If you want to lend or borrow money, ZOPA is a much acclaimed peer-to-peer lending service. Martin Kupp and Jamie Anderson concede that, as a business, it’s a Web 2.0 star. But can it last?
In 2006, the Internet became “hot” again. We saw a strong return of attention by companies, the media, and consumers for new and promising Internet-enabled business ideas – the so-called Web 2.0 phenomenon. Web 2.0 emphasizes online collaboration and sharing among users. Many of the most successful websites made headlines in one way or another. In photo sharing, it was Flickr. In social networking, it was MySpace and Facebook. And, of course, it seems like thousands of videos are shared every hour on YouTube.

One of the new Internet firms grabbing headline attention is Zopa, a UK-based peer-to-peer (P2P) online brokerage that links British residents who want to lend with those who would like to borrow. In Zopa’s world, lenders proffer money not to specific individuals but instead to a pool of people who have been verified to have similar creditworthiness.

Launched in March 2005, Zopa started with just 300 members; but, within just a few months, the Internet start-up had grown to more than 25,000 users. By March 2007 more than 140,000 people had signed up.

A start-up is born
Zopa was co-founded by CEO Richard Duvall, chief financial officer James Alexander and “business architect” David Nicholson. Duvall passed away after a battle with cancer in October 2006, and Alexander took over. All were involved with Egg, the online bank that was started in 1998. In 2007, Doug Dolton – highly experienced in the unsecured lending industry – became Zopa’s global CEO.

Zopa received more than £16 million in start-up funding from Benchmark Capital (which also backed eBay’s launch), Bessemer Venture Partners (which also backed Skype’s start), Wellington Partners, and private investors. Savvy capitalists have been keen on Zopa from the beginning.

Zopa stands for “Zone of Possible Agreement”, a term from negotiation theory. It refers to the overlap between one person’s bottom line (the lowest they’re prepared to receive for something they are offering) and another person’s top line (the most they’re prepared to pay for something). In practice, this approach underpins negotiations about the majority of products and services: a new car is sold for somewhere between the dealer’s absolute lowest price and the buyer’s highest willingness to pay.

The idea for Zopa was born from market research conducted by the company’s founding team that showed there was a growing potential market of “freeformers”. These were defined as self-employed, project-based or freelance workers who were not in standard full-time employment. Consequently, their incomes and lifestyles could be irregular, although they may still have been assessed as creditworthy. Freeformers were identified as being either underserved by existing financial services institutions or as people who simply didn’t want to deal with such firms. Zopa’s consumer research indicated a large number of freeformers in the United Kingdom – possibly as many as 6 million of UK’s 60 million population.

A borrower or a lender be
People join Zopa online as either borrowers or lenders. Once registered, lenders can loan money to a pool of people grouped together because of similar creditworthiness. Zopa assesses the credit scores of borrowers using the same Equifax-based credit ratings as used by UK retail banks and lenders. Zopa only offers services to borrowers who have achieved an Equifax rating of A*, A, B or C. The online bank also engages an agency to verify the identity of all lenders and borrowers, and Zopa’s own team of underwriters individually assesses each borrower’s ability to repay. After that, borrowers are assigned to a corresponding “lending pool” of people with the same level of creditworthiness. Zopa has tried to lock down its proprietary marketplace-matching platform, but it recognizes that the broader concept of P2P lending cannot, in itself, be protected from replication. Two other peer-to-peer lending sites (donjoy.net and prosper.com) have already been established in Korea and the United States.

By late 2006, the average borrower took a loan of £5,000 and the average lender deposited £3,000 per transaction. Only 0.05 per cent of Zopa’s
Zopa CFO James Alexander: In the zone
loans had turned into uncollectible debts. Zopa CEO James Alexander said he believed that Zopa had partly achieved such low default rates by injecting a “social aspect” into lending. Zopa members were able to see the usernames of other members on the site whenever they lent or borrowed. While this did not typically include the member’s full name (unless they had chosen a username that matched their real name) or their address, other members could see generic details such as age, marital status, geographic location, and loan purpose. Lenders could see how much had been borrowed, at what rate, and for what period of time; they could also track repayments. Consistent with the “freeformer philosophy” on which the business was built, Zopa’s customer research has revealed that many of its lenders and borrowers were united by a desire to distance themselves from conventional institutions.

When someone approaches Zopa for a loan, the various offers made by its lenders are displayed with those of all the other lenders in a specific market, then ranked: firstly by the rate lenders had set (lowest to highest) and, secondly, by the time the offer was placed in the market (earliest to latest). When a borrower made a borrowing request in a market, the money was taken from each lender in rank order until the full amount had been matched. The interest rate charged to the borrower for all the loan contracts would be the average rate at which the lenders were supplying the money, so each lender received the rate of return they asked for.

The main benefit for borrowers was that they could borrow relatively cheaply over shorter periods for small amounts. This was the reverse of banks, where lending typically became progressively cheaper for larger amounts over longer periods. The average interest rate on a Zopa loan in 2006 was a

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little less than 7 per cent – cheaper than the credit card and loan rates offered by most banks. For Zopa lenders, higher returns were possible compared to traditional savings accounts at traditional banks, up to a third higher than putting money in a bank term deposit account. For example, MoneyNet.co.uk has reported that some lenders are seeing returns of as much as 14 per cent.

Lenders can choose the balance of risk against return they require. While waiting for their money to be lent out, lenders earn 3.75 per cent interest on the untapped balance of their membership account. Zopa charges borrowers a fee of 0.5 per cent of their loan amount and lenders a 0.5 per cent annual service fee. Zopa deducts the fee from the holding account balance on a monthly basis, once the lender has received the monthly repayments from their borrowers. Zopa also earns money through selling payment protection insurance to borrowers who want it and through referring people who could not borrow from Zopa (due to a poor credit rating) to other loan providers.

At the end of November 2006, Zopa had 40 employees: 10 management staff, 7 sales and marketing personnel, 14 IT and operations personnel, 3 risk and fraud personnel, and 6 underwriters. Red Herrling reported in 2007 that the total number of employees had grown to 45.

A business model that adds value?
INSEAD’s W. Chan Kim and Renée Mauborgne would view Zopa as a value innovator. In an industry like banking, which has a highly established way of doing business, Zopa offers value by managing transactions differently. Zopa adds value to consumers by eliminating their need to work with traditional financial institutions in accessing credit; it also eliminates the requirement for many of the face-to-face interactions and manual processes that have traditionally been part of the borrowing experience. The company also raises flexibility and transparency for customers well above the industry’s standard, as customers can borrow smaller amounts over shorter periods and are not charged additional fees if they repay early.

Zopa adds value to the financial services industry (and those who want to lend money to others) by slicing the breadth of products and services on offer. Moreover, through its low-cost structure, Zopa is also able to reduce the costs and charges typically associated with borrowing. In parallel, Zopa’s low-cost structure enables it to raise interest rates for lenders while also giving them the sense that they are truly helping others in need. The Zopa slogan of “economic return and social reward” incorporates this concept nicely, and it’s a concept that can be illustrated and comprehended quickly.

Great – but can it last?
Zopa has developed a value innovation in the financial services industry, but will the company be able to capture value from this innovation? Jay Barney’s classic framework for analysing firm resources and sustainable competitive advantage helped us address this crucial question.

Barney classifies firm resources into three categories: physical resources, human resources, and organizational resources. Physical resources include, for example, specific technology, plants and equipment, geographic location and access to raw materials. Human resources include training, experience, judgement, intelligence, relationships and insights of individuals in a company. Organizational resources include the formal reporting structure, the formal and informal planning-controlling-coordinating systems as well as informal relations among groups within a firm.
and outside the firm, such as the customer base and the value of the brand. In order for these different types of resources to be sources of competitive advantage (or even sustained competitive advantage), Barney suggests that they have to be (1) valuable, (2) rare, (3) difficult to imitate, and (4) difficult to substitute.

Looking at the different resources that Zopa has developed, the company's deep customer knowledge, strong networks in the financial services world, proprietary software elements, creative and informal structure, installed customer base, and brand equity can all be seen as valuable. But when it comes to the question of which of these resources will be rare and difficult to imitate or substitute in the long term, the answer is less clear.

Tacit knowledge such as deep customer understanding, as well as the company's increasingly well-recognized brand and patented software components might well stand the test. Yet an assessment of the overall Zopa model - from a resource-based perspective - raises questions about the long-term sustainability of its competitive advantage. To us, many of the resources possessed by the company appear to be easily replicated by a well-resourced and determined competitor.

Another way to judge sustainability is to think about first-mover advantage. For example, eBay not only pioneered a new way to hold an auction, it leveraged its first-mover advantage into a size and popularity that others could not easily assault. Apart from the more static resource-based approach to assess sustainable competitive advantage, research addressing the theme of first-mover advantages offers yet another perspective.

According to Fernando Suarez and Gianvito Lanzolla, there are generally three ways to achieve a first-mover advantage: through technology leadership, through pre-emption of scarce assets, and through establishing switching costs. By starting earliest, first movers have more time than later entrants to accumulate and master technical knowledge. If this knowledge can be kept proprietary to the company, the experience gained from riding the learning curve can generate a substantial barrier to entry. First movers are able to achieve diminishing unit production costs with cumulative output thereby generating a sustainable cost advantage.

But, again, there appears to be little opportunity for Zopa to gain a sustainable first-mover advantage from technology leadership as other competitors are likely to be able to replicate the systems and software supporting Zopa’s business model relatively easily. Compared to proprietary products and technologies, it is particularly difficult to gain patent protection over business processes. It took Amazon several years to gain patent recognition for its “one-click” online purchasing innovation, but such success stories for process innovation in e-commerce are rare.

The second way to achieve first mover advantage is by pre-empting later arrivals’ access to scarce assets. For example, a first mover might possess a key location on a city’s main street, talented employees, other input factors, investment opportunities or key suppliers. It is questionable that Zopa can limit later entrants’ access to the assets underpinning its business model. It could, conceivably, seek to establish exclusive partnerships or alliances with other firms, such as Google or Yahoo, but the rationale for other firms in entering into such an alliance at the exclusion of other such partnerships is questionable.

The third way to build a first-mover advantage is by building an early base of customers who would find it inconvenient or costly to switch to the offerings of later entrants. Switching cost can arise from habit formation in buyers or from the installed-base effect in the presence of network effects. Similar to websites such as eBay and Amazon, Zopa customers make an investment of time and learning in registering on the site as a member and becoming familiar with the company’s processes and user interface. This kind of habit formation has been demonstrated to reduce customers’ readiness to switch between firms.

Zopa’s large installed membership base could provide Zopa with the advantage of an installed-base effect: the more people who register and use the platform, the more information Zopa can offer on the actual bad debt rate and, thus, the greater perceived degree of trust and security for every other member. The installed-base effect, and the impact that this has upon customer perceptions of trust and security, has been identified as a key driver behind the success of eBay and Amazon.
Nonetheless, despite Zopa’s rapid growth, the company’s 140,000 strong membership base is still dwarfed by the customer bases of many established retail and online banks. Egg has more than 3.7 million customers, and ING Direct (a relative newcomer) already has one million. This raises the question of how long it might take for an established competitor such as Egg or ING to build their own peer-to-peer membership base should they choose to replicate Zopa’s model.

As part of the new Web 2.0 phenomenon, Zopa has achieved value innovation in the retail financial services industry. Many consider Zopa as perfectly positioned to grow a dream business into a sustainable reality. Despite this, we question the ability of Zopa to sustain competitive advantage in the longer term. While many of Zopa’s resources and attributes are valuable and (for the moment) rare, these resources seem to be open to future imitation or substitution, quite possibly by someone with much greater resources to deploy. But whatever the outcome for Zopa, the peer-to-peer lending model that the company has pioneered is here to stay.

Resources
A complete Zopa case study is available at www.ecch.com.


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Zopa CEO: Doug Dolton