codat | Industry insider series

CENSUSWIDE
THE RESEARCH CONSULTANTS

The state of business lending

How economic shifts are influencing the business priorities and product strategies of fintech lenders

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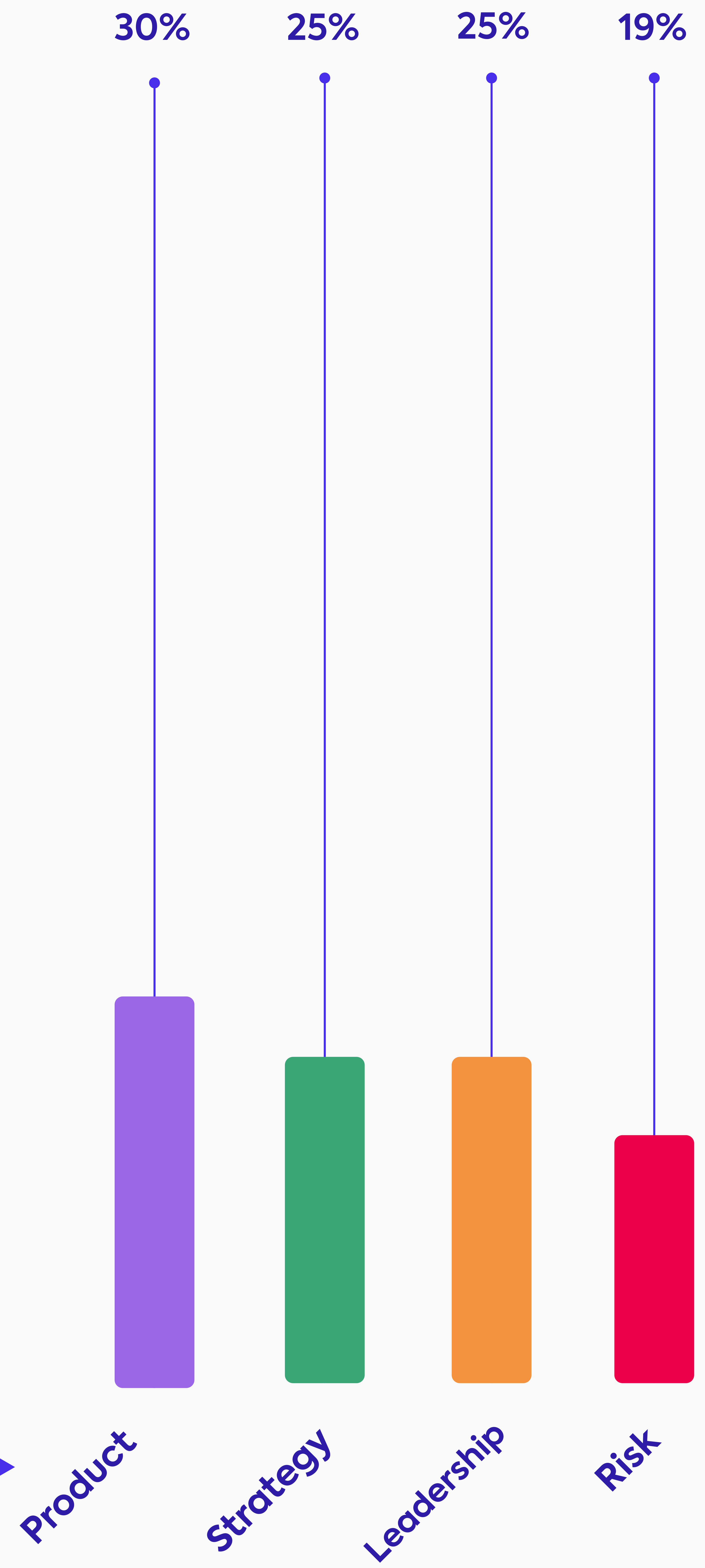
About the report

For the first report in our Industry insider series, we examine the challenges faced by non-bank lenders in the UK and USA. With the help of global research company Censuswide, we spoke to 115 senior stakeholders from product, risk, strategy, and leadership at non-bank lenders to understand the state of play, the barriers to growth, and precisely how these firms are adapting their product and business strategies to the current conditions.

The survey was carried out online by Censuswide between the 25th of July and the 1st of August 2023. Censuswide follows the ESOMAR principles, an international code for market and social research.

Who we spoke to



Q0. Qc. What department do you work in? (114 People surveyed)

Executive summary

1. Times are tough for lenders, but there are reasons to remain positive

79% of non-bank lenders say the economy is hurting their business. However, 40% have experienced growth in the last 12 months, albeit at a slower rate than other industries we surveyed in this series.

The data suggests several reasons to maintain a positive outlook. For instance, 1 in 5 lenders plan to expand to new geographies, and 17% plan to expand their teams in the next 12 months.

2. Rising interest rates are at the root of their challenges

Many of the challenges encountered by lenders can be traced back to increased interest rates.

Lenders are heavily reliant on capital to lend, but VC firms are exercising extreme caution. There's still some capital out there, but only a quarter are looking to raise it.

Lenders are struggling with rising cost of capital, and attempts to pass these expenses onto customers have resulted in reduced demand, something that 22% of lenders identified as their biggest barrier to growth.

In this climate, deposit-accepting banks have a competitive advantage over lenders due to their access to cheaper capital. As a result, almost 1 in 5 lenders consider increased competition from incumbent players to be their main challenge, while 26% of US lenders view their lack of product-market fit as a major obstacle.

3. Efficiency gains are imperative

Economic instability has led lenders to increase their focus on core business while cutting costs. Long-term survival is the name of the game, with 45% of US lenders having decreased their burn rate in the last year. Methods for achieving this tend to involve discontinuing low-margin product lines, slashing office expenses, and reducing headcount. When it comes to product priorities, increased efficiency is top of mind for 64% of lenders on both sides of the Atlantic.

4. As defaults rise, lenders plan to make smarter use of data

Defaults are up, and more than half of lenders say demand for credit is rising. As a result, lenders are finding ways to protect profits, tighten their belts, and continue to serve their customers. For example, 15% are focusing on reducing risk for new customers while 12% are doing the same for existing customers. 34% are prioritizing reducing the probability of default through better use of data.

5. Lenders are addressing market challenges by launching new products

Overall, expanding to offer new lending products is the top product development priority for many lenders. This is reflective of the fact that some identified a lack of product-market fit as a central challenge. Particularly popular in the US, it may be linked to the opening up of the Small Business Administration's popular lending program to fintechs.

6. Industry specialization is more important than ever

In an effort to ensure efficiency, lenders are specializing in specific industries and moving away from areas lacking strong demand. Focusing on specific verticals makes customer acquisition more cost-effective and the product more appealing to particular niches. This strategy is especially powerful in the lending space, where the structure of credit product needs to fit the business model. For example, a merchant cash advance caters well for eCommerce businesses, whereas asset-based finance would be more appropriate for a manufacturing business.

Part 1

The changing landscape

The higher interest rate environment continues to present real challenges for non-bank lenders and shows no signs of letting up. Although inflation continues to fall, times remain tough, with neither the Bank of England nor the Federal Reserve ruling out further interest rate hikes.

Relying on raising capital from external investors or a partner bank to lend, non-bank lenders are facing significantly higher costs of capital which they must pass on to borrowers.

At the same time, although the appetite for capital remains high, defaults are also on the rise as small businesses struggle to keep up with rising costs.

Despite the challenging macroeconomic climate, there are reasons to be positive. Fintechs are agile businesses, built to adapt and grow in the face of uncertainty. 40% still reported growth in the last 12 months, and a proportion are still making plans to grow the size of the team (17%) and expand to new geographies (19%) in the next year.

Our research shows that these five headline trends are shaping non-bank lending right now:

Economic conditions are tough:

79% of lenders say the economy has had a negative impact on their business over the last 12 months

There are still clear signs of growth:

40% of lenders say their business has grown in the last 12 months

Demand for credit is rising:

51% say they're seeing an increase in the number of applications, largely driven by US respondents

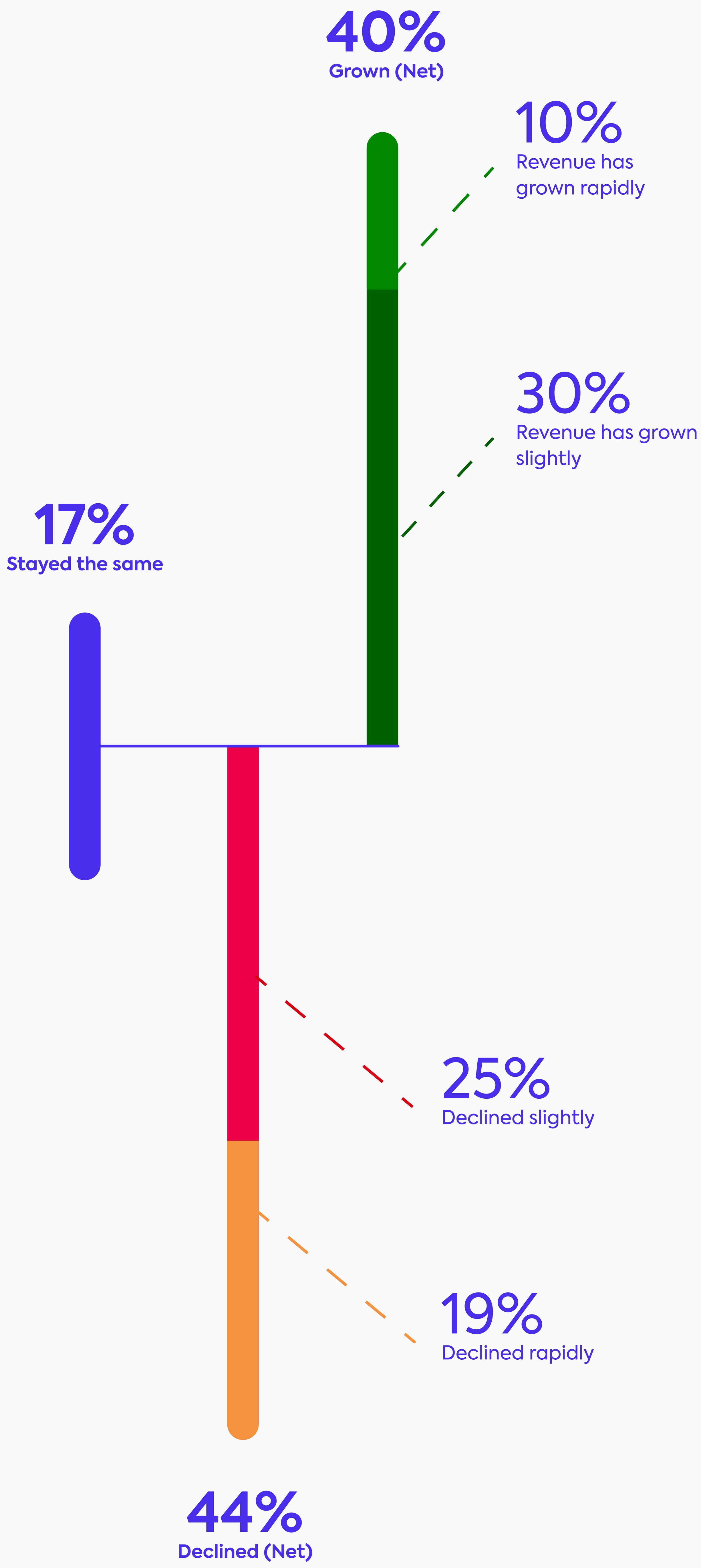
But defaults are up too:

41% reported an increase in loans left unpaid by borrowers

Lenders are adapting their business models and products:

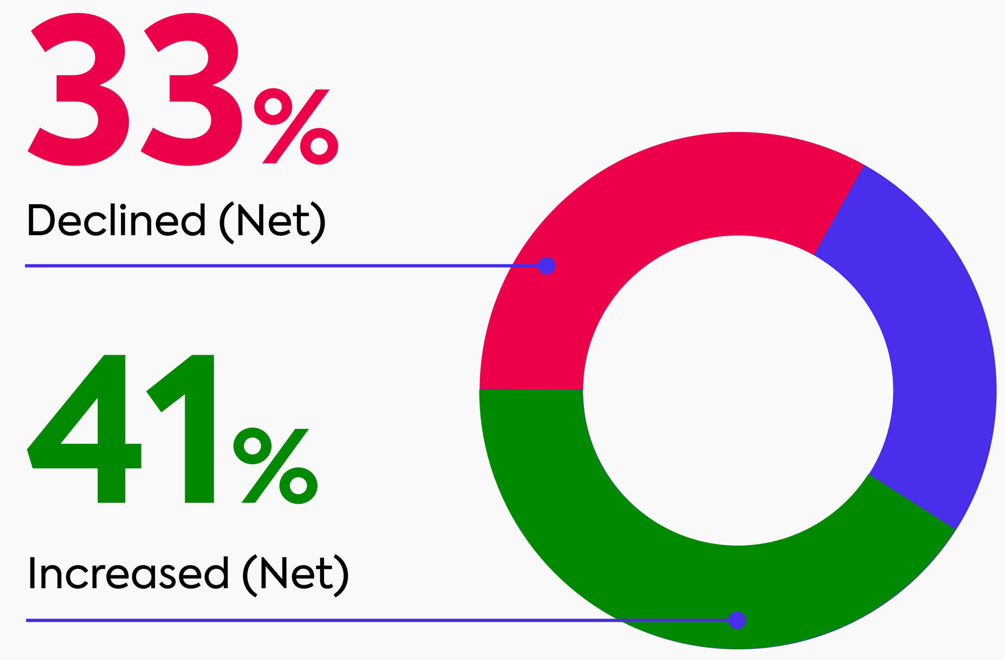
53% are launching new products, and 38% are specializing in a specific industry or industries

Business growth in the last 12 months



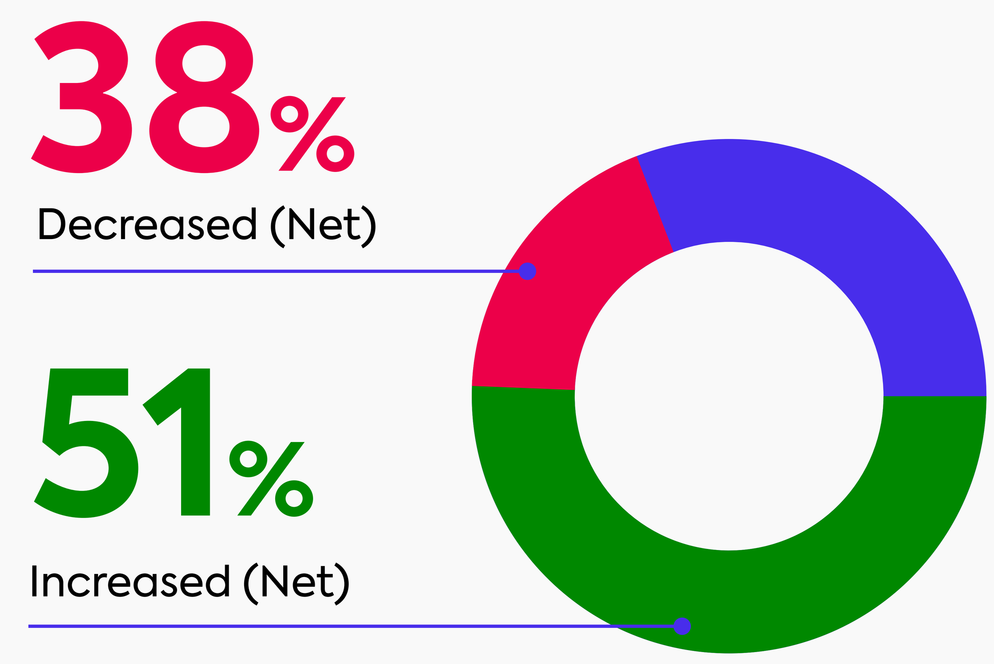
Q1. How, if at all, has your business grown over the last 12 months?

Default rate



Q14. How, if at all, has your default rate changed over the last 12 months?

Number of applications



Q18. How, if at all, has the quality and quantity of applications you receive changed in the last 12 months? Quantity

How is this playing out?

The stats paint a complex picture. Businesses need money for working capital, but they're finding it harder to get. Lenders are in a similar position: they're reliant on external capital to fuel their loan initiatives, which is becoming scarce. And with more businesses defaulting, lenders need to reduce risk by tightening their criteria.

The central banks have shared similar findings. According to the Federal Reserve, half of American banks adjusted requirements for commercial and industrial loans in Q3 of this year. The Bank of England found that default rates on loans to both small and medium-sized corporates increased in Q1, with no improvement in Q2.

But even with stricter criteria and fewer borrowers, the outlook remains positive. For instance, while lending platform Funding Circle isn't seeing the numbers it did during the height of government-backed schemes, its more "prudent approach to originations" still facilitated over £1 billion of funding in 2022.

Part 2

The barriers to growth

The rise in interest rates is presenting challenges for non-bank lenders on multiple fronts. Some of the most common barriers to growth cited by lenders were reduced customer demand and lack of product-market fit, both of which are likely connected with the higher cost of borrowing that they have had to pass on to customers.

At the same time, lenders are at an increased disadvantage compared to incumbent banks. Since most banks have access to deposits, they can absorb rate changes and undercut digital players on this front. As a result, the gap between fintechs and legacy banks may be widening once again. Overall, 63% of top barriers to growth cited by lenders can be connected with interest rate rises.

This melting pot of factors is seriously impacting the bottom line for lenders: 61% say revenue has either declined or stayed the same over the last 12 months. The decline is more pronounced in the UK, with half of non-bank lenders saying that revenue fell compared to 40% of their American counterparts. The main barriers to growth for non-bank lenders can be summarized as follows:

Reduced demand:

22%
say the economy has affected demand for alternative funding, despite the increase in demand for credit overall

Weak product-market fit:

19%
ascribe their growth difficulties to a lack of product-market fit, likely connected with the fact that loans have become more expensive for customers

Competition with incumbents:

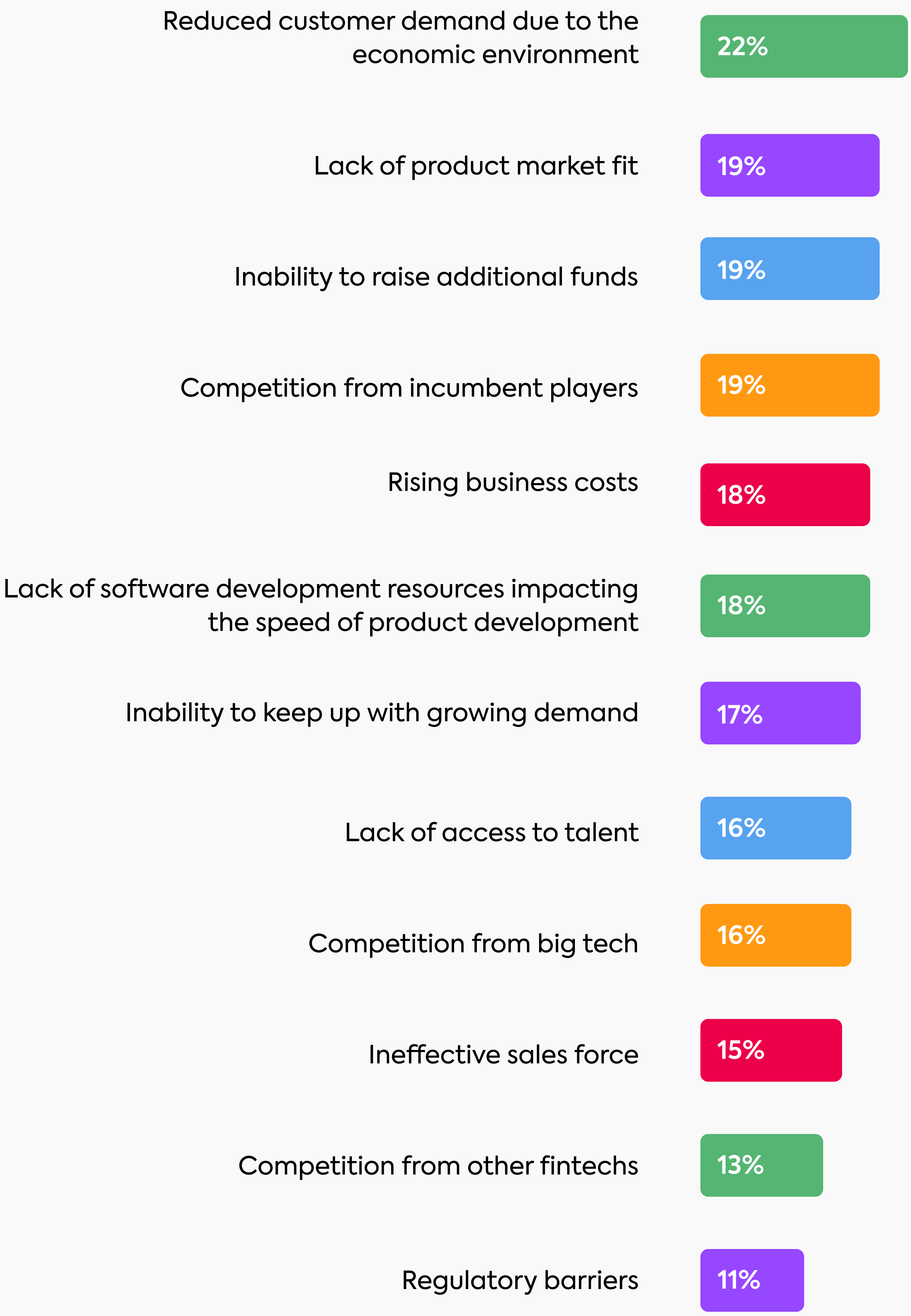
19%
say they're losing out to traditional banks, who are able to offer lower rates

Cautious investors:

19%
say they're struggling to raise money as capital becomes more expensive

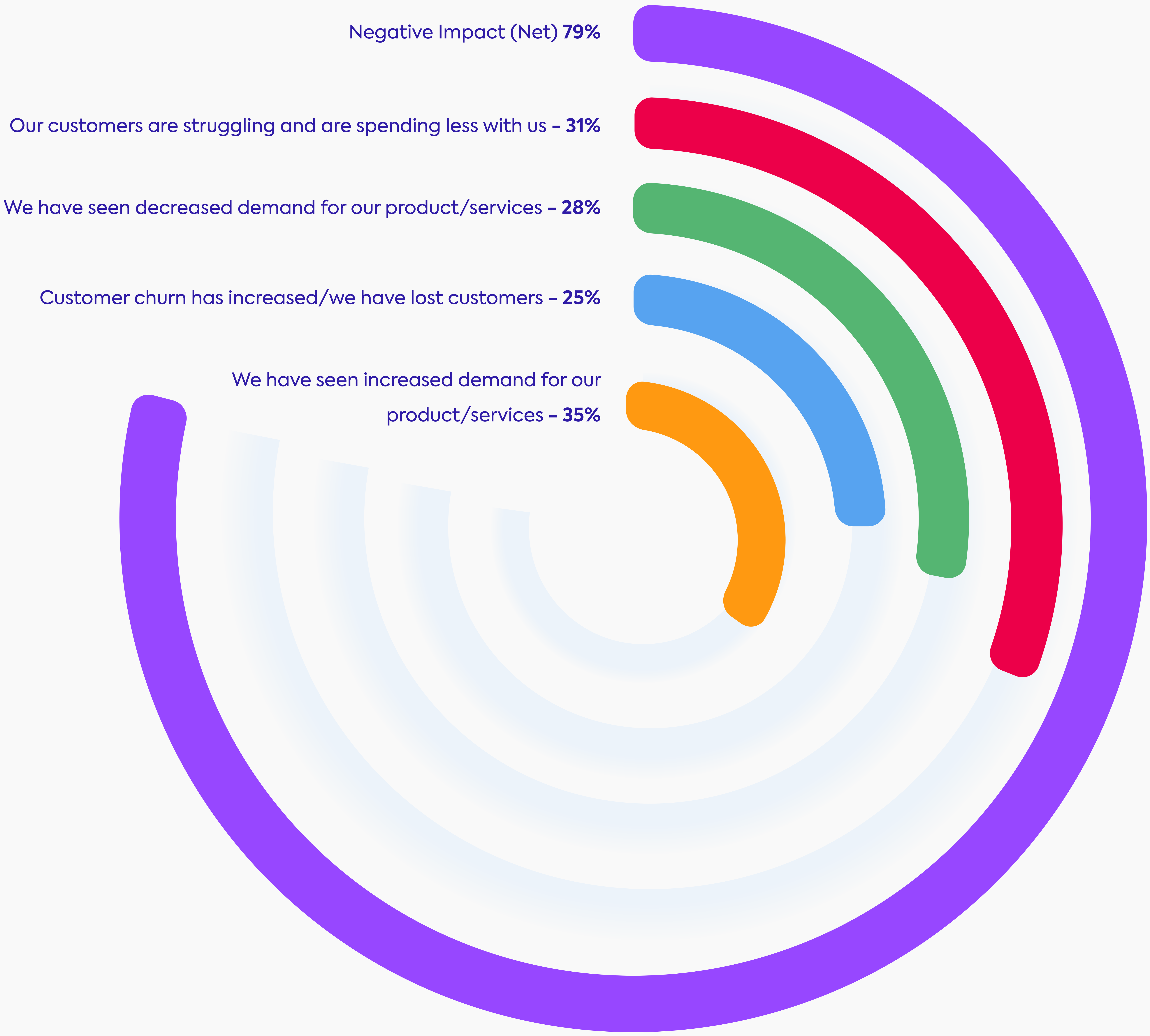
Overall, 63% of top barriers to growth cited by lenders can be connected with interest rate rises.

The biggest barriers to growth



Q6. What are the biggest barriers to growth for your company, if any? (Tick up to three)

How the economic environment is impacting business



Q10. How, if at all, has the current economic environment impacted your business over the last 12 months?

Attitudes towards venture capital funding

- We have taken/are taking steps to increase our runway so that we don't have to raise capital in the next 12 months **- 36%**
- We are working towards profitability so that we do not have to raise any further venture capital **- 30%**
- We are looking to sell the company or go public in the next 12 months **- 28%**
- We are looking to raise funds in the next 12 months **- 25%**
- We are continuing with our current run rate and are not planning to raise capital in the next 12 months **- 25%**

How is this playing out?

British lenders are having a different experience than those in the States. Take retention, where 45% of American respondents reported losing customers. In the UK, 38% of respondents reported the same.

For Brits, the state of their economy is a bigger factor hindering growth, while Americans are more worried about increased competition. But over a third of UK and US respondents agree that they need to make their existing cash go further as VCs tighten their belts.

Funding for fintechs has slumped in 2023, plunging globally by 49% since last year. Although over 90% of the digital lenders we spoke to are VC-backed, only a quarter say they are fundraising in the next 12 months.

Q4. What is your approach, if any, to securing additional funding in the next 12 months? (Tick all that apply)

Part 3

How lenders are adapting their business models

"Our management theme for 2023 is the year of efficiency," Mark Zuckerberg told investors in February. Other firms, from tech giants to fledgling startups, have been following a similar strategy for some time now too.

Non-bank lenders are no exception, with 64% of the firms we spoke to saying that product developments relating to efficiency were top of their agenda. Among UK respondents, the most common business priorities were diversifying into new revenue streams (29%), reducing business costs (23%), and becoming more focused on their core business (21%). In the US, 34% plan to improve internal processes in order to reduce underwriting and loan serving costs.

Lenders of all shapes and sizes also revealed an appetite to reduce risk for both new (15%) and existing customers (12%). 34% plan to do this by making better use of data.

As fintechs continue to make their organizations more nimble, we're seeing their efforts hinge on the following areas:

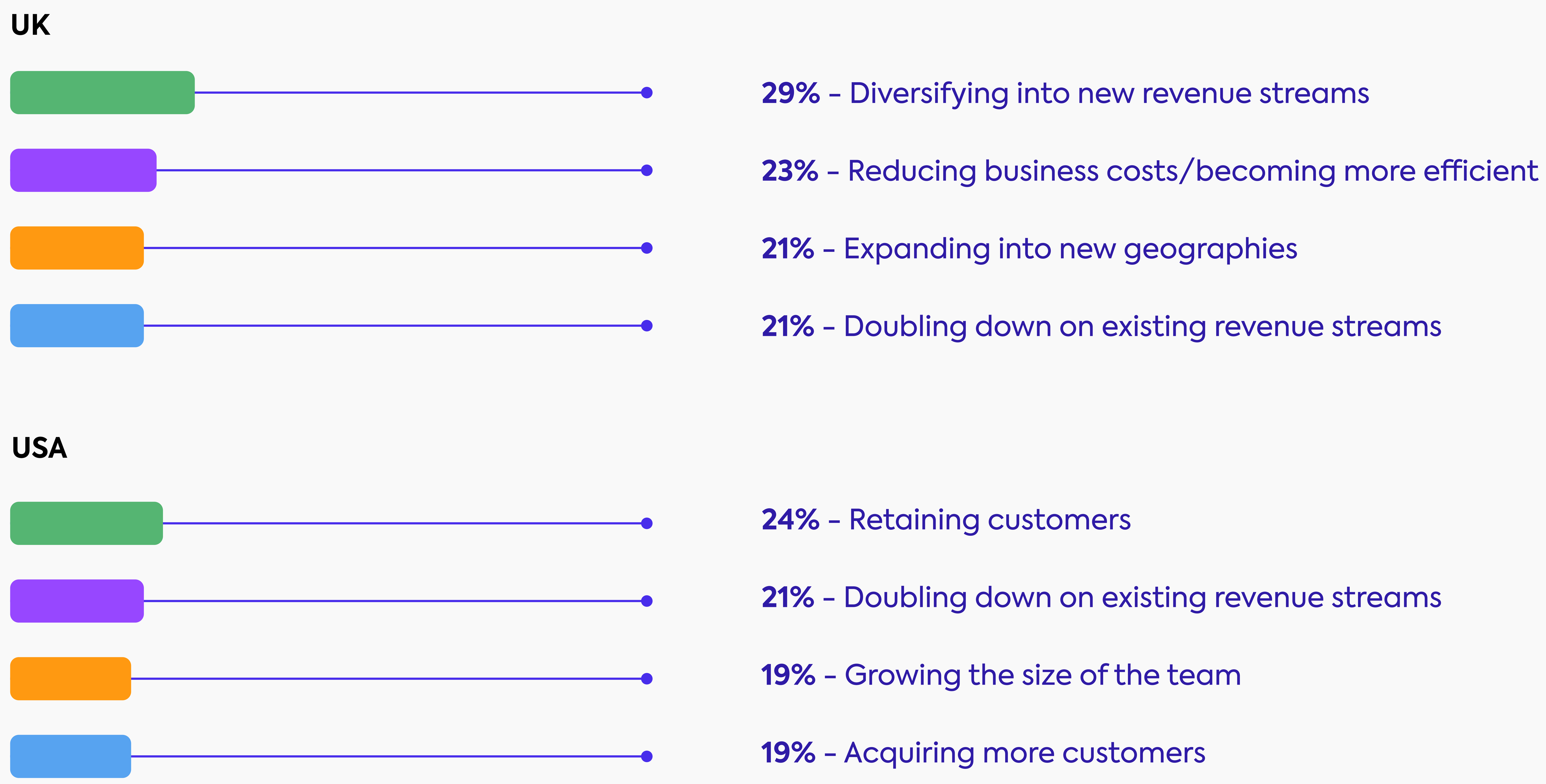
Customer retention:

1/4
of US respondents are prioritizing retaining customers

Reducing business costs:

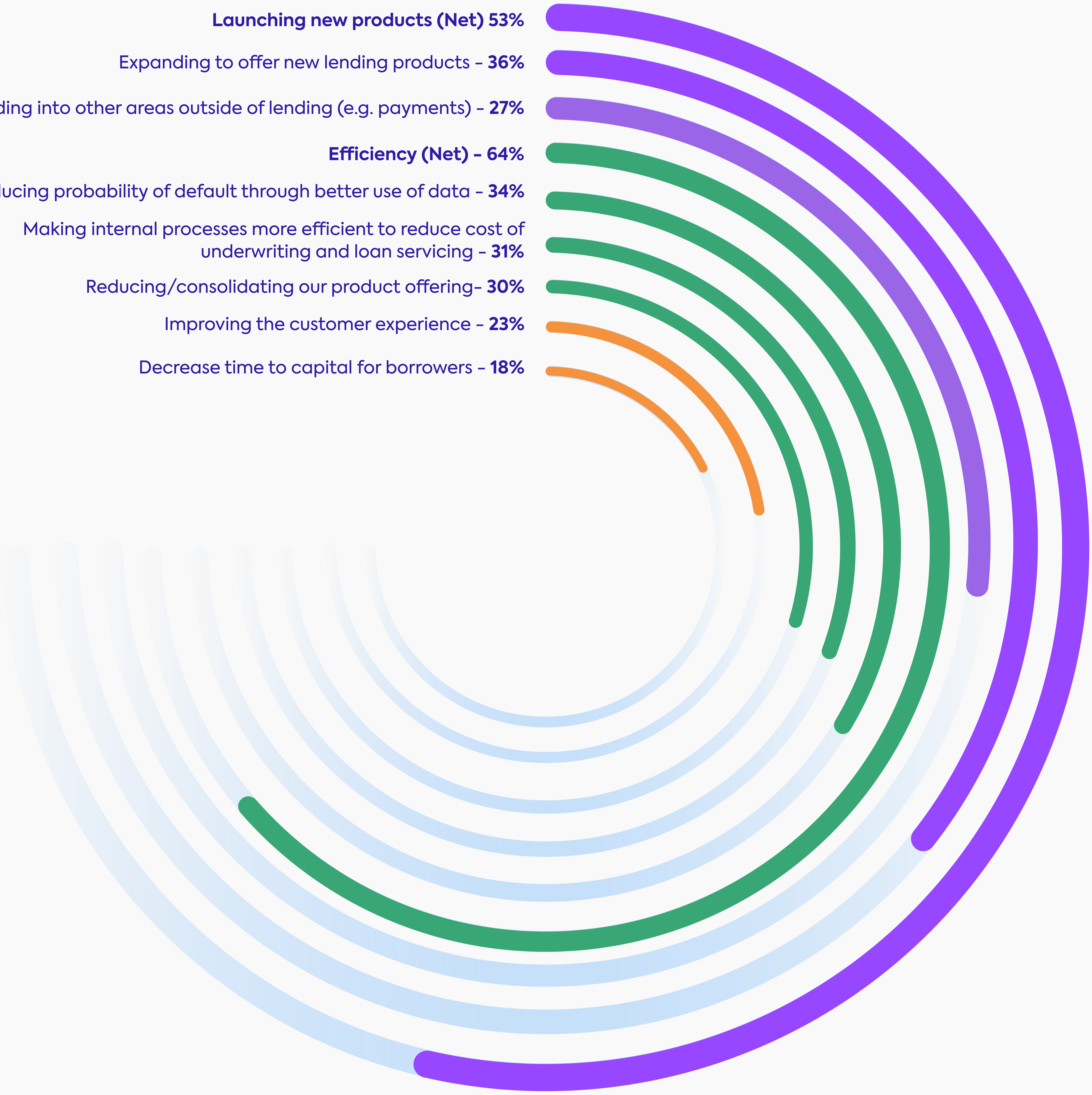
23%
of UK respondents are actively decreasing outgoing expenses

Top business priorities by geography



Q5. What, if anything, are your business`s top priorities at the moment? (Tick up to three)

Top product priorities



64% of non-bank lenders say efficiency is a top priority

Q11. Tell us about your priorities for product development. What aspects are most important to you when it comes to product development, if any?

Part 4

How lenders are adapting products

36% of lenders are looking to launch new lending products in response to market challenges. With non-bank lenders at a disadvantage compared to incumbents in this economy, providers are seemingly moving to other areas within lending to establish a stronger product-market fit, something that 19% said they were struggling with.

Comparatively fewer respondents plan to launch new products outside of lending. When efficiency is at the top of the agenda, it seems that optimizing the core business is the most attractive initiative.

Lenders are also making notable changes to their target markets. According to the data, a third of lenders are specializing in specific industries and moving away from areas lacking strong demand. Focusing on specific verticals makes customer acquisition more cost-effective and the product more appealing to particular niches. It also enables lenders to stand out from incumbent players during a time when it's become increasingly difficult to do so.

Others are taking similarly safe bets, as they stick to the businesses they can trust to pay them back:

Targeting mature businesses:

32%
are now targeting businesses with longer trading histories

Moving upmarket:

38%
of digital lenders in the US are focusing on bigger businesses

Narrowing the target market:

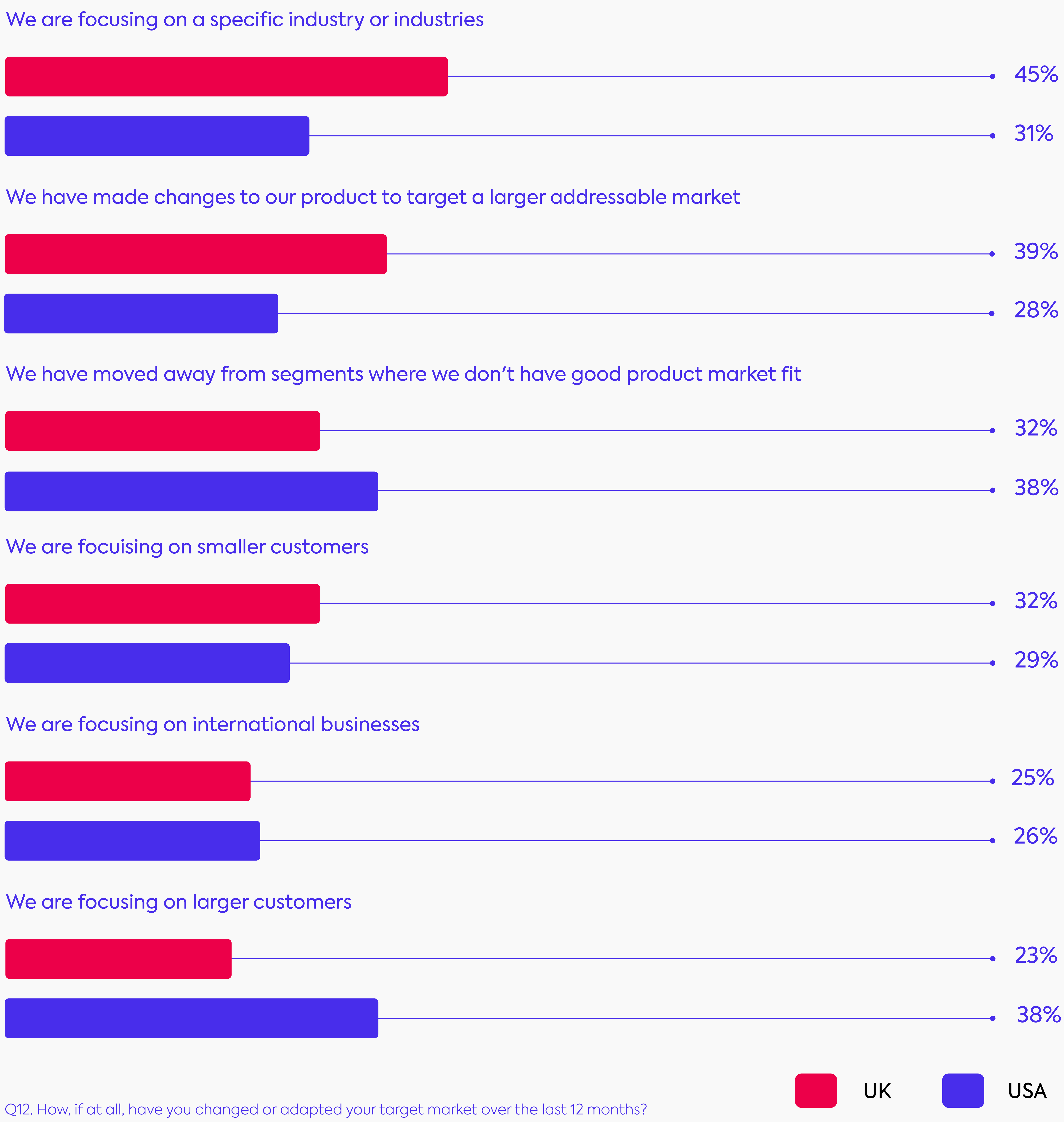
35%
are moving away from customer segments where they haven't achieved the right product-market fit

"We've worked quickly to evolve with our customers, moving from a single lending solution to a platform that facilitates payments across the consumer brand ecosystem via digital banking, bill pay, insights, and corporate cards to our customers - all in the last 18 months.

Our partnership with Codat allows us to take a full 360-degree view of our customers' business as we evaluate them, including eCommerce, wholesale, retail, and marketplace data which is so important as brands move to a more omnichannel strategy."

Tui Allen
VP, Product & Design
at Ampla

Changes in target market by geography



Q12. How, if at all, have you changed or adapted your target market over the last 12 months?

How is this playing out?

With revenue-based financing firms heavily impacted by economic shifts, there are plenty of recent examples of forward-thinking providers refashioning their offerings. For instance, market innovator, Pipe, is now focusing on an embedded capital-as-a-service product, and Capchase recently announced it was launching a B2B BNPL solution.

Plans to launch new lending products are particularly pronounced in the US, accounting for 41% of responses. This could be connected with the Small Business Administration's announcement that it's lifting the 40-year moratorium on allowing non-depository lenders to participate in its flagship 7(a) loan program. As a result, we can expect to see many more lenders launching new lending products in the near future. For instance, fintech lender Funding Circle has already made its plans to secure a SBLC license public.

However, with efforts to limit the SBA's authority to open up the program in motion, the extent to which the policy changes will place non-bank lenders on the same footing as incumbent players remains to be seen.

Conclusion

Tough economic conditions have put a strain on non-bank lenders, many of whom are facing challenges stemming from the high-interest rate environment. Despite this, lenders remain optimistic about their future, as evidenced by investments in geographical expansion, hiring, and reducing burn rate to shore up business in the short term.

Many non-bank lenders have recognized the need to adapt and are introducing initiatives to reduce business costs and defaults through smarter use of data.

Macroeconomic pressures are also having a tangible impact on product development decisions with many lenders expanding to offer new lending products and becoming increasingly industry specialized as a means to establish market differentiation from incumbent players.

While it could seem risky to experiment with new lending products during a downturn, it's the only way to stand out. The lenders that offer something genuinely different, while also being reliable, will keep attracting customers. As long as they can find efficient ways to do so.

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About Codat

Codat provides business data APIs for SMB lending and embedded accounting automation.

Our products connect banks and fintechs to all the major accounting, banking, eCommerce, and payments platforms small businesses use, enabling them to build features that save small businesses time and get them faster access to capital.

To learn more about our platform, get in touch via our website or the email address below.

www.codat.io info@codat.io

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