CRAIN'S NEW YORK BUSINESS

Tips for finding financing when banks say no
Need funds? An alternative universe awaits, letting you tap hard assets

By Elaine Pofeldt
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Errol Cvern knew that banks weren't likely to put out the welcome mat for his small business when he launched Select Express & Logistics in Manhattan. So for financing he turned to a startup-friendly alternative lender, Summa Capital, which offered him a flexible line of credit against his receivables in what is known as asset-based lending.

The now seven-year-old delivery business would probably be a good candidate for bank credit, with $20 million in annual sales. But Mr. Cvern is happy he stuck with asset-based lending now that the tight credit market has frozen many small companies out of banks.

“Hindsight being 20-20, we found ourselves in a very good position,” he says. “We can sleep at night. The last thing a company can afford is for a bank to come up with some bureaucratic answer as to why they can no longer loan you money.”

He's not alone. With lending to small businesses still tight, despite new federal programs to increase the flow of loans, more entrepreneurs are relying on nonbank sources, ranging from old-school retail industry financing firms called factors to new peer-to-peer lending operations that operate -online.

Asset-based lending grew by 8.3% in 2008, with total outstanding loans in the United States near $600 billion, according to the Commercial Finance Association, the trade group for the asset-based lending and factoring industries.

“When the banking industry was contracting, our lending was expanding,” says Andrej Suskavcevic, chief executive of the association.

Six New York City Business Solutions Centers (see nyc.gov/sbs) now provide help to small companies in obtaining financing from alternative lenders, as well as traditional banks and credit unions—and the demand is growing. In 2008, the centers facilitated 187 such loans. In the first five months of this year, the total reached 143.

“Small businesses often struggle to understand the differences in application requirements, target markets and loan products offered by lenders throughout the city, resulting in rejected applications or suboptimal terms,” says Cristina Shapiro, assistant commissioner of the city Department of Small Business Services.

Peer-to-peer lending, in which individuals make loans to entrepreneurs through matchmaking Web sites such as Lending Club and Kiva, is also taking off, despite some recent regulatory challenges. Celent, a global research firm focused on the financial services industry, estimates that peer-to-peer loans will total $3 billion in 2009, up from $1.6 billion in 2008.

“New York is the third-largest state for us in terms of loans being issued,” says Renaud Laplanche, founder and CEO of Lending Club, a Silicon Valley site that facilitates such loans nationwide.

Does it cost more to borrow from nontraditional lenders? Often, yes. Alternative lenders typically charge interest rates higher than 13%—greater than the current rate of about 8% on Small Business Administration 7(a) loans but cheaper than many credit cards. At Lending Club, for instance, the average rate is 13.5%, says Mr. Laplanche.

Then again, in many cases, small business owners have run out of options. “The most expensive money in the world is no money at all,” says Joe Ingrassa, managing member of Capstone Business Credit, a factoring company in New York City.

Capstone and other factors provide financing based on the value of customers' receivables; some buy the receivables and assume the risk of collecting them, while others will provide financing for up to 90 days, during which their clients must collect the amount owed.

Is borrowing from an alternative lender right for you? And if so, how do you find the right one? Here are six issues to consider.

1. How big—or small—you are

Some asset-based lenders prefer to lend to businesses with revenue above a certain amount. Capstone, for instance, often looks for clients with nonperishable products such as garments or electronics with revenue in the $8 million to $10 million range, and focuses on deals of $2 million or more. “They have the best growth potential,” Mr. Ingrassa says.

Look for a lender that caters to businesses in the same field doing deals around the same size, so its main financing packages are a good fit for your needs. Some lenders will refer you to colleagues who specialize in smaller deals if you don't meet their limits, so it doesn't hurt to ask.

If you need a very small amount of money, peer-to-peer lending may be a simpler proposition.

Oscar Veras, a Bronx legal assistant, was surprised at how easy it was to take out a $10,000, three-year personal loan at 13.79% interest on Lending Club to buy a restaurant. “It took about a week,” Mr. Veras says, noting he obtained the money from 42 people who lend money via the site as a personal investment.

2. How much skin you have in the game

Alternative lenders often expect company owners to hold a 50% stake in their ventures, up from 33% to 35% stakes in flusher times, says Bruce Director, a counselor with the Service Corps of Retired Executives in Manhattan. “No one is going to lend any client 100% of the financing,” he says. If you've only held on to a tiny piece of your company, other options may be better.

3. How much scrutiny you can comfortably handle

Expect to supply more paperwork with alternative lenders than you would for a bank loan, and don't be surprised if they want to scrutinize your personal tax returns. “Our due diligence is absolutely more stringent than a traditional finance company because our clients typically wouldn't be considered creditworthy,” Mr. Ingrassa says.

4. How much outside involvement you want

Before you sign any agreements, ask if your lender will want to take an active role in the management of your business if you hit any bumps. Some entrepreneurs welcome the help. “It's in nobody's interest to watch a business fail,” Mr. Suskavcevic of the Commercial Finance Association says. But if you would not, for instance, welcome strong suggestions to hire a new chief financial officer, or would not want a factor to collect receivables directly from your clients, don't sign on with a company that takes an aggressive approach.

5. How much you can afford to pay for financing

To calculate the true costs of borrowing from a factor, ask some detailed questions, says Marilyn Landis, who provides outsourced CFO services to companies around the country through Basic Business Concepts in Pittsburgh. Is there a minimum amount of financing you must do monthly? Will the factor charge a fee for wire transfers? Is there a termination fee to get out of the contract?

You may find that you want to use alternative lenders as a short-term solution. That's the case for Trina Thornbury, chief financial officer of Universal Apparel Management Corp., which is helping run Caffeine Culture, a young men's clothing line. Caffeine Culture, which currently relies on asset-based and purchase-order financing from Capstone, plans to phase out that funding soon.

“Working with Capstone has given us the ability to stabilize and grow in a way that we wouldn't have been able to do otherwise,” she says, “but we expect that within the next year, it won't be necessary for us to continue funding in this manner.”

6. How much flexibility you need

Although Summa Capital charges him a little more than a bank would, Mr. Cvern of Select Express & Logistics doesn't mind, because the lender's been willing to adjust his credit line—currently $1 million—as his receivables have grown. “If you're dealing with a bank that will only look at things annually,” Mr. Cvern says, “you're kind of stuck.”

KNOW YOUR ALTERNATIVES

ASSET-BASED LENDERS offer business loans and lines of credit secured by inventory, accounts receivable and other balance-sheet assets, from machinery to intellectual property. Asset-based financing is often used to help companies meet such rolling cash-flow needs as making payroll or building inventory.

FACTORING COMPANIES, a longtime staple of the retail industry, typically buy a business's accounts receivable at a discount and collect the receivables themselves. It is not a loan but a purchase of a financial asset, offering businesses quick access to cash and leaving customer debt-collection costs to the factors.

PEER-TO-PEER LENDERS are individuals or pools of individuals who make loans to entrepreneurs through matchmaking Web sites. In an auction-like system, lenders willing to provide the lowest interest rates “win” the borrower's loan. The process may include intermediaries that package and resell the loans.