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Entrepreneurs Turn to Alternative Finance

With bank lending standards not loosening any time soon, asset-based lenders, factors, and merchant cash advance providers are filling the void

By John Tozzi

The credit binge and the crash that followed have left entrepreneurs in a bind. Banks, faced with rising defaults, dramatically tightened lending standards to reduce their risk. Small business owners who borrowed liberally when credit was easy were blindsided by the downturn, and many now find their credit scores wrecked. Those with little debt on their books but facing slipping sales are also perceived as risky: They're shut out of traditional loans and even credit cards, and represent a growing market of businesses that banks won't touch.

Enter the alternative finance companies. They include asset-based lenders (which make secured loans for purchases of equipment or inventory), factors (which buy unpaid invoices at a discount), and merchant cash advance providers (which pay up front for the right to collect a share of a retailer's future credit-card sales). These sources of funds generally cost more, sometimes much more, than bank credit. But businesses that survived the recession will need to buy inventory and equipment, expand operations, and hire workers during a recovery—and they are finding few other options to fund their growth.

Banks don't plan to resume normal lending any time soon, even when economic growth returns. The Federal Reserve's most recent survey of senior loan officers found that most expect to maintain higher lending standards through the second half of next year. For riskier borrowers—including many small businesses—credit "will remain tighter than average for the foreseeable future," according to the report. Credit-card lending, once an easy source of unsecured funds, has also been curbed: 58 million cardholders had their limits reduced between April 2008 and April 2009, according to FICO (FICO).

A RIPE TIME FOR ASSET-BASED LENDERS

So alternative finance is growing even with credit markets seized up. While some finance companies like CIT have faltered, asset-based lending increased 8% in 2008, according to the Commercial Finance Assn., which represents some 300 asset-based lenders and factors. The group's CEO, Andrej Suskavcevic, sees continued growth ahead, as private equity groups and hedge funds look for profitable investments in nontraditional lenders. Companies squeezed by banks' rising credit standards—including distressed firms, startups, or those trying to finance exponential growth—are "perfect clients for asset-based lenders," he says.

Others, like Chicago entrepreneur Jim Mayer, are building innovative businesses to meet the borrowing needs of risky companies. Mayer is reviving a firm called DiversiCorp, which he ran in the mid-1980s and 1990s. DiversiCorp operated in a narrow field called collateral control. The company would reassure creditors by safeguarding inventory after it was shipped but before it was paid for—by keeping it under lock and key in the buyer's warehouse, for example, and releasing it as the buyer made payments. With Mayer on board, lenders—including suppliers, banks, or outside finance companies—could extend credit to riskier borrowers, knowing they would recover their collateral if the buyer didn't pay.

DiversiCorp did brisk business in the aftermath of the savings and loan crisis in the late 1980s, and Mayer sees a similar opportunity now. "We're going to be looking probably at two years that regulated lenders are going be bending to err in caution," Mayer says. "I think that's going to cause small business constraints with traditional financing." Companies selling goods will have to lean heavily on their suppliers and other nonbank lenders for financing, opening opportunities

for firms like Mayer's.

Atlanta-based FTRANS is doing something similar: turning accounts receivable into collateral that banks are comfortable lending against. The company charges businesses between 0.5% and 1% of sales to handle their entire receivables process, from monitoring customers' credit to collecting payments. At the same time, FTRANS partners with banks to provide customers a line of credit, secured by the receivables, so they can access that capital a few days after a sale instead of waiting 30 or 60 days for the customer to pay. FTRANS customers are companies with more than $500,000 in annual sales, including many professional service businesses like law firms or architects that generally don't have hard assets to use as collateral. "Banks use us to get comfortable with a customer that they might not otherwise be able to get comfortable with," says Dan Drechsel, chief executive of FTRANS.

MERCHANT CASH ADVANCE: GOING MAINSTREAM?

For smaller businesses that sell to consumers, merchant cash advance companies offer cash up front in exchange for collecting part of a merchant's future credit-card receivables. For example, a merchant might get $10,000 in cash immediately in exchange for $13,000 in future credit-card sales, collected as a set percentage of each swipe. The idea resembles factoring, but with a crucial difference: Factors advance cash after a sale has taken place but before the seller has been paid, while cash advance providers advance cash on sales that have not yet happened.

Cash advance companies target retailers and restaurants that do lots of credit-card sales and appear risky to banks. "It's extremely high cost of funds," says Jamie Savant, partner at the Strawhacker Group, a consulting company for the payments industry. "It was a vehicle for merchants that could not get traditional lines of credit through a bank."

The merchant cash advance industry wants to become a mainstream funding option for small businesses, rather than a last resort. Some business owners taking out merchant cash advances now have credit scores above 800, says Scott Greist, CEO of American Financial Solutions, a merchant cash advance provider. "You're seeing a lot of businesses who wouldn't have considered it before." David Robertson, publisher of *The Nilson Report*, a credit-card industry newsletter, predicts more companies will target this market in the next three years because "what was once a relatively small subset of the total is now a chunk of the total."

He also sees other alternative lenders targeting entrepreneurs who can't get bank credit: "There will be companies that look at that high-risk opportunity and say, we can come up with a product" for that market.

Tozzi covers small business for BusinessWeek.com.

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