

**(10)99  
PROBLEMS  
AND W2s  
AIN'T ONE**

SELF-EMPLOYMENT AND THE  
FUTURE OF FINANCIAL SERVICES

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**CORE**  
INNOVATION  
CAPITAL

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## EXECUTIVE SUMMARY: RISE OF THE (10)99 NATION

**53** million Americans count themselves among the independent workforce – contractors, part-timers, solo business owners, full-time employees with a side gig... and so on. That number is projected to grow over 4% per year through 2020, to reach about 66 million Americans.<sup>1</sup>

We believe this growth is not just a cyclical anomaly, it reflects a structural shift in the way labor is procured, managed, and deployed. At Core Innovation Capital we believe 1099 status is the new normal for many Americans, for three simple reasons.

1. Cost: it's cheaper – Employers save by engaging “1099s” rather than salaried “W2s.”
2. Technology: it's possible – SaaS is driving the unbundling of American businesses.
3. Lifestyle: it's preferable – Many 1099s enjoy greater flexibility, control, and variety.

As a focused venture fund, Core backs financial services companies that empower everyday Americans, by making financial products and services more efficient, affordable, and accessible. In doing so, we believe entrepreneurs can increase Americans' financial stability, and upward mobility. And so, in light of this seismic labor shift we ask ourselves – so what? What does this mean for workers' financial lives and for financial services in America? It turns out, quite a bit.

In digging deep, we've discovered that freelance workers confront material pain points across a spectrum of financial services - from tax and income volatility, to liquidity, savings, insurance, and credit. Fortunately, we've also found that fintech entrepreneurs are rising to the challenge, and developing early solutions through innovative product design, distribution, and technology.

Banking the 1099 Nation will not be easy - it will require navigating regulatory uncertainty; a deep understanding of the highly heterogeneous freelancer market segment; inventive and diversified distribution tactics; and flexible, interoperable products that remain relevant across various phases of a customer's professional life. We hope the following discussion will help fintech entrepreneurs better serve this market, and learn from others who are paving the way.

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<sup>1</sup> "Intuit 2020 Report." Intuit, October 2010. [http://http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/intuit\\_2020\\_report.pdf](http://http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/intuit_2020_report.pdf)

## GOT (10)99 PROBLEMS

 TAX	  BonsaiTax
 INCOME	  
 LIQUIDITY	   
 CREDIT	  Vouch 
 INSURANCE	   
 SAVINGS	  

# THE NEW NORMAL: 1099s ARE HERE TO STAY

America prides itself on being a nation of entrepreneurs. And with more than one in ten U.S. adults starting or running new businesses, we are. Yet the vast majority of U.S. entrepreneurial activity is small – nano small. Three fourths of U.S. firms have zero payroll - they are one-man bands.<sup>2</sup> And the ranks of self-employed “solopreneurs” are growing fast, with 53M Americans freelancing today, and upwards of 66 million Americans, or 40% of the workforce, by 2020.<sup>3</sup>

Economic, political, technological, and cultural forces are combining to drive this growth, and together, explain why 1099 status is the new normal:

- 1. Cost: it's cheaper** — Employers save by avoiding payroll tax obligations, reducing benefit outlays, and achieving more optimal utilization of labor.
- 2. Technology: it's possible** — From Fortune 500 corporations to Main Street, we are witnessing a great unbundling of American businesses, made possible by affordable, accessible software, wireless infrastructure, and ubiquitous mobile connectivity.
- 3. Lifestyle: it's preferable** — Depending on individual circumstance, contractor status may confer certain advantages, such as greater flexibility and control over the nature and timing of work. “On-demand” engagements also enable workers to monetize excess time and assets more easily.

## COST: IT'S CHEAPER

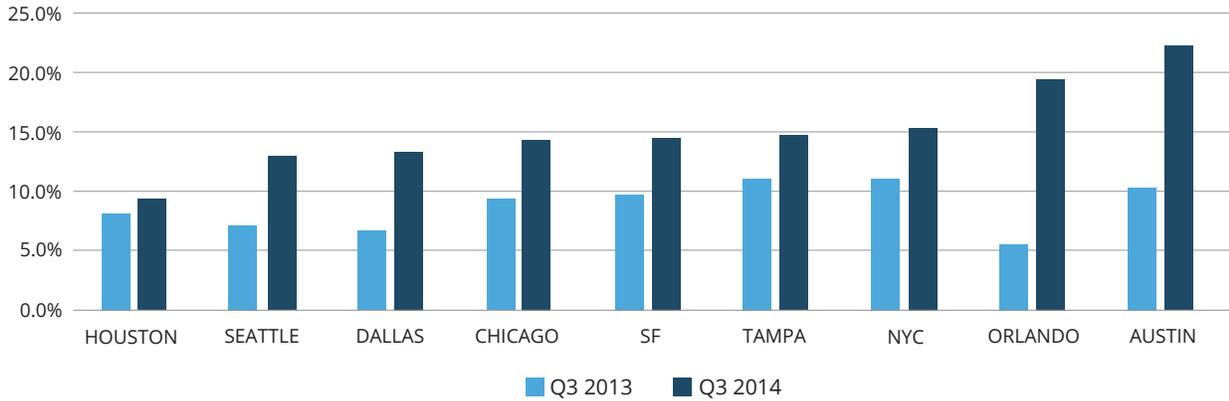
For those of us who work in tech, not a day goes by without coverage of the next on-demand start-up: “*Uber for X*”, we quip. As these service platforms proliferate, so too do the ranks of 1099 workers they employ. Yet despite the meteoric rise of Uber, AirBnB, TaskRabbit, and the rest, the shift from salaried W2s to 1099s is actually *not predominantly* driven by these high-profile tech companies, at least not yet. A 2014 study found that 83% of corporate executives report increasingly use of “contingent, intermittent, or consultant” workers.<sup>4</sup> Data collected by **ZenPayroll** also shows a dramatic increase in 1099s in the small and medium business segment across major metropolitan regions.

<sup>2</sup> Gordon Mills, Karen and Brayden McCarthy. “The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game.” Harvard Business School, July 2014. [http://www.hbs.edu/faculty/Publication%20Files/15-004\\_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf](http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf)

<sup>3</sup> “Freelancing in America Study” Edelman Berland, September 2014. <https://www.freelancersunion.org/53Million>

<sup>4</sup> “Workforce 2020 Report: The Looming Talent Crisis.” Oxford Economics, August 2014. <https://halopublications.s3.amazonaws.com>

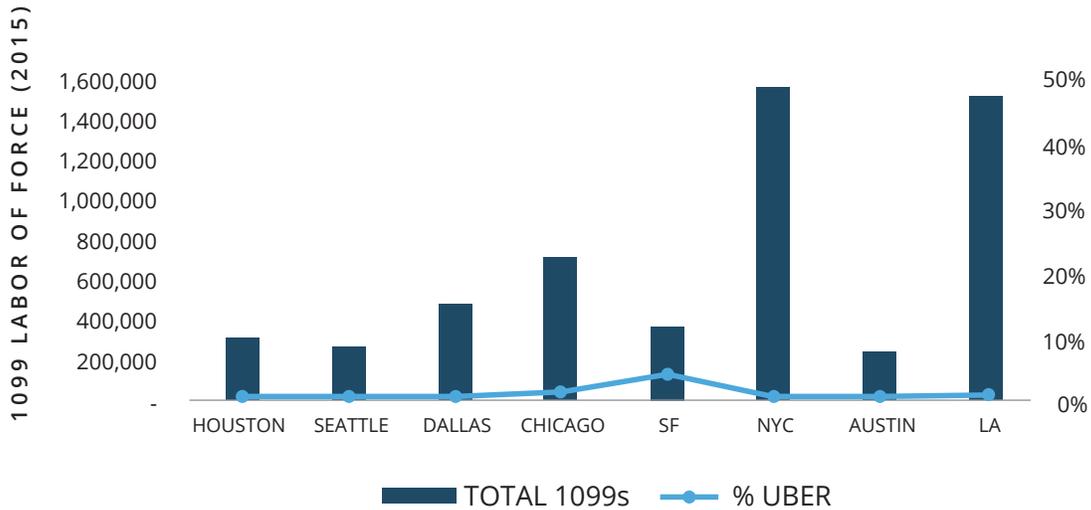
### 1099s AS PERCENT OF WORKFORCE



The Affordable Care Act went into effect in 2014, triggering a requirement that companies with 100+ FTEs provide workers with health insurance.

source: "The 1099 Economy is Real and Growing Fast," Zen Payroll, December 2014.

### UBER AS SHARE OF 1099 WORKFORCE



As the chart above suggests, Uber, the largest on-demand platform, still represents a small minority of total 1099 workforce in major metropolitan regions.<sup>5</sup>

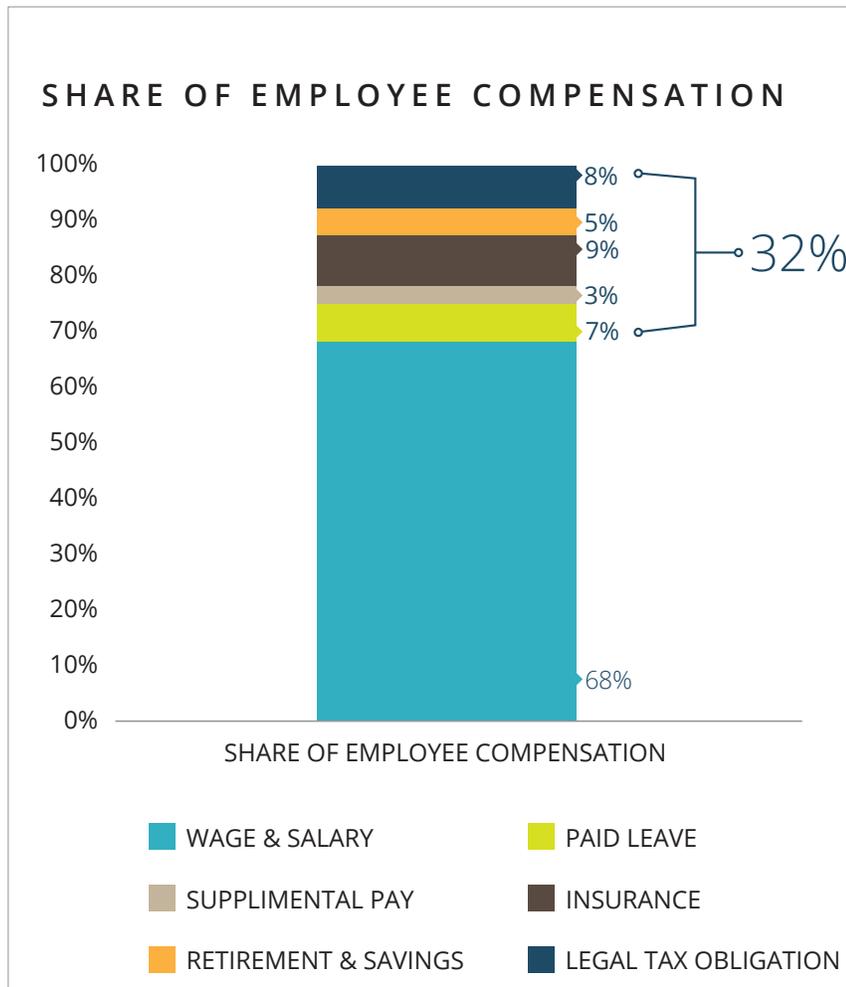
The growth in 1099s is a logical response by employers - tech and traditional, large and small - to rising costs of labor. While middle income wages have largely stagnated since the 1970s,<sup>6</sup> the cost of benefit obligations associated with full time employees has not. Health insurance costs in particular have escalated significantly,<sup>7</sup> but the cost of retirement plans, paid leave, social security and medicare contributions also add up. By classifying workers as 1099s

<sup>5</sup> Core Innovation Capital analysis. Sources: U.S. Bureau of Labor Statistics; Zen Payroll; Uber

<sup>6</sup> Mishel, Lawrence, et. al. "Wage Stagnation in Nine Charts." Economic Policy Institute. January 2015. <http://www.epi.org/publication/charting-wage-stagnation/>

<sup>7</sup> "2014 Employer Health Benefits Survey." Kaiser Family Foundation. September 2014. <http://kff.org/report-section/ehbs-2014-summary-of-findings/>

rather than W2s, employers are able to cut these expenses and reduce payroll costs as much as 30%. It's not a coincidence that ZenPayroll data shows a substantial uptick in 1099s across major U.S. cities over the same period that the Affordable Care Act went into effect. Businesses on the edge of the 100 FTE threshold likely shifted non-core labor to part-time or 1099 workers to avoid added healthcare costs.



So compelling are these savings that ZenPayroll estimates 10-30% of all employers in the U.S. “misclassify” workers as 1099s - reporting them for tax purposes as independent contractors when functionally, they are full time employees.<sup>8</sup> The Bureau of Labor Statistics calculates that average payroll costs of benefits to employers amount to \$10.61 per hour worked.<sup>9</sup> This adds up to roughly \$906 Billion<sup>10</sup> each year that employers save by engaging 53 million Americans as 1099s, rather than W2 employees. Whether classified correctly or not, there is no arguing that for employers, 1099s are cheaper in the short-run.

<sup>8</sup> “The 1099 Economy is Real and Growing Fast.” Zen Payroll. December 2014. <https://zenpayroll.com/blog/rise-1099-economy-infographic/>

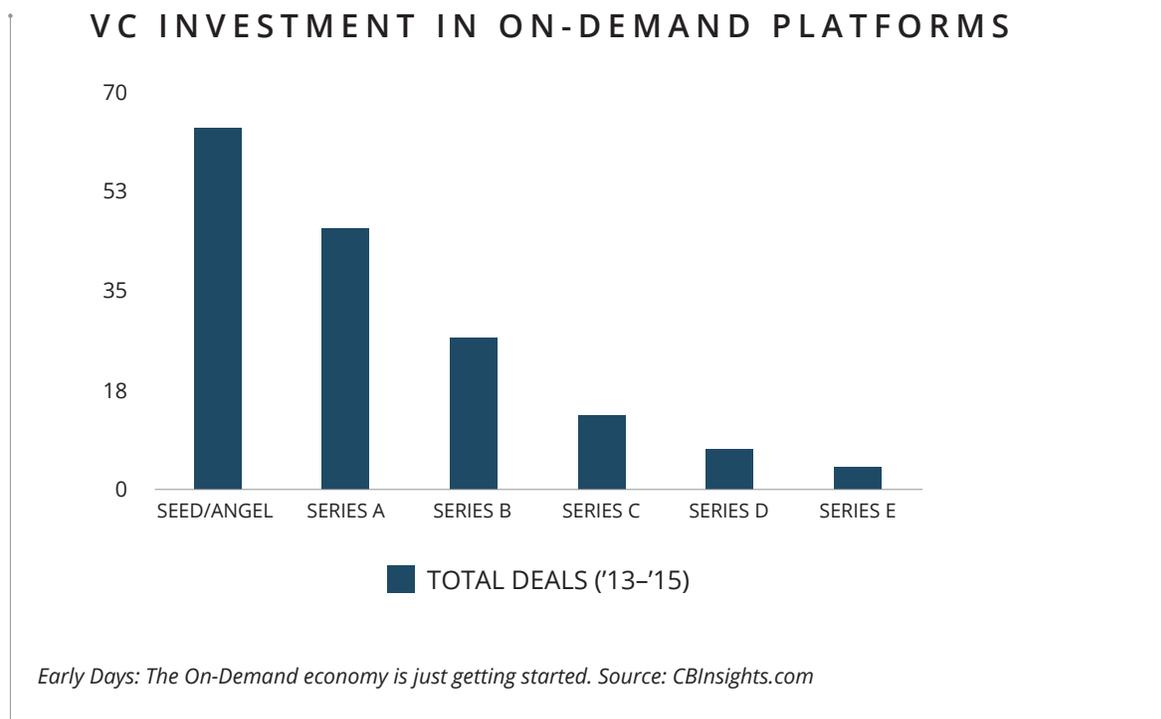
<sup>9</sup> “Employer Costs for Employee Compensation.” Bureau of Labor Statistics. June 2015. <http://www.bls.gov/news.release/ecec.nr0.htm>

<sup>10</sup> Assumes 31 hours worked per week, at 52 weeks per year, for 53M individuals. Sources for weighted average distribution of hours worked: Jiang, Andrew, et. al. “The 2015 1099 Economy Workforce Report.” Requestsforstartups.com. May 2015. <http://www.requestsforstartups.com/>

## TECHNOLOGY: IT'S POSSIBLE

The Service Economy is rapidly becoming the On-Demand Economy, as advancements in technology intersect with firms' eternal search for greater marginal efficiency and flexibility.

"On Demand" is just the latest advancement of a broader trend - the unbundling of American businesses. Over the last decade, capital-efficient SaaS companies have made it possible for businesses to access "[you name it] in a box" - accounting, procurement, inventory management, HR, payroll, benefits, legal services, and so on.<sup>11</sup> Business Process Outsourcing has many benefits. It puts sophisticated tools and capabilities in the hands of companies that would otherwise lack the skills or resources to develop them in-house, and it dramatically increases flexibility and scalability for firms large and small. Naturally, companies seek to achieve similar gains in efficiency and flexibility in one of their largest cost-centers - labor. But only with the recent proliferation of smart phones, geolocation capability, mobile internet and payment infrastructure, and sophisticated workforce management software - has it become relatively easy to transform a large portion of labor costs from fixed to variable.



Now, curated online platforms can replace the temping agencies of old - allowing firms to source, select, contract, manage and pay skilled professionals remotely with a few clicks. Now, mobile networks enable firms to tap pools of latent labor supply to deliver hyper-local services. And now, workers can select engagements at any time from a variety of options, based upon how each project fits their own priorities and skills. This fluid distributed labor force, connected by software platforms and mobile networks, enables firms to enhance marginal efficiency without sacrificing on quality (case in point - our designer, sourced via **LiquidTalent**). Given this, we anticipate that

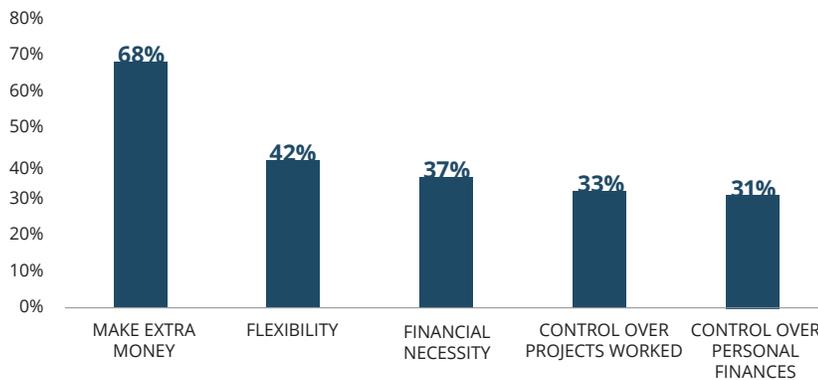
<sup>11</sup> Columbus, Louis. "Roundup of Cloud Computing Forecasts and Market Estimates, 2015." Forbes. January 2015. <http://www.forbes.com/sites/louiscolombus/2015/01/24/roundup-of-cloud-computing-forecasts-and-market-estimates-2015/>

centralized service providers will continue to be replaced by distributed platforms, and non-core W2 employees will increasingly be cut loose, only to be re-engaged project by project, as 1099 workers.

## LIFESTYLE: IT'S PREFERABLE

For some, 1099 status is a choice. Contractors have the right to control when and how they execute their work, unlike W2s, for whom employers dictate the timing, execution, and output of labor.<sup>12</sup> For many contractors, flexibility, control, and diversity of work are key drivers behind their decision to work independently. When compared to their W2 colleagues, 1099s place greater weight on these job characteristics. Indeed, 53% of contractors do freelance work by choice, vs. 47% who do so out of economic necessity. Within the subset of contractors who also hold full-time jobs, about 36% (5.1 million people) have considered quitting their full-time position to exclusively freelance.<sup>13</sup> For some, freelancing is clearly preferable.

### TOP 5 REASONS FOR FREELANCING



source: "Freelancing in America Study" Edelman Berland, September 2014.

And regardless of educational attainment or skill specialty, the proliferation of on-demand platforms allows individuals to monetize excess assets, time, or capacity with relative ease. Sixty-nine percent of freelancers agree technology has made finding work easier, with 42% finding work online, and 31% of those booking work in less than 24 hours.<sup>14</sup> The vast majority report experience increasing demand for their labor over the past year, suggesting contract work will be an attractive option for many for years to come.

<sup>12</sup> "Independent Contractor (Self-Employed) or Employee?" IRS, August 2015. <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-Self-Employed-or-Employee>

<sup>13</sup> "Freelancing in America Study" Edelman Berland, September 2014. <https://www.trsunion.org/53Million>

<sup>14</sup> *ibid.*

## GOT (10)99 PROBLEMS ...

As a fintech fund, we look at this data and ask ourselves - so what? What does 1099 status mean for Americans' financial lives? Quite a bit, it turns out. The financial ramifications of being a 1099, are significant and touch on almost every major product category we invest in - credit, payments, insurance, savings, and personal financial management. That amounts to serious pain points for a large and growing segment of the American workforce.

At Core, we see a robust batch of fintech entrepreneurs working to address these problems by building financial products tailored to the specific needs of 1099s.

### TAX: COSTLY & COMPLEX

Paying taxes is perhaps the most obvious challenge faced by contractors. Come April, accurately separating personal and professional expenses in order to maximize business deductions is a headache. Not only is filing more complex as a 1099 (asset depreciation schedules, anyone?), you're also on the hook for 2x what your W2 colleagues pay in entitlement obligations. Employers split the 15.3% payroll tax earmarked for Social Security and Medicare with W2 employees, but 1099s must pay it all themselves.<sup>15</sup> Oh, and there's the added benefit of seeing that full 15.3% come due to the government all at once come April 15th, rather than having it incrementally deducted from each paycheck. You're welcome - hope you've been saving.

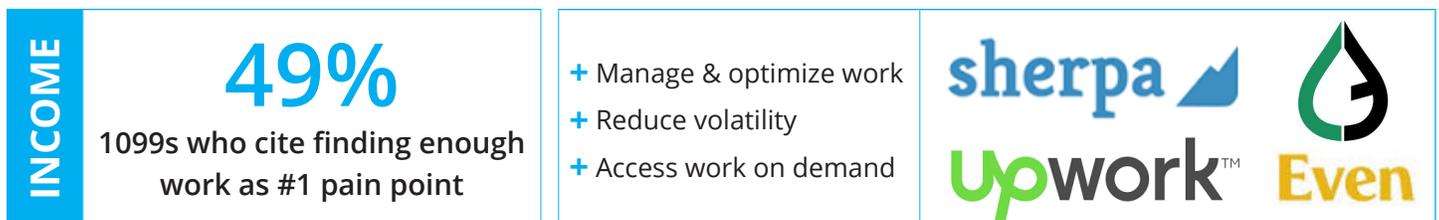
<b>TAX</b>	<b>15.3%</b> Self-employment tax obligation 2x W2 obligation	<ul style="list-style-type: none"><li>+ Tax estimation</li><li>+ Wage "deductions"</li><li>+ Expense classification</li></ul>	 <b>BonsaiTax</b> <b>Painless1099</b>
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**Solving for Simplicity:** Benny, Bonsai Tax and Painless1099 are just a few companies solving the tax challenge. Bonsai makes it easier for contractors to classify expenses and file their tax forms. Painless99 helps users sweep a portion of their monthly earnings into a tax-earmarked account, to ensure they have sufficient reserves to meet their obligation come April. Benny combines numerous features - making it a cinch for workers to classify their expenses, estimate tax obligations, and set aside savings for taxes (as well as insurance payments) as they are paid.

<sup>15</sup> "The 1099 Economy is Real and Growing Fast." Zen Payroll. December 2014. <https://zenpayroll.com/blog/rise-1099-economy-infographic/>

## INCOME: THE VOLATILITY TRAP

Flexibility, control, and project diversity have a dark side – it’s called volatility. Income volatility is the most common and significant pain point experienced by self-employed. When both wage and hours fluctuate, income is extremely difficult to predict. That means it’s nearly impossible to reliably match income to expenses, making budgeting a no-go. This volatility places 1099s at heightened risk of experiencing income dips that coincide with spikes in expenses. It is those moments when households are more likely to resort to costly alternative products, such as payday or pawn loans, to bridge the gap.<sup>16</sup> Given that 68 % of Americans can’t come up with \$500 to cover minor emergency expenses, it’s safe to say most 1099s are not well positioned to absorb these shocks without resorting to costly alternatives.<sup>17</sup>



**Solving for Consistency:** Fortunately, start-ups are attacking the problem of income volatility from various angles - from work optimization and sourcing tools, to defacto wage insurance. **SherpaShare** helps on-demand workers manage their various “gigs” from a single dashboard, identify inefficiencies, and optimize their time allocation to earn more. **LiquidTalent** is a marketplace focused on connecting curated, highly skilled freelancers with high-quality hyperlocal project opportunities. Like other marketplaces, such as **UpWork** and **Speedlancer**, **LiquidTalent** helps users find work quickly and easily - mitigating income volatility. Such platforms could increase global GDP by \$800 billion over the next 10 years, by facilitating new and faster matching between labor supply and demand.<sup>18</sup> **Even** is an Oakland-based startup with a creative approach to income smoothing. Even learns the cash flow patterns of users, calculates an “average” paycheck, and then guarantees users a minimum of that paycheck each month. If the user earns below that amount, Even will float them the difference at no interest. If the user earns more, they repay any past float and keep any additional earnings beyond that.

## LIQUIDITY: CASH IS KING

Liquidity is also a large and frequent challenge for 1099s. Pay cycles for self-employed contractors can easily be T+30 or T+60, leaving workers in a major cash crunch. In addition, workers must deal with any dispute resolution or payment collection issues that arise with a client themselves. This takes time, and time (when you have no fixed salary) is money. New York State estimates \$3-5 billion in freelancers’ wages were lost in New York alone due to client nonpayment and the opportunity cost of time spent trying to collect.<sup>19</sup>

<sup>16</sup> Morduch, Jonathan and Rachel Schneider. “Spikes and Dips: How Income Uncertainty Affects Households.” Center for Financial Services Innovation. October 2013. <http://www.usfinancialdiaries.org/issue1-spikes/>

<sup>17</sup> Morath, Eric. “Most Americans Don’t Have Savings to Pay Unexpected Bill.” Wall St. Journal. January 2015. <http://blogs.wsj.com/economics/2015/01/07/most-americans-dont-have-savings-to-pay-unexpected-bill/>

<sup>18</sup> Manyika, James et al. “A Labor Market that Works: Connecting Talent with Opportunity in the 21st Century.” McKinsey&Company. June, 2015.

<sup>19</sup> Rogers, William. “The Threat of Nonpayment: Unpaid Wages and New York’s Self-Employed.” Heldrich Center for Workforce Development at Rutgers University. June 2010.

<http://fu-res.org/pdfs/advocacy/2010-unpaid-wages-report.pdf>

LIQUIDITY	<h1 style="color: #0070C0;">\$3-5B</h1> <p>Amount freelance wages lost due to non-payment in NY</p>	<ul style="list-style-type: none"> <li>+ Real-time payment</li> <li>+ Invoice advance</li> <li>+ Dispute resolution</li> </ul>	  
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**Solving for Timely:** Novel payment solutions are helping contractors get paid earlier or in real time, with greater transparency and ease. **Fluid Financial** helps 1099s with outstanding invoices by advancing their earnings to fit a more normal pay period (i.e. T+14 vs. T+60). Given that Fluid is effectively underwriting the company, not the contractor, the advance is low risk and far more affordable than an unsecured personal loan. **Nowsta** and **Activehours** go a step further, allowing contractors to be paid as they complete their work, rather than on a biweekly pay cycle. Activehours charges no fee for this service, asking users simply to pay what they think is fair, while Nowsta charges 3-5% of the advance amount. Two companies improving how 1099s get paid are **Payable** and **PromisePay**. Payable improves workers' experience by enabling companies to disburse payments to distributed contractors rapidly and automatically, with greater transparency and fewer disputes. PromisePay prevents and mitigates disputes offering out of the box escrow that makes it dead simple for independent buyers and sellers to transact via online marketplaces, without a team of lawyers to ensure fulfillment and good behavior.

## SAVINGS & INSURANCE: LIMITED & LACKING

Historically, most workers obtained insurance and retirement benefits through employers, who would hire brokers to sort through a morass of plan options, offer a package of choices, and manage enrollment paperwork. Without any of that infrastructure, and none of the scaled purchasing power that employers wield, 1099s are left sourcing insurance and retirement plans themselves, and paying a premium for it. The result? Self-employed workers are 22% less likely to have any retirement assets, and much of the gap comes down to access.<sup>20</sup> While 79% of employers offer 401(k) or other retirement plans to full time employees, only 49% offer them to part-time or contract workers. The problem is especially acute in small businesses with fewer than 100 employees, where only 39% offer plans to part-time workers.<sup>21</sup>

Self-employed workers are twice as likely to lack health insurance as the general population.<sup>22</sup> Those who do have health coverage are more likely to have inferior coverage and higher out of pocket expenses than those who obtain coverage through an employer.<sup>23</sup> 1099s participating in the sharing economy, often find themselves betwixt and between the parameters of traditional insurance plans. They own and deploy assets that inherently change state from personal to commercial and back again. Traditional insurance plans were not designed to accommodate such dynamism in risk (as Uber has illustrated), and both carriers and tech platforms are

<sup>20</sup> Lichtenstein, Jules. "Financial Viability and Retirement Assets: A Look at Small Business Owners and Private Sector Workers." U.S. Small Business Administration. December 2012. <https://www.sba.gov/sites/default/files/files/rs401tot%20%281%29.pdf>

<sup>21</sup> Collinson, Catherine. "The Retirement Readiness Challenge: Five Ways Employers Can Improve Their 401(k)s." Transamerica Institute. October 2014. <http://www.transamericacenter.org>

<sup>22</sup> "The Uninsured: An Interactive Tool." Kaiser Family Foundation. January 2014. <http://kff.org/interactive/the-uninsured-an-interactive-tool/>.

<sup>23</sup> Allen, Karen and Christina Park. "Health Insurance Coverage for the Self-Employed with No Employees." National Center for Health Statistics. June 1999. <http://www.cdc.gov/nchs/data/misc/hincov.pdf>

now working in real time to address these shortcomings.<sup>24</sup> But in the interim, many participants will likely continue to engage in the sharing economy with significant exposure to commercial risk not covered under their personal plans.

<b>SAVINGS</b>	<h1 style="color: #0070C0;">22%</h1> <p>Less likely to hold any retirement plan assets</p>	<ul style="list-style-type: none"> <li>+ Low friction, low fee</li> <li>+ Forward-looking</li> <li>+ Dynamic yet passive</li> </ul>	  
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**Solving for Accessibility:** Startups are making it easier for 1099s to save by innovating to expand retirement plan access and rethink product design. **Honest Dollar**, a Core portfolio company, is an affordable 401(k) alternative for small businesses. Honest Dollar dramatically reduces the cost, administrative burden, and complexity of offering workers a retirement plan - whether they are W2 employees or 1099s. Through product design, startups like **Sweep** and **Digit** are making it easy for 1099s to save despite financial volatility. Sweep analyzes users' cashflow patterns to predict whether they will have sufficient income to meet upcoming expenses, or are at risk of running short. It also lets them set up rules to fund specific savings buckets - like an emergency fund - as soon as they get paid. Digit "learns" users' cashflow patterns, estimates how much is safe to save in a given week, and then automatically saves that amount for the user. When users are earning more or spending less, Digit automatically saves more. If users hit a tough spot, the app reduces saving rates or stops all together. Users can pause savings anytime, but otherwise don't need to actively engage - the app manages their savings rate dynamically and without intervention.

<b>INSURANCE</b>	<h1 style="color: #0070C0;">\$6.5K</h1> <p>Typical deductible cap on HDHP</p>	<ul style="list-style-type: none"> <li>+ Dynamic, tailored plans</li> <li>+ Aggregation &amp; curation</li> <li>+ Transparent comparison</li> </ul>	  
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**Solving for Stability:** In insurance, startups are also attacking the challenges of product access and design. Platforms such as **Peers** and **Freelancers Union** help connect contractors to resources ranging from work management tools to insurance products. Both companies also partner with other service providers to offer co-branded products designed specifically for 1099s, such as Peers' KeepDriving product (offered in partnership with **Breeze**) and Freelancers' Medical (offered through Empire BCBS). In health insurance, **Stride Health** fills the void of advice and access, by offering a transparent aggregator that helps users compare and enroll in health plans suited to their needs.

<sup>24</sup> Alba, Davey. "California Forces Uber and Its Rivals to Boost Insurance." Wired.com, July 2015. <http://www.wired.com/2015/07/california-forces-uber-rivals-bolster-insurance/>

Regarding product design, **Metromile** is an ambitious company that has introduced what is perhaps the first dynamic auto insurance plan, developed specifically for rideshare drivers. Metromile leverages drivers' connected phones to toggle an auto insurance policy between personal and commercial, depending on the state of the vehicle. Given that 1099s frequently use property and equipment for both commercial and personal purposes, there is significant opportunity for dynamic IOT- enabled P&C plans to become widespread.

## CREDIT: LIFE OUTSIDE THE BOX

In the realm of credit, self-employed borrowers present unique challenges with respect to underwriting and product design. Because their income is often spiky, seasonal, or contractually temporary, 1099 workers are likely to fail the income verification requirements of traditional bank lenders for large products like mortgages and auto loans.<sup>25</sup> As a result, self-employed borrowers are more likely to turn to loans from alternative specialty lenders. These products are categorically more expensive. Take mortgage, for example. The cost difference between a qualified FHA mortgage and a private "hard money" loan is easily as much as 500 to 800 basis points. Small business owners embody the struggle of the self-employed to access affordable credit - with one specialty lender estimating that 60% of small business owners are unable to access traditional "qualified" mortgages.

From a product perspective, the volatile nature of 1099 income is structurally incompatible with fixed, inflexible nature of loan repayments. Unless workers can earn (and save) enough in busy months to service their debt in dry months, the likelihood of delinquency or default is high. While a small number of loan products accommodate flexible repayment schedules - such as Federal Student Loans - many do not. Penalties for missed payments and prepayments are still the norm.

<b>CREDIT</b>	<h1>60%</h1> <p>Small business owners cannot access traditional mortgages</p>	<ul style="list-style-type: none"><li>+ Better Underwriting</li><li>+ Novel data</li><li>+ Flexible design</li></ul>	
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**Solving for Mobility:** For contractors who don't fit into the rigid "credit box" used by traditional lenders, start-ups are redefining the box and developing more sophisticated, contextual, nuanced underwriting models. Privlo is one of them. The company serves borrowers that are unable to obtain affordable "qualified" mortgages, offering them "non-qualified" mortgages at materially lower rates than the alternative "hard money" lenders who traditionally served the segment. **Privlo** looks beyond blunt signals, like spikey income or employment duration, to contextually evaluate a wide array of data and better determine a borrower's propensity and ability to repay. **Vouch**, a Core portfolio company, harnesses the power of a borrower's network to look beyond an individual's volatile income or

<sup>25</sup> "Underwriting Factors and Documentation for the Self-Employed Borrower." FannieMae. July 2015. <https://www.fanniemae.com/content/guide/selling/b3/3.2/01.html#Factors.20to.20Consider.20for.20a.20Self-Employed.20Borrower>

credit history and offer personal loans at lower rates and better terms. By building up a private network of sponsors who will attest to their creditworthiness, borrowers using Vouch are able to access more capital at a lower cost than they could otherwise.

In addition to more nuanced underwriting, creative product design is also needed to serve contractors' credit needs. **Breeze**, an innovative startup in auto finance, is reimagining auto leasing to be flexible, liquid, and capable of adapting to income volatility. Rather than lock themselves into inflexible auto lease or loan payments for 36, 48, or 50+ months, drivers seeking to access on-demand work can join Breeze and make weekly "membership" payments. Breeze inserts itself between lease finance companies and drivers, and services the lease. Should a driver seek to stop participating in on-demand platforms, he simply transfers the lease back to Breeze, which transfers the lease title to another individual. No harm, no foul, no default, and no damaged credit.

We could go on, but the point here is that 1099 status often adds up to more cost and more friction in an individual's financial life. When surveyed, only 32% of 1099s agreed with the statement "I feel secure in my financial situation," with 41% disagreeing or strongly disagreeing.<sup>26</sup> With 40-50% of the workforce projected to be 1099s by 2020, that adds up to a lot of financially insecure Americans.

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<sup>26</sup> Jiang, Andrew, et. al. "The 2015 1099 Economy Workforce Report." Requestsforstartups.com. May 2015. <http://www.requestsforstartups.com/>

## CHALLENGES & OUTLOOK

It is encouraging to see so many companies working to address the financial needs of this growing market. Yet we are clear-eyed about the challenges they must overcome in order to gain traction, scale efficiently, and build sustainable businesses.

### REGULATION

It's the elephant in the room - the issue of misclassification is attracting increasing scrutiny at both the federal and state level. Recent state court cases brought against on-demand platforms Uber and Homejoy challenge the notion that workers on those platforms can properly be classified as 1099 workers. For Homejoy, these suits accelerated the decision to shutter the struggling business. In July, The Department of Labor issued a statement reaffirming the proper distinction between 1099 and W2 workers, and emphasized growing concern over the practice of misclassification.<sup>27</sup> Some have proposed the creation of a third class of worker - a new tax status, that would combine the autonomy and flexibility of a 1099 with greater structural support from businesses - like training or basic benefits.

So, should we expect a massive contraction in the 1099 labor force? Not so fast. While the concept of a third classification is interesting, the complexity of implementation and the required cooperation of legislators means this won't be an option on the table for years - maybe a decade. In the near term, increasing regulatory scrutiny will force companies to more carefully consider how they source labor and structure their operating model. There are three possible scenarios, and companies will weigh the costs and benefits associated each:

- \* Eat the cost, and hire a workers as W2s
- \* Continue to misclassify 1099s, and assume liability risk for fines and back taxes
- \* Tweak the operating model, to ensure 1099s' work specifications fit the DOL guidelines

For a subset of companies whose business model requires tight operational control of workers, option one may be inevitable. Companies like Handy have chosen this path. Mom and pop shops are likely to continue to fly under the radar and misclassify a small number of workers under the assumption that the IRS has bigger fish to fry. And for the rest, tweaking operations to allow 1099 workers the autonomy and flexibility they are entitled to will almost certainly be the most cost-effective option. Labor sourcing platforms can play a huge role in supporting this third way, by providing curation and positive selection to companies. Offering trained, credentialed, pre-screened labor allows companies to maintain operational excellence without in-house training.

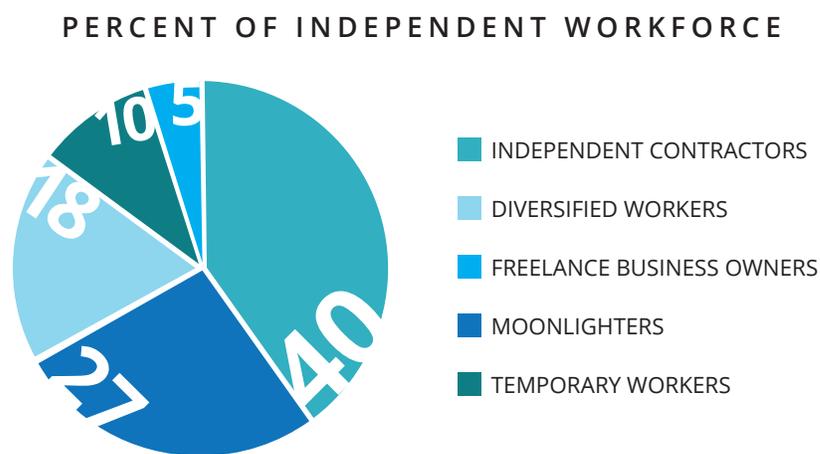
**BlueCrew** is one startup going a step further, by putting a new spin on the old staffing agency model. BlueCrew hires workers as W2s, trains them, and connects them to "low complexity" jobs - effectively outsourcing liability and providing clients the benefits of optimal labor utilization without the full cost of W2 obligation or misclassification

<sup>27</sup> Weil, David. "Administrator's Interpretation No. 2015-1." U.S. Dept. of Labor, July 2015. [http://www.dol.gov/whd/workers/Misclassification/AI-2015\\_1.pdf](http://www.dol.gov/whd/workers/Misclassification/AI-2015_1.pdf)

risk. We expect that sourcing platforms will play a critical role in mitigating the regulatory and operational risk in hiring contract labor.

## PRODUCT MARKET FIT

Given that we can expect a wide diversity of independent workers to participate in the labor force for years to come, companies must avoid the pitfall of lumping all 1099s into the same bucket. While they share certain characteristics, 1099s are an incredibly heterogeneous group, with wildly different income, credit, and industry profiles. The following chart shows the distribution of freelancers across various segments, which roughly map to their labor profile.



Source: "Freelancing in America Study" Edelman Berland, September 2014.

As you can imagine, a sole proprietor consultant is quite different from a grad student who is Ubering on the side, and different again from a full time teacher who teaches SAT prep courses on the weekend. Their pattern and magnitude of cash flows will vary widely, as will when and how they are paid, the technology and resources they use, and the financial products they have access to. A consultant that has been in business for herself for 5+ years with relatively high value, long-term contracts may need payment tools that facilitate dispute resolution and collection from a client, or access to liquidity in the event of long payment cycles. She likely won't need a specialty mortgage product. A teacher / tutor with both W2 and 1099 income likely won't need a retirement or health insurance product, but will need tools to make tax filing easier, and may wish to better estimate his future tax obligations on independent earnings.

## DISTRIBUTION

Clearly defining the subset of 1099s who are high-propensity customers is not only critical to effective user testing

and finding product-market fit, it is also necessary to overcome the second major challenge in this market – efficient distribution. 1099s are diffuse. Many startups are looking to partner with other tech-forward platforms to distribute their product, and in some cases this may be a viable strategy. But Uber won't partner with everyone, and even if it did, Uber drivers still represent a rounding error of this market. Most 1099s are still spread across that maddening blue ocean – small businesses. How do you get the dentist office receptionist / weekend waitress in Cincinnati to use your product? That is the question.

Many will try to distribute through the workplace. But given the fragmentation of small businesses, doing so will not be easy. In case you're not a student of small business acquisition, here are the Cliff's Notes: it's hard. SMBs with less than 50 or 100 FTEs are time and resource constrained. They have minimal HR infrastructure. Their near-term priorities (like staying in business) trump second order concern for the financial lives of their workers. Taking a cold, hard look at channels into the SMB market is sobering. Payroll companies, benefit brokers, insurers - these potential partners are often the incumbents, selling antiquated products that startups would either displace or compete with for attention.

So, what are the alternatives? How about targeted online acquisition? Well, maybe...but likely not. The products we've described are complex to understand and explain – think credit and insurance. They may require the participation or endorsement of the employer - think retirement and health benefits. They certainly come with a high bar of trust – as in payments, financial management, and savings. None of those features lend themselves fabulously well to fully online acquisition. Creativity will be required, as well as a thoughtful blend of channels that speak to the particular traits, behaviors, sociodemographic characteristics and industry profile of a company's target 1099 segment.

## RETENTION

Finally, companies must think carefully about the duration of their relationship with the customer. The golden ratio of lifetime value to acquisition cost is central to the long-term profitability of any company, and fintech companies serving 1099s must be especially sensitive to this, given the inherent fluidity of 1099's financial lives. These customers are more likely to shift between platforms and clients. They may move in and out of 1099 status multiple times in their lives. Payment, financial management, and savings tools must be portable, flexible, and interoperable. Insurance and credit products must remain relevant and competitive as the needs and opportunity set of the customer evolves. Otherwise, startups serving this customer may find themselves exposed to the very same volatility that makes their customers' lives so challenging and complex.

## CONCLUSION

The rise of the 1099 Nation is a structural shift driven by economics, policy, technology, and cultural forces - it is unlikely to reverse in our lifetime. Growth in 1099 workers will not halt in the face of regulatory scrutiny, though the way contractors are sourced, hired, and engaged will certainly evolve. Whether individuals freelance by necessity or choice, 1099 status imposes unique financial complexities and pain points. This represents a huge opportunity for financial services companies to innovate by rethinking traditional products and designing entirely new ones.

Fintech startups generally, but especially those targeting this segment, must consider the needs and unique characteristics of this market, and tailor their product, distribution strategy, and business model accordingly. The payoff is big. Banking the 1099 Nation will enhance financial stability and mobility for millions of Americans - and that will unlock massive value for companies, their investors, and their customers.

At Core, we'll be at the table. If you're in business to bank the 1099 Nation - drop us a line.



## **ABOUT CORE**

Core Innovation Capital is a leading financial services sector expert venture capital fund investing in companies that empower everyday Americans. Core leverages its deep expertise in financial services, technology and regulation to help entrepreneurs build disruptive, high-growth businesses. Core portfolio companies save 20 million customers more than six billion dollars every year. Investments include Oportun (formerly Progreso Financiero), NerdWallet, Ripple Labs, Vouch, CoverHound and TIO Networks. **Follow Core at @CoreEMC and online at [www.corevc.com](http://www.corevc.com).**

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