Starved for Cash, Main Street Turns to Alternative Lenders

Published: Wednesday, 20 Mar 2013 | 11:37 AM ET

By: Laura Schreier, Special to CNBC.com

Signs of a data-analysis revolution are everywhere. Remember "Moneyball?" The sports bestselling book and movie trumpeted number crunching over gut instinct. Data analysis is now reshaping the **small-business** lending space, too.

With bank loan competition still tight, more startups and **small-business owners** are turning to alternative lenders, which use technology-driven data analytics (aka fancy enterprise software) to gauge loan applicants. The new crop of lenders are also using nontraditional measures to assess applicants. Those measures can include payroll, Better Business Bureau ratings, **Yelp** ratings and more.

"It's sort of a mosaic of different data points," said Noah Breslow, chief executive of On Deck Capital, an alternative lender.

How Alternative Lenders Work

Most alternative lenders offer shorter-term, higher-cost loans. They also provide cash advances to businesses and then recoup the money through a cut of their future credit card transactions — technically not a loan at all. Despite the variety of alternative lenders cropping up, their unifying characteristic is their technology-driven decision-making.

Each lender has its own, proprietary system to gather information and assess would-be borrowers' strengths and weaknesses. Many rely most heavily on an applicants' submitted bank statements or other financial data. But more recently, public databases and even social-media activity have been factored into the decision-making process.

"Every restaurant we do, we look at their Yelp review," said Joseph Looney, chief operating officer and general counsel for cash-advance company Rapid Advance, which consults with data scientists to refine its methods and discover new insights into a business' prospects.

But wait. Before you get any ideas about juicing up your Yelp reviews for a loan, consider this.

Looney emphasized that Rapid Advance is not going to make a decision based solely on a string of online comments on a social media site. But Rapid Advance considers the mere presence of an active social-media footprint to be a good sign of an active business, he said.

Proceed With Caution

Although some alternative lenders must get approval from state banking regulators, there's no single, national oversight organization for them, and — perhaps ironically, given their data-driven outlook — no central database that records how much business they do, or their default rates.

"It's just like a big, black hole," said Ami Kassar, chief executive and founder of MultiFunding. Kassar's company consults with **small businesses** that are looking for credit, and advises them on the best ways to get funds without getting into crippling debt.

Kassar advises businesses to regard these private alternative loans with extreme caution. The cost of this money is much higher than borrowers enjoy at banks, and**small businesses** may yet be able to get less-expensive loans from other programs, even if banks shut them out.

But Breslow of On Deck Capital says the innovative underwriting techniques his company employs are bringing down those interest rates.

Merchant cash-advance companies have been around for years, Breslow said, but they typically made up for sloppier underwriting by charging high rates. But new technology-driven underwriting techniques are letting lenders price their risks more precisely, and exclude weaker borrowers from the pack. That's helped bring the average interest rate down, Breslow said.

The alternative-lending industry average for a six-month loan was 38 percent when On Deck started in 2007. Now, it's 15 percent, and Breslow said it may come down further as this underwriting continues to improve.

Kassar, however, is skeptical that improved underwriting has truly been the cause of lower interest rates. Equally likely, he said, is new entrants into the lender market who are helping to push down rates. And regardless, he said, the loans still end up being far more expensive than a traditional bank loan.

Higher Interest Rates

Charles H.Green, founder of the Small Business Finance Institute and a consultant for IOU Central, said traditional banks' low cost of capital allows them to lend for lower annual rates, often in the range of 5.25 percent to 7.25 percent. Interest rates for similar loans from alternative lenders range from 15 percent to 20 percent. Plus, merchant cash-advance companies — those that advance money and take a cut of credit-card transactions — can charge as much as 30 percent to 60 percent.

Still, Kassar acknowledged, these lenders are moving quickly to innovate their underwriting. Banks, meanwhile, are hamstrung by much heavier regulatory oversight, as well as a highly conservative outlook on such innovations.

Typically, getting banks to change any of their practices is "like getting a root canal nine times over," Kassar said.

More Technology = Faster Loan Process

The technology platform of lender IOU Central pulls in data such as personal business credit information, business cash flow, social media rankings, and other information from various databases. It can even consider such factors as restaurants' health score, said Robert Gloer, president and chief executive officer.

It's all up-front and automated, Gloer said, and it takes in multiple factors and spits out a single "score" that weeds out bad risks quickly. After the software does its calculations, humans make the final loan decisions. Still, churning through that first round of applications so quickly — compared to traditional loan-application processes without new data-driven software — eliminates a huge amount of cost and hours.

Data analysis also means **small businesses** have to prepare less paperwork when applying for their loan, Gloer said. For example, banks may ask **business owners**to prepare a resume. But IOU just scans a **LinkedIn** account.

Gloer said IOU Central's methods evolve constantly, and Breslow said the same of On Deck's enterprise software. "We have 40 engineers working on this system," he said. IOU Central's system taps sources that include payroll data, insurance information, accounting records, and social-media data.

Access to Needed Cash

For a large population of **small businesses**, usually those with well under $10 million in annual sales, these alternative lenders are possibly their only shot at business loans —despite the risks. Banks are eager to lend, but they're fighting over a small group of impeccable businesses with great collateral and a squeaky-clean record, said Green of the the Small Business Finance Institute.

And banks are using standards that shutout a large number of businesses, many of which have low credit scores from financing their expenses on credit card debt, or don't have enough collateral,or are simply too small to be worth the banks' time. Mid-sized businesses do have an easier time getting credit.

Barlow Research doesn't survey alternative lenders, but analytics director Bernie Kuechler said the company has received more requests for information on the topic. "There's definitely a growing market out there for these groups," he said.