THE WALL STREET JOURNAL.

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JOURNAL REPORTS: SMALL BUSINESS

With Alternative Lenders, Flexibility and Speed Come at a Cost

These Firms Can Be Alluring for Small Companies That Don't Qualify for Bank Loans. But Watch the Price Tag.

By ANNA PRIOR
August 25, 2014

Silicon Valley has cooked up digital inventions to simplify everything from dating to hailing cabs. Now it's looking to "disrupt" another field —how small companies borrow money.

Over the past few years, conventional banks have tightened their standards and left more small firms out in the cold. Sometimes the borrowers' personal credit history is less than stellar, or they're looking for deals that are too small for most banks to consider.

Enter alternative lenders—a booming group of online firms aimed at small companies that can't get what they need from regular sources. In some cases, alternative lenders can turn around a deal within a couple of days, or offer loans that last just a few months.

But that flexibility and speed come at a price. Annual percentage rates can soar north of 100%, and there can be steep fees and penalties for things like prepayment. What's more, even alternative lenders acknowledge that the field is dotted with unscrupulous operators that obscure the true costs of their loans.

With all that in mind, here's a look at the basic types of alternative lenders, and the benefits and risks they bring to the table.

Cash Now, Sales Later

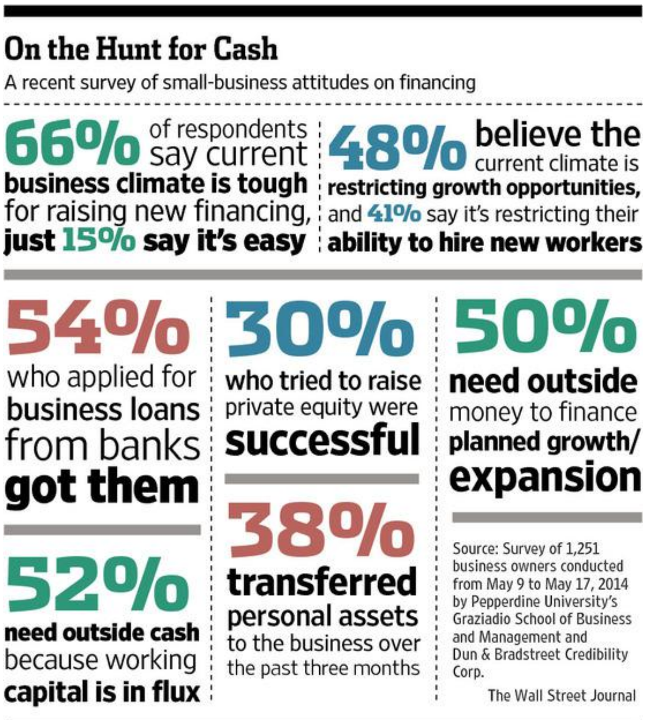
A common type of alternative-lending setup is the merchant cash advance. In return for a lump-sum payment, lenders get a share of future sales—typically a set percentage of the business's daily credit card sales—that covers the payment amount and any fees. The deals are designed for borrowers looking for short-term loans typically less than $100,000 for relatively modest and immediate expenses, like equipment repairs. The average time frame for repayment is eight to nine months, according to Fundera, a website that matches businesses with lenders.Another version of a short-term setup—offered by lenders like OnDeck— appeals to businesses with the same needs but offers different repayment terms: Borrowers pay back a fixed amount daily through automatic deductions from a checking account.

Critics argue that borrowers need to beware of pricing, including APRs that can at times top 100% for merchant cash advances and 50% for daily-repayment sites. Critics —like the nonprofit lender Opportunity Fund—also say some lendersobscure the loan's costs by presenting the payback amounts in dollar figures rather than providing an APR up front.

For instance, borrowers with a $40,000 loan may be told they have five months to pay back the loan plus $10,000 in interest for a total of $50,000. Some may see that as paying only 25% interest, but when that $10,000 is annualized, the APR jumps to about 110%, assuming daily repayment.

Plus, lenders may list other fees separately, making it hard to get a handle on the total cost.

Some critics say those are warning signs. "125% APR for a loan is just not OK in my book," says Mark Pinsky, president and chief executive of Opportunity Finance Network, a group of community-development financial institutions that primarily lend to small firms in low-income communities. "If they aren't telling you what the APR is, run, don't walk, away."



He advises that borrowers make sure they understand the fees associated with the product. And they should watch out for fees that might be buried in the principal amount of the loan.

Some alternative lenders agree that a reputable company will tell you its APR if you ask—and borrowers should ask. But Noah Breslow, CEO of OnDeck, says an annualized interest rate isn't necessarily the best way to look at the loans, because of the short payback period and because borrowers get an immediate return on investment. "Our customers are often trying to match investments which have short-term paybacks—inventory, replacing equipment, marketing…so they will generally choose a smaller-amount, shorter-term loan to optimize total cost," he says.

Almost Like a Bank

A less-common method of alternative lending—offered by online outfits like Funding Circle, Lending Club and Dealstruck—has terms that look a lot more like a traditional bank loan.

In this setup, called a peer-to-peer, institutional or marketplace loan, small firms are connected with individual or institutional investors who put up the cash. In some cases, as with Dealstruck, the site itself also has capital to lend. Amounts generally can be higher than those handed out by merchant-cash-advance lenders to cover heftier expenses, like opening new locations. Borrowers generally must make fixed monthly payments, and terms typically last from two to five years. APRs are generally 12% to 25%.

Critics argue that even those rates are still high, compared with traditional bank business loans. That's problematic, they say, because peer-to-peer lending tends to be more selective than cash-advance and daily-repayment options. Since some of these borrowers are close to meeting the standards at regular banks, critics say, they shouldn

Some alternative lenders and other experts argue that these longer-term, fixed-rate loans can help business owners build their credit profile and become more likely to qualify for a lower-interest-rate bank loan. (OnDeck says its shorter-term loans can also help build credit.) "Our goal is to show companies a graduation product and process that ultimately gets them to a bank or a credit union," says Dealstruck CEO Ethan Senturia. "We want to be the bridge from the traditional alternatives to the banks."

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