Cadence Bank Podcast: In Good Companies

Episode #2: Changing the Game: Alternative Lenders and the Disruption Mindset

For some entrepreneurs, there's no blueprint for their business, because they're reimagining their whole industry. We call these forward-thinkers "disruptors," because their new methods can transform entire industries, leaving the traditional leaders scratching their heads, wondering how they got left in the dust. But what makes a business disruptive? And how should that disruptor expect to fare as it introduces investors and consumers to a new paradigm?

Of course, most businesses out there aren't disruptive. But whether or not you consider yourself a disruptor, there's plenty to learn from them. With Cadence Bank's resident disruptor, Ross Vaughan, Executive Vice President of Commercial and Industrial Lending, we'll explore how disruptors approach consumers and utilize technology differently, and how that could be the key for your business warding off challengers.

Financial institutions have dealt with plenty of disruption over the years. We'll learn how banks like Cadence have innovated to keep pace with evolving technology. The current disruption facing the industry is the rise of alternative lending. On this episode of In Good Companies, we cover the ins and outs of alternative lending—the surprising details of how they work, what makes them different, and when one might make sense for your business.

Episode Transcript

Ross Vaughan: Yeah, well, look, innovation is a new industry. I don't think anybody ever thought that we would have William Shatner flying up into space, on a privately owned, spaceship.

Patrick Pacheco: Disruptors: they're here to rock your world, like The Rolling Stones or Led Zeppelin. They're changing every industry from transportation to entertainment and yes, even banking.

Ross Vaughan: I think the days of several teller lines at a bank are history. Most of the people in the United States that, I'm going to just pick an age—under 30—I don't know if they'd been into a bank or not.

Patrick Pacheco: I'm Patrick Pacheco and you're listening to In Good Companies from Cadence Bank, the podcast where we answer the toughest questions facing your business and guide you through the company life cycle from start to sale and success to succession.

Patrick Pacheco: In business, if you're standing still you're losing ground. You've got to always be finding new ways to do things better, faster, cheaper. No one epitomizes this mindset better than industry disruptors like Netflix and Uber, whose ideas changed the world for all of us. They assume nothing and upend centuries-old models, just by asking: “What if?” Of course, banking has its fair share of industry disruptors as well. Alternative lenders are changing who gets loans and how, challenging banks to adapt and evolve. Today, we're talking disruption in business and banking with our own disruptive force, Ross Vaughan, Executive Vice President of Commercial and Industrial Lending and President of the San Antonio market at Cadence Bank. You'll learn how disruptors get financed and how to apply a disruption mindset to your business. Plus, we'll dive deep into alternative lending; telling safe from suspect and how banks are innovating themselves.

Patrick Pacheco: So Ross, can you introduce yourself?

Ross Vaughan: Yeah, happy to. My name is Ross Vaughan and currently I'm an Executive Vice President of Commercial Industrial Lending in Houston and San Antonio. So I'm effectively the market president in San Antonio.

Patrick Pacheco: Ross may be president of the San Antonio market, but if we're talking sports, his loyalty still lies in Houston.

Ross Vaughan: The guy who owns the Rockets now is a friend of mine and it's yeah, Tillman Fertitta. It's interesting to watch because, he's, he talks a good game and when I'm talking to him, he's like “Well, what do you think about this?” “I don't get involved in that. And that's why I've got a president.” But then he gets involved in every single thing.

Patrick Pacheco: Ross loves talking about even more than Houston sports is disruption because for him, disruption is business driving society.

Ross Vaughan: Well, disruption occurs it seems like almost daily. For me, I define it as—it's usually technology-driven, but it means that a business that comes along that is using new tools to take market share from an old-line industry. Think Tesla for the auto industry or Amazon for the retail industry or Netflix for the TV or movie industry. These are all old-line industries. But those are three disruptors that have taken a massive amount of market share. So big industries where they have been able to use technology to, gain market share.

Patrick Pacheco: So when I was growing up, which, that hasn't really happened in full yet, but as I was growing up, we used the word innovation and it seems like that's the same thing as disruption. How do those two things differ?

Ross Vaughan: Well, I look at innovation as using tools to come up with something new to the market. So when I think about innovative companies, I think about Blue Origin, Virgin Galactic, and SpaceX. Those are companies that used innovation now to fly into space, whereas it only used to be the government. And you could say, drones are another innovation, drone photography now is used frequently. And so those are two examples of what I'd say, innovation that is taking it to a new step and usually innovation doesn't go backwards and only goes forwards.

Patrick Pacheco: Okay. Disruption's kind of the innovators plus, the people that take innovation and take it to the next step. So by definition, you're going to go out there and you'll be challenging incumbents. So that's pretty daunting when you're this small new company with some big idea that's untested. What, what does a company like that do in their first year to really make an impact? Do you tiptoe into that? Do you leg into the market? How do you go about, about entering that market when you have a disruptive technology?

Ross Vaughan: I think you've got to enter it as hard and fast as you possibly can. The key is you want to generate sales. Now when you enter it, initially, you're going to fly under the radar. I don't think Barnes and Noble thought anything about Amazon. I don't think GM thought anything about Tesla. But you want to get in there and you want to sell product as quickly as you can to generate revenue. And in many cases they're not making any money, right? Because they've sold the investors on the fact that look at some point it'll flip. And we will start making a lot of money, but up until that period of time, we need to get customers. We need to get press. We need to get people that will look at us as an alternative to the status quo.

Patrick Pacheco: So how long does a disruptive-type business, how long do they have to make money before investors start getting a little nervous, for people to start pulling out. Is it, you hit it hard for the first year? Some of the big disruptors that are out there as let's say a Tesla. How long does it take before you really turn positive and start showing that this can not just be a great idea, but actually be an idea that makes money?

Ross Vaughan: Well, that's going to vary a little bit, but I would say most businesses that I've studied. It's going to take you 5 to 10 years before you can really be able to show the investor community for sure that you can make money. And what I mean by that is, Amazon entered the market—they went public, I believe in 1998 or 99. And they told the market "We're not going to make money for many years," being defined as five-plus, let's say. And the investor community went along with that. And I forgot what year it was, but it was back around 10 year. I think it was early 2010, 2011. They finally flipped to profitability and the investor community could see what Jeff Bezos had been saying was correct. And man, that stock rocketed. And I think a lot of businesses that have come since—Netflix would be a good example. You spend $20 million on content. You hit, a few hit, get a few hits and man, then that's when you're generating positive cash flow. Same thing with Tesla. Tesla certainly has been aided by, credits that they've been able to sell to investors, but once you get to a certain point and get some volume then, and your investment period goes down and your revenue period goes up, that's when you can make some money.

Patrick Pacheco: But what happens once disruptors are on top of the pile. What keeps them from getting disrupted?

Ross Vaughan: They know that there's somebody out there that can do the same thing. I think they strive to stay innovative to protect their business. And I'll pick out an example that everybody will recognize, but IBM used to be, they used to dominate the computer industry. But IBM didn't change. They didn't adapt. And now they're an also-ran out there. They're trying to adapt, they're splitting the company into two: one is just going to be cloud and faster growth and the other one's going to be their old-line computer business, but that's a really good example of a business that didn't stay innovative. And you can say the same thing for the auto industry. the auto industry, EV is not really a new technology. I mean it's batteries. The battery technology is somewhat new, but EV's been out there for most of the major auto industries. But they, I think for the most part, they dismissed it and said, "Why do we need to do that?" Then you have a disruptor, like Tesla that comes in and suddenly they're all about EVs right now, EV trucks and EV cars. And so that's a good example.

Patrick Pacheco: IBM. I think they started wearing both blue and white shirts and that was their innovation at the time.

Ross Vaughan: I don't think we, anybody ever thought that we would have, William Shatner flying up into space, on a privately owned, spaceship owners and CEOs need to think outside the box and be open to different ideas.

Patrick Pacheco: If you haven't caught on, Ross is a big fan of disruption, but banks tend to favor businesses that have been around for a while. So I asked Ross how he approaches disruptors as a banker.

Ross Vaughan: Well, that's a good question. As bankers, we're generally looking at the past. And so if Jeff Bezos had come to me in 19, let's just say it was 1997. He said, "Look, I need to borrow some money because I'm forming this, company called Amazon. We're going to sell books online." I probably would have turned him down to be honest. I would've said, "Well, you got Barnes and Noble out there and they've got retail locations all over the nation and you're just going to sell them online." He would have had to share his vision of I'm going to be able to sell, nearly anything online. But I still probably wouldn't have loaned him money just because it's tough to loan money to a disruptor or innovator, because from a bank standpoint, it's just. It's, the future's unknown. And we look at the past.

Patrick Pacheco: So, if banks are hesitant to fund disruptors, where do they get their money? So I come in, I don't have any, I haven't a new business untested, no history. You talked about equity. So how do I go about getting funding for my new, I know it’s going to be spectacular, disruptive business, but everybody looks at me and says, “That's the same thing as door-to-door encyclopedia salesman. It's just, you're using the internet. Why would I want to lend to that?” How do you get funding for that type of idea?

Ross Vaughan: Well, it needs to be equity-financed. So you, the next question’ll be “All right. Well, how do you get the equity?” If you're Jeff Bezos and you're going to start selling books online. And I think this is the way it went. in his garage, he had a bunch of books and, once the word got out there and he starts selling books online, mailing them out, creating sales, then you can take that history and just call it a beta test. You can take that to equity investors and somebody and share your vision with them. And, there's plenty of money out there that will invest in something like that, if they can see your vision, if they can share that with you. Certainly there are some governmental programs like the SBA that, if you've got a business plan, They will, in many cases, loan you some money, but I would say the vast majority of, the innovators and disruptors that have been out there the past 20 years, they've done it approaching well-heeled, large private equity firms that will invest in good management teams that have a really good idea of how they can disrupt an industry.

Patrick Pacheco: Of course the financial industry isn't immune to being disrupted. I asked Ross how he sees banks adapting to changing market demands.

Ross Vaughan: The banking industry has been around a long time. It's highly regulated. I think that certainly there are disruptors to the industry. And I think one of the reasons why Cadence is merging with Bancorp South is because banks need to be able to spend more money on technology. And so you gotta have some size to be able to do that. If you're a small bank, let's just say has a billion dollars in assets or less, and you make, less than $10 million, you just can't spend a lot of money on technology. Whereas, a bank that's large that generates a billion dollars of cash profit, then you can spend some money on technology and compete where you want to compete with disruptive forces.

Patrick Pacheco: So what are some ways that you see banks utilizing technology to be disruptive to the end industry?

Ross Vaughan: Well, banks are using, and I think Cadence is a good example. We're using a more social and digital media to advertise the Cadence brand and to advertise our products. We also have interactive teller machines, where you go up to the, it looks like an ATM and you approach it. And somebody somewhere, you won't know where they're coming from, but they are going to provide teller services to you. You may be in Houston and they're in, in, Starkville, Mississippi, or they're in New York City. It doesn't matter where they are. They could be in London, England for that matter. But they're going to provide services to you and the machine has the ability to handle most of those teller transactions. Most of the people in the United States that, I'm going to just pick an age—under 30—I don't know if they'd been into a bank or not Yeah, they, everything is done digitally. If I was running one of the really large banks like JP Morgan or Bank of America, Wells Fargo, I would be looking at, not only internally being able to use technology, but I'd also be looking at, purchasing some companies that have done very well and are on the cutting edge of disrupting the banking industry. And again, I'll go back to PayPal. I didn't, PayPal was relatively small five years ago, they were part of eBay and, I knew what PayPal did. I knew what E-Bay did. And then they, PayPal was spun off. And where I really found out what PayPal does is I noticed on my kids like state. They had, these Venmo, transactions. And in Venmo here, Venmo there. I asked them, what is this Venmo? And basically that's how they exchange cash. They don't carry cash. They exchange it via Venmo and the banking industry, a large part of it has come out with a product called Zelle that does the same thing.

Patrick Pacheco: Yeah, that's a, if you think about it, I never, didn't really, I heard the PayPal you'd heard for a while, but here are the last two years, Venmo cash app. I hear those words all the time and these things that I never used, I find myself using constantly. There's you getting split a check on something you're buying a coach's gift, whatever it is, you just zip the money over to whoever's going to go buy it. It makes it very easy. Another disruptive force in the banking industry has been the rise of alternative lenders. I asked Ross to give us a little perspective on the subject. So let's start by defining our terms. What is alternative lending?

Ross Vaughan: Well, I define alternative lending as lending that is done outside the traditional bank market. And alternative lending has been around a long time. If you go back a hundred years ago, 125 years ago, go back to the early 1900s, the bank market wasn't built out like it is now. And you had a lot of locations that didn't even have a bank. And so what was the alternative lending market to a bank back then? It was wealthy people. The ones that had the money. And so if you had a good idea or you were running a, the local store, or you had a farm or you had a ranch or whatever, and you needed some money, you went to somebody in the community that you thought had the means to be able to loan you some money. And you would pitch them on loaning you some money. And in many cases, some of these, well, more well-to-do people ended up starting a bank because they were doing it out of their pocket. Anyway, why not start a bank? Especially if the area didn't have a bank. So it goes back a long time. And, now it's more—I'd say people look at alternative lending more along the lines of again, technology. What is an alternative lender doing from a technological standpoint that's different than a traditional bank?

Patrick Pacheco: So what are the, what are some of the things that, that are different? I know when I grew up, when I first heard alternative lending, I thought about a guy. Big guy and wearing a black seat that took my dog and my kid and my left hand for collateral and all of a sudden it's alternative. And I swear I must've gotten $3 million worth of loan offers in my mailbox here in the last month. Every day somebody sends me something saying “We can loan you $200,000, loan you $80,000.” So in that way it's different than a traditional bank that, that they're marketing to me. But what other ways are alternative lenders just different from traditional banking?

Ross Vaughan: You're right, alternative lenders tend to, for them, it's about generating again, getting back to disruptors, they're disrupting an industry. And so for them, The key is generating revenue. So they're going to try, I'm the same as you. I got an offer from Sofi in the mail to loan me, 5,000 to $100,000. And so they're looking at any number of ways, certainly a website, but they're traditional mail and I'm sure email, et cetera, but their key is they want to solicit consumers and small businesses to go onto their platform and apply for consumer credit, much like you would with a credit card application. And what they're going to sell you is the speed of execution versus a traditional bank. And that is a fact: most banks are still in the traditional position of, you walk in and you apply for the loan and they go through all the steps and then they get back to you in a week or two or three, whatever it takes. And again, banks are regulated. So it's more difficult for them to change. But the alternative lenders, that's really how they're disrupting is speed of execution. And it all comes down to credit risk. And as long as they can make relatively good decisions and, you don't get hurt if you're making a thousand loans for $1,000 each versus 1 $100,000 loan. You can have some losses when you're making a thousand loans at a thousand dollars apiece. So it's all about, they're knocking on doors, using technology and then selling the fact that they can fund quickly.

Patrick Pacheco: Yeah, I actually utilized an alternative lender on a home because I needed to get closed very quickly. So while they were correct. They were able to do it in a short timeframe. And even though banks are regulated, I have never had any type of lending where there was more fine tooth comb through every single—I had to explain transactions on the bank statement. “Who did you give $50 to?” It was really a very in-depth review. So is that because they're there, checking their credit risk or, why do they seem to really delve into a lot, versus the bank?

Ross Vaughan: Well, you said a mortgage. The larger the loan, then the more scrutiny it's going to get. And that's why, historically you've seen credit card issuers basically issue it to anybody. But the max that you can, your max credit limit is going to be something like $2,500, $3,500. And then over a period of time where you show that you've been making the payments, they'll increase it. Because at the end of the day, a credit card issuer can—their rate is going to offset a lot of those credit losses that they're going to take. Any, whether it be a bank or an alternative lender, anytime the loan is larger, they're going to take more time and they're going to perform more due diligence to establish that they think that the credit that they're going to issue will get repaid.

Patrick Pacheco: So bank, we go gather deposits, and that's how we make loans. Where do alternative lenders, where are they getting money to make loans?

Ross Vaughan: Alternative lending, you can basically say it's very much like mortgage lending, right? Most of the mortgage lending they're selling to Fannie Mae and Freddie Mac know selling those loans. The mortgage companies aren't keeping those loans on their books. And a lot of people assume that if you're doing business with an alternative lender, that they've got as much capital as a percentage as a bank would. And there a lot of people assume that they're a bank. In reality, alternative lenders since they don't, most of them don't gather deposits, so they don't have the funding sources. What they do is they fund a, let's just, I'm going to use a thousand loans at an average of a thousand dollars apiece. And then they're going to sell that basket. To an investor and the investor could be a bank. And they're basically gonna service, they're gonna, they're going to initiate the loan. So they get the customer, they make the loan and they're going to service the loan. And for that, they take some of the money off the table. The rest of it is going to be funded by whoever the investor is buying the basket of loans. And that's really, that's behind the scenes and nobody will know that, but that's how they're able to, be an alternative lender.

Patrick Pacheco: So we've covered what alternative lending is and how it functions, but there's an even more important question: why? Why do borrowers go to alternative lenders? And what are the pros and cons compared to a bank

Ross Vaughan: speed is I think a big driver. I think that, I think that a lot of business people are maybe intimidated by approaching a bank, because they've heard stories from their buddies or whatever. And look again, getting back to speed. if you've talked to a peer of yours and they go, well, shoot, I got, $50,000 in two days from X, Y, Z, Sofi, then that sounds really good. And versus going into a branch of a bank and sitting down with a loan officer and applying for it. People can get used to looking at their computer screen and applying for something. Happens all the time. Whereas going in and applying for something when you're sitting across from somebody again, that can be somewhat intimidating. Being able to do it online's a major pro, but there are a couple of cons. And one of them is that if you've got a spotty credit history, you really don't have someone to tell your story to. So you had a little, it could be any number of reasons why you had spotty, why you've got spotty credit history, but with a bank, a traditional source, you can sit down and talk about the income gaps or the non-payment of, or the slow payment of bills and mother other major credit issues that can, alter a credit score. So that's a con. I'd say also that some of these alternative lenders, they've got a minimum amount of money that you are required. And banks just don't have minimums. Now, again, it may not make any difference to you, but sometimes, the alternative lender doesn't want to, it's not going to go through their system unless they can make a certain amount of money on it. So they may have minimums. Also alternative lenders are not regulated like banks and many of them have gone out of business. And so they don't have a safety net. If they go out of business, what's going to happen is your loan is going to be sold to somebody else, and you don't know who it is. You don't know what they're, how they're going to approach it. It could be investors who just want to get, demand payment. You just don't know. And if you're a small business that, and borrowing on a revolving line of credit, Yeah, you may not be able to do that anymore. So there is no safety net for alternative lenders.

Patrick Pacheco: Does that affect it in the collection? Say you have an alternative lender and something starts to go bad. is it better being with a bank in that case? Is it worse being with a bank versus an alternative lender?

Ross Vaughan: Well, again, you don't have with an alternative lender, you don't have somebody you can go sit down and say, "Here's the problem. COVID, I couldn't open up my store." And so you try to work something out with an alternative lender, generally they're going to probably sell your loan to a collection type entity, or they're going to give it to a collection agency. And that collection agency is going to come after you, because again, you don't have anybody to talk to and tell your story.

Patrick Pacheco: They paid less than face value. So they're just trying to get as much out of it as they can and make some money.

Ross Vaughan: Absolutely. Anyway, it's very similar to a credit card. if you go back a few years, it used to be—and Patrick, you probably remember this. You're old enough to remember. But when you went into a department store, you wrote a check or you paid by cash for your merchandise. They actually had checks there that you could write off at different banks. And now everything's credit card and debit card. And the credit card companies, you can pay your balance or you can pay a little. But the fact of the matter is if you go into default, they're just going to sell your credit card, to somebody who's going to be a collector. And they're going to go after it.

Patrick Pacheco: With so many new lenders out there, how do you decide what's safe? For Ross, it's about doing the same thing to the lender that they do to you.

Ross Vaughan: Well, I think if you're going to have a series of draws—let's just say you were building a home and went to an alternative lender or you're a small business and you've got a revolving line of credit and you're going to fund up when you need it and paid back down when you don't. You need to be relatively, you need to perform your own due diligence. Be relatively cautious about who your lender is. Versus if you're doing it with a traditional bank, especially a bank that is a public company where you can go in and read the financial statements, read about how they're doing. That is probably preferable from a safety standpoint. If you're just going to get $5,000 upfront, it makes relatively little difference, cause you're getting the cash money upfront and maybe the worst thing that can happen is before you repaid it, that alternative lender somehow goes out of business and somebody else assumes that loan. And so you had that hassle, but if you're going to get it in draws or you've got a revolving line of credit, then I'd be a little bit cautious.

Patrick Pacheco: So it's almost like what the lender's doing, they're analyzing their risk, but now the borrower needs to think about what their risk is as well on both sides of the equation. I guess there's risks to all parties.

Ross Vaughan: Yeah. there is. But I don't think most borrowers perform that much due diligence. And basically if they can get approval, they're probably going to go for it. It's usually, “Here, I'll give you some money.” Most say, “Alright, give it to me.”

Patrick Pacheco: That's I know my boys, I would, I dread the fact that I actually get mail at some point says, “Just sign up and we'll give you $5,000,” because I'll start, they'll start coming home with the collection notices going, ‘Dad, what am I supposed to do with this thing?” Disruptors dream big, and they challenge our assumptions. There's lessons here for every business, even if you aren't trying to be the next Amazon. You've got to be improving and adapting all the time. The lending world is doing some adapting of its own and borrowers have more options than ever. It's really worth doing your due diligence and understanding your priorities so you can get the loan that's right for you and get back to changing the world. Big thanks to Ross Vaughan, Cadence’s very own disruptor. In Good Companies is a podcast from Cadence Bank member, FDIC, Equal Opportunity Lender. Sheena Cochran is our production coordinator, our executive producers, Danielle Kernell with the writing and production from Andrew Ganem and sound design and mixing by Alex Bennett at Lower Street media. I am your host, Patrick Pacheco. If you've made it this far, and you got something out of the episode, why don't you go out and give us a five-star rating in your podcast app? It's the best thing you can do to help the show grow and reach more people and join us next week, because when you're with us, we're In Good Companies.

Sheena Cochran: This podcast is provided as a free service to you and is for general informational purposes only. Cadence Bank makes no representations or warranties as to the accuracy, completeness, or timeliness of the content in the podcast. The podcast is not intended to provide legal accounting or tax advice and should not be relied upon for such purposes. To the extent that this podcast includes predictions about the economy, these predictions are subject to a number of variables and you should confer with your legal, accounting and tax advisors for their input regarding the possible outcomes of any economic subject matter discussed herein.