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The Impact of Alternative Finance on the Equipment Finance and Leasing Industry

By Charles B. Wendel

Alternative finance companies are increasing their lending. This article examines why and describes their typical business models. It also looks at how they can best work with equipment leasing and finance firms to serve more borrowing clients and increase revenues.

Editor's note: This article is based on the February 2015 Foundation study by FIC Advisors Inc. titled The Impact of Alternative Finance on the Equipment Leasing and Finance Industry: Maximizing Opportunities and Managing Threats. *The study is available at www.leasefoundation.org.*

Over the past few years, alternative finance (AF) companies have been increasing their lending activities, particularly in the small business and lower-end middle-market spaces. In 2014, the Equipment Leasing and Finance Foundation (Foundation) commissioned FIC to prepare a report that focuses on why AFs are increasing in importance, describes the typical business models they use to operate, and, based on past history and expected opportunities, suggests their likely future paths.

Perhaps of greatest importance to Equipment Leasing and Finance Association members, this report also highlights ways in which AFs and member companies can work together to serve more borrowing clients and build revenues. This article summarizes the key issues discussed in the report and incorporates recent activities within the AF segment, as more players enter and others refocus their approaches.

Today, analysts estimate that AFs capture less than 2% of the small business market or $5 billion to $6 billion in outstanding loans. However, this number appears to be growing quickly with, as we discuss below, substantial growth potential and increased market disruption based on both direct lending opportunities and the opportunity for AFs to work with traditional lenders, including equipment finance companies.

WHY IS ALTERNATIVE FINANCE INCREASING IN IMPORTANCE?

AF companies are nonbanks, often financed by private equity firms that provide debt to small businesses and consumers. Sam Graziano, CEO of Fundation, an alternative lender, characterizes AFs as "digitally enabled lending," that is, lending that delivers credit through the web and mobile enabled processes, leverages business process automation to increase lending efficiencies, and uses data aggregation and analytics both to enhance the quality of risk management and generate risk-based profitability.[1]

Four main factors have resulted in the increased growth and attractiveness of alternative finance companies:

- Limits in the appetite of banks to lend to small businesses
- The willingness of more borrowers to work with AFs
- The ability of AFs to apply technology and data analytics to streamline processes and expand their lending universe
- Ready access to funding and capital

Limited Bank Focus

While many banks continue to proclaim their interest in small business lending, credit losses suffered during the last downturn have resulted in a narrowing of the "credit box" in which banks operate and make loans. Many banks have tightened their requirements to a more limited group of industries and loan types while requiring stronger bottom-line performance from potential borrowers.

Table 1 (next page) estimates that, given internal requirements related to industry, time in business, credit risk, and other elements, banks consider only about 10% of all small businesses to be qualified borrowers. The other 90%, not all of which are creditworthy, represent a potential loan market for alternative lenders in excess of $1.7 trillion.

Multiple internal and external factors drive bank constraints related to small business lending, including increased capital requirements facing banks and the inability of most banks to offer loans with risk-based pricing. As Table 2 indicates, the costs of origination, underwriting, and ongoing monitoring and compliance result in many small business loans being value destroyers or at best marginally profitable.

Table 1. Banks Limit Their Small Business Focus

Banks focus on about 10% of total small business customers.

Bank qualified and non-qualified business				
Category	**Number of businesses (millions)**	**Potential dollar loan value (billions)**	**% of businesses**	**% of value**
Qualifying	3.7	$544	10.2%	23.8%
Not qualifying	32.4	$1,745	89.8%	76.2%
Total	36.1	$2,289	100.0%	100.0%

Source: Oxxford Information Technology and FIC Advisors Inc. analysis.

Table 2. Many Small Business Loans Lose Money or Are Marginally Profitable

$100,000 loan example

Loan origination	$1,000–1,500	
Underwriting	$1,000	
Loan review	$100	
Operations	$250	
Monitoring	$500	
Compliance	$250–500	
Total	$3,100–3,850	
Interest income (assume 6.25% loan)		$6,250
Loan cost to charges bank unit (3%)		$3,000
Total noninterest costs to generate loan		$3,100–3,850
Net income		**($600) to +$150**

Source: FIC Advisors analysis.

Although a few of the biggest banks have developed streamlined processes and introduced decision modeling that reduces operating costs and improves pricing, many regional and community banks continue to sell to and service small businesses with the same cost structure they apply to middle-market loans. One banker who reviewed Table 2 commented that his bank spends about the same to generate a $50,000 loan as a $500,000 loan, resulting in his bank emphasizing larger loans and de-emphasizing what he considers high-cost small loans.

Of course each bank operates with a unique set of costs, fee, and other revenue components and needs to customize the above analysis to mirror its own situation, developing a quantitative analysis of actual costs rather than relying on anecdotes. In many cases, banks will find their assessment points to negative or subpar returns from small business lending.

Borrower Willingness to Work With AFs

A 2014 *Inc.* magazine article summarizes some of the key contrasts between banks and alternative lenders and the attractiveness of these companies (Table 3).

Whereas borrowers pay more for loans from alternative lenders, an increasing number are willing to do so for reasons of speed of decisionmaking, flexibility of loan structure, and availability of funds. One alternative lender, James Hobson, COO of OnDeck, in his presentation to this year's ELFA's Executive Roundtable, cited a 2014 Federal Reserve Bank of New York study stating that small businesses spend an average of 33 hours searching and applying for financing.[2]

In addition, the gap between the timing required for bank versus nonbank decisionmaking is often greater than that indicated above, with some banks requiring more than a month for a decision versus some alternative lenders that are able to make decisions in 24 to 48 hours or less.

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Role of Technology and Digitally Enabled Lending

Without the effective and enhanced use of technology, alternative lending in its present form would not exist. The most

Table 3. Contrasts Between Banks and Alternative Finance Companies

	Banks	AFs
Typical small business loan APR	6%–8%	20%–50%
Time to close loan	2 to 3 weeks	3 to 4 days
Approval rates	19%	64%
Average small business loan size	$350K	$85K

Source: Inc. Magazine, "How Big Banks Compare to Alternative Lenders" http://www.inc.com/magazine/201405/alix-stuart/loans-big-banks-compared-to-alternative-lenders.html?cid=readmore.

productive AFs have moved from the manual underwriting that still occurs at many banks to automation of key business processes.

> Equipment finance companies have the opportunity to provide aggregators with their turndowns and/or join their lending groups to receive potential loan opportunities for their review.

Although an underwriter may also review a loan before funding, the AF's emphasis centers on building streamlined processes and limiting personal "touch." AFs also apply multiple and varied data points to each customer to assess and quantify risks and allow for risk-based pricing across the portfolio.

Ready Access to Funding and Capital

Private equity firms have largely fueled the growth of alternative lenders. These investors believe that alternative lenders can capture substantial market share from the banks while generating returns that exceed what is available from many other investments, particularly in a low-rate environment.

AFs have multiple funding options beyond private equity, including bank loans (for example, CAN Capital recently secured a $650 million credit facility from a bank group led by Wells Fargo), securitizations (in 2014, OnDeck issued the first non-Small Business Administration direct business lending securitization), and IPOs (both Lending Cub and OnDeck went public in 2014 with implied valuations of $23.4 billion and $8.9 billion, respectively).

TYPICAL BUSINESS MODELS

What are the typical business models? In its broadest context, alternative finance involves four business models:

Reward-based. This activity involves the Kickstarter model, whereby individuals fund creative projects, often with a "thank you" or acknowledgment as their only repayment. Investors receive no financial return.

Donation-based. This model primarily is used to fund charitable donations.

Equity-based. Targeted at accredited investors who can receive a stake in a company and build an ownership portfolio, this area remains under development, because the investment provisions of the 2012 Jumpstart Our Business Startups (JOBS) Act will not be in place until early 2016.

Lending-based. Lending activities provide the central focus for investors and AFs as well as the area in which a revenue growth opportunity may exist for the equipment finance industry. While lending-based activities continue to evolve, alternative finance companies work with traditional lenders in one or more of four primary ways: aggregator, marketplace lender, direct lender, and service provider.

Aggregators

Companies such as Biz2Credit, Fundera, and Lendio in effect act as loan kiosks or brokers. Without putting their own equity at risk to make a loan, they offer a range of loans to end borrowers based on teaming up with lenders that operate with different risk appetites and product preferences. Fundera's loan product list includes SBA loans, term loans, equipment financing, lines of credit, invoice financing, short-term loans, merchant cash advances, and small business startup loans.

Typically, this process involves potential borrowers entering financial and business information online and then receiving tentative loan offers from one or more bank or nonbank lenders. For example, Biz2Credit's website states that borrowers can complete a loan profile within four minutes using a PC, tablet, or smartphone.

Aggregators provide value to borrowers by establishing a network of lenders with varied appetites related to risk and loan type, and they conduct an initial screen of applications to match up borrowers with their most likely lenders. Their goal is to move to close loans much quicker than banks. Fundera's website states that its quickest time to fund a loan was two hours.

Aggregators usually work with traditional lenders in two ways. First, they solicit referrals from lenders that are unable or unwilling to lend to certain businesses, based on industry, credit history, or other factors. Referral sources receive a fee for a closed transaction related to these turndowns and also maintain control over the relationship, potentially capturing deposits, cash management, and other business.

In addition, the aggregators are often interested in expanding their lending pool, adding more lenders to their mix to increase both the options available to borrowers and their likelihood of success. For example, today Biz2Credit operates with 1300+ bank and nonbank lenders.

Equipment finance companies have the opportunity to provide aggregators with their turndowns and/or join their lending groups to receive potential loan opportunities for their review.

Marketplace Lenders

Like aggregators, marketplace lenders avoid credit-related losses by introducing institutional and individual investors to lending opportunities. Lending Club and Funding Circle are two of the largest players in this space. Funding Circle's website states

In effect, marketplace lenders act as asset managers, applying proprietary data analytics to assess loan applications and match borrowers with appropriate sophisticated investors.

that it provides "fast, affordable business loans for the millions of American small businesses who the banks have left behind." Investors in its loan securities can be asset managers, family offices, or other institutions as well as individuals interested in investing in the fractional loan marketplace. In effect, marketplace lenders act as asset managers, applying proprietary data analytics to assess loan applications and match borrowers with appropriate sophisticated investors.

Marketplace lenders solicit referrals from traditional lenders such as equipment finance companies and pay fees for closed transactions, while the referring lender maintains overall control of the relationship.

Direct Lenders

Direct lenders risk their own capital or borrowed funds to provide small business loans, both originating and, typically, holding the transaction on their balance sheets. However, these companies vary in how they position themselves with borrowers based on loan size, risk appetite, and pricing, among other factors.

One direct lender, Fundation, focuses on term loans of up to $500,000 with rates starting at 7.99%. In contrast, while OnDeck offers term loans up to $250,000, its primary focus has been on smaller lines of credit lending, with rates usually ranging from 29.9% to 49% APR. However, most loans are paid off within a few months, with OnDeck automatically deducting weekly payments from a company's bank account.

Fundation's risk focus centers on companies that are at or approaching near-prime status, whereas companies such as OnDeck and merchant advance lenders tend to focus on subprime borrowers, accounting for their higher rates.

OnDeck's website cites its partnership agreements with BBVA Compass and First Tennessee as two examples of bank referral programs for which the banks receive fees while maintaining the overall small business relationship. In its earlier years, some of OnDeck's volume resulted from referral relationships with a number of leasing and equipment finance companies.

Infrastructure and Platform Solutions

Alternative finance companies have invested heavily in technology related to streamlining the loan application process for the borrower, the internal movement of information within their shops, overall operational efficiency, and the quality and depth of the risk management process, among other areas.

Several AFs—Lending Club, Prosper, and OnDeck among them—are now offering their operational and risk management platforms to traditional lenders. Their focus centers on allowing lenders to leverage the AF's capabilities and the prior investments made by them to reduce the cost of making a loan and, thereby, increase profitability. In addition, the AF's risk management platforms and proprietary analysis can allow lenders to extend loans to selected companies that traditional lenders may have previously turned down.

Both Prosper and Lending Club have announced consumer focused lending partnerships with groups of community banks. In addition, Lending Club has teamed with Alibaba to finance manufacturers purchasing products in China through Alibaba. Similarly, Google and Lending Club joined to offer low-interest financing to Google partners, focusing on expanding the sales of Google-business expansion opportunities. These and other players are considering similar opportunities in the business space.

With its focus on SBA lending, SmartBiz provides platform solutions to Celtic Bank and the California Small Business Development Fund, among others. OnDeck offers turnkey solution to partners to offer working capital loans to current and new customers, including using its "streamlined underwriting and OnDeck score," pre-approving customers, "instant," 24-hour turnaround, and other features including the option to self-fund the loan or refer it to OnDeck.

At this point, only a handful of alternative finance companies are offering platform solutions, although more are in the process of doing so. Faced with increasing costs, traditional lenders, including small-ticker lessors, may benefit from at least assessing the capabilities these providers offer to determine the attractiveness of the third-party solution they offer.

As summarized above, numerous opportunities exist for equipment finance companies to cooperate with alternative finance players. Whether as aggregator, marketplace lender, direct lender, and/or platform provider, AFs are anxious to work with traditional lenders such as equipment finance companies.

These new entrants understand the origination potential that traditional players offer as well as the favorable reputation and networking ability they enjoy with most of their customer and prospect bases. They want to take advantage of those strengths to build origination volume.

Although the potential revenue opportunity of working with alternative finance companies may be significant, traditional lenders need to balance that opportunity against a number of risks, including reputation, execution, and compliance risks.

RULES OF THE ROAD: SELECTING AN ALTERNATIVE FINANCE PARTNER

Given the number of alternative lending approaches now being offered to borrowers, the increasing number of AF players, and increasing demands on the time of traditional lenders, companies contemplating working with an AF should consider applying a brief qualifying checklist to each potential partner.

Compliance Capabilities

Regulators are holding lenders to increasingly high standards related to transparency, privacy protection, and related areas. Sharing client information with others involves a compliance hurdle that can be difficult to overcome, particularly if an opportunity involves working with a high-rate lender. Banks are also sensitive to working with some AFs that emphasize collecting loans through account sweeps and offering multiple loans to the same borrower, potentially straining the borrower's ability to repay.

Given these sensitivities, the most appropriate partner has already built an internal compliance capability, established appropriate internal operating standards, and developed ongoing working relationships with various regulatory agencies.

Turnkey Emphasis and Excellence in Execution

Most traditional lenders lack the time (and in some cases the staffing and sales capability) to exploit the revenue opportunity that AFs provide. AF partners should be able to contribute to and even lead the sales process to ensure that the AF's initiatives provide meaningful growth to the traditional lender's bottom line.

Demonstrated Patience and Persistence in Marketing

Traditional lenders may take months to evaluate partners and determine their short list of candidates. AFs need to demonstrate their willingness to stick with the process and follow up; that intensity also serves as an indication of the likely intensity of their ongoing engagement with the company.

As straightforward and relatively simple as the above criteria are, traditional players will find that few AFs meet these hurdles.

WHAT DOES THE FUTURE HOLD FOR ALTERNATIVE FINANCE COMPANIES?

Although both the number of these companies and how they compete will change, many alternative finance companies will remain part of the permanent financing landscape. AFs are currently focusing on a number of competitive issues:

- **Competition and cannibalization is increasing.** As noted, AFs focus on different risk and pricing segments within small businesses. Increasingly, lower cost AF players are competing against higher rate loan providers as borrower performance improves and lenders gain greater confidence from their risk-management analytics.
- **Rates are declining.** As a result of increased competition and new entrants, spreads are declining, although they still remain far above typical bank rates.
- **An increasing number of banks are entering the market.** In at least three cases (two regional banks and one top-10 bank), banks are actively developing approaches that compete directly in what has previously been the preserve of alternative finance companies. These banks are evaluating customer cash flow, bank statements, receivables, and other factors to provide loans to companies that had been considered unbankable. Some of these banks may offer their platforms to other banks, putting them in direct competition with some AF providers.
- **Origination and execution issues are emerging.** As more players enter the market, the ability to efficiently generate loan leads becomes a greater challenge. Both during our research for the Foundation report and subsequently, we have found many alternative finance companies struggling to generate sufficient volume. This issue has resulted in pushing many players to work cooperatively with traditional lenders.

> Sharing client information with others involves a compliance hurdle that can be difficult to overcome, particularly if an opportunity involves working with a high-rate lender.

- **Risk management and business models are going to be tested.** Alternative finance has begun to play a disruptive role with its emphasis on fast and convenient technology and processes. However, the AF risk-management approach differs from that used by most traditional lenders and, while arguably assessing an increased number of performance and risk factors, has yet to be tested during an economic down-cycle. In addition, AF's reliance on private equity firms and non-depository funding could put some players in a vulnerable position when the economy contracts.

- **Consumer Financial Protection Bureau (CFPB) and other regulators may focus on AFs.** Until now the AF industry has operated with far fewer regulatory constraints than banks. However, this favorable circumstance is subject to change if the CFPB begins to consider some small businesses within its definition of consumer banking. Conversations with the heads of several bank-owned equipment finance companies indicate the CFPB may be in the process of doing so. Management at the top AF providers expects increased regulatory scrutiny and has hired experienced compliance personnel to address this area.

The above factors, among others, will likely lead to a shakeout within the industry. Those lenders that lack sufficient origination capabilities and the ability to scale up in size to increase efficiencies, and that fail to establish a defensible segmented niche may disappear while a few large alternative players continue to gain additional share.

CAN EQUIPMENT AND ALTERNATIVE FINANCE COMPANIES WORK TOGETHER?

Multiple options exist for equipment finance companies to work with and take advantage of the capabilities that alternative finance companies offer, including these:

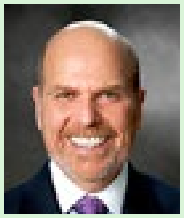
- **Obtain referrals from aggregators.** Companies such as Fundera and Biz2Credit want to provide leads to lenders in order to expand their ability to meet borrower needs.
- **Provide leads for a referral fee to marketplace lenders or direct lenders.** Virtually all alternative finance companies express an interest in working with tradit`ional lenders to review their turndowns or analyze their customer base to determine additional potential lending opportunities.
- **Leverage platform solutions.** OnDeck, Lending Club, SmartBiz, and others offer their operational and risk management platforms to traditional lenders with the twin aims of increasing operating efficiencies and expanding potential lending within the current customer base.
- **Compete directly.** Many equipment finance companies possess the customer history and analytic capabilities to replicate the approaches used by some alternative lenders. However, the investment required in time, people, and technology will make this an uneconomic and unattractive initiative for most lenders.

The alternative finance industry continues to evolve, with expectations that it will continue to disrupt the traditional loan market. Given the expected growth of these companies and the potential economic and strategic value they can provide, equipment finance and leasing companies should assess their level of interest in working with these lenders as well as their most appropriate path for doing so.

Endnotes

1. From presentation by Sam Graziano, CEO of Fundation, "Introduction to Alternative Lending," made to the Commercial Finance Association's Alternative & P2P Lending Forum 2015, March 19, 2015.

2. From presentation by James Hobson, COO of OnDeck, "Alternative Finance Solutions," made to the ELFA Executive Roundtable, March 17, 2015.



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