bn	Loans O/S	56%	$1,322bn	9%	$118bn	$0.8nb	Comm. mREITS, alt. lenders	Regulatory, market dislocation
Total	$13,195bn		59%	$7,792bn	20%	$1,566bn	$10.9bn		

Goldman Sachs believe that there is $11 billion of profit that alternative lenders can capture in the US

Source: Goldman Sachs

As an asset class, alternative finance is obviously keen to secure inflows from institutional investment. It's a huge pool of capital that can give the industry the scale it wants (on the supply side at least), provide liquidity and hold the platforms up to ever higher standards. And there is no doubt that institutional investment is also a stamp of approval that shows a maturing sector. And if the funding gap is to be closed for SMEs, it will require institutional money - of that there is no doubt.

A DOWNSIDE?

However, it does raise a concern that alternative finance will lose its innocence somewhat. The sector has been built on the back of retail investors who were either looking for a better deal or wanted to disintermediate the financial services sector (or both).

It felt like a much fairer and a much more democratic way of investing money. Now the sector would claim - with justification - that is still the case. But the big concern is that institutional investors and funds that control large pools of money will be able to get a better deal than individual retail investors can. We've already mentioned that they can leverage their resources and skills to take advantage of the transparency in the P2P sector. We know that institutions have more capacity to invest in whole loans. The fear is that they can cherry pick the best investment opportunities, leaving retail investors to choose from less attractive opportunities.

One view on this is that it should be up to the platforms to manage this and communicate it to their retail investors.

Another view (unsurprisingly, from the institutions themselves) is that it is up to the investors and their advisers to do their due diligence and ascertain if their chosen platform is giving an edge to institutional investors. Our view is that it's fine to push this responsibility onto the investors/advisers - provided, and only provided, that it is made very clear to them what advantages are afforded to institutions. We don't believe that this is the case at the moment.

As we noted earlier, the term peer-to-peer seems to be fading out of fashion, and (the more institutional sounding) marketplace lending is replacing it, perhaps reflecting that many platforms are now institution-to-peer as much as 'peer-to-peer' now. The most nuanced view of the nomenclature is:

- **Peer-to-peer lending:** consumers and institutions are the lenders
- **Marketplace lending:** institutions are the lenders
- **Balance sheet lending:** platform is the lender

In summary: institutional funding is vital if the platforms are going to address the funding gap, and the rigour institutional investors bring to the sector should benefit retail investors as well. However, the funds must look at each individual platforms' credit, risk and compliance procedures if they are going to be successful over the long term. Just using their scale to snap up loans still leaves them exposed to some big risks.

SIPP ACCEPTANCE

Alternative finance investments are SIPP acceptable provided they meet the rules around taxable property, unauthorised payments and trading. If they do not meet the rules, they will be subject to a tax charge.

SIPP BENEFITS (2015 / 2016)	£	£40,000 ANNUAL LIMIT	£	£1,25m LIFETIME LIMIT	%	25% TAX FREE LUMP SUM	%	0% CGT

- **Taxable property** consists of residential property (including residential ground rents, timeshare/ holiday homes and the grounds of residential properties) and tangible moveable property - this includes art, antiques, fine wine and vintage cars. In effect, anything that one can touch and move potentially falls into the tangible moveable property category. In addition the scheme member and connected parties must not derive any personal use or enjoyment from the property.

Alternative Finance Investments are unlikely to fall foul of this rule unless the loans were used to fund a purchase of taxable property. This could potentially trigger a tax charge. It also precludes any payments in kind or 'rewards' for an investment (these would be considered personal use).

- **Unauthorised Payments** is a biggie for alternative finance in SIPPs. The rule is there to prevent SIPP investors making payments to "connected parties" and liberating cash from their pension tax free ("pension liberation"). In most scenarios, a loan cannot be made to a connected party without incurring tax charges, but P2P lending would make it fairly easy to circumvent the rules. Andy Leggett of Barnett Waddingham calls this "buddy loans":

"BUDDY LOANS"

SIPPs prevent connected parties make loans to one another without incurring tax charges

- **Trading.** This rule is there to ensure that there is no advantage to running a business within a pension. Alternative finance investments are unlikely to fall foul of this provision.

For more information on what is and is not allowable in a SIPP, go to *www.in-review.com*

Meeting the rules for SIPP acceptance is only half of the picture though. The SIPP operators themselves will only accept alternative finance investments if it makes commercial sense for them, and that decision might come down to the issue of whether the investment is classified as a non-standard asset or not.

After seeing a lot of investment into esoteric assets via SIPPs (much of which the FSA/FCA considered was inappropriate for the investor), the FSA/FCA took several steps to clamp down on this sort of activity and protect unwary consumers.

One of the tangible outcomes has been higher capital adequacy requirements for SIPPs holding non-standard assets. Non-standard assets are defined in the negative, i.e., anything that is not a standard asset "Standard assets must be capable of being accurately and fairly valued on an ongoing basis, readily realised whenever required (up to a maximum of 30 days), and for an amount that can be reconciled with the previous valuation" (FSA Consultation Paper CP12/33).

If alternative finance platforms don't meet these criteria, then any SIPP operators they work with will have to meet the higher capital adequacy requirements - another hurdle the platforms have to overcome.

A more intangible outcome after the regulator's intervention is a very wary SIPP industry. It seems that the FCA expects SIPP operators to play their part in consumer protection. This means more thorough due diligence on investments made via a SIPP and checks on appropriateness and suitability, again raising costs for the operators.

So why should the platforms bother chasing SIPP acceptance? Quite simply, there is a lot of money in SIPPs.

According to John Moret of MoretoSIPPs consultancy, currently there are approximately 1.2 million SIPPs in the UK with £150 billion in assets. Of these, 270,000 of them are full choice SIPPs controlling £70 billion in assets and logic would suggest that these operators and their investors will be the first to take an interest in alternative finance.

The remainder are 430,000 restricted choice SIPPs with £30 billion in assets and 500,000 platform SIPPs with £50 billion in assets. There's no reason why these cohorts wouldn't eventually also invest in alternative finance, but at the volume end of the market the processes will need to be quick, clean and simple to keep costs down.

Our guess is that some of the bigger providers at this end of the SIPP market will negotiate preferential terms with product providers (something they are used to doing in the world of mainstream investments) or perhaps even create their own alternative finance platforms. We wouldn't be surprised to see some white labelled products pop up here. Hargreaves Lansdown are among a few already making moves in this direction.

Furthermore, in the light of the new pension freedoms, Moret has predicted that the SIPP industry could grow to 2 million SIPPs with £300 billion in assets by 2017. If the alternative finance platforms can crack it, this is a big market.

In summary: alternative finance is finding its way into SIPPs already: Abundance Generation, Assetz, Mayfair Bridging, Proplend, RateSetter, Rebuilding Society, ThinCats, Zopa and Wellesley & Co have all secured acceptance with some SIPP operators and there's no doubt that the investment case for alternative finance also makes sense within a SIPP, but there are technical and commercial barriers to overcome to make this work on a bigger scale.

We think that the more sophisticated nature of a SIPP and SIPP investors (at least in theory) means that both equity crowdfunding and peer-to-peer lending would work within a SIPP, but we suspect more investors will be tempted by the uncorrelated, lower risk, high yield nature of peer-to-peer (and other debt instruments such as debentures) rather than the high risk/return profile of unquoted equity.

"The UK government has supported the development of alternative finance since its inception and naturally has an interest in how the peer-to-peer sector can support SMEs who are so vital to the UK economy"

One final point. It's estimated that 80% of SIPPs are advised (Source: MoretoSIPPs), so working with financial advisers might be the key for the alternative finance platforms here.

MANDATORY REFERRAL SCHEME, BRITISH BUSINESS BANK AND GOVERNMENT SUPPORT

The UK government has supported the development of alternative finance since its inception and naturally has an interest in how the peer-to-peer sector can support SMEs who are so vital to the UK economy. The two major planks of government support have been the deployment of funds through alternative finance providers via the British Business Bank and the mandatory referral scheme for high street banks.

The British Business Bank provides finance to smaller businesses by deploying its funds through partner intermediaries - which now include alternative finance platforms. To date the bank has already issued over £200million of awards to the alternative finance space, the recipients being Zopa, RateSetter, Funding Circle, MarketInvoice and Urica. Back in 2012 when this initiative really got started, the previous Business Secretary Vince Cable said in a statement: "As businesses are continuing to struggle to get credit from their banks, developing alternative lending channels is essential so firms are less reliant on banks. Our aim is to create a more diverse financial infrastructure which better serves the needs of our small and medium-sized companies."

The mandatory referral scheme will oblige ten major banks to refer on businesses they turn down for credit to alternative finance providers. Launching in 2015, this initiative follows on from a deal that Funding Circle did with Santander in June 2014, demonstrating how such a scheme could work in practice. (Although interestingly, according to an online poll for Liberis, while 85% of SMEs think the scheme is a key to the future success of the small business sector, 48% thought that it would make funding more expensive for businesses.)

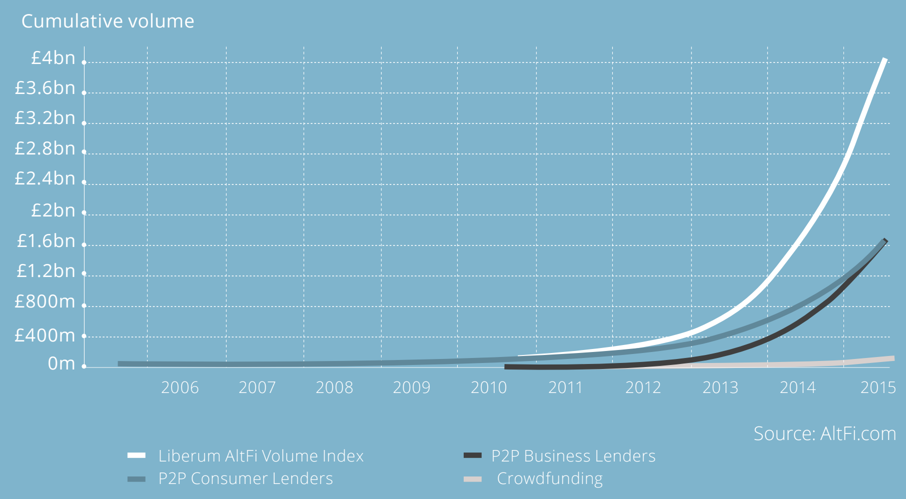
In addition, the UK Government-backed London Co-Investment Fund (LCIF) is set to invest £5million in London's finest seed-stage technology, digital and science businesses through Crowdcube. The investment pot is earmarked for high-growth firms making the transition from start-up to growth phase and typically for companies looking to raise between £250,000 and £1million.

And to be fair to the banking sector, some of them have made tie-ups with the lending platforms outside of the mandatory referral scheme: Santander and Funding Circle, Royal Bank of Scotland and Assetz and Metro Bank and Zopa are all good examples. We should be clear about the points we're making here – the mandatory referral scheme is a good indication of the Government's direction of travel, but the banks have independently come to the conclusion that they need to work with the peer-to-peer lending sector. Both of these demonstrate that peer-to-peer lending must be taken seriously.

MEANINGFUL MARKET DATA

Anything which increases the visibility and transparency of a market should enhance its appeal to investors and we've seen developments in this area with new indices, reviews and service companies entering the market.

THE LIBERUM ALTFI VOLUME INDEX UK (2005-2015)



Source: AltFi.com

THE LIBERUM ALTFI RETURNS INDEX (2006-2015)

Source: Alt Fi.com

"Sure, raising equity and lending money is nothing new, but doing it so quickly, so transparently and at such a low cost online is a significant change and a challenge to the existing models."

- **Liberum and AltFi Data** have worked together to produce a number of indices that measure the growth in volume and the returns of the alternative finance sector
- **Liberum AltFi Volume Index UK** is the market leading peer-to-peer index, tracking the growth of the UK industry from inception. The index is updated daily and users can use interactive graphs and charts to explore the evolution of the industry. A similar index measuring the European peer-to-peer industry is also available.
- **Liberum AltFi Financial Disruptors** Index measures the performance of listed companies who are considered to be disrupting incumbent banks and financial services companies with their business model and approach. (More information at *www.altfi.com/data*)

There is also another index, provided by 4th way (www.4thway.co.uk). This is a less rigorous, forward looking index that is based on the interest rates that the platforms expect ordinary lenders to achieve, on average, after fees and forecast bad debts, if they spread their money equally between the constituents. Each lending platform has a slightly different way of calculating this number, so while the index may give a good indication of possible returns, it can only ever be a broad approximation.

AltFi also provides extensive news coverage and analysis of the sector on its website and hosts alternative finance research seminars, events and awards, all of which can help interested parties get a grip on the market.

In the equity crowdfunding space CrowdWatch powered by Crowdnetic, allows users to analyse market data by sector, industry, security type and geography. This tool gives users the ability to view real time listings across several large UK platforms (10 at the time of writing), tracking how much and when an investor chooses to commit capital to a company. The platform also allows users to view valuation data by the same criteria. This type of market insight makes researching and comparing investments across platforms less daunting, and also opens up the industry to greater transparency.

CrowdWatch also operates in the US with some of the largest US platforms and their data is already being used in indices, such as the CNBC Crowdfinance Index, tracking the 50 largest capital commitment by private US companies listed on CrowdWatch's platform.

Ratings and reviews are part of mainstream fund based investments and an essential resource for many investors. They are starting to become part of the alternative finance world as well.

On the ratings side, in July 2014 research agency FE gave the RateSetter platform a cash-like risk rating of 1, based upon the low levels of volatility the platform's investors have experienced to date. In June 2015, ARC Ratings awarded alternative mortgage lender LendInvest a rating of SQ1, which is the highest rating the company has, based upon the platform's ability to originate deal flow and its underwriting and servicing capabilities.

On the review side, All Street is a new entrant proposing to provide individual investment reviews of equity crowdfunding opportunities for retail investors. SIPP Investment Platform (now trading as in:review) also developed a peer-to-peer platform review service in 2014, with a 70+ question DDQ covering seven key aspects of peer-to-peer platforms. The objective is to help its subscriber base of SIPP operators and financial advisers carry out due diligence on platforms that their clients may wish to invest in via their SIPP.

Finally, we know that a handful of legal and compliance firms, PR gurus and marketing agencies are targeting the alternative finance space - all keen to find a role for themselves and play a part in this exciting new sector!

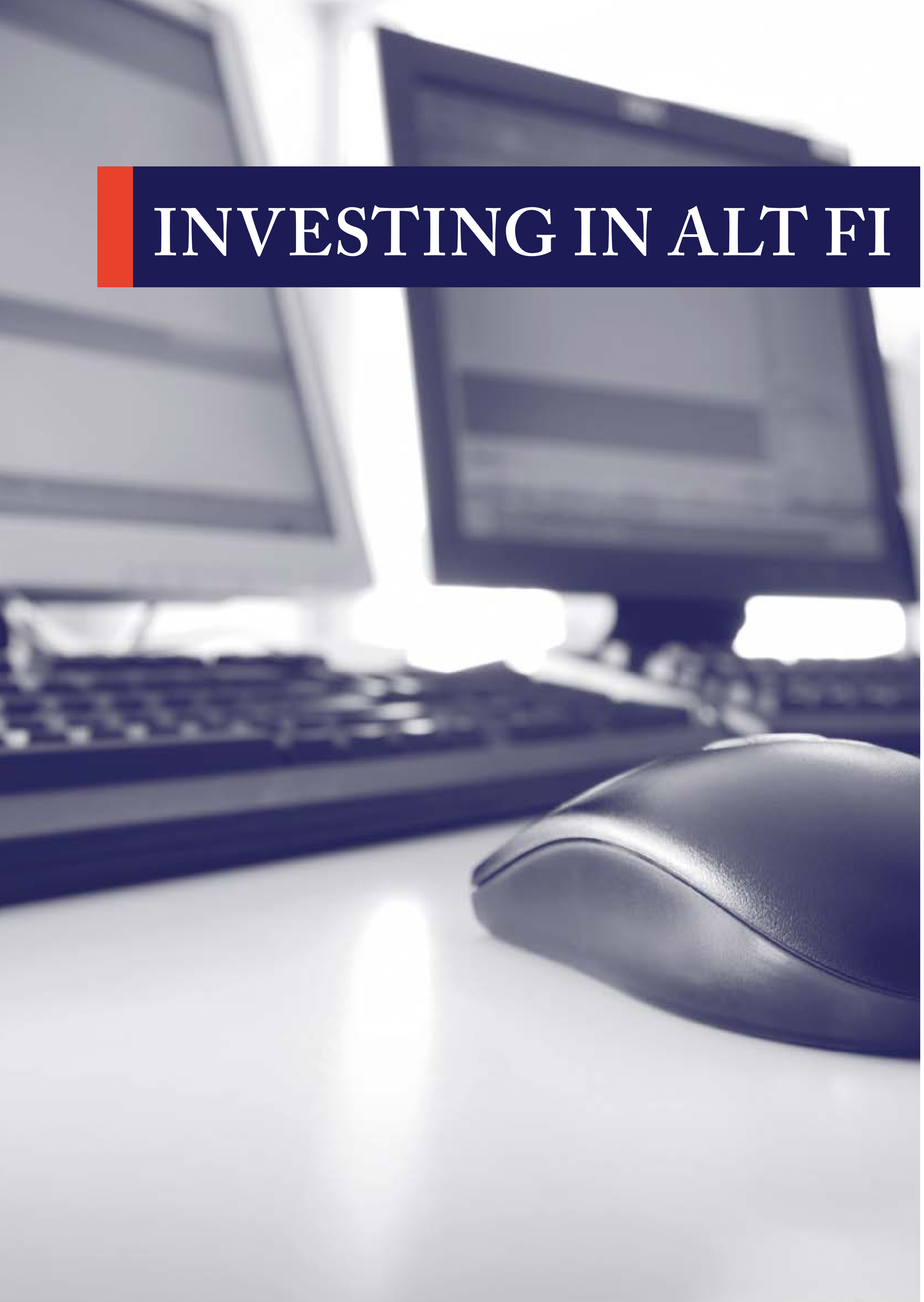
CONCLUSIONS

Sure, raising equity and lending money is nothing new, but doing it so quickly, so transparently and at such a low cost online is a significant change and a challenge to the existing models. Taken together, we think that all of these developments paint a very clear picture of an asset class that is rapidly maturing.

A few years ago it, while it was an unregulated activity undertaken by a few brave or foolhardy souls who stumbled across the platforms online, it could be easily ignored. But in a very short space of time it has grown in scale, attracted institutional investors, been brought under the FCA's umbrella, started to produce meaningful data on risk and returns, is on the verge of being accepted into the nation's most popular investment wrapper and turned itself into a conduit for the government to supply credit to SMEs. That's a pretty impressive track record.

KEY FINDINGS

- The FCA is particularly concerned that 62% of equity crowdfunding investors surveyed described themselves as retail investors with no previous investment experience in early state or VC investment
- The Innovative Finance ISA will accept peer-to-peer lending and launch in April 2016
- Investors have been able to offset losses from failed loans against other peer-to-peer income for tax purposes since April 2015
- Institutional investors have been increasingly interested in alternative finance and we have seen the emergence of several large dedicated funds and investment firms
- Alternative finance investments are SIPP acceptable provided they meet the rules around taxable property, unauthorised payments and trading
- The mandatory referral scheme will oblige 10 major banks to refer businesses they turn down for credit to alternative finance providers



INVESTING IN ALT FI

RISKS OF ALT FI

For such a new asset class, working out what the risks are is difficult. Or to be more accurate - working out what the risks are is pretty easy, but quantifying them is very difficult.

Assessing and comparing the various ways the platforms have tried to mitigate these risks adds another layer of complication. We've done our best to set out and assess the risks for each of the different varieties of alternative finance below, but ultimately this is just our view of the risks - there isn't lots of data to provide empirical evidence. Mike Baliman, host of the London Fintech Podcast and a consultant on the topic of risk, wrote a series of articles in the alternative finance sector for AltFi - you can find them online and we'd suggest reading them in conjunction with this to give a full and complete overview.

The platforms have considered these risks and have implemented different ways to mitigate them – something we'll examine in more detail further on.

BIG PICTURE RISKS

What are the big picture risks that are common to all of the alternative finance platforms?

No FSCS protection: Simple, but important. Any investment via an alternative finance platform will not be covered by the Financial Services Compensation Scheme, which compensates the first £75,000 of any deposit with an institution if that institution goes bust. So if a platform that's holding your money goes into meltdown, that money may well be lost for ever - a big contrast to a bank deposit.

No Track Record: While past performance is not a guarantee of future returns, it is a guide to help assess the competence of somebody who is going to invest on your behalf. A longer track record that shows success throughout the business cycle is an indication of competence - but as a new asset class very few platforms (perhaps only Zopa) can evidence this. So while lending platforms can model how they think they might perform if interest rates rise or defaults increase, we have no empirical evidence to judge them on.

Lower Levels of Scrutiny and Data: Public markets have enough money moving through them to justify extensive amounts of research on the investment opportunities - produced by both the buy and sell sides. Big institutional investors can afford to scrutinise the markets and the underlying investments very carefully and there are a plethora of sources of market data and information.

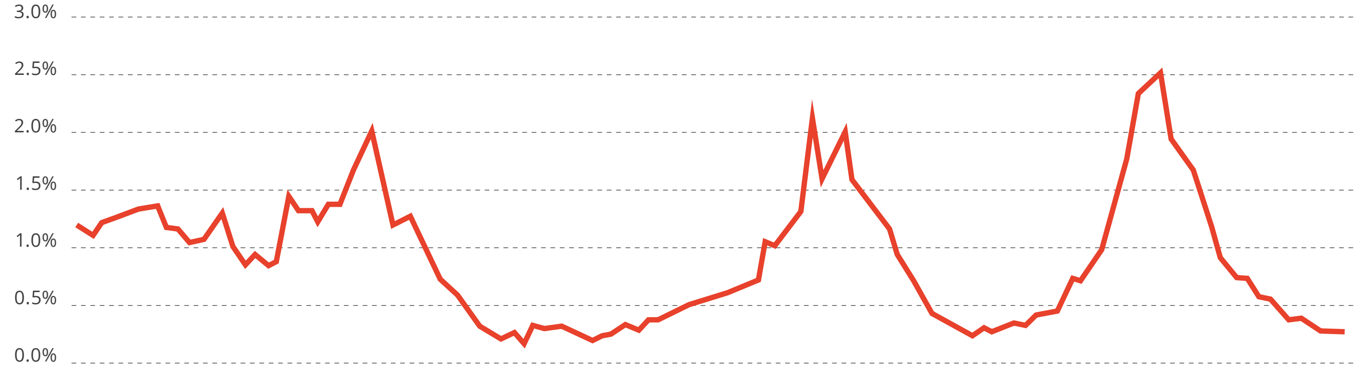
This scrutiny and information ecosystem doesn't exist in alternative finance yet (although, AlfFI, Liberum and the institutional investors are starting to bring it about), meaning that markets are less efficient, price discovery is less transparent and poor practices have more chance of going undetected for longer.

Incentives, IPOs and Chasing Volume: Lending Club, the US peer-to-peer platform that lends to both consumers and businesses, made its stock market debut in December 2014 at $15 per share, valuing the company at $5.4 billion. That's a huge return for the founders and owners of the platform and it is of course something that every other alternative finance platform will have noticed with more than passing interest. It's such a massive carrot, it could lead some platforms into chasing volume to give a short term boost to their revenues and achieve the sort of scale that would indicate that they are IPO ready. Inevitably, this will mean sacrificing quality for quantity and can only really result in a worse overall performance for investors. This, unfortunately, feels distinctly oldFi - institutions putting their own profits and goals before their customers.

Frauds: To date there have been relatively few frauds on alternative finance sites – and certainly none that have been very high profile, although we have heard on the grapevine that a leading lending platform was successfully targeted. There are a handful of fraudulent companies who have targeted equity crowdfunding sites - notably Kickstarter, which is a US

"Investing in peer-to-peer is different to other forms of investing – it is very important to have a highly diversified portfolio of investments, to reinvest capital quickly which has been repaid, and to understand the impact of any lack of liquidity on risk" **Stephen Findlay, BondMason**

THE BUSINESS CYCLE - US CORPORATE LOAN LOSS RATES (1985-2014)



It's hard to assess a peer-to-peer lending platform's credit model if it has not been through a full cycle

Source: Federal Reserve

rewards based site (it doesn't really purport to be an investment based site) and does little to no due diligence on the opportunities it lists. Equity crowdfunding sites are the more obvious target for any fraudsters, but this is nothing unique to online crowdfunding - dodgy equity salesmen have existed as long as equity sales.

We do know that peer-to-consumer lender Zopa uses the AU10TIX to verify borrowers' identities online, and that it thinks this system has already paid for itself after capturing one fraudulent borrower out trying to withdraw a "sizeable" amount of cash.

In May 2015 we also saw the first examples of cloned websites in the P2P space. An unauthorised firm set up zopaloanreviews.com and essentially passed itself off as P2P lender Zopa. The FCA moved swiftly to shut this site down, but it is another potential scam consumers and businesses must be aware of. Again, it is not unique to the alternative finance sector, but the online nature of alternative finance perhaps makes it more vulnerable to cloning than traditional finance firms. It's easy to protect against though - check the financial services register or consumer credit interim permissions register.

Regulatory Risk: To date, the platforms have had a successful relationship with the regulator, but over the next few months they will move from interim permissions to full authorisation. A few commentators we have spoken with think that this means there could be some real speed bumps ahead as some of the platforms may be inadvertently structured as Alternative Investment Funds (AIFs): investments, risks, management of the underlying assets and returns are all pooled and therefore they are an AIF.

There are also concerns that some of the platforms do not meet the rules around client money, and that some are not following the rules around financial promotions.

All of these are of course serious problems, but we feel that they are natural in a new and developing sector, and that the platforms' intentions are genuine and that any of them that are in breach of the regulations will work with the regulator to overcome any issues. It is an issue worth keeping an eye on over the next few months as the platforms move to full authorisation though.

PEER-TO-PEER LENDING RISKS

BORROWER DEFAULT

This is the biggest difference with putting money in the bank – the risk has been shifted from the bank to the lender. As with all lending activities, the biggest risk is that the borrower defaults, leaving the lender without their principal - a capital loss. The ways to mitigate this are well known: diversification across a lot of different loans and by carrying out some sort of assessment of the creditworthiness of the borrowers. Here are two of the platforms' four principal activities (the other two being origination of borrowers and lenders and servicing loans) and investors EITHER need to have faith in their chosen platform's ability to carry them out OR investors have to have faith in their own ability to do so - both options are available. It's the simplicity and low costs of the platforms that make option two attractive for active investors, and opens up the possibility of out-performance.

OPERATOR INSOLVENCY

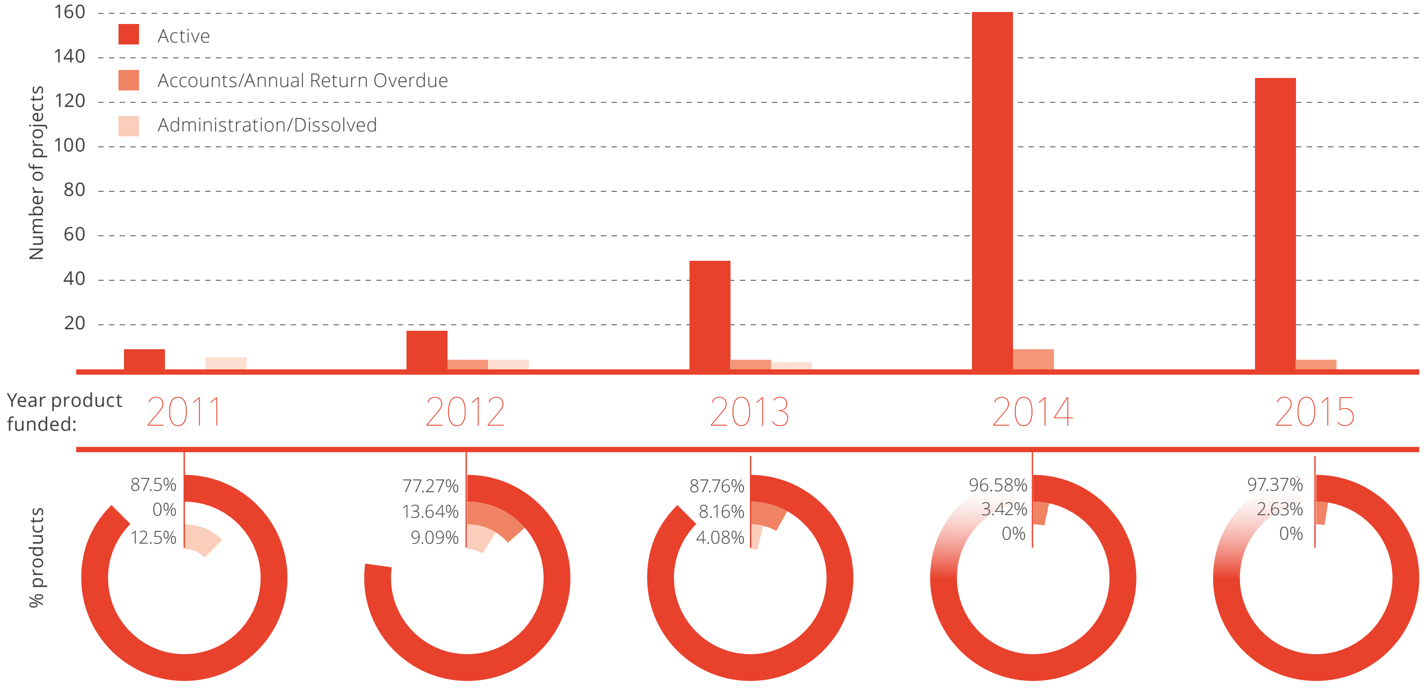
A real concern lies in a platform blow up due to undisclosed losses, or poor cost control, or a failure to keep originating lenders and borrowers. NESTA, the innovation think-tank that has produced several in-depth reports on alternative finance in conjunction with the University of Cambridge, predicted a major platform blow up in 2015. At the time of publication there is still over a month to go.

INTEREST RATE RISK

Another risk that applies for any fixed income investment. If interest rates rise, some longer term peer-to-peer loans might look less attractive, and this will be compounded by a lack of liquidity - it might be hard to exit investments in anticipation of an interest rate rise.

"Lender security is at the heart of everything ArchOver does, it is our primary concern"
Angus Dent, ArchOver

CROWDFUNDED COMPANIES STILL IN BUSINESS (2011-2015)



The crowdfunding industry is still young and there is not much data to assess – but so far crowdfunded companies are doing better than expected

Source: AltFi Data

Which brings us on nicely to...

LIQUIDITY RISK

There are platforms that operate secondary markets for their loans and fractions of loans where they match buyers and sellers. Just how deep these markets are is unclear at this point in time – see our survey for more on this. Certainly there is no centralised clearing house for all the loans across the entire sector - investors have to rely upon the community on their chosen platform. A run on a platform's loans would mean liquidity would become non-existent very quickly, which would suggest that bigger platforms with higher volumes are less risky.

CROWDFUNDING RISKS

VALUATION

Of course there are many secrets to successful business angel investing, but surely one of the biggest is no secret at all - you must invest at a sensible valuation, to give you a realistic possibility of making a return on your investment. But how do you value a new business? Or how do you value a small, unquoted business that has not issued any shares before? This is notoriously tricky and is probably as much an art as a science - which suggests that wisdom and experience have a role to play here. The difficulty with most crowdfunding models is that the valuation is company led. They put a valuation on their business, and then go out and see if they can find crowdfunding investors who are willing to invest at that valuation. This is NOT what conventional venture capital funds and business angels do, where the valuation is a product of negotiation. Traditionally, companies raising funds would expect to get their valuation beaten down, Dragon's Den style. This missing step is seen as the biggest weakness in the majority of online equity crowdfunding platforms.

DILUTION

Another big risk of being a small shareholder in an unquoted company - there is very little that can stop the company raising more money by issuing more shares at a later date, and therefore diluting the value of existing shares. This can be prevented by securing preferential shares of some description, or having some meaningful influence on the board and executive team, but again these measures are absent from some crowdfunding models.

EXIT RISK

Early stage firms are unlikely to pay out any dividends to shareholders, so the only way to see any kind of return on your investment is from some sort of exit - either a trade sale of the firm to a rival, a management buy-outs now not allowable for EIS & SEIS or an initial public offering on a recognised exchange. Getting a business to an exit is no mean feat and requires luck, skill and good planning. There's no liquidity to get out before the exit (or at least very, very little) and no income in the meantime.

The track record of successful exits would be an interesting statistic for platforms to share with investors, but as the oldest platform is only four years

"Investing in commercial real estate debt offers investors attractive fixed income returns with downside capital protection, it's the safest part of the property investment as you are the first to be repaid" **Brian Bartaby, Proplend**

old the data simply doesn't exist in a great detail yet. However, AltFi Data has attempted an analysis, based upon cross referencing the successful crowdfunding campaigns from the last four years on Crowdcube, Seedrs, SyndicateRoom and Crowdbnk with Companies House data.

As you would expect, the proportion of successfully funded firms that are still active is higher for more recent fundraising years (there having been less time for things to go wrong).

Given the commonly held assumption that half of all companies fail in their first five years, equity crowdfunded companies appear to be doing better than expected. Indeed only 12.5% of companies funded in 2011 have dissolved. However, it is difficult to say if many crowdfunding investors expected more than 10% of their portfolio to return zero.

There has also been one genuine exit (not just a crowdfunding round prior to an AIM listing that was already scheduled, as was the case with the MILL Residential REIT). E-Car Club raised £100,000 in 2013 from 63 investors via the Crowdcube platform. The business has just been sold to Europcar, Europe's foremost car rental company. Though exact figures are yet to be disclosed, the 63 private investors will reportedly receive "a multiple return", reported to be between two and three times their initial investment.

ASSET MATCH

Asset Match are worth mentioning in despatches while we are discussing liquidity in unquoted shares. Asset Match provides an online marketplace for buyers and sellers in privately held shares. It's not a free-for-all: they limit it to companies it has performed due diligence on and rather than being open year round like the stock market, each company will have its own auction periods (usually quarterly). It's a great FinTech innovation that will hopefully expand to provide a useful service and meaningful liquidity for both investors in unquoted shares and small companies who want to raise money. We understand that about £18million has been traded to date.

PIVOTING

"Pivoting" is using investors' money for something other than the original intention. It's not fraud – the money is put to work – it's just put to work in a different opportunity, perhaps for very good reasons. The highest profile example of this was on Seedr's where well known city superwoman Nicola Horlick raised £150,000 to launch a restaurant in Chiswick. After a number of setbacks the plan was changed and she opened an Oyster Bar in Clapham. As far as we know, this has been a success, but it demonstrates the lack of control investors have as small-scale of unquoted equity as minority shareholders.

QUANTIFYING PEER-TO-PEER LENDING RISKS

BORROWER DEFAULT

Quantifying this is linked to the issues around the lack of track record: we won't know if the loans that the platforms are writing today are any good or not until they reach their full term. Furthermore, we can't really assess their underwriting until a platform has been through the full business cycle. To their credit, the platforms are aware of this and trying to address it: Zopa, RateSetter and Funding Circle make their full, inception to date, loan books available online for anybody to analyse and calculate their own default rate.

Zopa, the longest standing platform, has a default rate of 0.6% (as of July 2015) since their launch in 2005, which compares very favourably to other lenders. This has come down from a high of 0.88% in 2012. As the only peer-to-peer platform to live through the 2008 financial crisis, they provide a unique data point - loans they wrote in 2008 exhibited a 10x jump in default rate. This kind of data is the best option for assessing default rate risks on platforms at the moment, with the big caveat that it doesn't look at the risk within an individual lenders' own portfolio - which could be a very different story.

Another proxy to help us measure default rate risk would be Funding Circle's stress testing exercise. They engaged Hymans Robertson to apply the Prudential Regulation Authority (PRA) banking stress test to their own lending book. They modelled how the loans would perform if UK GDP drops by 4% on a cumulative basis, interest rates climb from 0.5% to 4.2%, and inflation jumps from 1.8% to 6.6%. (Note: UK GDP dropped 7% in the 2008 financial crisis)

The bottom line, results wise, is that even in these extreme economic conditions the average annualised returns for Funding Circle investors remained upward of 5.5%. Annualised bad debt rates rose from 2.2% to 3.4% at peak on a yearly basis. Over the 3 year stressed period, the Hymans Robertson analysis suggested that bad debt would be at 2.5% at year 1, peak at 3.4% after year 2, and begin to fall again in year 3.

On the surface of it, these examples look good - but as we said above, they don't model the risk in an investor's unique portfolio. When browsing the sites, you can find expected overall default rates, but they're not given with upper and lower bounds, or given in different economic scenarios or broken down by credit score. We think that there is a lot more useful information that platforms could be providing to help investors quantify default risk.

One point worth noting - the P2PFA standardised the methodology for calculating defaults back in June 2014, so for sites that are members of the P2PFA, it is possible to make meaningful comparisons.

OPERATOR INSOLVENCY

In theory, as the platform was only matching borrowers and lenders, the underlying contracts should still be in place, and an administrator can step in to run off the book (the FCA regulations oblige the platforms to have this plan B in place and ready to go). Jonathan Segal, Partner at Fox Williams LLP takes a closer look at this process for us:

PLATFORM MELTDOWN

TRUSTBUDDY FAILS

Although this report is focused on the UK alternative finance industry, it would be a mistake not to mention a high profile platform in Europe which has had to suspend its services in early October 2015. TrustBuddy, a Swedish peer-to-consumer platform, specialised in payday style loans for much of its lifespan, having originated over €232 million in loans since its launch in 2009 and even managed to list on the Swedish stock exchange, OMX. Its share price stood at SEK 1.20 in November 2014 and by May 2015 was down to SEK 0.44.

In September 2015, a change of management occurred and the attempt to turn the platform around revealed many more problems. 37 million (£2.8m) of the 300 million SEK (£22.6m) lent through the platform had not been allocated to lenders, and it was found that lenders were owed 44 million SEK (£3.6m) more than what was held in the client accounts. It wasn't long before the Swedish FSA stepped in and ordered the platform to suspend its services from 7th October, 2015. The new management team has said their "investigation showed a number of breaches against internal and external regulation" and it was likely to have been going on since the platform launched. Later in October, the platform filed for bankruptcy and the decision to shut its doors was officially decided.

While this is definitely an example of worst-case scenario, it is best to keep in mind that the UK platforms have pushed for regulation and want it to be enforced. Swedish platforms are only regulated under the existing consumer and business lending rules and it is the feeling of the industry is the original TrustBuddy management was using the new and exciting fintech to carry out shady business practices. However it should be a reminder that alternative finance investments still require due diligence and should only form a small percentage of a total investment portfolio.

What happens in the event of a P2P platform meltdown?

"So your clients are asking you how to beat a deflationary economic cycle, and the market-leading rates of certain peer-to-peer lenders are catching your eye, but you have a nagging suspicion that those rates are too good to be true. You know that the peer-to-peer lending market is largely untested in an economic crisis, and so what really happens in the event of a peer-to-peer platform meltdown?

Each lender on the platform (i.e. the 'investor') has a legal contract (a loan agreement) with each borrower to which he/she lends. In theory, the lender takes no counterparty risk on the peer-to-peer platform itself – it only takes counterparty risk on the borrower, and trusts that the peer-to-peer platform has adequate underwriting processes in place to reduce such risk and spreads the risk across a number of borrowers. If the peer-to-peer platform is no longer operational, the lender still has its legal rights against the borrower (i.e. to receive money from the borrower under the terms of the loan agreement and to enforce the loan in the event of non-payment).

The lender's monies (both monies ready to be lent to borrowers and to be received back from borrowers as interest and capital repayments) are required to be held in a segregated client monies account. If the correct procedures are followed, such monies will be ring-fenced on the peer-to-peer platform's insolvency.

So how does the lender continue to collect the money from the borrower, especially if the borrower is anonymous to the lender and his/its identity is only known by the peer-to-peer platform? Is counterparty risk against the peer-to-peer platform replaced by operational risk?

The FCA requires a peer-to-peer platform to put in place systems and controls to ensure that loans continue to be administered in the event of platform failure and, if necessary, a third party is able to take over the management and administration of the platform.

This can be achieved by the peer-to-peer platform (i) entering into an agreement with a third party back-up service provider to take over the management and administration of the platform in the event of platform failure, (ii) ensuring that it holds sufficient collateral in a segregated account to cover the costs of managing and administering the platform while the loan book is wound down; or (iii) arranging for a third party to act as guarantor for all loans outstanding. Most platforms choose to make arrangements with a back-up service provider. Lenders can take comfort if such provider is another reputable company.

In the event of a platform meltdown, a lender may also be able to look to any contingency fund a platform has put in place. The monies in a contingency fund are often held on trust for all lenders on the platform and so if the lenders are out of pocket as a result of the platform's failure, they may be able to ask the trustees of the contingency fund for any monies they have lost as a result of the platform's failure. The operation of a contingency fund in an insolvency scenario is untested though and so reliance should not be placed on the size of the fund.

Of course no peer-to-peer platform is covered by the FSCS and so a potential lender through a peer-to-peer platform should look towards a trusted brand and the calibre of the management in deciding where to place their cash. Adherence to the P2PFA (Peer-to-Peer Finance Association's) code of conduct is also something which may provide additional comfort to a lender. One thing's for certain though – in the event of a peer-to-peer platform's meltdown, a lender's capital is likely to be tied up for longer than intended while the loan book is run off"

Contributed by Jonathan Segal

foxwilliams

"One thing that can be certain over the next few years is that interest rates will rise. We don't know by how much but the direction is assured" **Geoff Miller, GLI Finance**

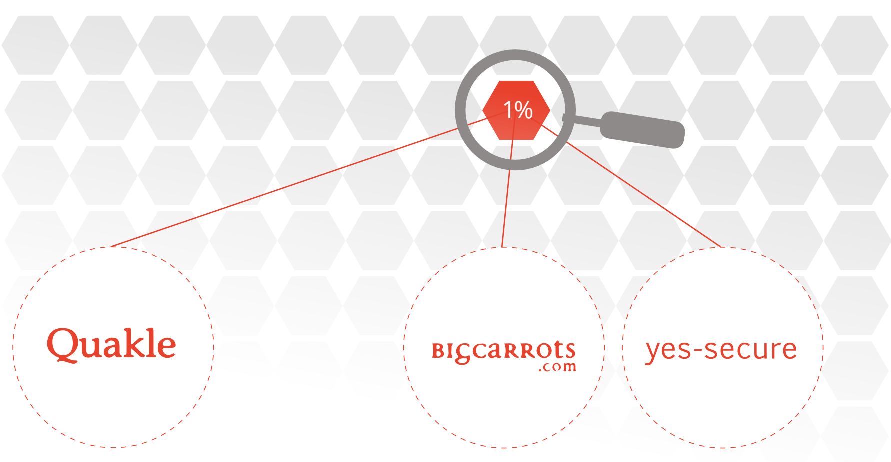
There have also been a small number - less than half a dozen according to our research - of alternative finance websites that have launched and then either disappeared or simply become inactive, apparently without any consumer detriment. We can only assume that these were a mix of chancers and idealists who realised very quickly that these businesses are harder to launch, and much, much harder to scale then they first thought. The highest profile example here was Wonga, the payday lender which launched a peer to consumer lending platform called Invest and Borrow. It appeared to take a margin of around 90% for itself, and didn't last more than a year.

Because of the nature of these abortive launches, they're very hard to track, but our sense is that this phase of the growth of the industry has passed – our view is that any new entrants into the sector today will be backed by very large businesses.

Interest Rate Risk?

Another aspect to interest rate risk is the contention that when base rate rise again, peer-to-peer lending will suffer as investors move back into conventional bank deposits. We think this is debatable - peer-to-peer lending platforms should still be able to maintain their margins, and still have lower costs and therefore be able to offer better rates than the banks. But if rates go up and inflation stays low, there is a chance some consumers will decide they don't want the additional risks that come with peer-to-peer lending.

PLATFORM FAILURES



Platform Failures to Date

In the UK, the biggest failures to date have been Quakle, Yes Secure and Big Carrots. We also saw GraduRates absorbed into RateSetter in 2014.

It seems apparent that all of these failed because they had not invested the time and effort into building the right credit models - they were overwhelmed by the number of bad debts they faced. As we understand it Yes Secure investors did get all of their money back, but there is no record of how successful investors in the other two platforms have been in recovering their money. All three platforms were tiny in comparison to the market leaders and cumulatively probably accounted for less than 1% of the market.

What is perhaps a less obvious, but more pertinent interest rate risk is what lower interest rates will mean for banks' ability to write business. Freed from the shackles of abnormally low margins, banks' risk appetite will increase and they will start lending again. The question for alternative finance platforms is will they be competing with you for deals? If the answer is yes, that could present a real challenge for the platform. This suggests that platforms operating in niches that banks don't want to compete in have a more sustainable business model. For these platforms, forming cooperative relationships with banks could be a real positive that assists with deal origination. More on this in our concluding sections. This brings us to the final risk we want to consider in this section.

What Happens When Inflows Dry Up?

No asset class can continually receive net inflows of investment. The tide comes in, and the tide goes out again – and when it does, we'll find out who's been swimming without their trunks on, as Warren Buffet famously put it.

When inflows dry up, smaller peer-to-peer lenders will struggle - not just to create liquidity - but to stay in business. Their business is matching lenders and borrowers, and if they have no lenders, they have no business. This is another reason to back platforms that either have deep pockets (think big owners) or a very finely honed niche where they can continue to originate lenders (think tapping into motivated communities such as people who want to support renewable energy or student lending for example).

QUANTIFYING CROWDFUNDING RISKS

VALUATION

Company led valuations will always be problematic. This is compounded by the business model of the platforms, which are paid in part by the investee

"Investors must understand the true value of the security and how easy it is to collect in case of default." **Angus Dent, ArchOver**

companies when they raise money, so the platforms themselves have an interest in seeing businesses raise money at higher valuations - a clear conflict of interest that must be managed.

We've had a real life example of the issues around valuations. In April 2015, Camden Town Brewery raised about £2.3 million from over 2,000 investors for a 4.54% equity stake on Crowdcube. This gave the company a £75 million valuation, but at the same time a Belgian manufacturing company invested £10 million for a 20% stake - valuing Camden Town Brewery at £50 million, a 33% drop in the valuation.

In this instance, investors were able to buy shares on the basis of the lower valuation - they got a larger stake for the same price. But it does serve to highlight the very serious concerns about the crowdfunding valuation process. It's difficult to avoid the suggestion that a lot of equity crowdfunding might be little more than "pump and dump" schemes.

THE LACK OF DATA

A big issue with crowdfunding is the lack of quantifiable data. Now, some of this is understandable, and a lot is not.

It is understandable that there have not been many exits - a sale or listing that means there is a capital gain for investors - to date. As we stated above, exits are hard to achieve and take some time to bring about. With equity crowdfunding only being a few years old, the lack of data on this point is simply down to time, and we won't be able to judge the success of crowdfunded businesses getting to exit for a little while yet. It's going to be a key metric once we can measure it and the evidence from other forms of angel investing suggests that the number of exits will be quite low.

What is less understandable is that there is very little data on aspects of crowdfunding that can be measured. We don't know how many businesses successfully raise money on these platforms and how many fail; and we don't know how many of those that have been successful are still in business and how many have gone bust. And of those that are still in business, we have no information on how well they are doing - what are they valued at now, how many people are they employing, how much they are turning over or how much profit they are making.

"We are at an important inflexion point for the rapidly expanding alternative finance industry. Losses are now being incurred, investor appetite is being tested and companies are becoming selective about which providers to work with. We have the firm belief that through continued professionalism, improved transparency and a focus on delivering real investor value the alternative finance industry offers exceptionally exciting times ahead for a lucky few."

James W Sore, Syndicate Room

CONCLUSIONS

We think that there are a couple of points to make here. Of course there are risks in both peer-to-peer lending and crowdfunding, but actually a lot of the risks are not unique to the alternative finance sector.

Certainly, in crowdfunding the risks of investing at the wrong valuation, getting diluted as a small investor and not being able to exit the investment (as well as the simple fact that most small companies fail) are risks that have always existed when buying unquoted equity. The two differences here are the fact that the valuation is not a product of dynamic tension between the issuer and investor and the fact that investment has been made so easy.

Peer-to-peer lending will be a new asset class to a lot of investors, and perhaps does expose them to risks that they have not been exposed to before. But they are by no means unquantifiable risks that investors cannot understand - provided they have access to the right information.

And of course the platforms themselves are aware of these risks, and many of them have developed business models or innovations that try to mitigate them - something that we will cover in more depth in the next section.

- Risks that are common to all alternative finance platforms include: no FSCS protection, no track record, lower levels of scrutiny, incentives to chase volume, fraud and regulatory risk
- Peer-to-peer lending has the specific risks of borrower default, operator insolvency, interest rate and liquidity risks
- Crowdfunding has the specific risks of valuation, dilution and exit
- Identifying these risks is easy, but quantifying them can be more problematic

USPs & RISK MITIGANTS

Time for a bit of a deeper dive into the sector. As we've already mentioned, there are actually lots of differences between the platforms - differences in specialisms, differences in business and operating models, differences in the ways they structure investments and differences in the ways they try to mitigate risks. We'll examine those differences in this next section.

TAXONOMY #2

Innovation charity NESTA and the University of Cambridge have been researching and publishing on the alternative finance sector since at least 2011. In their 2014 "Understanding Alternative Finance" paper they provide a detailed and useful taxonomy (on the right hand page), which has a little bit more detail than the one we used in the introduction.

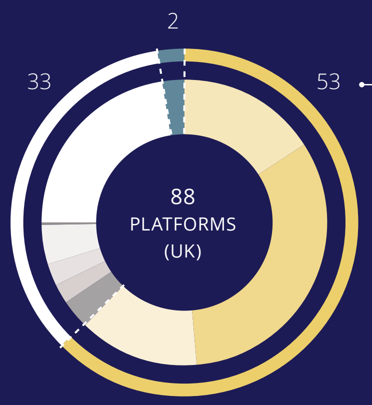
However, it is possible to break the sector down still further depending upon whether they are specialist or generalists when it comes to sourcing and assessing borrowers.

DISTRIBUTION OF PLATFORMS (UK)

In our research we identified 102 platforms in total, 88 of those are still operating in the UK:

EQUITY CROWDFUNDING:

- 20 platforms - UK start-up and growing companies
- 1 platform - the gambling industry
- 4 platforms - property
- 2 platforms - ethical companies
- 2 platforms - high tech industry
- 3 platforms - renewable energy



PEER-TO-PEER LENDING:

- 14 platforms - peer-to-consumer
- 29 platforms - peer-to-business
- 12 platforms - both

INVOICE FINANCING

PEER-TO-PEER OPERATING MODELS

As well as these specialisms, platforms can also be distinguished by their operating model. In the peer-to-peer world, there are different ways of matching lenders and borrowers, which can broadly be split into two: Marketplace and Auction. In a marketplace model the lenders offer funds at defined interest rates and in an auction (technically, a reverse auction), lenders bid on loans with the lowest rates winning.

There are lots of models sitting beneath this broad distinction though. Some platforms offer automated functionality - lenders can set their lending criteria and the platform will automatically bid on loan opportunities that meet their criteria. Some platforms just offer "products" - you can lend for a fixed term at a set rate, putting your faith in the platform to choose suitable loans and diversify investors. Alternatively, lenders can choose to research and select their own borrowers and the amounts they want to lend.

Some platforms explicitly make the credit risk part of the lender's decision making process (giving them an opportunity to outperform by seeking out better deals) and some try to remove the credit risk as far as possible (by having a contingency fund) so lenders are more passive, and the interest rate and term are the only variables in their decision making process. Some platforms give their borrowers a credit score (and obviously lenders then have to assess how robust the platforms' credit models are). Some platforms invest their own money alongside their investors, giving them some skin in the game as well. Some allow investment in loans alongside institutional investors at a fixed percentage.

Some platforms only make repayment loans, some offer repayment and interest only. Some only offer fixed rates to lenders, some only variable rates and some both. All of them offer a range of loan terms. Some allow borrowers to repay early, others do not.

In addition, the fees they charge to borrowers and lenders and their minimum and maximum lending amounts also vary.

In short - collectively the platforms offer lenders and borrowers access to the entire range of lending activity. For retail investors, this is perhaps the biggest innovation: they can now access all of these markets directly whereas previously they would only be able to place their money on deposit with a bank.

Perhaps it is worth examining some of these concepts in more detail:

- **Contingency fund:** This was a concept pioneered by RateSetter, who call it their Provision Fund, with the intention of mitigating credit risk as far as possible, leaving people free to make their decisions based on interest rates (they set the rates - hence "RateSetter").

PEER-TO-PEER LENDING PLATFORMS BY FOCUS

Property	SMEs	Particular UK region	Asset backed lending	Specific profession	Student finance	Generalists	Specific sector
16	14	3	4	2	1	10	3

AN IN-DEPTH TAXONOMY OF ALTERNATIVE FINANCE

PEER-TO-PEER (P2B) BUSINESS LENDING

Debt based transactions between individuals and existing businesses which are mostly SMEs with many individual lenders contributing to any one loan.

PEER-TO-PEER (P2C) CONSUMER LENDING

Individuals using an online platform to borrow from a number of individual lenders each lending a small amount; most are unsecured personal loans.

INVOICE TRADING

Firms sell their invoices at a discount to a pool of individual or institutional investors in order to receive funds immediately rather than waiting for invoices to be paid.

DEBT-BASED SECURITIES

Lenders receive a non-collateralised debt obligation typically paid back over an extended period of time. Similar in structure to purchasing a bond, but with different rights and obligations.

COMMUNITY SHARES

The term community shares refers to withdrawable share capital; a form of share capital unique to co-operative and community benefit society legislation. This type of share capital can only be issued by co-operative societies, community benefit societies and charitable community benefit societies.

DONATION-BASED CROWDFUNDING

Individuals donate small amounts to meet the larger funding aim of a specific charitable project while receiving no financial or material return in exchange.

REWARD-BASED CROWDFUNDING

individuals donate towards a specific project with the expectation of receiving tangible (but non-financial) reward or product at a later date in exchange for their contribution.

EQUITY-BASED CROWDFUNDING

Sale of a stake in a business to a number of investors in return for investment, predominantly used by early-stage firms.

PENSION-LED FUNDING

Mainly allows SME owners/directors to use their accumulated pension funds in order to invest in their own businesses. Intellectual properties are often used as collateral.

Source: University of Cambridge (2014)

"In order to allow investors who have different risk parameters & return requirements to all participate in the same loan, Proplend pioneered the Peer-to-Peer Tranche Model"

Brian Bartaby, Proplend

In our research we found that nine platforms have now adopted this innovation and have some kind of a contingency fund. The fund is used to repay capital losses to lenders in the event of a default and is built up by charges on the borrowers - a small percentage of their fee is placed into the fund.

The funds work in one of two ways. They either step into a borrower's shoes when the borrower fails to make payments and fulfill the contractual payments (interest and principal) for the remainder of the loan term (this is how RateSetter's fund works), or repay principal and any interest owed as a lump sum at the point that the borrower defaults (Zopa fund works like this). With neither model is the lender out of pocket, but in the second model they have more reinvestment risk. When looking at the size of a contingency fund and comparing it to the size of the outstanding loans - all other things being equal - a mature contingency fund that operates in a similar way to the first example needs to be bigger.

Legally the fund is owned either by trustees or a separate company, for the benefit of the lenders who will have beneficial access to it in the event of a default. Platforms with contingency funds usually publish how large the fund is and how much of their outstanding loans it covers, with a comparison to their expected default rate. Of course (and to their credit the platforms are explicit about this) the contingency fund is NOT a guarantee and it is not regulated by the FCA or PRA. They are similar in purpose to the capital adequacy requirements imposed on banks and insurance companies by rules such as Basel III and Solvency II, but are not subject to anything like the same level of supervision or scrutiny. Defaults could exceed the value of the fund and lenders would then suffer capital losses.

"Products": Some platforms package up the loans and simply offer a small range (say, three) of loan terms and interest rates for consumers to choose between. Lenders are essentially passive, simply choosing the product and trusting the platform to diversify them across a range of loans that will pay the required rate. Investors can choose to have their income paid away or reinvested. This is a great way to passively access the asset class, but does mean that the investor is putting their faith in the platform's ability to originate borrowers, assess their creditworthiness, mitigate the credit risk and diversify their portfolio. It also means that lenders potentially can't access the best deals that more active investors might uncover.

Autobid: Investors set their lending criteria, using variables such as credit rating, maximum individual loan size, minimum number of loans, minimum interest rates (or maximum - in a marketplace if lenders set rates too high borrowers will reject them and their money will sit idle). This is a compromise between actively seeking out individual opportunities and passively investing in a product.

The products and autobid functions go some way to solving one of the problems with investing in peer-to-peer lending via a SIPP: the perceived need to carry out due diligence on each individual loan. Investing via a product or autobid methodology should ensure that all of the underlying loans meet the same criteria. This starts to feel similar to investment via a GDCV (Genuinely Diverse Commercial Vehicle) which is SIPP acceptable. They also feel closer to something that IFAs could advise on: assessing the platform and then choosing the right risk return profile for their client is comparable to assessing a provider and then their product.

In summary, there is a huge amount of diversity in the peer-to-peer sector and every kind of lending activity is available for investment. Yes, the headline activity is matching borrowers and lenders, but once you look beyond that there is a myriad of different opportunities in the marketplace, all with different risk and return profiles. Obviously different models are going to appeal to different people, depending on whether you are an institution, an unadvised consumer, a financial adviser, a SIPP or SSAS operator, a workplace pension trustee or otherwise; the peer-to-peer sector certainly cannot be dismissed in one fell swoop, because there is as much diversity here as there is in mainstream funds.

CROWDFUNDING OPERATING MODELS

Although the peer-to-peer market is much bigger and seen as the more investible asset class, there is still an awful lot of diversity to talk about in the crowdfunding sector. Just like peer-to-peer lending, the headline activity is simple and nothing really new: providing investors with the opportunity to purchase equity in companies. But underneath that, there are a whole range of issues and innovations to get to grips with.

On the one hand, perhaps it's logical to start with the risks. There is no doubt that equity crowdfunding is, on the whole, more risky than peer-to-peer lending. Equity is generally more risky than debt, and equity in small, unquoted companies is the riskiest of all. And being a small shareholder (as most crowdfunding investors are) brings additional risks with it - individually at least, small shareholders exercise very little influence over the board and run the risk of having their shares diluted further down the line.

What this means is that anybody browsing crowdfunding websites needs a healthy regard for the principle of *caveat emptor*. It's something that concerns the FCA, because the platforms make accessing these investments very easy, and the fear is that unwary investors are caught up in the hype and make inappropriate, unsuitable (or, let's face it, downright stupid) investment decisions.

On the other hand, why shouldn't ordinary investors have access to these investments? *Caveat emptor* cuts both ways - if the buyer accepts responsibility for their actions, why shouldn't they be allowed to do what they want with their money? Being able to access the kinds of investment opportunities that were previously only the preserve of the very wealthy is progress and a genuine "democratisation" of investment. By lowering the minimum investment amounts and transaction costs, by reducing the time and effort required to source and select opportunities and by cutting out expensive intermediaries, it can be argued that the platforms are doing retail investors a great service - not to mention the investee companies who are accessing the funds.

"In the near future, demand from sophisticated investors will see the need for a model that bridges the gap between the less sophisticated crowdfunding approach and the more professional and mature Private Equity and Venture Capital markets." **James Codling, VentureFounders**

As usual, the truth probably lies somewhere in between these two poles. There's nothing new about equity investing, it's always been risky, and dodgy equity promoters and salespeople are an occupational hazard. But sensible allocations, diversification, research and due diligence are the best way investors can mitigate against catastrophic losses.

Between them, the equity crowdfunding platforms have developed a couple of innovations to assist investors:

SEEDRS offers a unified nominee structure, so that, whilst the investors are beneficial owners of the shares, the platform acts as the legal shareholder. This avoids some of the complications associated with having lots of small shareholders for the investee business, simplifies administration and in theory means that the platform can have some influence over the board to protect the rights of their investors.

SYNDICATE ROOM has developed a model where ordinary retail investors can co-invest with experienced business angel investors and are guaranteed the same terms. This gives investors some assurance that thorough due diligence has been carried out on the investee company, that the valuation has been set by the investor and not the company, and that they are being treated fairly and hopefully won't be diluted at a later date.

crowdcube is widely regarded as the original equity crowdfunding site and offers two products alongside the direct equity investments available on its platform. One is a venture fund, where a professional fund manager will select and manage investors' portfolios on their behalf. (Crowdcube still offers this on their website, but the original fund management firm that launched this initiative has moved their operation onto the Seedrs platform.) The other is mini-bonds, which are unsecured retail bonds that are typically offered by more established (but still small and often early stage) companies.

PRE-EMPTION AND TAG-ALONG

These are all concepts in corporate law designed to protect investors' rights as companies grow and raise more capital.

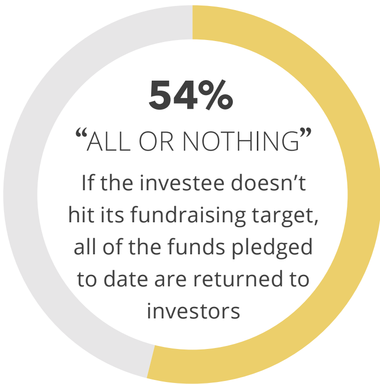
Pre-emption ensures that existing investors have the right (but not the obligation) to maintain their level of shareholding in a company if it goes on to issue further shares as part of a subsequent fundraising round. Generally, if a company is raising more money, it's growing which is good for the company. An investor should have the opportunity to take advantage of that growth.

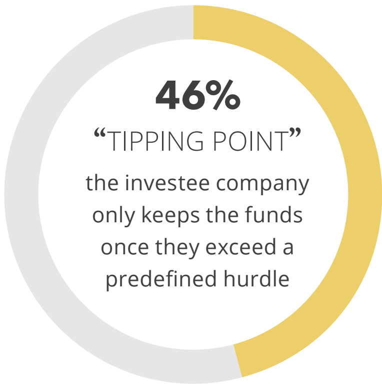
Tag-along rights ensure that, if a potential purchaser makes an offer to buy a majority shareholding in the company, investors are able to participate in the sale at the same price per share. This means that small investors can benefit from any good deals struck by the majority shareholders.

As well as these three major innovations, there is also the same variety of specialist platforms as we find in peer-to-peer, with specialisms ranging from particular regions, to high tech investments, renewable energy, social enterprises, property and gambling, amongst others.

CROWDFUNDING PLATFORM OPERATING MODELS

There are differences in the operating models of the platforms. They undertake differing levels of due diligence on the firms selling equity and have different rules and time limits for fundraising campaigns:





In our research into UK based crowdfunding platforms, ***13*** *operated an all or nothing model and* ***11*** *operated on a tipping point model*

"Another key point to note and major selling point: the majority of the investments offered on the equity crowdfunding platforms are either EIS or SEIS"

Another key point to note and major selling point: the majority of the investments offered on the equity crowdfunding platforms are either EIS (Enterprise Investment Scheme) or SEIS (Seed Enterprise Investment Scheme) qualifying, meaning that investors can claim generous tax reliefs - *for more on EIS, download our EIS Industry Reports, available on www.intelligent-partnership.com.*

There have been some other interesting developments in UK crowdfunding recently.

Firstly, some AIM listed firms have been carrying out further fundraising via crowdfunding platforms. As AIM shares have been ISA qualifying since 2013, these have been claimed as the first examples of crowdfunding via an ISA (although if you were to place the shares in an ISA, you would forgo the much more generous EIS benefits). Secondly, we've seen examples of crowdfunding sites jointly hosting IPOs for firms listing on AIM, and of crowdfunded firms exiting via an IPO on AIM. We think that both of these developments are very positive as an AIM listing provides much needed liquidity and demonstrates that it is possible for investors to successfully exit.

DEBT INSTRUMENTS

It's also important to mention debt instruments. These fit into a bit of a grey area in the alternative finance world. Although they are debt, they are not the small slices of loans of the kind that fit into the peer-to-peer space, and as such the FCA has placed them in the same category as equity based crowdfunding. However, they are not equity stakes either. They take the form of either mini-bonds or corporate debentures and can offer both fixed and variable rates of interest, repayment or interest only and secured or unsecured. Some are simply offered to potential investors and some are sold using a reverse auction process. Theoretically, they are all securities that can be bought or sold on a secondary market, but of course in practice that is subject to liquidity - hence the FCA's new classification for these instruments in PS14/4 as "non-readily realisable securities". In our research into UK based crowdfunding platforms, seven offered mini-bonds and two offered debentures.

These debt instruments are worth closer examination, because even in this small sub-sector of the alternative finance market, once again we think that there are wide variations between the different investments on offer.

At first glance the concept of providing debt to an early stage company might feel risky. How does the company generate the cash to service the debt and repay the principal? Most (but not all) of these debt instruments are unsecured and will be behind more conventional lenders in the queue to get their money back should the investee firm go into meltdown. From this perspective the FCA's decision to classify these debt instruments alongside equity and call them all "investment based crowdfunding" makes sense.

Mini-bonds

However, on the other side of the coin, investors are rewarded with higher interest rates over shorter terms. They have more certainty over their returns and eventual exit than equity investors do. Mini-bonds can be (but are not always) listed and are usually approved by an authorised person and verified by a law firm for promotional purposes. (For more on mini-bonds, see our report on the mini-bond asset class available for download from www.intelligent-partnership.com). Mini-bonds are risky, but they are safer than more informal loan-notes (which we have seen promoted to retail investors) and give investors a hybrid option that sits between equity and peer-to-peer.

Debentures

To the best of our knowledge, only one platform (Abundance Generation) currently use corporate debentures as the legal structure for their investment. Abundance raises money for renewable energy projects and the fit between the project and the investment seems good - the debentures run for 20 years and pay either fixed or variable returns bi-annually. 20 years is about the lifespan of renewable energy installations before they need any serious maintenance, and the income is underpinned by the feed-in-tariff, which guarantees the price for the electricity that is generated. The capital is repaid across the lifetime of the loan, along with the interest.

PROVIDERS IN FOCUS

We have mentioned it a lot leading up to this page, but it is extremely important that advisers realise that any two alternative finance platforms are not the same. This industry is very innovative and there are a variety of business models out there. Advisers should look deeper into the platforms and examine who they lend to, how they mitigate risks and the due diligence they carry out on their borrowers and fundraisers.

The following section has been provided by the alternative finance providers that have agreed to cover the costs of designing and printing this report. They are profiled here so that readers can get a feel for how each of them operates. These pages do not qualify for structured CPD.

Whilst the platforms have had some input and participation in putting the report together, we stress that the work has been done by Intelligent Partnership and any error or omissions are entirely our own.

This collaboration is part of our effort to work with alternative finance platforms to educate financial advisers on their asset class. The intention is to get the report into the hands of the 5,000 financial service professionals who are most interested in this topic, increasing the levels of awareness within the adviser community.

ArchOver

ArchOver is a leading UK crowdlending platform with a remit to bring high value Investors seeking secured returns together with quality Borrowers looking for flexible and economical finance solutions for their businesses. ArchOver's model is peerless in terms of its approach to securing lenders' capital. All loans over the ArchOver platform are Secured and Insured. ArchOver's mission is to provide the most professional and usable online marketplace to connect Borrowers with Investors.

TYPE OF INVESTMENTS

We offer fixed term, fixed rate loans from 3 months to 3 years with returns between 5.5 - 8% per annum.

- Investments are in multiples of £1,000. There is no maximum providing it forms a balanced part of your investment portfolio
- Security of 125% and insurance cover every loan on the Archover platform
- Loans start at £100,000 with no maximum. The loans are secured and insured against the Accounts Receivable of the Borrower

TYPE OF INVESTORS

The ArchOver crowd is made up of individual investors and institutional investors:

- **Individual investors** made up of sophisticated, high net worth and ultra-high net worth individuals on average lend £5,000 and upwards per transaction
- **Institutional investors**: Our institutional crowd is made up of institutions, family offices, schools, wealth managers and other similar organisations that share our low risk appetite

TYPES OF RISK MITIGANTS

ArchOver allows businesses to borrow up to 80% of the value of their Accounts Receivables (ARs). Once the loan is made they must maintain their ARs at a minimum of 125% of the value of the loan (monitored monthly by Archover).

- **Secured:** ArchOver register a 'First Floating Charge' at Companies House on the Borrowers ARs. If a Borrower defaults we collect the AR
- **Insured:** The ARs are insured by global rated credit insurance firms that carry out additional due diligence on the Borrowers and their customers before they reach the platform. The insurance pays out on default/late payment by firms listed on the ARs. Investors are the loss payee on the insurance policy
- ArchOver insists on face to face meetings with potential borrowers, the loan is monitored monthly and all lenders and borrowers money is held in client accounts (CASS7 compliant)
- ArchOver is part of the Hampden Group who manage in excess of £2bn in assets

WHO WE LEND TO

We lend to B2B UK businesses with a minimum turnover of £1.2m that have been trading for at least two years. ArchOver is the first Crowdlending platform to offer competitive loans leveraged against the quality of a Borrower's customers. ArchOver works with well managed businesses that historically have strong Accounts Receivables (ARs). These ARs are valued significantly above the amount of money that the businesses want to borrow.

DUE DILIGENCE

Risk management is crucial to ArchOver's operational model and defines our approach to both Borrowers and Investors. ArchOver has a low appetite for risk; if a Borrower does not fit our Secured & Insured model, or fails credit analysis and due diligence, we will not approve their loan application.

ArchOver only engages with good companies with quality clients whose value is analysed throughout the on-boarding process.

Our loans are secured against the Accounts Receivable (AR) asset which fluctuate monthly, so it is fundamental that the prospective borrowing company can maintain their AR at the required level for the loan's duration. We critically review each Borrower's trading history and sales cycle by analysing a 12-month client debtor history.

Borrowers must have been trading for a minimum of two years, during which time they should have built up recurring trade and a clear understanding of the volume of turnover by client going forward. This enables us to review the projected debtors to predict likely fluctuations in the security.

We demand strong management controls and review any family connections within the management team, directors and controlling shareholders.

BVD credit scores are reviewed alongside the current and ageing creditor balances. Poor credit scores and a high creditor balance with significant ageing could indicate the creditors being stretched for payment and subjects the Borrower to potential winding up petitions from creditors.

The next stage is a review of the management accounts and future projections for loan term requested. The management accounts must consist of a P&L statement showing actual to budget, a Cash Flow, and a Balance Sheet with supporting schedules, especially if accruals and prepayments are too high.

Projections must include P&L, Balance Sheet and Cash Flow: all are expected to acknowledge receipt of loan amount sought, interest payable and fees.

If the Borrower's loan application is successful, the projections will be used as part of the ongoing monthly monitoring and all future reports will be measured against them.

BondMason is the UK's first peer-to-peer platform exclusively for investors. Investing from as little as £1,000; investors have achieved an average net return of 8.6% per annum since April 2015. In a just a few clicks, investors can invest in a highly diversified portfolio of P2P investments, sourced by BondMason from the best loans across the best peer-to-peer platforms.

TYPE OF INVESTMENTS

Invest any amount from £1,000 in total (and invest as little as just £10 per loan investment).

- Investors invest in receivables which are linked to peer-to-peer debt and loans. The BondMason P2P Investment Account enables investors to invest in a diversified portfolio of 100+ loan positions across carefully selected and vetted peer-to-peer platforms in just a few clicks. This enables investors to invest their money quickly and easily, and access it just as easily. Giving them exposure to P2P returns, through a well-balanced and diversified portfolio

Target return to investors is 7.0% per annum net, with the BondMason P2P Investment Account achieving 8.6%.

TYPE OF INVESTORS

- Retail, institutional, family offices, trusts, corporates etc.

Minimum investment amount of £1,000.

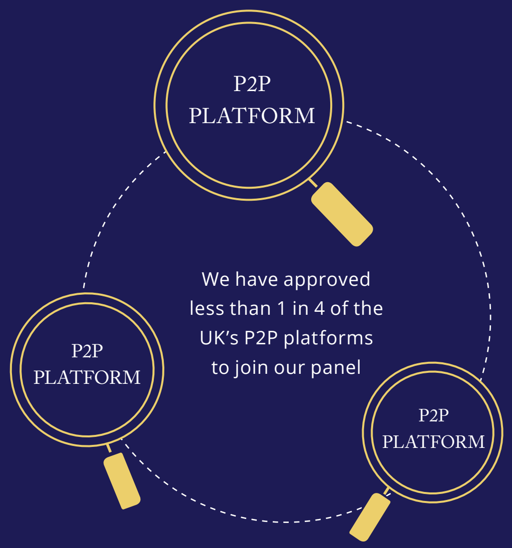
The BondMason team comes from an institutional investor background, and is pleased to work with intermediaries such as IFAs and wealth advisers - to provide their clients with an attractive access point to the peer-to-peer investment industry.

TYPES OF RISK MITIGANTS

- Investors benefit from a highly diversified and balanced portfolio of 100+ investments sourced from the best P2P loan platforms
- We diligence peer-to-peer platforms before approving them to our panel, approving less than 1 in 4
- The majority of loan investments are asset-backed loans, which can demonstrate very low realised loss rates in the event of default
- A number of our approved peer-to-peer platforms have their own contingency funds and loss protection, for the benefit of our investors

The BondMason P2P Investment Account has not incurred any losses since inception.

SELECTING THE RIGHT PLATFORMS



Our clients are able to build a balanced portfolio of 100+ loan positions in just a few clicks, accessing attractive risk-adjusted returns with ease. Safe in the knowledge that BondMason is on their side and fully aligned to their interests.

BondMason carefully selects and diligences the best peer-to-peer platform partners, that originate loan positions for our clients to invest in. We aim to achieve an annual return of 7% per annum net after fees and any losses to our investors.

We only approve peer-to-peer platforms partners if they can demonstrate a good track record and experience of sourcing and pricing credit, and a sound set of processes to manage borrowers. We conduct our own analysis and due diligence on each platform, giving our clients comfort that they are investing appropriately.

From our panel of approved peer-to-peer platforms, we source loans which have a risk-return profile to suit our clients' needs. We have a bias toward asset-backed loans and loans which can demonstrate characteristics of minimising any risk of default, as well as minimise any expected losses in the event of default.

BONDMASON FACTS:

We have experience of successfully investing over **£2bn** over the last 15 years

We have achieved **8.6%** per annum since starting in April 2015

We have not invested in any loans that have realised losses, or defaulted to date

From rebellious teenager to fully grown adult; regulating the maturation of the alternative finance industry.

Regulation. It's a word which inherently strikes fear into Chief Executives across the financial services sector. Greater levels of compliance, increasing demand for transparency and better risk management are all things that don't come cheap. They require investment, new systems and processes and can expedite the need for growth strategies to be re-evaluated.

The alternative finance industry is no different, but rather than sending those that operate in this exciting and rapidly growing space running for the hills, more stringent and better enforced regulation should be welcomed. Not because there must be a sudden knee-jerk reaction to the recent failures at TrustBuddy, but because there must be a collective realisation that it is unavoidable.

The reason? Because the alternative finance sector is no longer alternative. Its rapid growth and demonstrable successes in delivering much needed growth capital to SMEs means that it is now a viable and crucial part of the credit ecosystem. In some ways, we have become a victim of our own success, and whilst the banks were too big to fail, through innovation, entrepreneurial drive and a willingness to find a better way of doing things, we too have become indispensable to the UK economy.

What's more there are greater things to come. One only has to look at the projected trajectory of origination volumes to realise that demand from borrowers and awareness levels of the benefits of alternative finance continue to grow. It is through this lens of opportunity that more stringent regulation of the sector must be viewed and its implementation will bring several benefits.

Firstly it will allow the sector to more effectively attract institutional capital. Sophisticated investors are already beginning to wake up to the returns that alternative finance can generate in a low growth and low interest rate environment and a clearer regulatory framework would only accelerate this trend. As an industry we must ensure that we are able to meet the investment criteria of institutional players and provide comfort and transparency around how their capital is being managed and deployed. A firm definition around what constitutes a non-performing loan would for example go a long way to ensuring investors can accurately assess the risk profile of potential investments and enabling them to build a diversified portfolio of assets. Attracting these types of investors is crucial to the scalability of platforms and is the only way through which the industry will be able to service the huge lending gap created as traditional banks retrench from the market.

The second benefit of more effective regulation is that it raises the barriers to entry for new platforms. Critics will argue that this flies in the face of competition, that it's "not in the spirit" of entrepreneurialism or that a bigger more fragmented marketplace is a good thing. Nonsense. Raising the barriers to entry achieves one fundamental objective that must not be forgotten; it means that management teams must take a longer term view. No longer can platforms be sprung up with investors cash used to fuel rapid growth all to make a quick buck for the unscrupulous founders. People entering the sector must do so because they want to build serious, well-run businesses with robust risk management systems in place.

Finally, regulation will drive some sensible and much needed consolidation in the sector. It's a dog eat dog world out there and only the best businesses must survive. This is a good thing and it is the natural evolution of what remains a nascent market. If we want borrowers to sit up, take notice of the sector and have the confidence to trust alternative finance providers, then we must offer them a compelling proposition delivered through modern, customer-centric channels. There is a huge variety in the quality of technology that supports platforms across the industry and we cannot afford the reputational damage that would be caused by any failure that left borrowers high and dry; be that a mis-selling scandal, a data leak or the collapse of a funding line.

The sector has made remarkable progress in a short space of time. We have proved our worth, filling a vital credit gap in the wake of the financial crisis and earning government support through the passing of the Small Business Enterprise and Employment Act. The opportunity to continue reshaping the credit ecosystem is there for all to see but to seize it we must embark on a regulatory journey that shifts the industry from that resembling a rebellious teenager to a fully grown adult.

Landbay is an online peer-to-peer lending platform that offers retail and institutional investors the opportunity to lend money directly to property investors through UK residential buy-to-let mortgages. All loans are secured by first-ranking mortgages over tenanted residential properties across England and Wales. The Landbay platform simplifies the traditional lending process, offering a direct transaction between lenders and borrowers.

TYPE OF INVESTMENTS

Invest any amount from £100.

- 3 YEAR FIXED. 4.4% annualised

Earn a fixed rate of interest for three years, before switching automatically to our Base Rate Tracker.

- BASE RATE TRACKER. 3.5% per annum

Earn 3% per annum on top of the current Bank of England Base Rate (BBR). Whenever the BBR moves, our tracker moves too.

TYPE OF INVESTORS

- Retail Investors
- Institutional Investors

TYPES OF RISK MITIGANTS

- Diversification of investments – spreading each investment across multiple mortgages helps protect our lenders' money from the effects of one borrower missing a payment or defaulting, or if demand falls away in a particular area
- Secured investments – against income-generating assets; tenanted homes
- Rigorous credit, compliance and Due Diligence processes – to ensure that we only lend to suitable applicants and against properties that obtain at least 125% rental coverage of the loan
- Reserve Fund – we hold a discretionary fund derived solely from our margin, which can be called upon to make up any shortfall should a borrower default or fall into arrears

WHO WE LEND TO

Our mortgages are available to experienced buy-to-let landlords via our FCA-regulated and accredited mortgage broker partners.

We fund mortgages of £70,000 - £500,000, provided that this represents less than 80% of a property's value. This is done to maintain a sufficient buffer in case property prices should fall.

We insist on rental income of at least 125% of the mortgage interest cost, and the borrower must have personal income of at least £30,000 per annum (over and above any rental income).

Deciding which homes we lend against is a fundamental part of the process – we only lend into areas with proven and robust rental demand.

SEVEN STEPS OF MORTGAGE APPROVAL

We subject every application to rigorous analysis before we agree to lend. Our credit and compliance process is as follows:

1. Applications are made online with our FCA-regulated brokers
2. An exhaustive credit assessment is undertaken; for affordability and credit, with checks for anti-money laundering and fraud
3. The Decision in Principle is only given once the results of these checks have been ratified by our Credit Committee
4. We instruct a RICS valuation, which must be endorsed by our Credit Committee and a leading property consultancy
5. Once these steps are met, the loan and securities associated with the application are finalised with a major law firm
6. Securities are then passed to the Security Trustee, who holds them in trust, on behalf of investors
7. Finally the loan is transferred to Paratus AMC, a leading mortgage administrator, who manage it until it is repaid

Proplend is an online peer-to-peer lending platform that allows investors to lend direct to borrowers with loans secured against UK income producing Commercial Property. All loans are supported by a 1st legal charge and can offer 200% capital protection. Proplend's simple, secure and transparent online platform allows borrowers to gain access to funding otherwise not currently available, and investors access to low risk, fixed income returns.

TYPE OF INVESTMENTS

- **Commercial Property:** Office, Industrial, Retail, Leisure & Residential Blocks
- Investors get to choose loans on a deal by deal basis via:
  - **In Funding:** participate in the live funding of a loan
  - **Proplend Loan Exchange (PLE):** invest in loans that have been drawn down by the borrower and offer investors access to immediate monthly income
- Minimum of £5,000
- Investors have full transparency of the borrower, the property & the tenants
- Direct loan contracts between borrower and investor

TYPE OF INVESTORS

- Retail Investors
- Institutional Investors
- Family Offices
- SIPP and SSAS

TYPES OF RISK MITIGANTS

- Investors are able to build a diversified loan portfolio of multiple loan parts by geographic location, property type, interest rate and loan term
- Rigorous credit and due diligence process on the borrower, the property & the tenants by both Proplend and third party property professionals (RICS Valuers & Lawyers)
- **Investment security** – 1st legal charge over an income producing commercial property, which can be sold, and the proceeds used to repay investors in the event of a default
- **Interest reserve** – loan specific 6 month interest reserve should a borrower miss a monthly payment

Proplend Loan Tranche Model:

- Not every investor has the same risk profile or investment return requirement
- For this reason, Proplend pioneered the 'Proplend Loan Tranche Model', which allows multiple investors to participate at three separate LTV levels, each with their own risk profile and return levels
- Each tranche offers a fixed interest rate of return
- The higher LTV, the higher the risk and the higher interest rate return
- Tranche A is considered one of the safest P2P Loan investments with a minimum 200% capital protection

COMMERCIAL INCOME PRODUCING PROPERTY			average net returns	RISK
	66-75% LTV	TRANCHE C	9.6% p.a.*	
	51-65% LTV	TRANCHE B	7.6% p.a.*	
	0-50% LTV	TRANCHE A	6.4% p.a.*	

DUE DILIGENCE PROCESS

Proplend's borrower relations and underwriting team has a combined 60 plus years in the property finance industry. This highly experienced and trusted team is responsible for the due diligence process and has produced a zero default rate to date.

Once a borrower has submitted an online registration form, Proplend completes a primary review to determine the viability of the loan and to assess whether or not it would be attractive to their investors. If deemed suitable an initial set of terms are agreed, and upon acceptance, the team begins a further due diligence review.

During the full due diligence review, Proplend visits the property and meets with the borrower.

A credit analysis is initiated on the borrower, the property and the tenants. This includes a review of the properties cash flow and an examination of the leases. Credit checks for any company, or individual, offering security on the loan and anti-money laundering checks are also performed.

Professional reports are then instructed, which include a valuation of the property to ensure that it offers adequate security for the loan. A registered RICS Valuer completes this, and a Certificate on Title is prepared by the borrower's solicitor and confirmed by Proplend's solicitor.

Proplend prepares the security package that includes, as a minimum, a first legal charge on the property but can also include a personal guarantee, a corporate guarantee, and a debenture. All security is held in trust by Proplend Security Limited on behalf of the group of lenders.

The loan request will contain specific covenants to which the borrower must adhere, which include a maximum of 75% loan to value (LTV) and a minimum interest cover of 1.25x. These covenants will be checked on an ongoing basis.

Once the loan is approved and posted on the platform investors have full transparency of the due diligence reports, which they can access via their Lender Dashboard.

*After fees, before bad debts and taxes as of November 4th, 2015

Equity crowdfunding has democratised investment in startups, helping entrepreneurs to make their business visions a reality and allowing individuals to invest and become real-life 'Dragons'.

While many platforms have sprung up, at SyndicateRoom we have developed a unique model with benefits you can't find anywhere else. Here's why: we only list companies that are already backed by professional 'business angels', who are investing their own money and thus have taken an active role in evaluating the strength of the deal. We then offer our members the 'same share class and same price per share' if they decide to invest alongside these professionals.

We believe this curated and transparent approach allows our members access to a more sophisticated set of investment opportunities.

TYPE OF INVESTMENTS

Investment through SyndicateRoom entails buying equity in high growth companies covering a wide range of industries. We are the European leader for life science companies raising funds, which account for 35.2% of our deals. Other big industries for us are hardware, engineering, software and internet ventures. Whereas most crowdfunding platforms have rarely moved beyond business to consumer opportunities, SyndicateRoom has helped fund businesses in a wide variety of industries. Overall, we've now helped raise over £38m for almost 60 companies. Furthermore, SyndicateRoom achieves a market-leading 80% closure rate.

TYPE OF INVESTORS

Our members are self-certified as being either

- sophisticated investors
- or high net worth individuals

TYPES OF RISK MITIGANTS

All opportunities are led by a 'lead investor' who contributes at least 25% of the round. This lead investor negotiates terms and conducts his/her due diligence. Uniquely, SyndicateRoom members invest at the same share class and at the same price per share as that lead investor. This balances the risk across lead investors and online investors. By making the risks involved clear and transparent, we are taking a big step towards enabling investors to make informed decisions.

DUE DILIGENCE PROCESS

COMPLIANCE AND LEGAL REVIEW

SyndicateRoom's team of experienced and tenacious Investment Associates are responsible for the pre-launch review process that ensures only high quality opportunities are offered to our investors. Each opportunity is subject to a detailed compliance review, focusing on the business plan and any related marketing materials. SyndicateRoom then applies a legal review of core documents, carried out by an external legal team. This review is particularly focused on the company's articles of association and shareholders agreement, ensuring legal protections, such as pre-emption rights, tag along, drag along and voting rights are ensured. In particular, this review ensures that SyndicateRoom investors receive the same share class and same price per share as the lead investor.

These compliance and legal reviews are designed to serve the interests of SyndicateRoom's investors. They go well beyond the baseline requirements set out by the Financial Conduct Authority (FCA), and are a core element of SyndicateRoom's investor-led approach.

GOING FURTHER

SyndicateRoom's investment associates go the extra mile to ensure that each opportunity complies with both the terms and the spirit of the lead-investor model.

The investment associates speak directly with each lead investor, in order to understand the due diligence that they have conducted, the negotiation which arrived at the company's valuation and the expertise and industry experience they bring to the company raising funds.

A final review focuses on the planned use of funds, historical and forecasted financial data and a holistic analysis of the business plan. If the opportunity is considered appropriate to progress, it is then presented to SyndicateRoom's investment committee for final approval.

This detailed review process has cemented Syndicate Room's reputation for quality. Investors and the wider industry have taken notice, naming SyndicateRoom as Best Investment Platform at the 2015 Growth Investor Awards and both Alternative Finance Platform of the Year and Crowdfunding Platform of the Year at the 2015 AltFi Awards.

VentureFounders is a UK-based equity investment platform designed to make Angel and Venture Capital style investing more accessible, affordable and transparent.

Venture Founders believes that this market should be open to all who can afford and understand the risks associated with early stage investment. Through VentureFounders, investors can invest from a minimum of £1,000 in some of the UK's fastest growing and most exciting companies.

With a solid foundation in financial services expertise, the VentureFounders team is comprised of FCA approved, highly skilled investment professionals with extensive private equity, investment management and business growth experience.

The majority of the investment opportunities are offered in collaboration with leading Venture Capital firms or Angel networks with established track records and sector expertise. The result is a curated range of structured opportunities in early-stage, scalable and high growth businesses, many of which are EIS (Enterprise Investment Scheme) qualifying.

By using a nominee structure, the experts at VentureFounders ensure investors receive the full economic interests of their investment with the benefit of being part of a much larger pool of capital, with a greater say in the business.

TYPE OF INVESTMENTS

VentureFounders sources liquidity from private investors for Venture Capital and Angel backed companies, focusing on fundraises of £1-5 million. These fundraises range from early-stage to Series A.

TYPE OF INVESTORS

VentureFounders caters to sophisticated investors who understand the risks of investing in high-growth, early-stage businesses and who have the available capital to do so. All investors must self-certify before investing in the opportunities presented by VentureFounders.

INVESTMENT CRITERIA

VentureFounders supports early-stage growing UK businesses. In order to ensure the best possible opportunity to maximise the returns to investors, VentureFounders undertakes extensive due diligence. VentureFounders assesses each opportunity against the following criteria before presenting it as an investment opportunity on its site:

SIGNIFICANT SUPPORT FROM EXISTING SHAREHOLDERS OR NEW ANCHOR INVESTORS

Businesses that are usually past proof of concept and have received significant backing from institutional investors as well as support from existing shareholders.

INNOVATIVE AND DISRUPTIVE BUSINESS IDEA WITH A SUSTAINABLE COMPETITIVE ADVANTAGE

Businesses that are, in their own way, innovative and disruptive. We often find that innovation involves some form of technology. However this is not exclusively the case and we raise funds for very innovative businesses outside the technology space, all of which have demonstrated a high degree of differentiation and a defendable competitive advantage.

CLEAR VALUE CREATION STRATEGY WITH MONETISATION OPTIONS FOR INVESTORS

Fundraises that see the process as the start of a long-term partnership and a journey towards the business ultimately entering the next phase of its lifecycle and achieving an exit for our investors. Although an exit is likely to be a number of years after the initial investment, it is very important that entrepreneurs have a firm view on potential exit routes at the time of the investment.

PASSIONATE AND EXPERIENCED MANAGEMENT TEAM

Management teams with diverse and complementary skill sets, strong business acumen and ability to translate their business strategy into successful day-to-day operations. They are passionate about their company and fully invested in making it successful.

PRODUCT/SERVICE THAT HAS GONE PAST 'PROOF OF CONCEPT' AND HAS MARKET VALIDATION

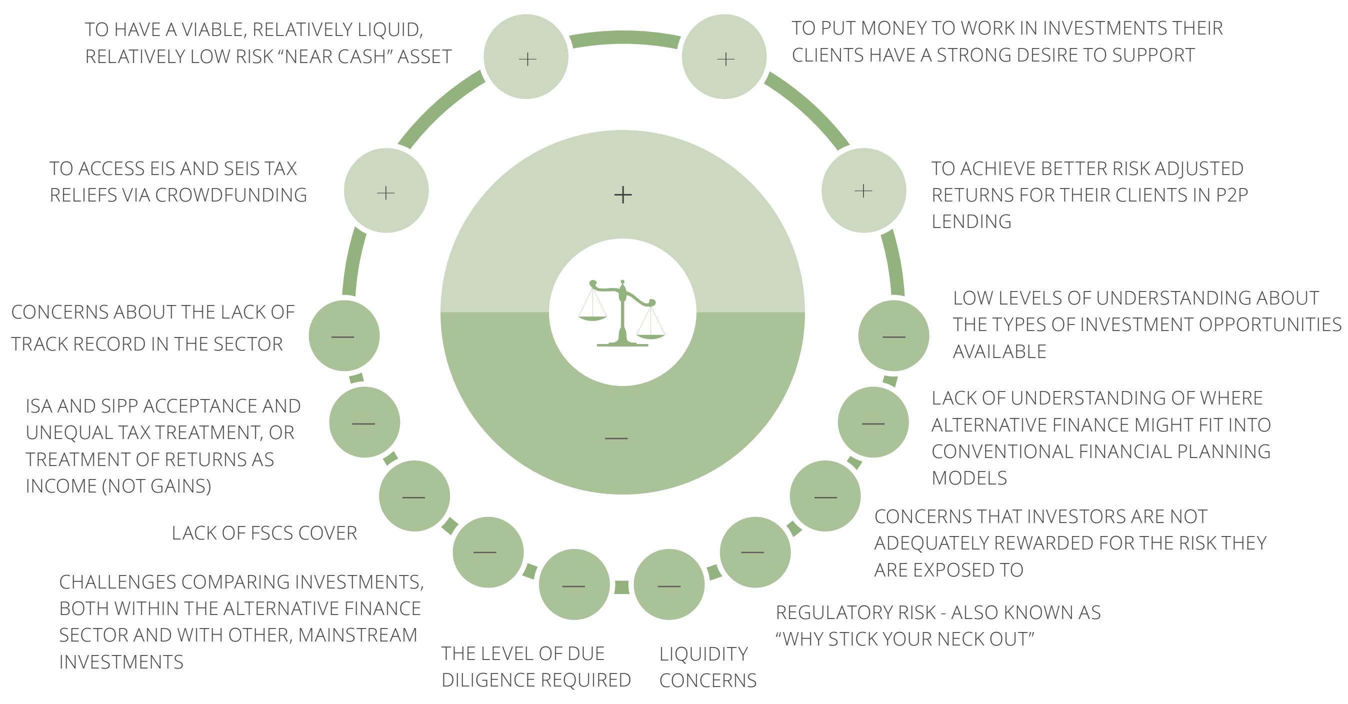
The company's product or service to have already had some external market validation and is past 'proof of concept'. These businesses are typically, but not exclusively, revenue generating and have secured a strong client pipeline or order book.

LARGE MARKET OPPORTUNITY AND ABILITY TO SCALE

Opportunities that have the ability to deliver significant financial returns for our investors. Therefore we ensure that our businesses have the potential to achieve significant scale within their market and that their growth won't be constrained by relative market size or competitive environment.

GUIDANCE FOR ADVISERS

REASONS WHY ADVISERS HESITATE AND WHY THEY SHOUD CONSIDER ALT FI



WHY SHOULD ADVISERS CONSIDER ALTERNATIVE FINANCE?

Firstly, we think that it's important that advisers at least have an understanding of alternative finance and can talk knowledgeably about it to their clients, whether they choose to recommend investing in or not. Independent advisers do have an obligation to look at the whole-of-market for their clients and so need at least a basic understanding of the sector. Hopefully this report goes some way towards addressing that for advisers.

It's also worth acknowledging that some of the alternative finance platforms have made some (albeit tentative) steps towards attracting investment from advisers, by setting up advisers portals online that allow advisers to register and manage cash and investments online for their clients.

Another point is that in its policy statement on alternative finance (PS14/04) the FCA explicitly stated that retail investors who are neither sophisticated investors nor high net worth had to restrict their investment in crowdfunding to 10% of their net investible assets unless they were taking advice. This is an acknowledgment that advisers have an important role to play in this sector - although it is hard to imagine any adviser recommending that a client invests greater than 10% of their net investible assets in an equity crowdfunding opportunity!)

So it seems as though there is some expectation that some advisers at some point will be considering investment on these platforms.

REASONS WHY

#1 BETTER RISK ADJUSTED RETURNS

It is potentially possible to achieve better risk-rated returns by investing in peer-to-peer lending. Yields range from around 3% to 10% per annum. By carefully selecting opportunities a well-diversified lending portfolio that includes peer-to-business and peer-to-consumer, secured and unsecured loans can be built. Choosing shorter term loans can offer some protection against the risk of interest rate rises, and it makes sense to diversify across the platforms as well. Another sensible measure would be to stick to the biggest alternative finance platforms that generate the most volume (although this might mean foregoing some more interesting and attractive opportunities on the smaller platforms). We estimate that a portfolio built like this could generate around 6%-8% yield per annum.

That's pretty attractive, especially in today's low interest rate environment. It's not safe enough or liquid enough for rainy day money, and with no prospect of capital gains it won't form the backbone of an accumulation strategy, but it does sit nicely in between the two. The downside is the time and effort it would take to put together - and maintain - a portfolio like this, which makes a good case for one of the new funds in this space that we mentioned earlier.

REASONS TO CONSIDER ALT FI — BETTER RISK ADJUSTED RETURNS — SUPPORTING CAUSES — ACCESSING TAX RELIEF — NEAR CASH

#2 NEAR CASH

Money in a bank account is being eroded by inflation. Money held on an investment platform (such as Transact or Novia for example) might actually be subject to an annual management charge which exceeds the yield. So we see a need for relatively liquid, near-cash solutions that have inflation beating yields with low risk and volatility. We note that RateSetter, for example, raises an FE rating of 1 (where cash is 0). It's an indication of how advisers could start to utilise this asset class for their clients.

#3 SUPPORTING CAUSES

Both lending and crowdfunding offer investors the opportunity to support businesses in ways that mainstream investing does not - even if it is just supporting SMEs and helping to bridge that funding gap. Many investors will take some satisfaction from that, and for those that are more committed, the various specialisms, such as funding renewable energy projects or student education, allow investors to go a stage further. We wouldn't underestimate the value investors place on being able to feel more of a connection with the businesses that they support with their money.

#4 ACCESSING TAX RELIEF

The last point is perhaps a bit tenuous. Yes, the lower levels of investment mean a whole new class of investors can access EIS and SEIS tax reliefs for the first time. But these reliefs shouldn't drive the investment decisions - the tax tail should not wag the investment dog - certainly in the case of less wealthy investors whose tax planning should be centred on ISAs and pensions. If you're wealthy enough to have to think about what else to invest in because your ISAs and pensions are maxed out, then you're wealthy enough to invest in traditional EIS and SEIS opportunities. But the tax benefits are a great incentive for the right investors, or can be seen as a great bonus for those who would be investing anyway.

OVERCOMING SOME OF THE HESITATIONS

UNDERSTANDING THE OPPORTUNITIES

Hopefully as the sector develops and awareness among the general public grows, advisers will also come to better understand the sector and the opportunities available for them and their clients. Initiatives like this report will be part of that, and over time advisers will educate themselves about this new asset class.

As with many other alternative investments though, understanding the asset class and buying into the investment case, and actually investing clients' money are two very different things.

LACK OF TRACK RECORD

One of advisers' primary concerns will be the relatively short track record of the alternative finance sector and the fact that it has not proven itself through the entire business cycle. Until it's clear how the asset class performs through a recession, which platforms survive consolidation as the industry matures and which platforms have the talent and leadership to scale successfully without compromising quality, most advisers are likely to hang back with "let's wait and see" as their guiding mantra.

However, data is available in great detail and the back history is growing all the time. It is a feature that is almost unique to alternative finance, but for the biggest platforms it is possible to download and examine their entire loan books. And AltFi Data is publishing indices of the overall market performance. This issue is being addressed by unprecedented transparency and the passage of time.

ARE INVESTORS ADEQUATELY REWARDED?

Are investors adequately rewarded for the risk they are exposed to? There is a danger that as more investors come into peer-to-peer lending, it pushes the yields down - although this is a risk that exists nearly everywhere where yield can be found in today's low interest rate environment.

In the well diversified portfolio we suggested above, we think a yield of 6% is possible. The yield on the big three peer-to-peer lending platforms is around 5%, as measured by LARI - the Liberum AltFi Data Returns Index. Investors in high street saving products might get 3% and the yield on a basket of FTSE All-share stocks might be around 3.5%-4% (of course equities mean that there is the prospect of capital gains or losses in the mix as well). An investment in UK Gilts currently yields from 0.5% - 3% depending upon the term. As always, the key judgment is if the additional 2%-4% yield is worth the risk, and that will always depend upon the investor's circumstances. If pushed, our view would be that it is worth the risk, especially if you are investing carefully in a well-diversified portfolio as we suggest.

Obviously equity crowdfunding has no yield and no price return index to allow these kinds of comparisons - a reflection of how risky buying unquoted shares is. When it comes to crowdfunding, the hope is that out of a well-diversified portfolio, one or two investments will return 10x capital or greater and more than offset the losses that have been made elsewhere. But investors need to be aware that there could be a long wait for returns, with no prospect of an exit in the meantime – this is just part of the nature of unquoted equity and is not unique to crowdfunding.

However, we would consider debentures to be much less risky where the cash to pay the interest is coming from renewable energy feed-in-tariffs. The interest rate can be compared to other options, and an assessment of the risk vs reward can be made.

ISAS, SIPPS AND TAX TREATMENT

As we said in our review of significant developments to date, peer-to-peer lending will be accepted in ISAs from April 2016, the government is consulting on including other forms of alternative finance in ISAs, much of the alternative

FINANCIAL STRENGTH | MANAGEMENT TEAM | BUSINESS MODEL | CREDIT ASSESMENT PROCESS | OPERATING MODEL | FEES

finance universe is SIPP acceptable (subject to the operator admitting it) and other inequalities about the tax treatment of peer-to-peer lending have already been ironed out – so in summary, these issues are being successfully addressed.

DUE DILIGENCE

As we've noted successfully putting together and monitoring the kind of diversified lending portfolio that we've suggested will take a lot of work, including an assessment of the platforms themselves and the underlying investments.

PEER-TO-PEER LENDING PLATFORM DUE DILIGENCE

The due diligence might not be as onerous as it seems at first glance when it comes to peer-to-peer lending though. Once the initial due diligence work has been done, if the platforms have an auto bid function, or automatic reinvestment according to pre-set criteria, or if they offer anonymised products, then the process can be thought of as something closer to a traditional fund – there is no need to assess each individual loan the client invests in.

Thus the initial due diligence work needs to be on the platform themselves:

- Their financial strength – do they have deep pockets (or owners with deep pockets) so that they can keep writing business even if inflows slow down
- Their management team - look for financial services experience on the board at an operating level, rather than at a non-exec level
- Their business model – are they specialist or generalists
- Their volumes – with generalists we would suggest that the more volume the better. Bigger inflows mean they can write more business and diversify more effectively. Specialists who pick a niche may get around this issue if they are good at sourcing borrowers and lenders within that niche
- Their credit assessment process – are they good at making loans, this is the core of the business after all!
- Their operating model – are retail lenders treated fairly? Institutional investment brings many benefits in terms of scale and can be very much a positive for retail investors, but can also crowd them out
- Their fees, charges and incentives – are the platform's interests aligned with the retail lenders? At this stage in the development of the industry, the big carrot of a successful IPO may be encouraging some platforms to chase volume at the expense of quality.

IN:REVIEW PLATFORM REVIEW PROCESS

There are services out there that offer platform reviews. The **in:review** review process we mentioned earlier is based on 180 different criteria against which are used to assess peer-to-peer lending and crowdfunding platforms. These can be categorised into seven main aspects. A broad outline of each aspect with respect to peer-to-peer platforms is as follows:

LOAN SPECIFICS – An analysis of the loans and loan parts, their returns (and any categories associated with them) and fees

LIQUIDITY – An analysis of the conditions attached to the loans including early repayment, redemption, cancellation and transfer

CONTINUITY – A review of the Platform's business continuity and disaster recovery plan, its triggers, costings and timings

COMPLIANCE – This aspect covers the platform operator's regulatory compliance, including its high level controls, CASS compliance, AML, capital adequacy, client reporting, promotional material and its complaints procedures

SECURITY – Examination of the security attached to the loans, how and under what circumstances it can be enforced, the platform operator's assessment procedures on potential borrowers, default, late payment and contingency fund analysis

TAXATION – Whether investing via a member-directed pension scheme may lead to tax charges for the SIPP/SSAS operator through unauthorised payments, taxable property or otherwise – only really relevant in the context of a SIPP or SASS

PARTIES – A review of the platform operator and any ongoing counterparties, including their provenance, experience and regulatory record

in:review.

These seven criteria would be a good starting point for any independent due diligence process.

"The bottom line is that any investment into equity crowdfunding will be risky, as the two big things they are the valuation and their rights as a shareholder."

ALL STREET REVIEW PROCESS

All Street is the only provider of reviews we know of in the equity crowdfunding space (although other firms such as MICAP and Allenbridge provide reviews of single company EIS offers), and they also cover debt instruments and debentures. They work on a subscription model and provide their reports online to their members. These investigate 8 key areas:

INVESTMENT OVERVIEW – An executive summary of the opportunity, potential returns, and risks including an assessment of the terms and conditions of the platform hosting the deal and investors rights as shareholders

PEOPLE BEHIND THE BUSINESS – Examining the quality, industry experience and business background of the key employees, advisors and board members

MARKET TRENDS – Looking at the size of the target market, the market growth rates, disruptive trends and regulation

COMPETITION – Identifies the key players in the industry and analyses the company's strengths and weaknesses compared with its competitors

BUSINESS PLAN & REVENUE MODEL – Analysis of the key financial data relating to the company's current operations, business plan and projected revenue generation

FUNDING NEEDS & COMPANY FINANCIALS – Analysis of the company's funding needs: what growth the capital is supposed to fuel and how much money the company needs to meet its goals

PEER REVIEW & EXTERNAL EXPERT INSIDE – Cross-reference and independent verification of the information provided by the company in their crowdfunding pitch

FINAL ASSESMENT – Comprehensive analysis of what is good and bad about the proposed opportunity

ALL ST

ONGOING MONITORING

The ongoing monitoring splits into two parts. Firstly, monitoring the overall portfolio to make sure that it matches the specified criteria (and separately, as part of the advice process, making sure that those criteria are still suitable for the client). Secondly, monitoring the alternative investment platform to see if redemptions rise, bad debts rise or if calls on the contingency fund rise. With the largest platforms committed to transparency and making their entire loan books available, this is actually relatively easy to do. We think that if the peer-to-peer lenders can get together with advisers, agree on the metrics they need to see and then publish them in a standard format, they'll be a lot closer to getting advisers on board – and this is a step that should be easily achievable.

DUE DILIGENCE ON CROWDFUNDING OPPORTUNITIES

Crowdfunding does not give investors the option of passively investing in a product or using at autobid function to invest according to pre-set criteria. Each individual opportunity must be assessed on its own merits – it's very much active investment management! We think this is part of the appeal, but of course what it means is that each individual company raising money must be assessed using criteria that would be applied to any investment in unquoted equity – we won't go into fundamental investment analysis here , but suffice to say at this level it goes beyond looking at the numbers and requires an assessment of the business plan, management team and Ts & Cs of the actual investment opportunity as well.

The bottom line is that any investment into equity crowdfunding will be risky, band the two big things that investors must focus on are the valuation and their rights as a shareholder. Even if the business model is fantastic, if the valuation is too high or there is potential for dilution the risks are greatly magnified.

REGULATORY RISK - Also Known as *"Why Stick Your Neck Out"*

If the mainstream markets crash, well at least everybody was wrong together. If the adviser does something a little bit different to the conventional, and it goes wrong, there is the possibility that clients will complain and the ombudsman will want an explanation. Regulation in the advice sector is so tight, it can reduce the adviser's inclination to recommend certain solutions even if they match the client's risk profile. But as we noted above, the regulator has indicated in the policy statement that advisers have a role to play in this asset class. Advisers will also have to consider the risks of non-involvement in these types of investment.

KEY FINDINGS

- With yields ranging from around 3% to 10% per annum, carefully selecting a well-diversified portfolio could generate around 6% per annum
- Beyond the financial returns, supporting causes and accessing tax relief are other reasons advisers should be considering alternative finance
- If platforms offer an autobid or automatic investment function then advisers may only need to do due diligence on the platform and monitor the platform on-going

CONCLUSIONS

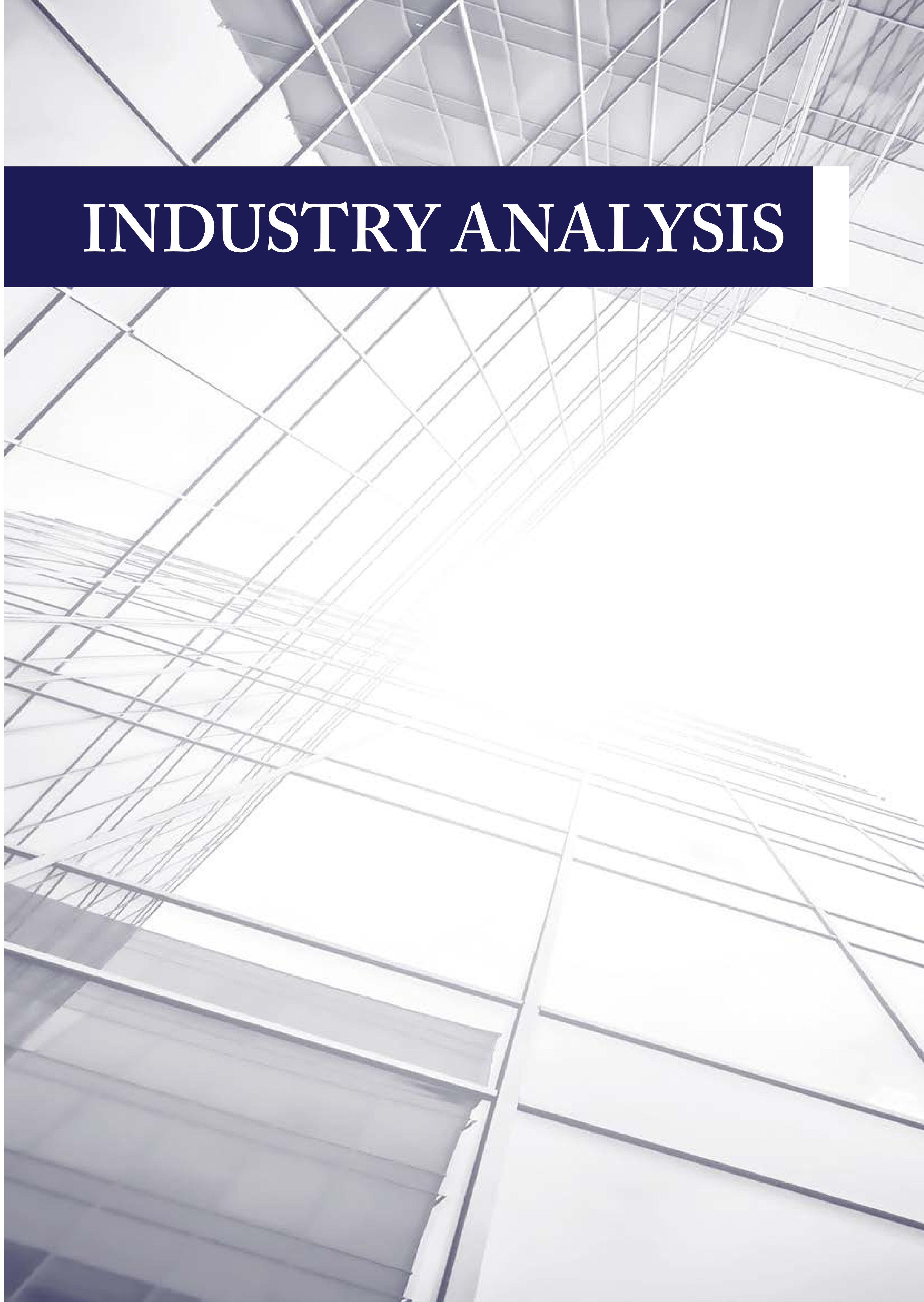
At the moment there is no guidance from the regulator on compliance, suitability or appropriateness. We think that peer-to-peer lending does look like something that could be suitable for all kinds of investor, including ordinary retail investors, in the right amounts. It's riskier than cash and bonds, but with yields so low these traditional asset classes are not attractive right now, so an allocation to peer-to-peer could make sense.

We would suggest (again) that the best way to achieve this would be with a diversified portfolio that includes consumer and business lending, property and asset backed loans, spread across a handful of the biggest platforms with the most volume and focused on shorter-term loans to mitigate interest rate risk. Picking out individual platforms and opportunities could potentially bring greater rewards, but we think this strategy would probably be too time consuming for advisers to implement for their customers – it's equivalent to stock picking instead of investing in funds. For these reasons, advisers may well be more tempted by the closed ended funds that have launched in this space. These funds have ballooned from zero to more than £1.2 billion market cap in just over year, in tandem with the growth of the sector.

Equity crowdfunding is an option for ordinary retail investors, if they are only investing small amounts – the ability to invest with such low entry levels is the beauty of the crowdfunding model, the reason why we can praise it for opening up the asset class to many more investors. However, it's hard to imagine an adviser ever recommending an opportunity to a client unless it is something that really speaks to the client for other, non-financial, reasons. The exception to this rule might be corporate debentures, which can offer much lower risk opportunities as they are paid back over the lifetime of the investment: one reason why many commentators don't class them as crowdfunding at all (not the FCA though – it classifies debentures alongside equity as non-readily realisable securities).

"We are at the beginning of the third Industrial Revolution and the entire financial system is starting to see some core changes. How much longer will Alternative Finance be referred to as 'Alternative'? I suspect not much longer. Alternative Finance is quickly becoming a crucial part of the wider industry with leading players such as SyndicateRoom changing the 'status quo' of financial services by providing customers with what they want: top quality service."

Gonçalo de Vascondelos, SyndicateRoom



INDUSTRY ANALYSIS

THE PLATFORMS

The following analysis is based upon information we have had access to thanks to AltFi Data and our own research. It's a comprehensive look at the whole sector, and we're confident that we captured data on all of the platforms available in the market at the time of writing. The intention is to help readers understand the size and scale of the industry, how it breaks down into the different varieties of alternative finance, what sort of experience investors can expect and what an investment might look like in terms of minimum amounts, forecast returns, frequency of returns, fees and term.

The information we share here should be enough to allow advisers to get a feel for the market before they start to assess individual platforms for themselves.

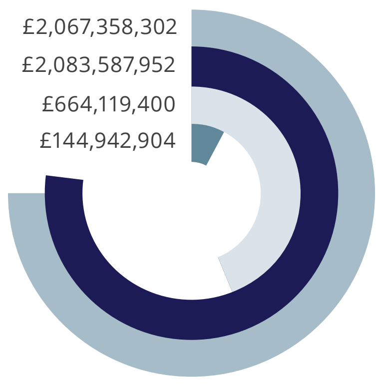
To put this research together, we carried out desktop research to build a register of the important details of all of the platforms, then asked the platforms to verify the information we have collected (we usually get a 50% response rate) and (where possible) cross checked our results against AltFi Data's.

THE PLATFORMS

We start by looking at the number of platforms in the market, how they break down between the three major alternative finance sectors and what sort of volumes of investment are they able to make.

LIBERUM ALT FI VOLUME INDEX

as at 10 Nov 2015



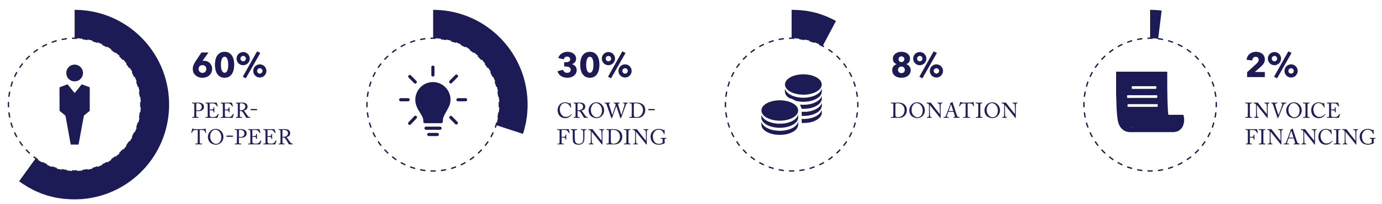
VOLUMES ACROSS THE MARKET

The alternative finance industry has been broadly broken up to three sectors: peer-to-peer, crowdfunding, and invoice financing.

To get an idea of the amount of business these sectors are doing, Liberum and AltFi Data track the total amount of funds deployed since the first platform launch in 2005. You can find out more about the index constituents and the criteria for inclusion on its website altfidata.com.

One point to note: AltFi Data classifies debt based crowdfunding as peer-to-business lending. However, for our analysis, we have included debt based crowdfunding platforms within the overall crowdfunding sector. We breakout the debt based crowdfunding details and examine them separately where we think it adds something to the analysis.

PLATFORMS BY SECTOR



The majority of platforms are peer-to-peer lending platforms. Despite sometimes grabbing more headlines in the mainstream media, there are only half as many crowdfunding and just two invoice financing platforms.

(In fact there are already many services to provide invoice financing to business, but only two are open to online retail investors in the same manner as other peer-to-peer platforms).

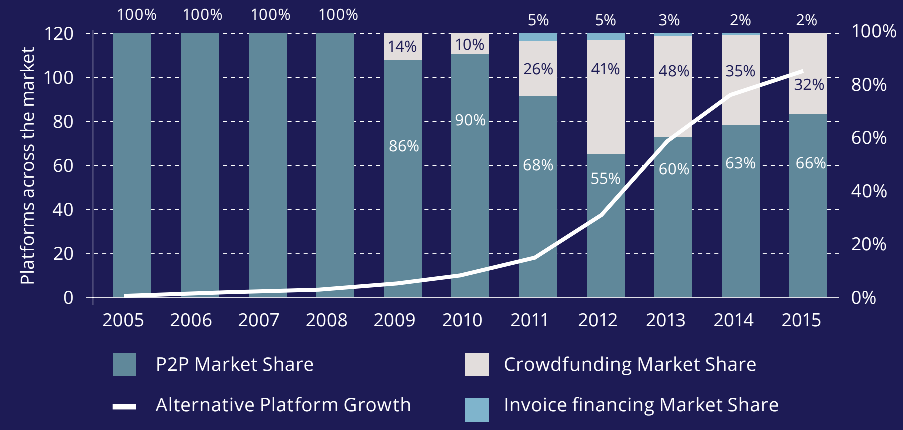
There are a handful of donation based crowdfunding websites that are open to what are called "backers" instead of investors. Donation based crowdfunding sites may not pay financial returns, but backers can receive other forms of incentives, such as T-shirts or the opportunity to receive a first production on a new innovative product. We've included them here for completeness, but note that for the remainder of the analysis, these platforms are left out as they do not provide a financial return.

"These mini-bonds and debentures can be used to fund a variety of activities from start-up company funding, to charitable activities, to renewable energy projects"

PLATFORM GROWTH BY THE NUMBERS

Here we look at the growth in the number of platforms over the last 10 years. Growth was slow initially, but from 2008 onwards, platforms have been launching at an accelerated rate. We think that this has been driven by low interest rates, banks' reluctance to lend as they repaired their balance sheets and the flexibility that alternative financing provides for its customers – as well as some "me too" platforms setting up.

PLATFORM GROWTH AND MARKET SHARE



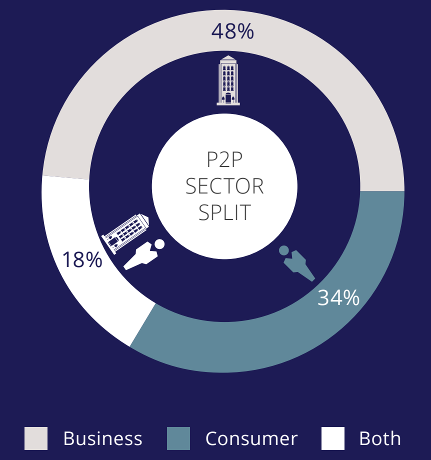
KEY FINDINGS

- Peer-to-peer have the largest market share (66%) split up by 34% consumer, 49% business and 18% lending to both
- The 1st platform launched in 2005 with over 100 platforms launched in the UK to date

PLATFORM SUBSECTORS

The peer-to-peer sector offers financing to individuals (consumers) as well as businesses. Looking at just the peer-to-peer market we see that the majority (48% of platforms) are focused on lending exclusively to businesses and 34% lend exclusively to consumers.

P2P SECTOR SPLIT



18% offer both types of investment. We suspect that this will be quite a fluid picture – as platforms develop their businesses, they may start to lend to other sectors.

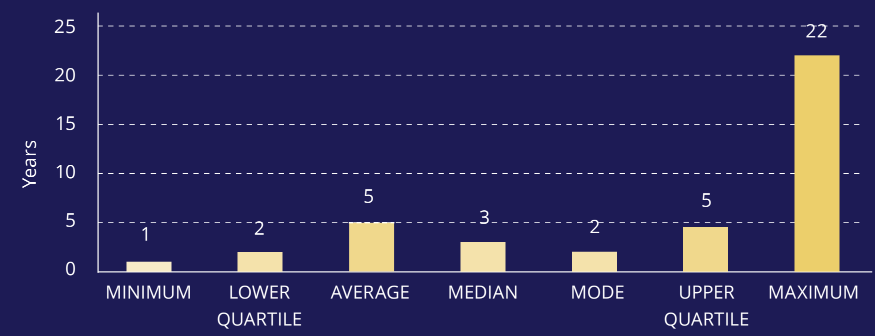
MINIBONDS AND DEBENTURES IN FOCUS

Mini-bonds and debentures are debt based investments but investors are purchasing a security rather than making a loan. These investments tend to be longer term than those of peer-to-peer lending, with the average term of these investments being five years and terms reaching up to 22 years.

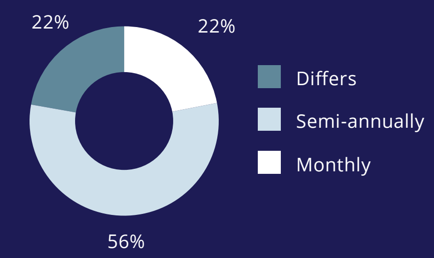
The advantage of debt based crowdfunding is the ability to receive regular coupon payments as well as receiving the principal at the end of the term. The majority of these mini-bonds and debentures (56%) pay on a semi-annual basis, **22%** pay monthly and **22%** had payments that varied from investment to investment.

These mini-bonds and debentures can be used to fund a variety of activities from start-up company funding, to charitable activities, to renewable energy projects. The risk, return and term profiles will vary for each and need to be reviewed individually.

DEBT CROWDFUNDING INVESTMENT TERM:



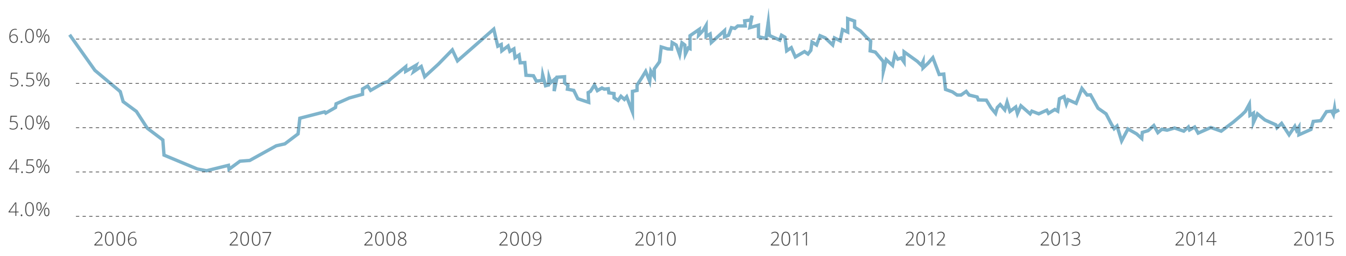
DEBT BASED CROWDFUNDING PAYMENT FREQUENCY:



PERFORMANCE

It's the search for higher yields that has driven many investors to alternative finance. Typical returns, and how those returns are paid out, will vary across the different sectors and from platform to platform.

LARI PERFORMANCE TRAILING 12 MONTH RETURN (2006-2015)



The Liberum AltFi Returns Index (LARI) is designed to measure the returns generated from peer-to-peer lending Source: Alt Fi Data (2015)

PEER-TO-PEER RETURNS

It is typical of platforms to advertise an annualised minimum level of return, a range of potential returns, or an average rate of return. As noted earlier in the report, some platforms have developed investment products that are built around a specific level of return and maturity.

Obviously actual returns vary by each investment, but the advertised forecast annual rates of return give investors and their advisers an indication of what can be achieved.

Most of the forecast rates of return are clustered between 5-10% per annum. What is interesting to note is that there is very little variation between the peer-to-business and the peer-to-consumer sectors.

However, what may not be obvious here is whether or not these targeted returns are calculated net of fees, taxes or default rates. In fact, we took a look at how each platform calculated their rates of return and found that 49% are gross of fees and charges, while only 16% were net, and the remaining 35% either did not advertise a forecast rate of return or did not clarify whether it was net or gross. As each platform will have differing fee structures and ways of adverting, this inconsistency could trip up potential investors.

Another source for assessing returns is the LARI (Liberum AltFi Date Returns Index) which calculates a return based upon the performance of the big three peer-to-peer lenders (RateSetter, Zopa and Funding Circle).

Note that the LARI only looks at the big three (which represent over 60% of the market and we expect it to shortly include another two qualifying platforms, taking its coverage up to 80% of the market). Higher yields might be achievable on some of the smaller platforms that have fewer investors.

We can see from our research that the average forecast annual yield is nearly 9%, much higher than what the actual data from LARI is telling us, or the 6% we feel can be achieved.

But whether you use the big three or the smaller, second tier platforms this data suggests that the yields are certainly respectable.

CROWDFUNDING

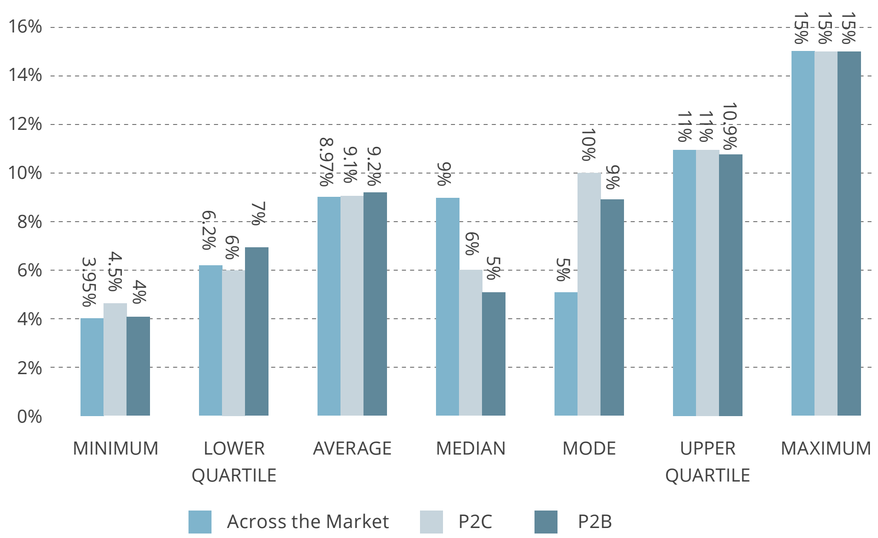
Very few equity crowdfunding platforms advertise a forecast or targeted rate of return, as outcomes are much more uncertain with unquoted equity investments. They are more likely to use historical case studies as a way of demonstrating what can be achieved. The exceptions are platforms that crowdfund debt based securities such as debentures and mini-bonds that do have a pay-out profile. The yield from these investments range from 5-8% and some are fixed and some are variable. It is still a small section of the market though, and there aren't enough data points to do much analysis.

LARI PERFORMANCE

	ABSOLUTE RETURN	CHANGE
3 MONTH	1.62%	+0.01
1 YEAR	5.45%	+0.05
3 YEAR	18.05%	-0.03

Source: Alt Fi Data as of 30 September 2015

ADVERTISED FORECAST ANNUAL RATES OF RETURN



"Obviously equity investments only pay on exit. However the innovation of debt instruments such as corporate debentures and mini-bonds mean that some crowdfunding platforms do offer investments with regular interest payments."

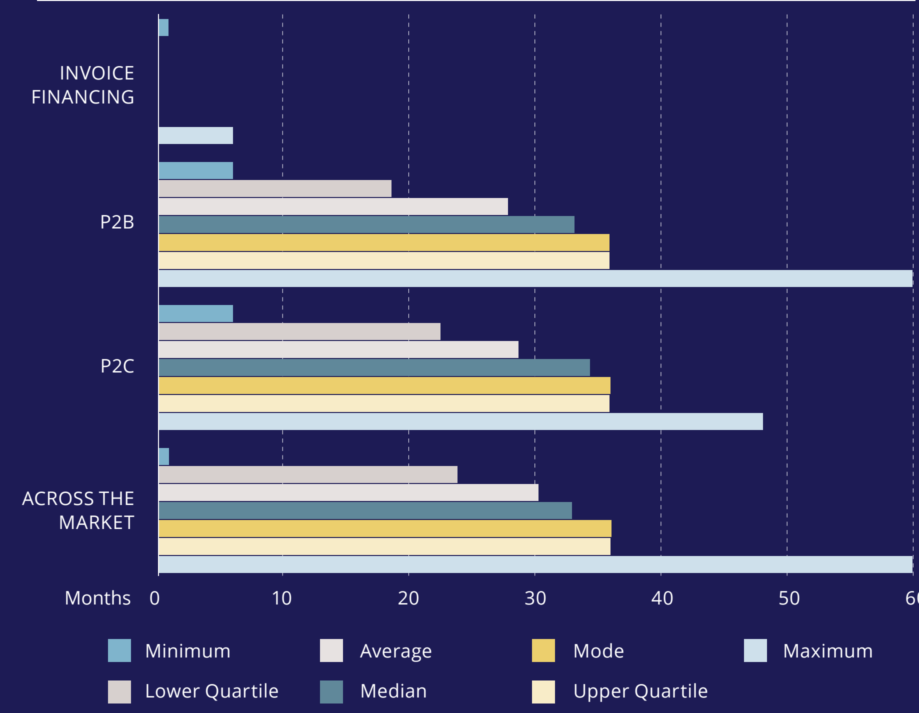
INVESTMENT TERM

Crowdfunding has the longest investment terms in the market at 264 months or 22 years – although this was a unique outlier, the investment was in a debt based security and the underlying assets were renewable energy projects underpinned by feed in tariffs, which have an equivalent lifespan. Obviously the majority of equity crowdfunding projects cannot say when their investors will achieve an exit due to the nature of the investment.

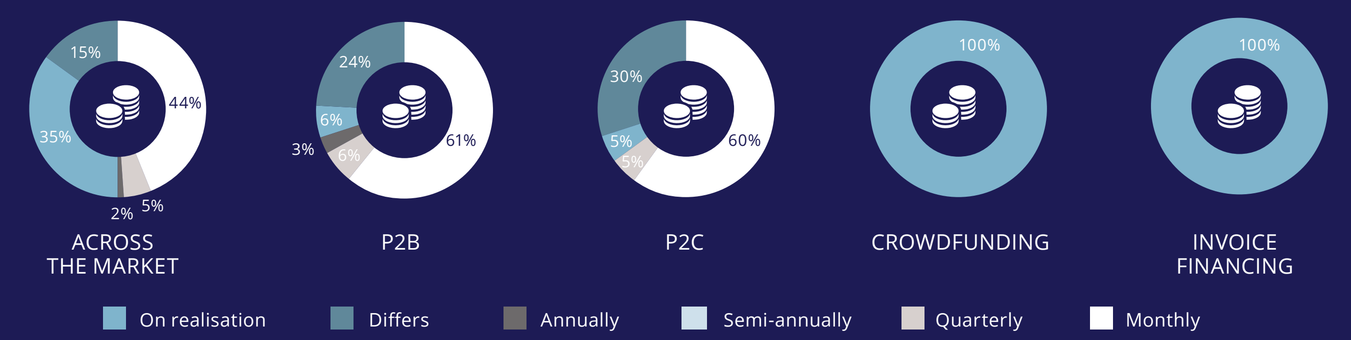
Unsurprisingly, invoice financing has the shortest maturities as this activity is strictly used to create working capital for the firms' borrowing and invoices are (hopefully) paid within a matter of months.

The peer-to-peer sector comes with a larger range of investment terms, anywhere from 6 months to 5 years.

INVESTMENT TERM BY SECTOR



PAYMENT FREQUENCY



PAYMENTS TO INVESTORS

Payment profiles differ. Some platforms pay income monthly, quarterly or semi-annually and some only pay on exit.

Obviously equity investments only pay on exit (or if the investee firm starts paying a dividend, which is very unlikely for these early stage companies). However the innovation of debt instruments such as corporate debentures and mini-bonds mean that some crowdfunding platforms do offer investments with regular interest payments.

Invoice financing only pays out on maturity, however, as seen earlier, these are short term – only ranging from 1 to 6 months.

KEY FINDINGS

- There is very little to distinguish the returns quoted by peer-to-consumer and peer-to-business lenders
- The LARI (based on actual, achievable, returns) shows an absolute return of 5.45%, much lower than the platforms' own forecasts, demonstrating the problem of platforms using different calculation methodologies
- Investment terms can range anywhere from 1 month in invoice financing to 264 months in debt based crowdfunding

TRANSPARENCY

TRANSPARENCY

The alternative finance industry presents itself as being fairer, more democratic and more transparent that mainstream financial services. This is a hard claim to measure and substantiate, but we've looked at a handful of indicators here.

TRADE ASSOCIATIONS

There are two major trade associations that operate in the UK, the Peer-to-Peer Finance Association (P2PFA) and the UK Crowdfunding Association (UKCFA). These associations aim to bring greater credibility to the sector and set out best practice regulations that their members must adhere to. Their regulations are more stringent than those already set out by the FCA and UK Government.

Successfully applying for membership of the P2PFA means going through a lengthy application process to demonstrate how the platform meets the key requirements set out by its Operating Principles. These principles cover areas such as management, capital requirements and IT systems, among other things. Some members have also made their loan books available to their registered users. We looked at the loan books of the "big three" in another section, but five platforms that are members of the P2PFA currently make their loan books available. It may be that their rigorous criteria have put off potential members; we found that only 10% of peer-to-business and 17% of peer-to-consumer platforms were registered with the P2PFA. In addition, the UKCFA has attracted 26% of peer-to-business platforms and 4% of peer-to-consumer platforms. There has been one high profile exit from the P2PFA: Wellesley & Co left in November 2014 due to differences over Wellesley & Co's marketing strategy.

The crowdfunding sector is much smaller, but an overwhelming 67% are members of the UKCFA. (Note that crowdfunding platforms are not eligible for membership with the P2PFA due to the nature of their activities, so unlike P2P platforms they only have one option). The UKCFA is designed for a range of business types in the alternative finance sector, so its code of practice is much more broadly written. The association promotes a professional, transparent and consumer driven industry. Those wishing to become members need to agree to its code of conduct as well as pay an annual fee to cover the lobbying and promotional costs of the association.

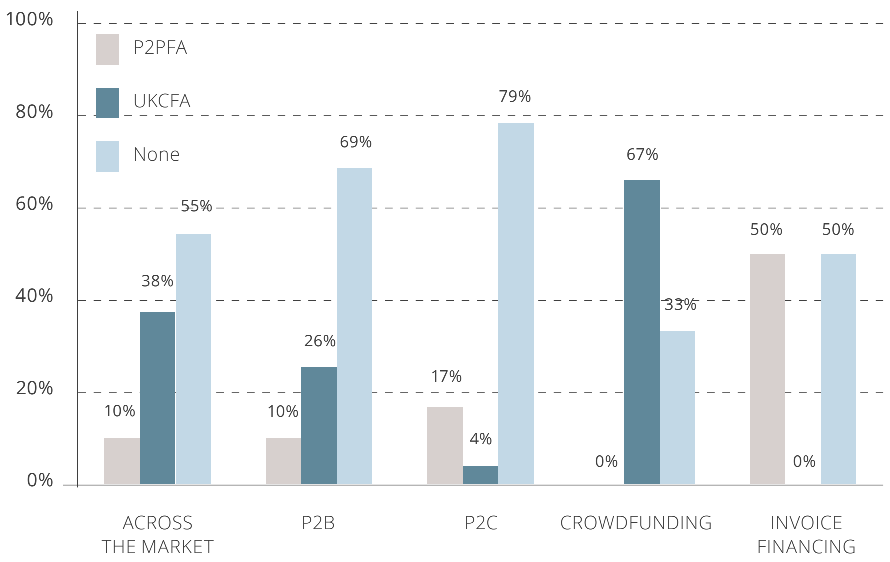
One invoice financing platform has decided become a member of the P2PFA (there are only two invoice financing platforms in total at the time of writing).

INCLUSION IN THE LIBERUM ALTFI INDEX

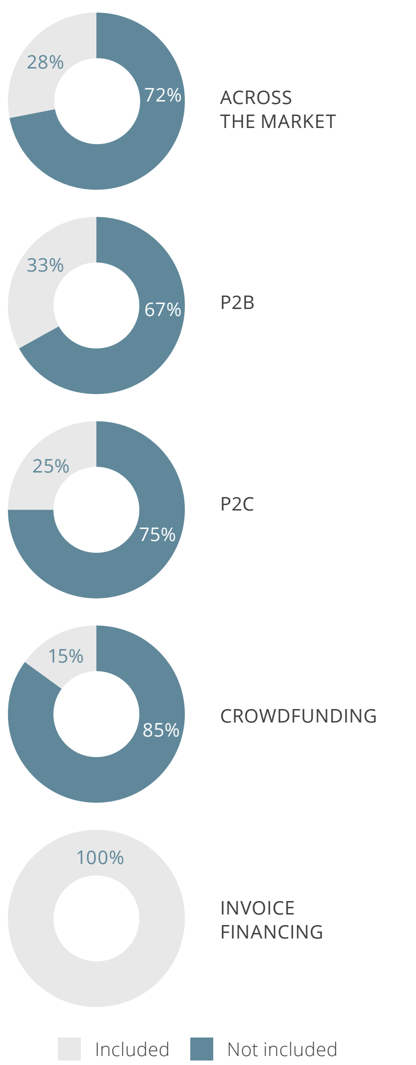
The Liberum AltFi Indices increase the transparency of the sector by tracking the growth of the UK industry since its inception. However, there are strict criteria for inclusion: platforms must have a cumulative origination volume of greater than 0.1% of the total index. These tight inclusion criteria mean that only 28% of all platforms are included in these indices.

This analysis shows us that there is a "long tail" of platforms who do not originate very much business.

TRADE BODY MEMBERSHIP BY PLATFORMS



LIBERUM ALTFI INDICES



THE CONSUMER JOURNEY

FCA AUTHORISATION

The FCA policy statement 14/04 required all peer-to-peer platforms to seek FCA Authorisation. Happily, of all the platforms we looked at in our research only two were not authorised by the FCA - and this was not the result of platforms trying to sneak in under the radar! One platform was still in beta testing and we assume they were seeking authorisation, while the other platform was for Bitcoin investors and was therefore outside the FCA's perimeter - for the moment at least.

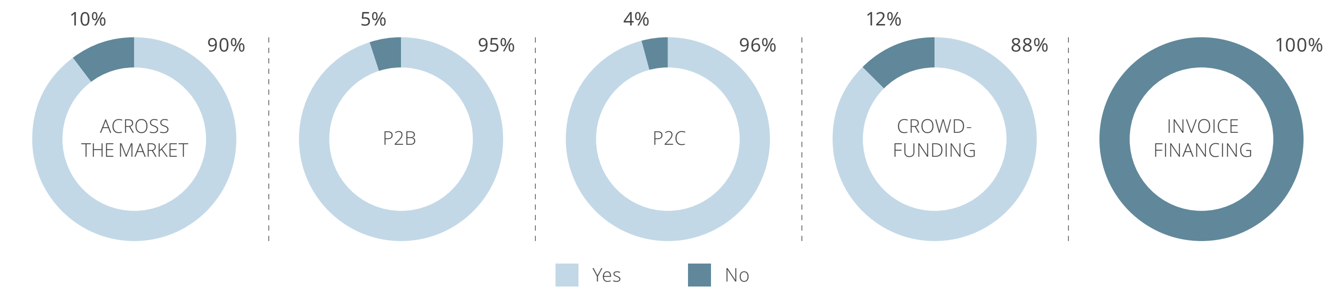
Most crowdfunding platforms are either directly authorised or are the appointed representatives of authorised firms. 90% of platforms across the market were directly authorised by the FCA.

Note: for the purposes of our analysis, we have considered interim permissions to be the same as authorised. Interim permissions are a temporary measure to give platforms time to comply with the requirements of full FCA authorisation.

Mini-bonds are an interesting conundrum in terms of regulation. While they are not regulated by the FCA, they can be listed on a stock exchange, which will have its own rules and regulations to list. However, they tend to be small exchanges such as the Irish Stock Exchange where the regulations may be less robust than the more mainstream markets.

Invoice financing falls under asset-backed securities; this is not currently a regulated activity by the FCA.

FCA AUTHORISATION



COMPARISON TO BANK ACCOUNT & CALCULATION OF FORECAST RETURNS

Some peer-to-peer platforms have previously explicitly compared themselves to a bank account, drawing the ire of the FCA. Peer-to-peer lending is not lending the same as a bank account – the risk of bad loans lies directly with the lender, as opposed to the bank – so it's good to see that this misleading comparison has been expunged from the marketing efforts of the platforms.

49% of platforms calculate their forecast returns gross of fees and charges (and possibly taxes and expected rate of default), while only **16%** were net. The remaining **35%** either did not advertise a forecast rate of return or did not clarify whether it was net or gross.

KEY FINDINGS

- Trade associations hold their member to even more stringent regulations than the FCA
- All platforms that were required to seek FCA authorisation did so
- 49% of platforms stated returns gross of fees and 16% net of fees

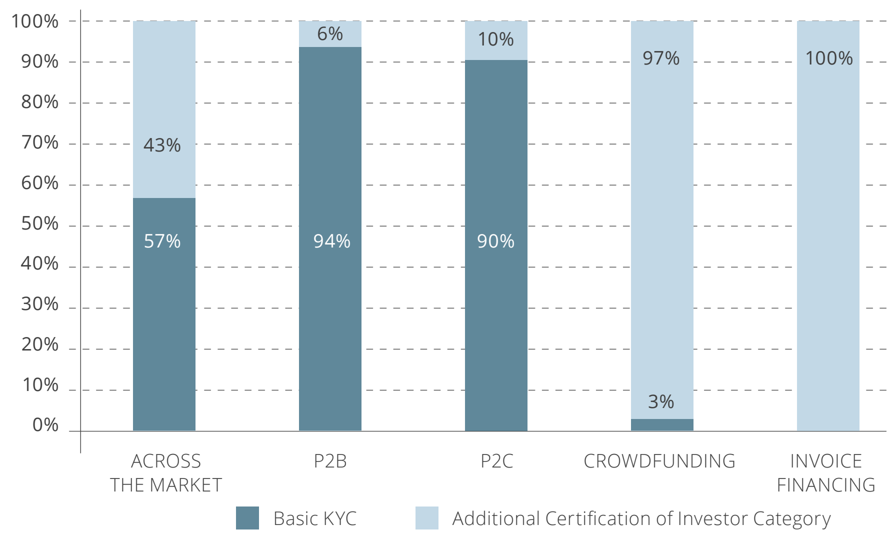
THE CONSUMER JOURNEY

REGISTRATION

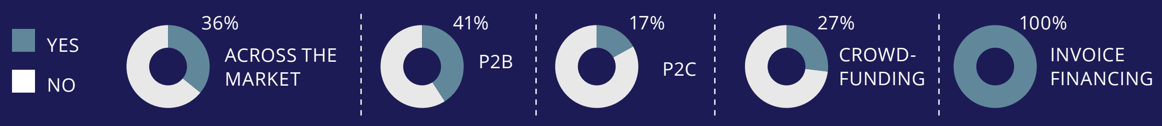
After deciding which platform to invest with, the first step is to register. Typically this is as easy as setting up a Facebook account – you fill in your name, email and a few other details. However, the PS14/4 regulations for investment based crowdfunding require platforms to verify if consumers are either a HNW or sophisticated investor, or a retail investor who will certify that either:

- they won't invest more than 10% of their net investible assets,
- or that they are receiving advice.

LENDER VERIFICATION



CHARGES AND FEES TO LENDERS



This is usually a simple check box. Registration is quick and simple when compared to many other investments. This is of course a blessing and a curse – it's a genuine consumer benefit that helps democratise investing, but does make it easier for unwary investors to quickly get out of their depth and make mistakes.

The majority of peer-to-peer platforms only require a KYC (know your client) check, to comply with money laundering regulations. However, crowdfunding platforms are all required to verify which category of investor their members fall into and those retail investors should sign a Restricted Investor Statement which will allow the platform to communicate direct offer financial promotions for these investments for 12 months after the date of the statement. PS14/4 states that firms can integrate client certification and appropriateness test requirements if they wish, but to remain compliant there only needs to be a valid statement in place at the time of communicating the promotion. We found that 97% include a certification test step upon registration or before investment.

MINIMUM INVESTMENTS

The lowest minimum investment level required across the whole market is only **a penny**, but can be as high as **£65,000**! This wide variation reflects the differences in the models they platforms use and the type of investors they are focused on.

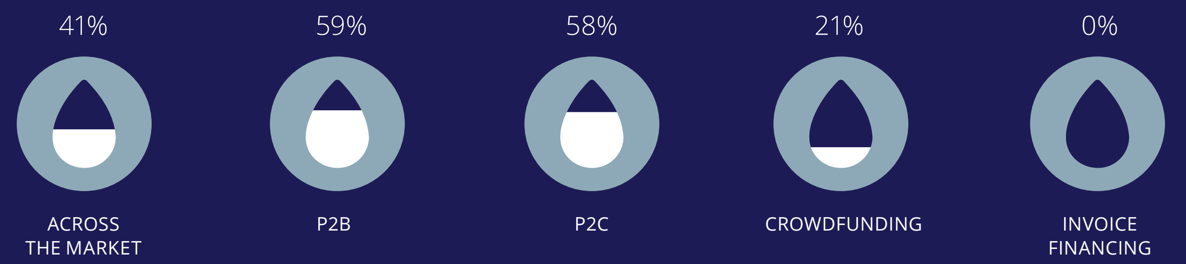
Invoice financing is a small sector with only two platforms at the time of writing, and these particularly focus on HNW/sophisticated investors. To even open an account, investors will need a minimum £50,000 (although this is not how much they will need to commit to one investment - the minimum investment is around £700).

MINIMUM INVESTMENTS (2015)

	MIN.	1Q.	AVERAGE	MEDIAN	MODE	3Q.	MAX.
ACROSS THE MARKET	£0.01	£20	£3,450	£100	£100	£1,000	£65,000
P2C	£0.01	£10	£3,557	£25	£10	£5,000	£25,000
P2B	£0.01	£25	£4,581	£100	£100	£1,000	£65,000
EQUITY CROWDFUND	£1.00	£10	£782	£100	£10	£1,000	£5,000
DEBT CROWDFUND	£5.00	£5	£849	£100	£5	£1,000	£5,000

LIQUIDITY OF INVESTMENTS

The data we've collected shows that 59% of the platforms do not currently have secondary markets for investors to sell their investment, though many are developing secondary markets. Active secondary markets are a consideration for alternative finance and we expect the number of secondary markets to increase moving forward. However, just because a market exists does not mean that it will be deep enough and liquid enough to guarantee an exit for investors at a price they feel is fair. And (as with any market) the real test for liquidity will come when large numbers of investors want to exit at the same time. Note that invoice financing platforms do not operate secondary markets, but the assets return to cash very quickly anyway.



CHARGES AND FEES

Another advantage this sector has over traditional lending institutions is the low overhead costs of an online marketplace; this allows platforms to charge lower fees or no fees at all to investors. Its common practice for some or all of the charges to get passed onto the borrowers or companies wishing to list on the platform (just like "free" current accounts). Overall only 36% of platforms listed on our register currently charge any type of fee to investors. Interestingly, the platforms that list business investment opportunities were more likely to charge fees to lenders, perhaps reflecting more work involved in sourcing deals and carrying out due diligence.

Of course, the platforms have to make money, and their fees and charges have to be applied somewhere – we think that the key metric to look at here is the difference between the lender and borrower rate, not how that is divided between the two parties – it's the difference between the two that tells you how much the platform is charging for its services.

COMPARING THE BIG THREE

Where charges are applied to lenders, there is not one single charging model that has been adopted by the platforms.

Annual fees charged on the total loan amount lent are common and are around 1% per annum across the whole market. Commission or selling fees are charged on loans sold on the secondary market, and range from 0.25% to 1.5%. They are charged on either the amount left outstanding on the loan or on the original investment amount. In the equity crowdfunding and invoice financing sectors there are a few platforms that charge a performance fee on profits, which range from 7.5% to 15% for crowdfunding and 10%-30% for invoice financing.

COMPARING THE BIG THREE

This analysis was produced by AltFi Data in April 2015 and is a comprehensive analysis of the loan books of the big three peer-to-peer lending platforms – Zopa, Funding Circle and RateSetter.

This kind of analysis is only possible because they are prepared to publish their loan book data – anybody can access this by downloading the data in CSV format from their websites. We can only applaud this level of transparency. It's not something that you would ever see from the banks, and it's data that helps investors understand how their money is lent. As the risk of default sits with the investor (unlike the banking model), it seems reasonable to let investors have access to this sort of information.

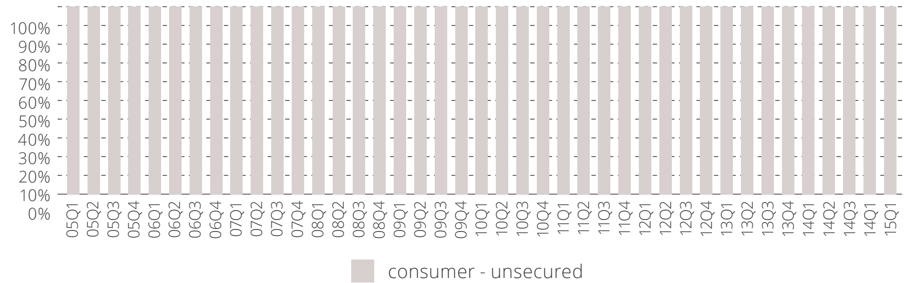
The rest of the analysis and charts in this section were produced by AltFi Data:

" The key theme that we found as we examined the trends in loan origination is diversification – platforms are evolving and maturing, lending different types of loan to different types of borrowers at a greater range of rates. This isn't surprising, we probably didn't have to do this analysis to know that, but exactly how this evolution and diversification is taking shape in each platform is interesting to observe and they are not all moving in the same direction.

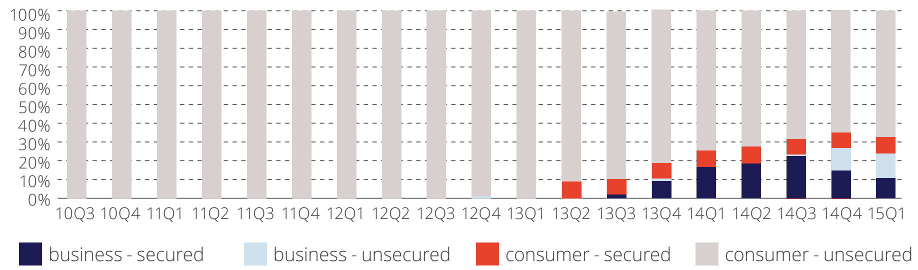
KEY FINDINGS

- 57% of platforms require investors to fill in a KYC check either when the register or before they make their first investment and the remaining 43% require to certify what category of investor they fall into
- Minimum investments from as little as a penny to £65,000
- Only 41% of platforms offer a secondary market, but we expect to see this figure increase within the next 12 months
- Only 36% of platforms charge investors a fee

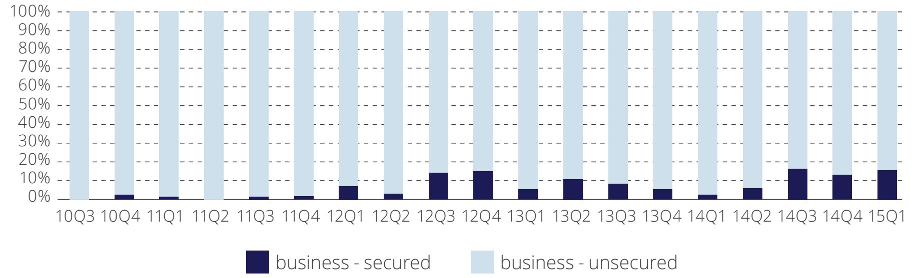
__Zopa__'s story is the most straightforward – for 10 years, it has lent to consumers on an unsecured basis (it has done a small amount of lending to sole traders, but this is classified as consumer lending here).



If we then look at __RateSetter,__ for the first 11 quarters of its lending, RateSetter lent exclusively to consumers on an unsecured basis. Then in mid-2013, the platform began to lend to consumers on a secured basis and has subsequently branched out into secured and, most recently, unsecured business lending.



This diversification trend can also be seen in __Funding Circle__'s lending. The platform initially lent solely to businesses on an unsecured basis but secured lending is becoming an increasingly large part of its business, with 15% of last quarter's lending being secured. The vast majority of this growth is driven by Funding Circle's expansion into property backed lending.



"'All the platforms have remarkably stable lending rates since RateSetter and Funding Circle entered the fray in 2010" **AltFi.com**

From their websites, one can gather that Funding Circle lends to businesses whilst RateSetter and Zopa lend mainly to consumers. We've looked at who the platforms have been lending to each origination quarter since they launched.

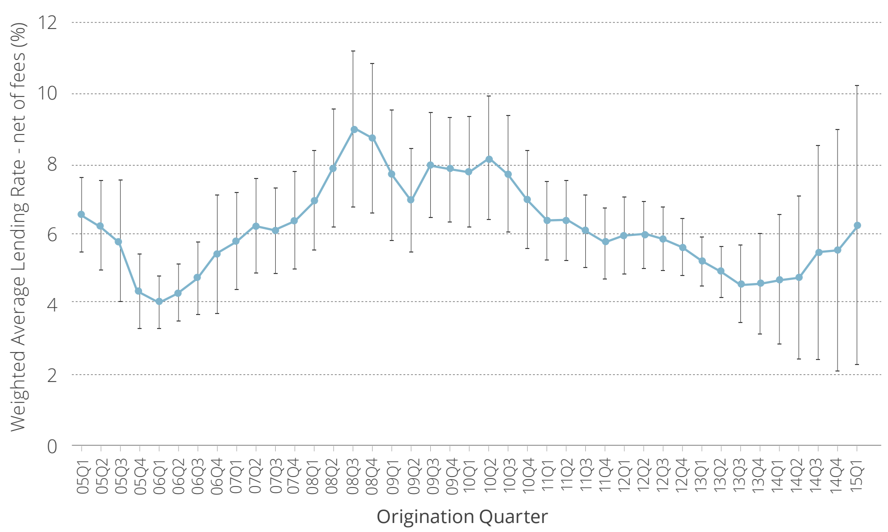
To get a feel for the riskiness and diversity of the lending of each platform, we looked at the weighted average interest rate that lenders received after platform fees and any contingency fund fees. It must be noted here that a direct comparison of the absolute level of this lending rate between platforms is not useful because of things like differing default rates and the existence of contingency funds or not. However, comparing the trends in lending rate between platforms is possible.

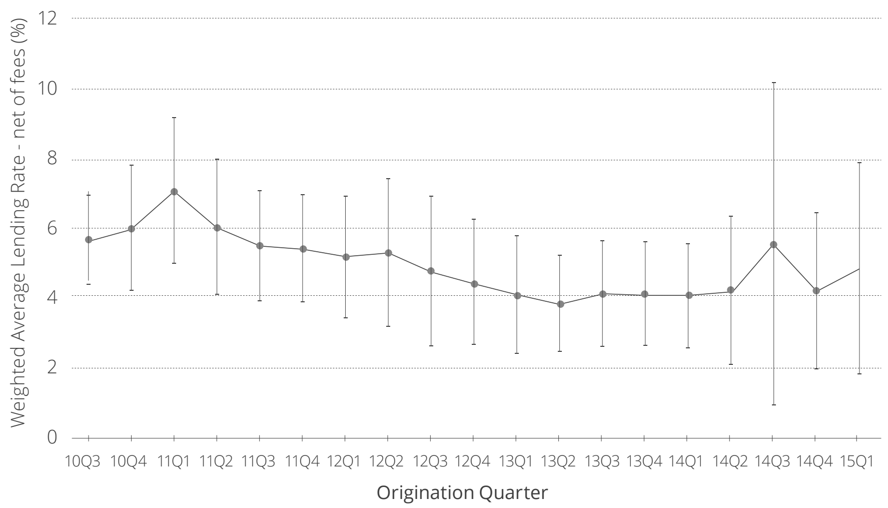
All the platforms have remarkably stable lending rates since RateSetter and Funding Circle entered the fray in 2010. Prior to 2010, it is interesting to observe Zopa's lending rate increase in the 2008/2009 period as the credit crunch set in.

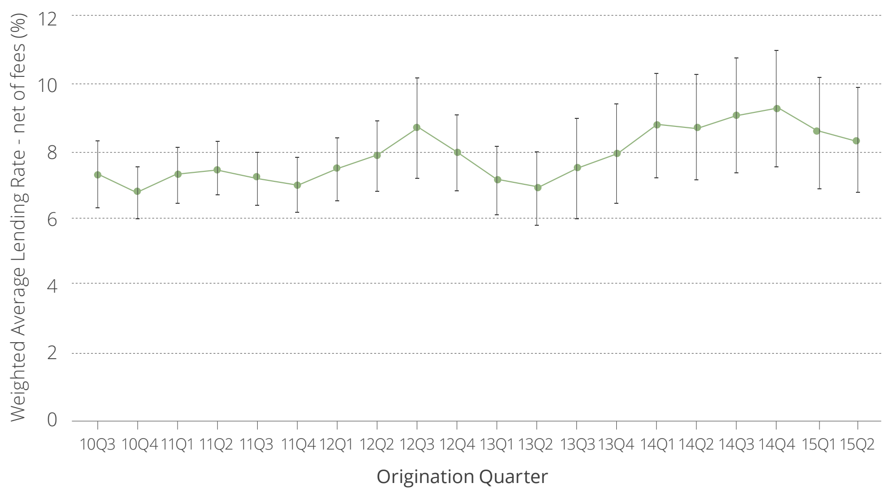
As a measure of the diversity of interest rates on loans made within the origination quarter, we have marked the standard deviation for each point on the chart. One standard deviation includes 67% of the population. The bigger the standard deviation, the more diverse the lending rates are.

A larger range of lending rates could indicate a larger range of borrower quality (as one would expect lending rate to be reflective of borrower quality). It is interesting to note that the lending rate standard deviation of all three platforms has increased over time. This indicates a diversification of the loan books and could be as the platforms offer riskier loans to investors as their credit models are refined. Funding Circle, for instance, has introduced two new risk bands at the lower end of the credit spectrum since it began lending.

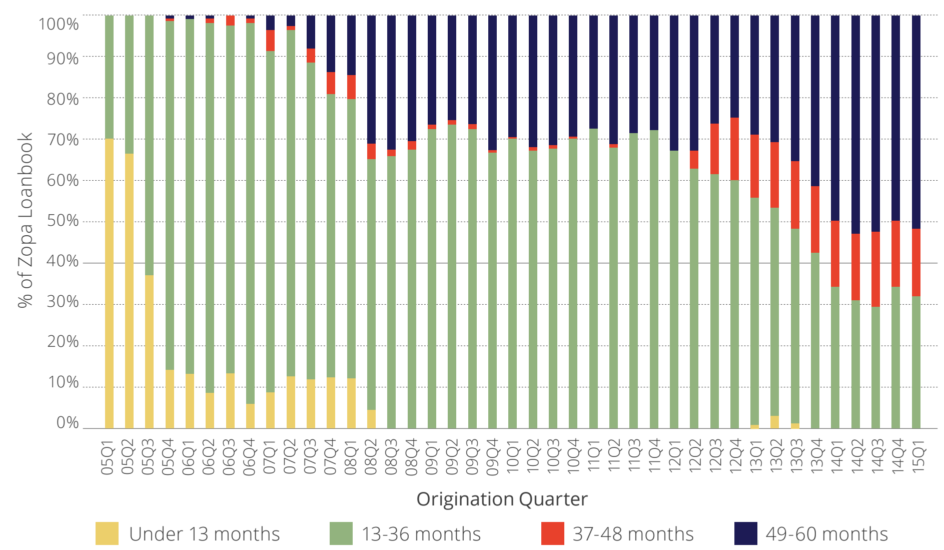
Perhaps the most surprising observation about these charts, however, is the large increase in standard deviation seen in Zopa's loan book over the last two years. The timing of this coincides with the introduction of Zopa's Safeguard fund. This could indicate a change in lending strategy as Zopa attempts to maintain its pace of growth.

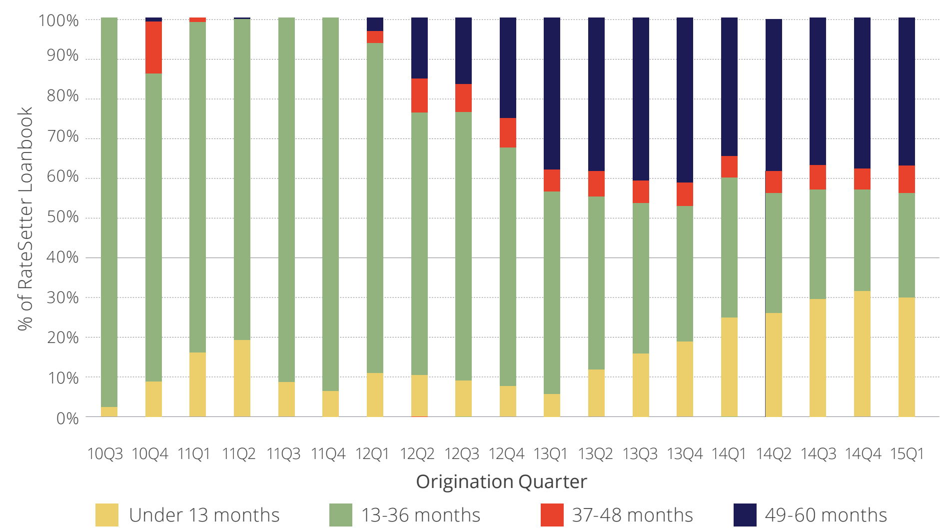


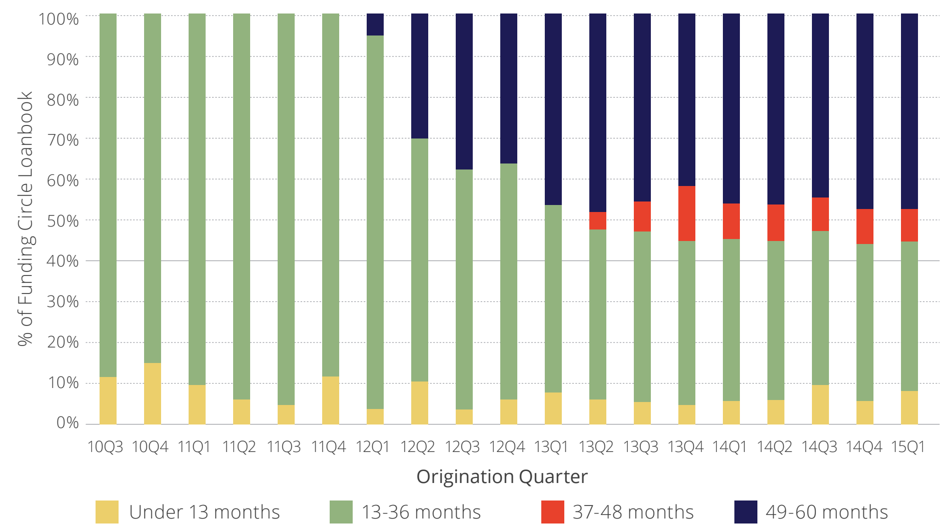




"The transparency that they create in publishing these loan books is virtually unprecedented and will hopefully enable investors to better understand the asset class and enable enlightened investment decisions to be made"







Those of you who are familiar with the rates that Zopa and RateSetter offer their lenders may be surprised to see Zopa's mean lending rate higher than "RateSetter's, (as RateSetter currently offers lenders about 150bps more yield than Zopa on its 5yr rate). However this is explained when we look at the term of the loans which makeup the loan books with RateSetter's loan book being weighted towards shorter term loans which will tend to have lower yields. Taking a closer look at the terms of the loans in each origination quarter, it can be seen that all platforms started by making shorter loans and then moved into making longer duration loans. Funding Circle has had a surprisingly stable term composition of its lending over the last 2 years. We can see opposite trends, however in the Zopa and RateSetter loan books with Zopa's proportion of longer loans increasing whilst RateSetter's proportion of shorter loans is increasing - diverging strategies from the UK's top two peer-to-peer consumer lenders.

This article barely scratches the surface of what can be done with the information that Zopa, RateSetter and Funding Circle provide. The transparency that they create in publishing these loan books is virtually unprecedented and will hopefully enable investors to better understand the asset class and enable enlightened investment decisions to be made. For our part, we'll keep crunching the data and writing about what we find – so watch this space..."

DEFAULTS

The Peer-to-Peer Finance Association (P2PFA) is one of the trade associations for the alternative finance sector. In addition to representing the industry, it provides a set of standards of which members must follow. Among these rules members must use the P2PFA standard, which allows for comparable and meaningful statistics for platform default rates. We've summarised the published information in the table below (the data is as of November 2015):

PLATFORM		2010	2011	2012	2013	2014	2015 (Jan - Nov)
RateSetter	ARREARS	0.0%	0.0%	0.002%	0.009%	0.02%	0.017%
	EXPECTED DEFAULT RATE	1.4%	1.4%	1.4%	1.54%	2.486%	2.206%
	ACTUAL DEFAULT RATE	1.812%	0.634%	0.914%	1.392%	1.646%	0.544%
ThinCats	ARREARS	0.0%	21.82%	1.02%	2.65%	1.14%	1.11%
	EXPECTED DEFAULT RATE	0.0%	0.07%	6.77%	1%	0.66%	1.48%
	ACTUAL DEFAULT RATE	0.0%	0.07%	11.33%	1.37%	2.74%	3.28%
Funding Circle	ARREARS	0.0%	0.4%	0.9%	0.2%	0.0%	0.0%
	EXPECTED DEFAULT RATE	3.2%	3.3%	4.2%	4.5%	4.6%	3.7%
	ACTUAL DEFAULT RATE	4.0%	5.5%	3.7%	3.3%	1.2%	0.3%
LANDBAY	ARREARS	N/A	N/A	N/A	N/A	0.0%	0.0%
	EXPECTED DEFAULT RATE	N/A	N/A	N/A	N/A	0.1%	0.10%
	ACTUAL DEFAULT RATE	N/A	N/A	N/A	N/A	0.0%	0.0%
LENDING WORKS	ARREARS	N/A	N/A	N/A	N/A	0.01%	0.01%
	EXPECTED DEFAULT RATE	N/A	N/A	N/A	N/A	1.54%	1.54%
	ACTUAL DEFAULT RATE	N/A	N/A	N/A	N/A	0.29%	0.0%
LendInvest	ARREARS	N/A	N/A	N/A	0.0%	0.0%	Not Provided
	EXPECTED DEFAULT RATE	N/A	N/A	N/A	0.88%	0.0%	Not Provided
	ACTUAL DEFAULT RATE	N/A	N/A	N/A	0.0%	0.0%	Not Provided
MADISTON LendLoanInvest	ARREARS	N/A	N/A	N/A	N/A	0.0%	0.9%
	EXPECTED DEFAULT RATE	N/A	N/A	N/A	N/A	1.5%	1.5%
	ACTUAL DEFAULT RATE	N/A	N/A	N/A	N/A	0.0%	0.0%
marketinvoice	ARREARS	N/A	0.0%	2.61%	1.41%	2.04%	Not Provided
	EXPECTED DEFAULT RATE	N/A	Not Provided	Not Provided	Not Provided	Not Provided	Not Provided
	ACTUAL DEFAULT RATE	N/A	0.0%	0.14%	0.09%	0.0%	Not Provided
zopa	ARREARS	Not Provided	0.31%	0.08%	0.02%	0.03%	0.02%
	EXPECTED DEFAULT RATE	Not Provided	2.01%	1.5%	1.41%	2.30%	2.81%
	ACTUAL DEFAULT RATE	Not Provided	0.96%	0.78%	0.55%	0.61%	0.13%

"The level of information does potentially mean that stock pickers can identify opportunities to outperform."

DEFINITIONS

The following are the definitions laid out by the P2PFA

Non-Performing Loan (or in Arrears):

- More than 45 days overdue in interest payment; or
- More than 45 days overdue with principal repayment; or
- Legal action for enforcement of the loan has commenced; or
- The loan is being or has been renegotiated with a borrower, or
- The loan has not otherwise been in full compliance. The amount of arrears is the amount overdue for payment in the first two cases above.

Capital Losses (Default):

- Any portion of a loan that has not been repaid, 120 days following the original loan repayment date;
- All costs incurred by the lender in relation to the enforcement of a Non-Performing Loan, where such costs are not recovered in full from the relevant borrower;
- Any loan amount where there is a reasonable expectation that the borrower is not going to repay the loan on the original repayment date (i.e. theborrower has gone bankrupt etc.)

Members are required to report on a 12 monthly calendar basis (January to December) the following:

• Actual arrears (as a percentage of all outstanding balances from loans made in the calendar year of the loan)

• Expected defaults (as a percentage of lifetime default rates of amount lent in the calendar year of the loan)

• Actual defaults (a percentage of the total lent by the platform in the calendar year of the loan).

SUMMARY OF DEFAULT RATE INFORMATION

The information here gives a good top level view of the platforms, and we think it may be satisfactory if your objective is to select a platform. A key metric might be the expected rate versus the actual rate.

Investors who want to be more active by picking their loans may want to delve deeper into their loan books and examine the variation in default rates by investment terms, credit rating and interest rates on offer – among other variables. The level of information does potentially mean that stock pickers can identify opportunities to outperform.

The move to standardise default rate reporting makes it easier to compare platforms and we expect that more meaningful comparisons will be drawn out as the platforms mature.

SURVEY RESULTS

With all of our previous Industry Reports we have conducted a survey of the main market participants - including financial advisers, wealth managers, professional intermediaries and investment providers, and platforms.

The adviser survey for this report posed us with a big challenge collecting responses as advisers have little to no (most likely no!) experience in this sector.

However, our intention was to build a picture of what efforts the alternative finance market have made to engage advisers and how much advisers understand alternative finance – so even negative adviser responses gave us important data points.

CONCLUSIONS

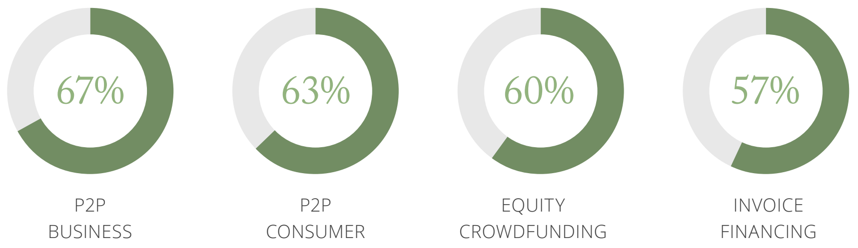
To be honest, we've only scratched the surface of what is possible with the loan book data. If and when other lenders reach the same size as the big three and also make their loan books available, it will mean that there is an extraordinary level of data available to retail investors to help them assess the performance of the platforms. How many of them have the time and inclination to examine the data is another question, but the intentions behind this initiative must be applauded. For those who don't want to dive into the data, the LARI is a useful indicator of top level performance.

ADVISER SURVEY

We had a total of 130 responses, from firms ranging in size from sole traders to a team of 35, and assets under management of £9 million to £500 million – so we believe we have captured a good representation of the adviser market.

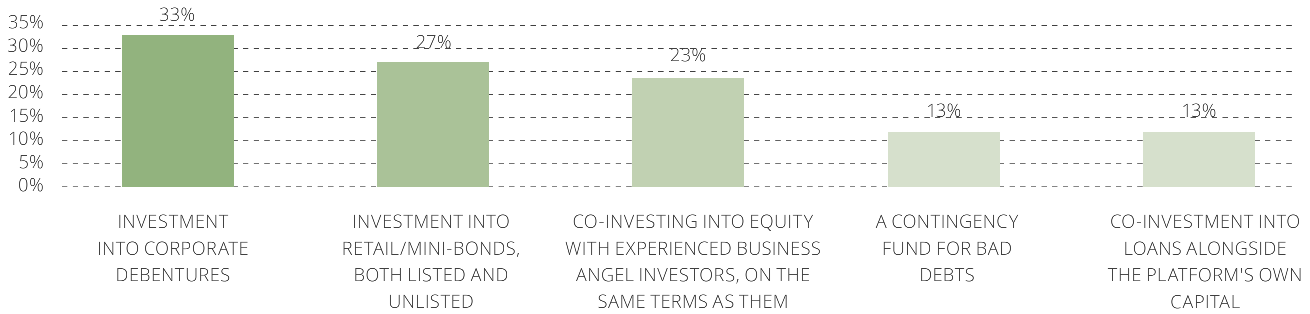
The survey consisted of 16 questions and took most respondents less than 5 minutes to complete.

Q. Are you aware of the following types of online alt fi platforms?



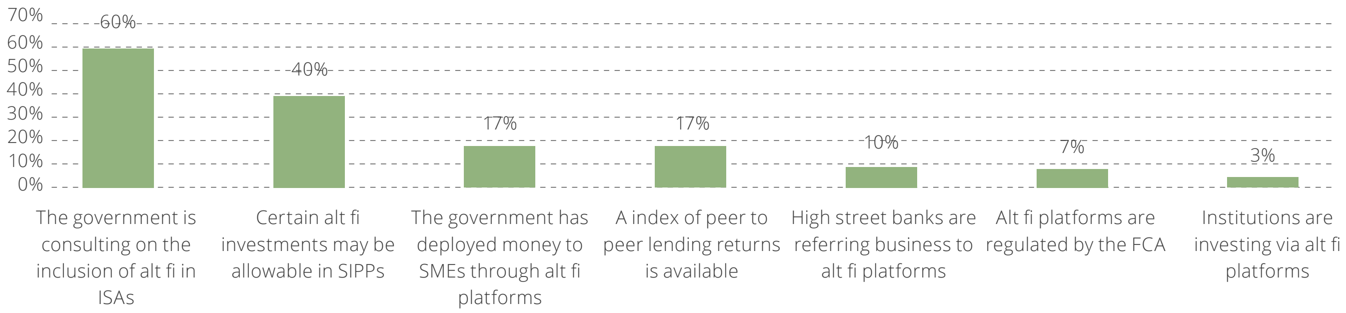
Over half of advisers were aware of the different types of alternative finance. Peer-to-business lending gets the most recognition (67% had heard of it) and invoice financing has the lowest level of awareness (57%).

Q. Are you aware of the following alternative finance models?



However, once we got beyond the headlines and started asking questions about the different operating models and investment options, levels of awareness dropped significantly. Investment into corporate debentures (33%) scored the highest – perhaps surprisingly as they are such a small part of the alternative investment universe, but we can speculate that the advisers we surveyed had come across them via more conventional investment channels. Only a small number of advisers were aware of significant risk-mitigants, such as contingency funds in peer-to-peer lending and co-investment in crowdfunding.

Q. Are you aware of the following?



Unsurprisingly, more advisers (60%) were aware of the headline grabbing news around peer-to-peer ISAs, and a significant minority (40%) were aware that it was SIPP acceptable – possibly due to their familiarity with SIPPs. However, the vast majority of advisers in our sample were not aware of some of the key milestones (and signs of a maturing sector) that the alternative finance industry has achieved to date. Most striking was the discovery that only 7% of advisers realised alternative finance was now regulated. If the alternative finance industry wants to engage advisers, then there is a lot of work to do to educate them about the sector.

Q. Do you expect alternative finance to fall within your advice process in the next 12 months?

Despite the pending introduction of the peer-to-peer ISA within coming months, only a small portion (**9%**) of respondents felt that this sector would fall within their advice process within the next 12 months. This result chimes with the one to the right – at the moment they are not being asked about alternative finance by their clients.

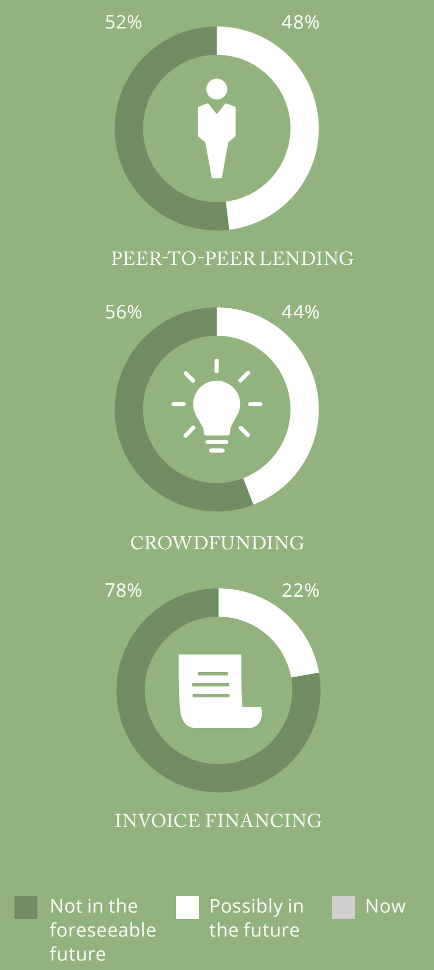
This was a qualitative question designed to help us understand what is holding the advisers back from participating in this sector. There were several responses calling for greater regulatory requirements and increasing research on the sector, and several responses were clear that no change would make them likely to recommend alternative finance at any point in the near future.

"At the moment, financial advisers are not being asked about alternative finance by their clients"

Q. Which of these have clients enquired about over the last 12 months?

Only a small portion of advisers have had their clients speak to them about alternative finance in the past 12 months.

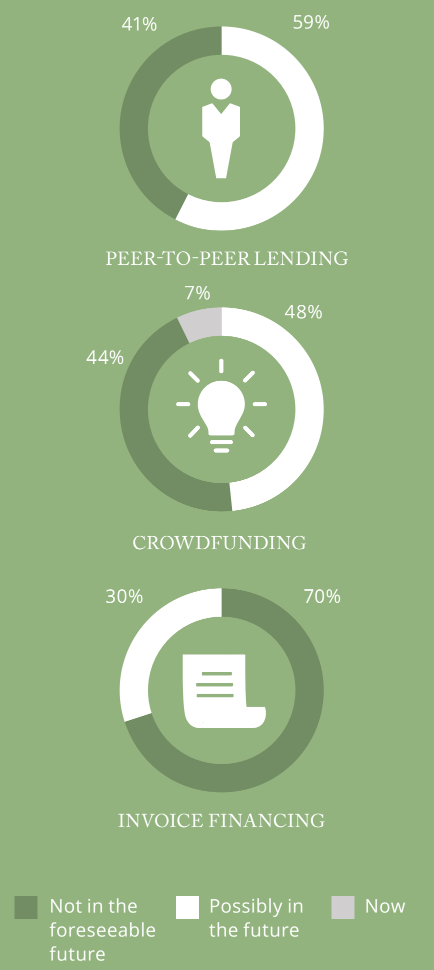
Q. Would you recommend clients invest in:



None of the respondents currently recommend investing in alternative finance to their clients.

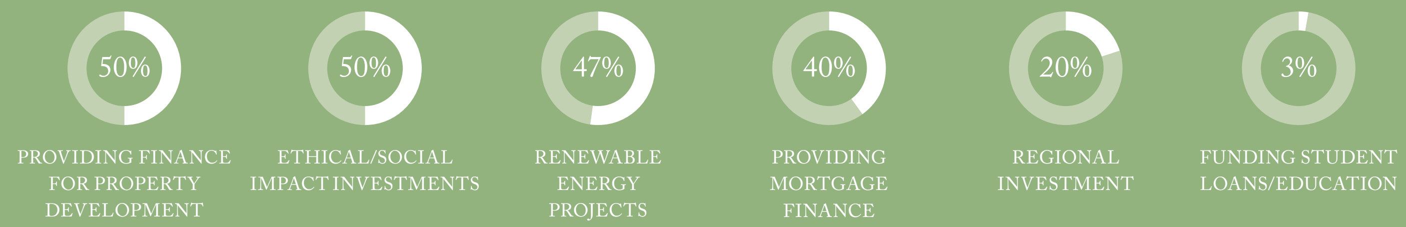
However an encouraging 48% and 44% would possibly consider recommending clients to invest in the future in peer-to-peer lending and crowdfunding respectively – we can conclude that a significant portion of advisers are understandably cautious and want to wait and see how the sector develops, but they retain an open mind.

Q. Would you personally invest in:



59% would possibly invest in P2P lending in the future, but **41%** stated that they would never personally invest in this sector. **7%** of advisers already invest in crowdfunding personally, with a further **48%** prepared to consider it in the future. Invoice financing was the least popular sector, with **70%** stating they would never consider it – but bear in mind that this sector also had the lowest levels of awareness. Perhaps advisers have had bad experience getting their own invoices paid?

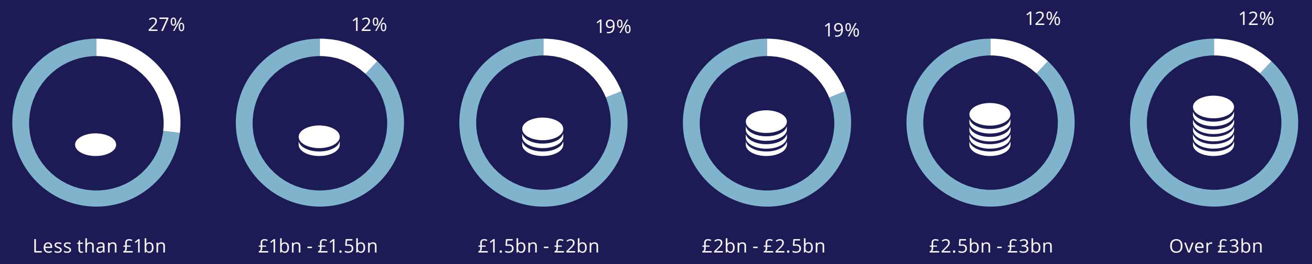
Q. Are you aware that some alt fi platforms specialise in the following areas



There were higher levels of awareness that the platforms specialised in different markets.

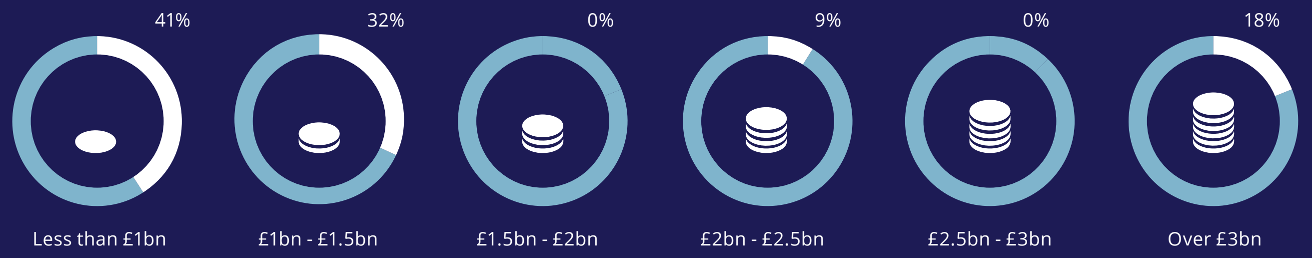
"40% of our sample would like to know more and be able to speak knowledgeably about alternative finance to their clients"

Q. How much money do you think has been invested in peer-to-peer lending in the UK?



According to AltFi Data, cumulative lending for peer-to-peer lenders has reached over £4 billion in the UK. Only 12% of respondents answered correctly, while many (27%) seemed completely unaware of the scale of the peer-to-peer lending market.

Q. How much money do you think has been invested in crowdfunding in the UK?



Just over £118 million has been invested through crowdfunding in according to AltFi data.

Q. Would you like to be in a position to speak knowledgeably to your clients about alt fi in the next 12 months?

40% of our sample would like to know more and be able to speak knowledgeably about alternative finance to their clients. Bearing in mind the results above, this is not necessarily with a view to making a recommendation, but whatever advisers think about the merits of the asset class, it makes sense to be able to discuss it knowledgeably.

* OTHER SURVEYS

There have been some other surveys of adviser attitudes to alternative finance. PollRight found that 70% of financial advisers foresee increased client risk appetite, while 45% believe the new ISA rules will ramp up interest in peer to peer lending.

Yorkshire Building Society found that just 4% of advisers had invested in the peer-to-peer space, while a further 14% would consider investing. The remainder, over 80%, wouldn't invest in the space, for now.

CONCLUSIONS

Based on the results from our sample, it appears that advisers have not really looked beyond the headlines that have been written about alternative finance in the mainstream press. While more than 60% of them had heard of the three main areas of alternative finance (peer-to-consumer lending, peer-to-business lending and equity crowdfunding) and were aware of the consultation on including peer-to-peer lending in ISAs, there was little awareness of the details beyond this.

It is impossible to escape the conclusion that a lack of knowledge about the different operating models, the innovations like contingency funds and developments such as regulation all contribute to advisers' reluctance to participate. But we will resist the temptation to over-egg this: alternative finance remains a new asset class and heavily regulated advisers are instinctively cautious - this will be as much a part of their reluctance as any lack of knowledge.

However, we do think that a longer track record for alternative finance, wider take-up from the public and greater awareness of developments within the industry will start to see advisers move from being sceptical, to being interested, and then finally to being engaged.

PLATFORM SURVEY

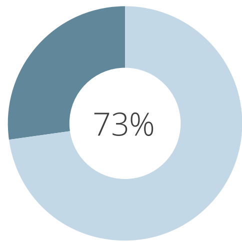
The survey comprised of 8 questions and we had responses from 15 platforms, including all of the biggest, top tier platforms operating in the UK.

They survey was designed to get a feel for how platforms are currently interacting with advisers, how well they understand the adviser community and what (if any) plans they had to develop distribution through advisers. We also asked questions to help us get a better understanding of factors affecting investors - such as secondary markets and institutional investment.

Q. What do you think are the biggest barriers that prevent advisers from recommending alternative finance investments?

Lack of awareness and **education** was thought to be the biggest barrier for advisers by most platforms. Regulations and concerns over compliance were a close second.

Q. Do you currently market your platform to financial advisers? If not, do you plan to in the future?



73% of platforms either already market to financial advisers, or plan to in the future. What form this marketing will take remains unclear, but based on our adviser survey (and the platforms' responses to the other questions) there will have to be a big educational effort to break down the educational barriers that are keeping many advisers from participating in the market.

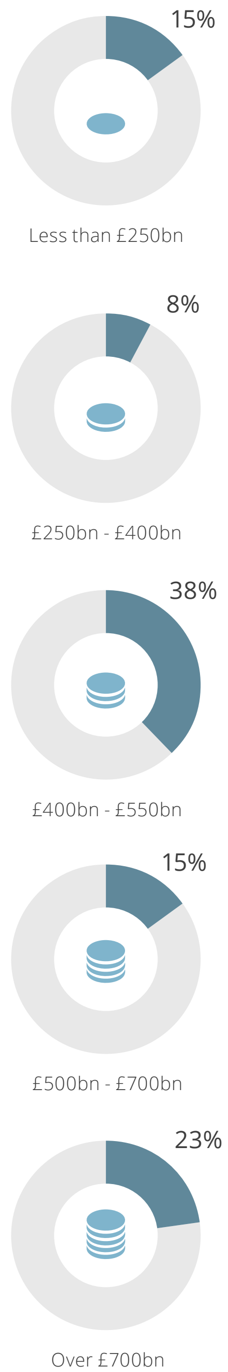
Q. Have you received any investments from institutional investors?

73% of the respondents have seen institutions invest via their platforms. This may reflect our sample, which was heavily weighted to the largest peer-to-peer lending platforms, who have received the most institutional investment to date.

If yes, approximately how much?

Some platforms were not willing to disclose this information. Among those that did respond answers ranged from as little as £100,000 to £20m and we know that on the biggest platforms it is much larger than this.

Q. What is your estimate of how many funds the UK financial advice community has under its control?



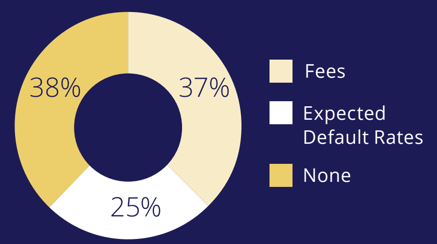
It's estimated that there is £590 billion in assets under the influence of advisers. 38% of platforms put the figure at just a little less than this, between £400bn and £550bn and 15% were in the right bracket. Platforms seem to have a good understanding of the size of the opportunity in the advised distribution channel.

"...the secondary markets are not very deep, and that investors should not rely on them as an easy exit route for the moment"

Q. If you operate a secondary marketplace, approximately how many loans or loan parts are sold each month and what is the value of your monthly transactions in the secondary marketplace?

Very few respondents chose to answer this question fully. Of the responses we did receive, the numbers ranged from 30 to 150 loans or loan parts each month, with values from £1,000 to £75,000 a month. Answers were very sparse and we do not feel this is a meaningful data point – and of course the numbers above are only really relevant in the context of the total size of the respondent's market. Our assumption is that the low level of responses indicates that the secondary markets are not very deep, and that investors should not rely on them as an easy exit route for the moment. However, the flow of information on this topic should start to improve soon – for example Funding Circle do publish the volume of loans traded on their secondary market (at the time of writing it is about £5 million a month).

Q. When advertising a likely return to potential investors, do you take into account:



This question is designed to gauge transparency – are platforms' communications "clear, fair and not misleading"?

Our view is that platforms should be stating expected returns net of fees and forecast default rates, but this is not standard practice. Only 25% of respondents take into account expected default rates and only 38% account for fees. However, many platforms do not charge fees to the investor (64% across the whole alternative investment market) so this may not apply to most platforms and can explain part of the response.

Q. How many investments have you had that have been made on the recommendation of a financial adviser (that you are aware of)?

The majority of respondents said zero, but on the positive responses the numbers ranged from two to over 100 investments and one respondent stated that 25% of all investments made on its platform were at the recommendation of a financial adviser. It is encouraging to see that some platforms have had the interaction with advisers already and although numbers are small, the market is growing and new developments with ISAs and SIPPs should slowly encourage more advisers to get involved.

CONCLUSIONS

The majority of the platforms we surveyed were either already marketing to advisers or planned to do so – some had already received investments from advised clients. They had a good understanding of the size of the opportunity and what advisers' barriers were likely to be. Our guess is that they will be very interested in the results of our adviser survey, and perhaps a little surprised at how little impact they have had on the advice community so far.

INVESTOR SURVEY

There has already been a lot of research into investors' levels of awareness of alternative finance and several surveys of investors' have already been done. We've summarised them here.

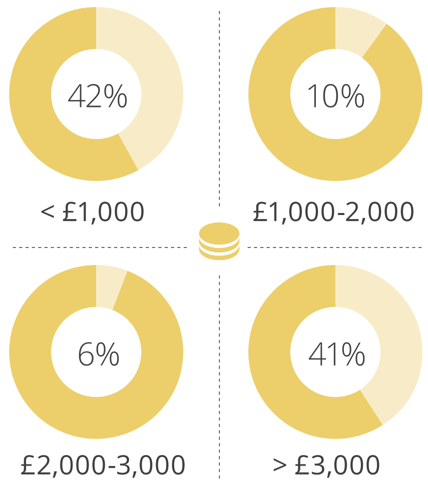
In 2013 Nesta and the University of Cambridge surveyed 2,000 individuals and found that 58% of those were aware of at least one form of alternative finance, but those that used alternative finance was still relatively low. In fact, only 14% of those that were aware of alternative finance actually invested in it - the majority via donation/reward based crowdfunding or peer-to-peer consumer lending platforms.

60% of all respondents believed they were "unlikely" or "very unlikely" to begin or to continue using an alternative finance platform in the near future. 56% felt that alternative finance was too risky. Respondents that were aware of alternative finance but who had not invested to date stated the three most important factors that would change their mind were better returns (72%), more transparency and understanding about where their money is going (62%) and if they could receive better guidance on how to use the different platforms (62%).

Wellesley & Co. carried out a survey of over 2,000 people in 2014 that revealed several key trends within the peer-to-peer lending market. The average amount invested is £2,717, with men typically investing more than women (£3,432 vs £1,748). The survey also highlighted three key changes that would cause current peer-to-peer investors to increase their investments – inclusion within an ISA (47%), better interest rates (47%) and clearer regulation (34%). Those that did not already invest in peer-to-peer lending felt similarly, with clearer regulation (19%) and better interest rates (21%) the key changes that would make investment more attractive.

MONEY LENT BY INDIVIDUAL LENDERS:

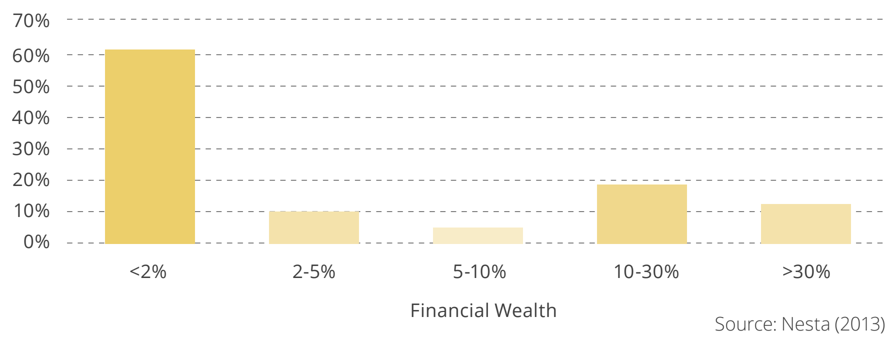
Nesta surveyed 630 lenders on Funding Circle in April 2013.



Source: Nesta (2013)

Here we see that the majority investors are contributing less than £1,000 (42%) or greater than £3,000 (41%)

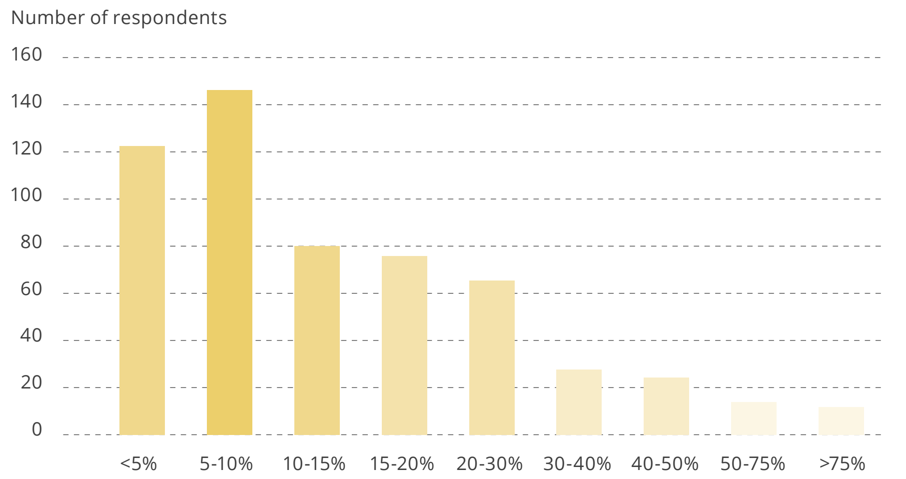
PERCENTAGE OF FINANCIAL WEALTH LOANED THROUGH FUNDING CIRCLE



Source: Nesta (2013)

Over 60% of investors on Funding Circle invested less than 2% of their financial wealth on the platforms. This is a good indication that investors are being cautious, however there where a large number of investors investing over 10% and over 30% of their financial wealth, which is somewhat worrying if they do not have significant capacity for loss.

WHAT % OF YOUR PORTFOLIO COULD BE MADE UP OF YOUR FUNDING CIRCLE INVESTMENTS?

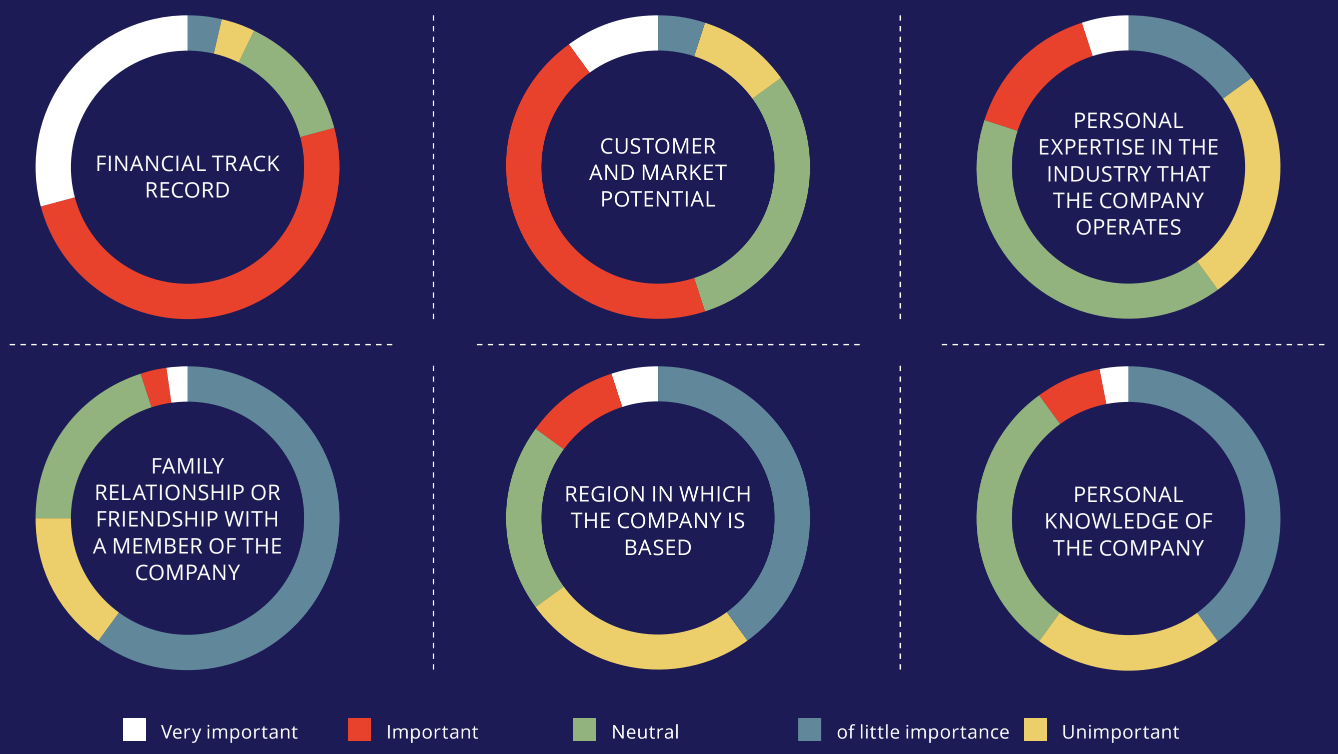


Source: Nesta (2013)

Again, this chart demonstrates the optimism Funding Circle investors have about the future. Most investors felt that between 5% and 10% would be a suitable portfolio allocation, with some respondents even stating over 75% of their portfolio. Perhaps they know something we don't...

"...the most important factors in investors' decision to lend to a particular company were the financial track record, market potential and the company's personal expertise in the industry that the company operates"

Q. How important are the following factors in your decision to lend money to a particular company?



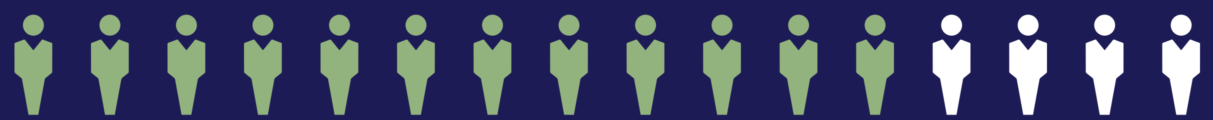
Source: Nesta (2013)

Lastly, looking at the most important factors in investors' decision to lend to a particular company were the financial track record, market potential and the company's personal expertise in the industry that the company operates.

Yorkshire Building Society has also surveyed consumers, discovering that 42% claim to be familiar with the concept of peer-to-peer lending. Of those people, 60% were unaware that peer-to-peer investments are not protected by the FSCS – perhaps a significant finding, although we suspect that awareness of the FSCS could be low in general.

Q. Do you expect to increase the amount you lend through Funding Circle in the coming year?

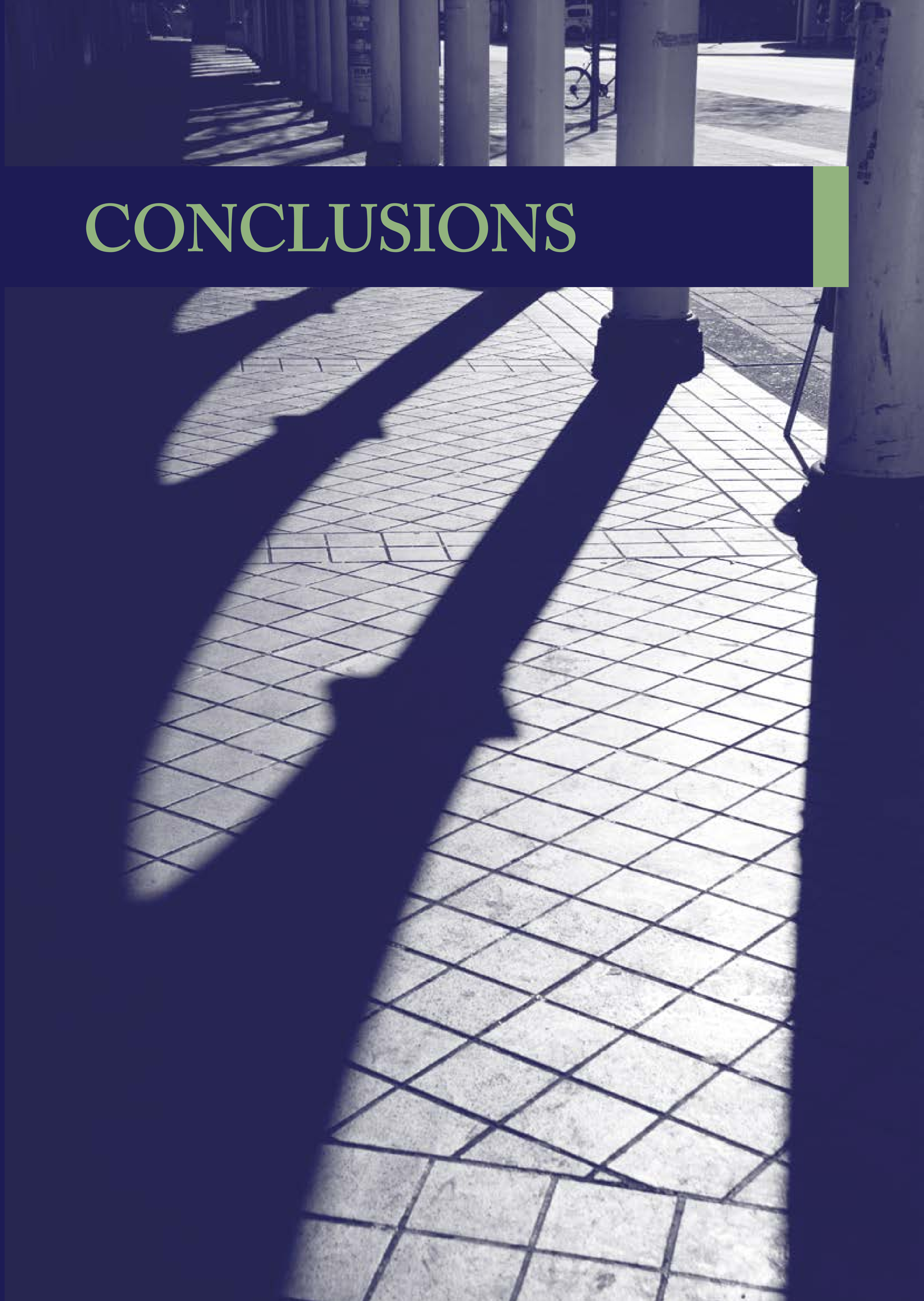
Investors from Funding Circle seem to feel optimistic about their peer-to-peer lending future, with 75% stating they expect to increase the amount they lend through the platform.



CONCLUSIONS

These investor surveys can be read in conjunction with the NESTA / University of Cambridge survey results we included earlier. We think that the University of Cambridge data is the most credible at the moment (rather than surveys by the investment providers). Taken as a whole, the investor survey data presents a mixed picture – but one common theme is low levels of awareness, which could be taken as an indication that there is a lot more growth to come in the sector, and high levels of enthusiasm among the most engaged investors.

CONCLUSIONS



CONCLUSIONS & OUTLOOK

READERS

We hope the report has been insightful. We also hope that we've managed to lift the lid on a new and fast growing asset class and give advisers, SIPP operators, wealth managers and other retail financial service professionals some food for thought. If you've read the whole thing through from cover to cover, you'll now be able to talk knowledgeably about it to your clients, have meaningful discussions with your peers, and (perhaps most importantly) be able to make an informed decision about what you want your level of involvement to be.

ADVISERS AND THE ALTERNATIVE FINANCE INDUSTRY

Our surveys tell us that advisers are wary of alternative finance for the moment, but we suspect that a lot of that is down to unfamiliarity. For many, their perception is that this alternative finance is high risk, unproven, unregulated activity. They're not aware of key milestones and developments such as contingency funds, FCA regulation, meaningful market data, the mandatory referral scheme and the inflow of institutional money. We're not sure that some of them are even making a distinction between crowdfunding and peer-to-peer (marketplace) lending.

So one of the tasks facing the alternative finance industry is to educate advisers and other financial services professionals about their sector. Now this is no joke: advisers are risk averse when it comes to their client's money and will take some convincing - and it's not as if there is a shortage of other investment assets competing for their attention. But we think that there should be benefits for both sides of the equation if alternative finance and advisers can play well together. Advisers control a huge pool of money that could be put to work via the platforms - and the platforms can offer a near-cash option that is attractive in today's low-interest rate environment, the possibility of better risk-adjusted returns, additional diversification and lower-entry levels to EIS and SEIS benefits.

INVESTING IN ALTERNATIVE FINANCE

We think the best approach is to build a diversified lending portfolio - diversified across platforms, durations, interest rates, business and consumer lending, secured and unsecured loans. This kind of portfolio can be built on a DIY basis, or achieved by investing in one of the handful of new funds that have sprung up. The portfolio can be held in either an ISA (directly from 2016 or right now in the case of funds) or a SIPP wrapper and can also help address non-financial objectives by giving consumers a higher degree of control over where their money is put to work.

These non-financial benefits also speak to equity crowdfunding. Investing in this segment of the alternative finance industry is much more risky, but the low entry levels are opening this asset class up to retail investors in a meaningful way and many of the current investors enjoy supporting businesses they like the look of. The prospect of crowdfunding platforms tying up with traditional brokerages and participating in every stage of fundraising activity is very exciting. Debenture and mini-bonds - securities that share some characteristics of both lending and equity - are also an exciting development. Some of these look very risky, but some look like very good investment options.

OUTLOOK

The influx of institutional money is currently a big driver for the industry. This brings risks with it as well as benefits, but overall we think it can only be net positive - it will give platforms the scale they need to succeed, help to plug the funding gap for SMEs and bring more rigour to the sector. Inevitably though, there will be winners and losers and investors might well feel like they should stand clear until the likely shakeout has occurred.

Another big driver for the industry right now is the prospect of big IPOs. We hope this does not incentivise platforms to sacrifice quality, or their principles, as they chase higher volumes in the hope of getting to the IPO stage.

Nearly everybody is predicting that a large platform will go bust in the near future as well - we suspect that this prediction is based on the law of averages, rather than any empirical evidence, or just the desire of commentators to be able to point to their prediction if it does happen and claim startling powers of foresight. Well, shame on us, but we're no different. With so many new businesses in a crowded space, it's kind of inevitable that one of them will make some critical errors - then the contingency funds, run-off plans and strength of the underlying contracts will be tested. Useful lessons will be learned, for the benefit of everybody else.

Overall though, the outlook for the sector is positive - despite its rapid growth it still only accounts for a small percentage of investment activity here in the UK and levels of penetration and awareness among consumers and businesses are still low. There is a lot of growing room! And the sector DOES offer a better deal to consumers, more transparency and an alternative to the banks and mainstream investments.

It's new, it's exciting and it will experience growing pains - but it can't be ignored any more.

SWOT ANALYSIS

STRENGTHS / WEAKNESSES

ALT FI MARKET   P2P LENDING SPECIFIC   CROWDFUNDING SPECIFIC

OPPORTUNITIES / THREATS

GLOSSARY OF TERMS

Alternative Finance (Alt Fi)	Form of financial service that differs from mainstream equity and debt in the sense that the services are provided outside traditional banks.
Alternative Investment Market (AIM)	A sub-sector of the London Stock Exchange that lists shares of smaller companies with more flexible regulatory requirements
Business Property Relief (BPR)	A relief from inheritance tax on qualifying business assets between the rates of 50-100%.
Crowdfunding (CGT)	The practice of funding a project or venture by a large group of individuals. Typically does not require a large amount of capital to be invested.
Enterprise Investment Schemes (EIS)	A series of UK tax reliefs originating in 1994 with the aim to encourage investments in small unquoted companies in the UK.
Financial conduct Authority (FCA)	The financial regulatory body in the UK that operates independently of the government.
Her Majesty's Revenue and Customs (HMRC)	A non-ministerial department of the UK Government responsible for the collection of taxes, the payment of some forms of state support, and the administration of other regulatory regimes including the national minimum wage.
High Net Worth Investors (HNW)	Investors with over £200k in investible assets or an annual income in excess of £100k per annum.
ICAP Securities and Derivatives Exchange (ISDX)	An independent stock exchange in the UK that lists smaller and growing companies.
Individual Savings Account (ISA)	A retail investment scheme which enables individuals to hold cash, shares and unit trusts with tax free growth.
Mini-Bond	A debt instrument issued by smaller companies that pays the lender interest and principal upon maturity.
Open-Ended Investment Companies (OEICs)	A type of open-ended collective investment scheme with a reasonable expectation of liquidity.
Peer-to-Peer Finance Association	Represents a large majority of the alternative financial services market in the UK including peer-to-peer lending to consumers as well as invoice financing
Peer-to-Peer Lending	The practice lending of money to individuals or businesses without the use of a traditional financial intermediary. Includes peer-to-consumer lending, peer-to-business lending and invoice financing.
Net asset value (NAV)	The value of an asset after deduction of any liabilities.
Professional Indemnity Insurance (PI)	PI covers costs and expenses incurred in your legal defence, as well as any costs that may be awarded, if you are alleged to have provided inadequate advice, services or designs that cause your client to lose money.
Seed Enterprise Investment Scheme (SEIS)	A series of UK tax reliefs launched in 2012 to encourage investors to finance high-risk startups. Different from EIS due to the amount of tax relief received from investing.
Self-Invested Personal Pension / Small Self-Administered Scheme (SIPP/SSAS)	UK government-approved personal pension schemes that enables individuals to make independent investment decisions.
Small and Medium-Sized Enterprise (SME)	A company with fewer than 500 employees and an annual turnover of less than £100 million
United Kingdom Crowdfunding Association (UKCFA)	An association that promotes crowdfunding for UK businesses, projects and ventures

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PLATFORM REGISTER

PEER-TO-PEER LENDERS

The data is as of November 2015

PLATFORM DETAILS		LENDING MARKETS OFFERED		SECURITIES			DETAILS		INVESTMENT BASICS		INVESTMENT OPTIONS						ALTFI DATA VOLUMES		
											"PRODUCTS"								
PLATFORM	INCEPTION DATE	P2B	P2C	PROVISION FUND	SECURED LENDING	UNSECURED LENDING	INSTITUTIONAL LENDERS	SPECIALISM	CHARGES TO LENDER	MINIMUM INVESTMENT	PRODUCT NAME	MIN INVEST	GROSS INTEREST	"AUTOBID" FUNCTION	"REINVEST" FUNCTION	SELF INVEST	MARKET SHARE (<3 MONTHS)	CUMULATIVE TOTAL	YEAR TO DATE
ArchOver	2014	✓	x	x	✓	x	✓	ASSET BACKED	x	£1,000		£1,000	7.00%	✓	x	✓	0.31%	£8,475,000	£6,595,000
assetz	2013	✓	✓	✓	✓	x		GENERALIST	x	£0.01		£20	9.00%	✓	✓	✓	0.66%	£83,053,044	£27,404,736
FOLK 2 FOLK Local Secured Lending	2013	✓	✓	x	✓	x		REGIONAL	x	£25,000		£25.000	7.00%	x	x	✓	1.60%	£74,902,550	£34,065,400
Funding Circle	2009	x	✓	x	✓	✓	✓	SME	✓	£20	A^+	£20	8.20%	✓	x	✓	20.52%	£908,626,520	£431,978,040
											A^+	£20	10.30%						
											B	£20	10.36%						
											C	£20	11.40%						
											C^-	£20	12.90%						
fundingknight	2013	x	✓	x	✓	x	✓	SME	✓	£25		£25	10.58%	✓	x	✓	0.71%	£27,066,500	£17,613,500
FundingSecure	2013	✓	x	x	✓	x		ASSET BACKED	x	£25		£25	12.70%	x	x	✓	0.77%	£16,224,433	£12,947,530
LANDBAY®	2014	x	✓	✓	✓	x	✓	PROPERTY	x	£100		£100	4.20%	x	x	x	0.82%	£13,946,030	£12,181,545
lendable	2014	x	✓	x	✓	✓	✓	GENERALIST	x								0.23%	£7,205,991	£6,294,140
LENDING WORKS	2014	x	✓	✓	x	✓		GENERALIST	x	£10	3 years	£10	5.10%	✓	✓	✓	0.57%	£16,290,975	£11,602,076
											5 years	£10	6.20%						
marketinvoice	2011	✓	x	x	✓	x	✓	ASSET BACKED	✓	£50,000		£50,000	14.53%	✓	x	✓	12.07%	£558,568,550	£245,144,672
Money & Co.	2014	✓	x	x	✓	x		SME	✓	£100		£10	10.00%	x	x	✓	0.10%	£6,899,300	£3,494,300
Platform Black	2012	✓	x	x	✓	x	✓	GENERALIST	✓	£50,000		£50,000	15.00%	x	x	✓	1.34%	£105,550,850	£22,746,735
Proplend Secured P2P Lending	2014	✓	✓	✓	✓	x	✓	COMMERCIAL PROPERTY	✓	£5,000	Tranche C	£5,000	10.44%	x	x	✓		£7,620,500*	£6,513,500*
											Tranche B	£5,000	8.30%						
											Tranche A	£5,000	6.98%						

The platforms included on the register are those that are included within the Liberum AltFi indices.
These platforms were not chosen for any particular commercial reason.

*Data provided by Proplend

PLATFORM REGISTER

The data is as of November 2015

PLATFORM DETAILS		LENDING MARKETS OFFERED		SECURITIES			DETAILS		INVESTMENT BASICS		INVESTMENT OPTIONS						ALTFI DATA VOLUMES		
											"PRODUCTS"								
PLATFORM	INCEPTION DATE	P2B	P2C	PROVISION FUND	SECURED LENDING	UNSECURED LENDING	INSTITUTIONAL LENDERS	SPECIALISM	CHANGES TO LENDER	MINIMUM INVESTMENT	PRODUCT NAME	MIN INVEST	GROSS INTEREST	"AUTOBID" FUNCTION	"REINVEST" FUNCTION	SELF INVEST	MARKET SHARE (<3 MONTHS)	CUMULATIVE TOTAL	YEAR TO DATE
RateSetter	2010	√	√	√	√	√	√	GENERALIST	x	£10	1 month	£10	3.10%	x	x	x	19.27%	£874,423,150	£430,512,846
											1 year	£10	4.40%						
											3 years	£10	5.70%						
											5 years	£10	6.70%						
RELENDEX	2013	√	x	x	√	x		PROPERTY	√	£500		£500	8.00%	√		√	0.00%	£4,911,000	£1,686,000
Saving Stream	2013	√	x	√	√	x	√	PROPERTY	x	£100		£1,000	12.00%	x	x	√	2.69%	£67,442,807	£52,507,500
ThinCats	2011	√	x	x	√	x	√	SME	√	£1,000		£1,000	10.57%	x	x	√	1.68%	£135,179,000	£46,796,000
Wellesley & Co.	2013	√	x	√	√	x		SME	x	£10	18 months	£10	4.00%	√	x	x	2.93%	£275,823,144	£132,259,879
											3 years	£10	4.75%						
											5 years	£10	5.50%						
											30 days	£10	3.50%						
zopa	2005	x	√	√	x	√	√	GENERALIST	x	£10	3 years	£10	3.80%	x	√	x	22.63%	£ 1,153,213,753	£909,697,615
											5 years	£10	5.00%						

The platforms included on the register are those that are included within the Liberum AltFi indices.
These platforms were not chosen for any particular commercial reason.

PLATFORM REGISTER

CROWDFUNDING PLATFORMS

The data is as of November 2015

PLATFORM DETAILS		PRODUCTS OFFERED				DETAILS			INVESTMENT BASICS		INVESTMENT OPTIONS		ALTFI DATA VOLUMES		
PLATFORM	INCEPTION DATE	EQUITY	MINI-BONDS	DEBENTURE	FUND	NOMINEE ACCOUNT	VALUATION (COMPANY/ INVESTOR LED)	SPECIALISM	EIS / SEIS	PRE EMPTION AND/OR TAG ALONG RIGHTS	CHARGES TO LENDER	MINIMUM INVESTMENT	MARKET SHARE (LAST 3 MONTHS)	CUMULATIVE TOTAL	YEAR TO DATE
abundance.	2011	x	x	√	x	x	INDEPENDENT VALUATION	RENEWABLE ENERGY	x	N/A	x	£5	0.09%	£11,853,503	£3,355,862
CrowdBnk Adventure Capital	2011	√	√	x	x	√	COMPANY LED	SME	√	x	x	£10	0.00%	£3,675,359	£1,571,999
crowdcube	2012	√	√	x	√	√	COMPANY LED	SME	√	PRE-EMPTION ON A SHARES	x	£10	0.18%* 84.37%	£10,368,500* £102,388,913	£5,840,000* £60,364,211
SYNDICATE ROOM	2013	√	x	x	x	√	INVESTOR LED	SME	√	√	x	£1,000	32.97%	£38,878,632	£22,403,247
ukbondnetwork	2012	x	√	x	x	x	COMPANY LED	GENERALIST	x	N/A	x	**£5,000**	0.14%	£5,581,000	£2,315,000
VENTURE FOUNDERS	2014	√	x	x	x	√	INVESTOR LED	SME	√	√	√	**£1,000**	**	**	**

*Crowdcube mini-bonds are classified under peer-to-business lending on the Liberum AltFi Indices
** VentureFounders does not currently supply data for tracking by AltFi Data

CPD AND FEEDBACK

CONTINUING PROFESSIONAL DEVELOPMENT (CPD)

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Members of these professional organisations represent the majority of the insurance and financial services industry.

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The review process included an assessment of the technical accuracy and quality of the material against CPD Accreditation standards. Achieving the recognised industry standard afforded by these organisations for this report, and our training, demonstrates our commitment to delivering only balanced, informative and high quality content to the financial services and investment community.

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Intelligent Partnership actively welcomes feedback, thoughts and comments to help shape the development of this industry report, with a particular interest on the topics readers would like to be covered in more detail in interim and future annual reports.

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Feedback can be given on the website or via email:

intelligent-partnership.com/feedback

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Participation and feedback are gratefully received.

ENDORSED CPD PROVIDER

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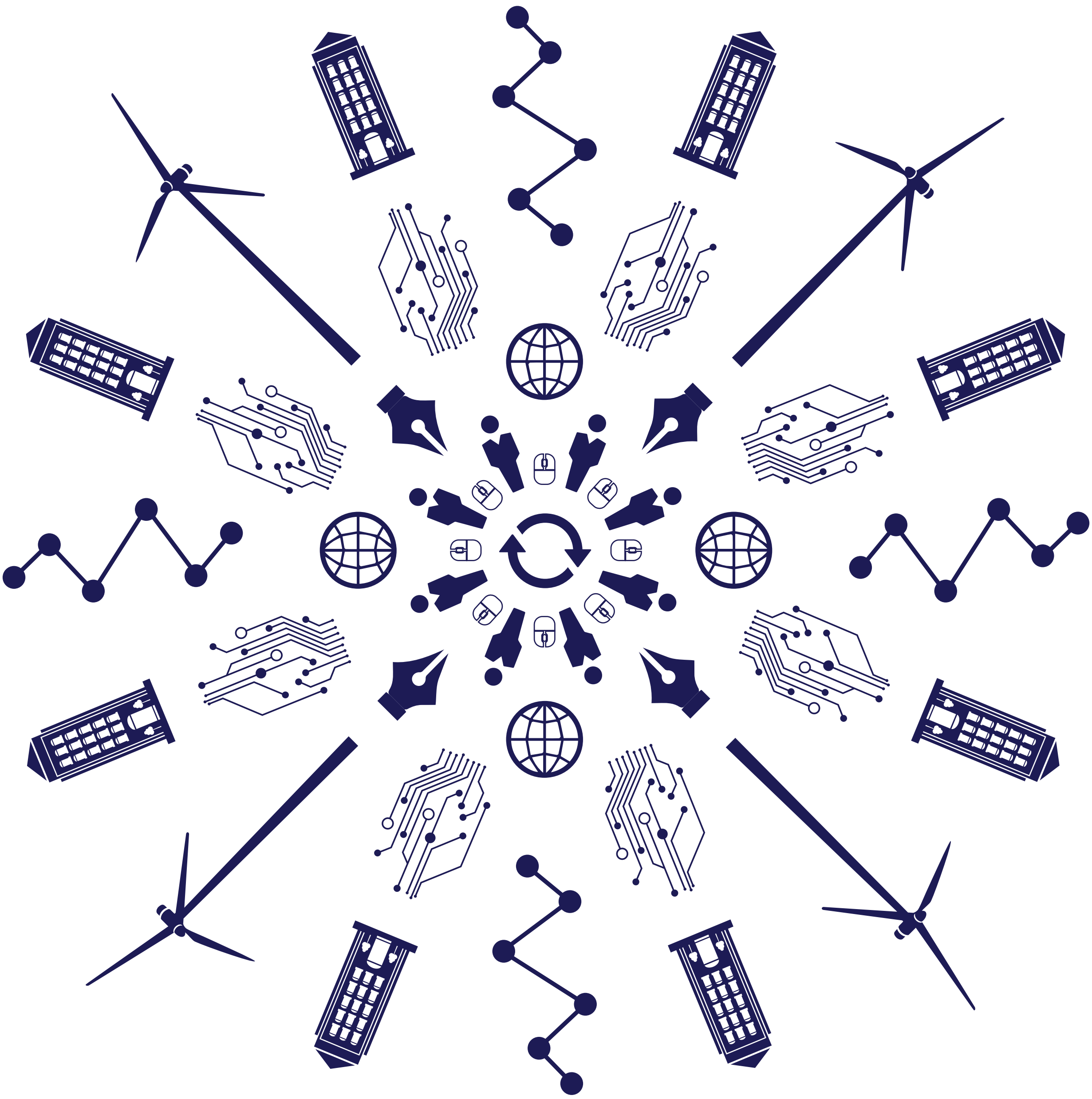

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