JULY/AUGUST 2014 | ISSUE 4

DAILYFUNDER

TAKING THE PLUNGE: Wall Street jumps into a pool of loans

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CHANGE ON ALL FRONTS

By Sean Murray

If you've been paying attention to current events, we've entered the era of securitization. It's a major milestone for the industry at large.

MURRAY

So will growth continue unabated or are there potential roadblocks ahead? In this issue, we take a closer look at the OnDeck Capital securitization deal and dig into a matter that has everyone on edge, the threat of regulation. Is government a friend to be looked upon for support? or a foe with no bounds?

As that landscape unfolds, we may find that it is not regulatory pressure that drives change, but forces from within the industry itself.

Traditional installment loans are the latest iteration of ingenuity and growth. Who would've thought that we'd come full circle? Small businesses are once again being marketed products with transparent APRs and monthly payments, and it's not coming from the banks.

Exploding new frontiers beg the question, how much are folks making in this business? We conducted a survey online and some of the results might surprise you. Of notable interest are the perceptions on stacking. As you might've seen in the last issue, some funders are alleging it as tortious interference, but insider opinion is swaying regardless of the legal merits. For better or worse stacking has disrupted the industry.

And that's not all. At the recent Exponential Finance conference presented by Singularity University & CNBC, leading experts came together to inform financial services leaders how technologies such as artificial intelligence, quantum computing, crowd funding, digital currencies, and robotics will impact business. For the rest of this year and beyond, disruption is on the menu.

Sincerely,
Sean Murray

ALTERNATIVE LENDERS FLIP THE SCRIPT

Traditional loans are back from the dead

BY DALE LASZIG

Alternative business lenders are beginning to offer a product that doesn't seem quite so alternative – term loans.

While banks are still the primary place to find loans with fixed repayment periods and set monthly payments, more and more non-bank players are venturing into the territory that was once the sole province of FDIC-insured institutions.

But, unlike bank loans, many in the alternative lending arena say their term loans are actually superior to many offered by banks because of their quick application process, which is simplified and accelerated compared with what banks can offer.

And with banks approving so few loans, and then only to businesses with pristine credit scores, many industry observers say that term loans offered through the non-traditional lending market may just be set to take off in new ways.

Industry advocates say business owners previously declined by banks after lengthy waiting periods can learn in five minutes if they're approved for a loan. Many finance executives say process improvements were the key drivers of the increasing popularity of term loan, peer to peer, and crowd funding products in the small to midsized business sector.

The evolution of alternative lending

Gary Chodes is founder and CEO of Raiseworks, an online direct lending platform headquartered in New York City that links small businesses to institutional lenders, helping private companies achieve success while delivering stable, attractive returns to investors.

"Alternative finance is a new generation of financial service providers not affiliated with banks that are willing to use a variety of inputs - both traditional and non-traditional - to evaluate the creditworthiness of a business," Chodes said.

The industry's focus on the underserved small to midsized business sector has fueled the growth of a new generation of financial service providers in the wake of the credit crisis, Chodes said.

The subsequent diversification of product offerings in response to customer requirements continues to evolve, with term loans becoming the fastest-growing part of the alternative financial services landscape.

"Financial products being offered by alternative lenders come in a variety of structures," Chodes said. "Merchant cash advance is simply the more established choice for small retail and restaurant businesses that have short-term borrowing needs."

Chodes said that merchant cash advance continues to grow, but in the overall scheme is becoming a smaller and smaller part of the alternative lending pie.

"Term lenders, on the other hand, are not focused on daily collections or credit card receipts; their focus is typically a two to four year term with monthly or bi-monthly predictable payout schedules," Chodes said.

LendingClub, a peer-to-peer lender based in San Francisco, links creditworthy consumer borrowers to approved investors online, bypassing traditional bank branch infrastructure. Tom Green, LendingClub's vice president of new business initiatives, has long admired the contributions of entrepreneurs and small business owners to the U.S. and global economies.

"Small and midsized businesses have delivered 66 percent net new job creation since the 1970s, a contribution that's currently at risk due to lack of capital," Green said. "This market segment is highly underserved. Small business lending is a $200 billion dollar industry and we think it could be double that size. Many small to midsized business owners are fearful of merchant cash advances and the adverse impact these products may have on their businesses due to the high cost – APRs can easily exceed 100 percent."

A transformative moment

Nik Milanovic manages marketing and partnerships at Funding Circle, a San Francisco-based online loan marketplace that connects small businesses with accredited investors who fund up to $500,000. Milanovic cited his background in microfinance as a reason for his fascination with Funding Circle's "innovative model of non-bank finance that would transform the commercial credit market."

> *"Alternative finance is a new generation of financial service providers not affiliated with banks that are willing to use a variety of inputs..."*
>
> —Gary Chodes

He said that the rising tide of alternative lending is an "exciting space" for consumers and business owners.

"We're all aware that bank lending has dried up for small business owners," Milanovic said, "so we are providing a valuable service and see this as a core product line – rates are low, and may even get lower in the future, with three to five year terms. These services are being provided with the added benefit of excellent customer service."

Technology is changing the rules of engagement in many industries and alternative lending is no exception.

"In this transformative moment in our industry, the ability to use technology to expedite underwriting decisions is transforming business lending and making it possible to quickly and efficiently provide working capital to business owners," Chodes remarked.

A sharing economy

Chodes cited broader acceptance of technology in the private sector, coupled with continuing demand for working capital as key drivers of loan offerings by new, non-traditional lenders.

"Mass adoption of online communications

means that business owners have a greater comfort level interacting with lenders electronically," Chodes continued. "This wasn't always the case. Allowing payments and bank account history to be shared electronically is a relatively new concept. We've seen a dramatic uptick in online behavior by business owners over the last few years."

Chodes said the printed statement from the bank has become a relic.

"These technology trends coupled with an improving economy make it an ideal environment for alternative lenders to thrive," Chodes said. "Tremendous amounts of capital are in demand by small businesses, in amounts we've never seen before. Conversely, banks in the post-credit crisis are uninterested or ill-equipped to meet this demand from small business. Consequently, participation by banks in the small business lending sector has plummeted over the last five years."

"We're more interested in the nearly bankable to the near subprime. We want to help these customers graduate out of MCA into a healthier product...and ultimately into a bank relationship."

—Candace Klein

Milanovic shared this view, expanding on the net benefits of automation. "More people are turning to alternative lenders," Milanovic explained, "for a variety of options and benefits: Speed – Flexibility – Feedback – and Realistic Underwriting. Approval takes an average of one week from the start of the application to funding of the loan."

The social component of borrowing in the New Economy is also shaping an increasing number of crowd funding and peer to peer lending.

"The sharing economy and greater ecosystem deploy full resources reflected in businesses like AirBnB and Uber," Milanovic said, "because eliminating the intermediary generates much more utility out of each segment."

The target audience

Candace Klein is chief strategy officer at Dealstruck, a crowd lending platform based in Carlsbad, California, that connects small business borrowers with institutional investors. Klein attributes the rising tide in peer-to-peer lending, crowd funding, and other forms of alternative finance to increased demand by borrowers.

"We're not targeting the bankable borrowers," Klein said. "We're more interested in the nearly bankable to the near subprime. We want to help these customers graduate out of MCA into a healthier product, like a term loan with a manageable APR, and ultimately into a bank relationship."

She said many of Dealstruck's customers are referred by banks.

"Our bank referral partners know that we can help business owners in the interim by improving their credit worthiness, taking them from a daily debit to a monthly payment structure, and ultimately sending them back to the bank," she said. "Dealstruck products are not MCA, and they're not factoring. Our products provide a roadmap to the best products offered by traditional lenders. We can help customers get off the MCA hamster wheel and empower them to achieve financial solvency."

LendingClub targets small to midsized enterprises, with revenues between $75,000 and $10 million, which have been in business for at least two years. Green described the model as an online credit marketplace that uses technology to match borrowers looking for loans with investors looking for yield – an alternative system that has lower costs than the traditional banking system.

"Banks spend five percent of assets on operating costs (compared to two percent at LendingClub) and they prefer to deal with loans that are $1 million and up," Green said. "Costs of acquisition and boarding lower the appeal of loans that are less than $250,000. Because we use technology to lower costs we can offer loans of up to $100,000 with rates starting at 5.9 percent. This is competitive with the rates offered by banks, but our process is much easier and $100,000 is a manageable amount for a lot more businesses."

Your terms or mine?

Many in the merchant cash advance community have yet to be sold on the value and sustainability of term loans. Most would agree that MCAs and term loans are intrinsically different products, with wildly different evaluation criteria.

Green describes the MCA focus as upfront, short term, expensive capital, compared to the term-loan focus, which is more long term with reasonable APRs. "MCAs generally look at cash flow," said Green, "while term lenders tend to evaluate a number of data points to assess the underlying strength of our commercial prospects. Our commitment extends beyond the term limits of the loan; we want to build relationships with our customers."

Green said that for those who have an advance and didn't realize initially how expensive it would be, LendingClub helps them graduate to lower cost capital.

"For others who went through a lengthy bank approval process only to learn that they would not get funded, our instant approvals take less than five minutes and won't affect their credit score," Green said. "For our extended family of customers, we offer transparency and one to five year terms with reasonable interest over time, so if a business pays off early they save money. The capital we provide is cheap enough that we expect it to be below the return on equity of the small business – making it a sustainable way to fund their growth."

In the end, Green suggested LendingClub thinks a lot less about how they compare to other lenders and a lot more about how they can reach as many business owners as possible.

"And since we've taken our company from zero to $4 billion in loans in less than seven years – and we're now the ninth most valuable VC-funded company in the world," he added, "I think that philosophy and business model is serving us very well."

Pay it forward

Milanovic is encouraged by organic growth in term loan products at Funding Circle and in the alternative lending industry in general, which he called "a testament to the many people who trust the products we're providing."

He went on to say that borrowers take cash advances for very different reasons than they would take a business loan, largely due to circumstances and the preferences of the individual business owner. Many MCAs offer 24 hour underwriting, and someone who needs to be funded that fast simply isn't a good fit for a term loan.

> *"Small and midsized businesses have delivered 66 % net new job creation since the 1970s, a contribution that's currently at risk due to lack of capital."*
> —Gary Chodes

"We're interested in growing businesses over time," Milanovic said. "In fact, we refinance many MCAs with term loans which have no prepayment penalties."

Among the many competing products within the vast experimental theater known as alternative lending, there are enough funding alternatives to satisfy the whims of the most discriminating customers. Taking the extra time to identify the right product fit for a customer can be a rewarding experience. Even if you never see them again, you may still be indirectly rewarded.

As Candace Klein said, "If we've done our job, our borrower doesn't need us anymore. That customer becomes our best referral source and lowest cost of customer acquisition."

As the credits roll, it may well be worth noting the many ways in which nontraditional lenders are collectively flipping the conventional financing script for consumers, business owners, and investors. Every day, in a multitude of ways, alternative finance professionals are helping small business owners obtain working capital in their own way and on their own terms.

GOVERNMENT: FRIEND OR FOE

Examining the fed's potential effect on the alternative business lending industry

BY MICHAEL GIUSTI

It would be excusable for alternative business lenders to have mixed emotions when thinking about the federal government.

On the one hand, federal officials are encouraging alternative business lenders to use free data resources to innovate new lending products and encourage the flow of capital to cash-starved businesses.

But on another hand, some funders are watching skeptically as other federal agencies "choke off" funding to short-term consumer lenders that critics say are operating predatory businesses. Skeptics worry that if officials are willing to shut down ostensibly legal consumer products, alternative business funders may be next.

Still others feel that if the industry keeps its nose clean, then there can continue to be opportunities amid the uncertainty of working with the feds.

DATA ADVOCATES

During the Lendit 2014 conference in San Francisco, a Treasury Department official offered a decidedly positive message regarding business financing.

During her presentation, Sophie Raseman, director of smart disclosure at Treasury, emphasized that she is excited about the opportunities that exist to use government open data resources to inform small business lending decisions.

"We think right now is a very promising time to tap into open data resources to better serve the small business segment," she said.

She called on the lending community to look at the resources being made available through the government's new data policy, which says that all newly generated data sets at the federal level will be made open and available to the public as the default.

One example she gave for how business lenders could use open government data was to use the economic trend data regularly released by different agencies to better fine tune forecast models for business segments.

Another example was to use data from the Department of Labor's reports about retirement plans to verify company information, such as the number of employees.

She said another key initiative being pushed at the federal level was to allow borrowers to capture data about them that has been reported to various government agencies, and to use that data to help streamline application processes for loans.

"We are looking for where entities are already reporting data, and then giving the borrowers the ability to securely and safely send that data to the lender," Raseman said.

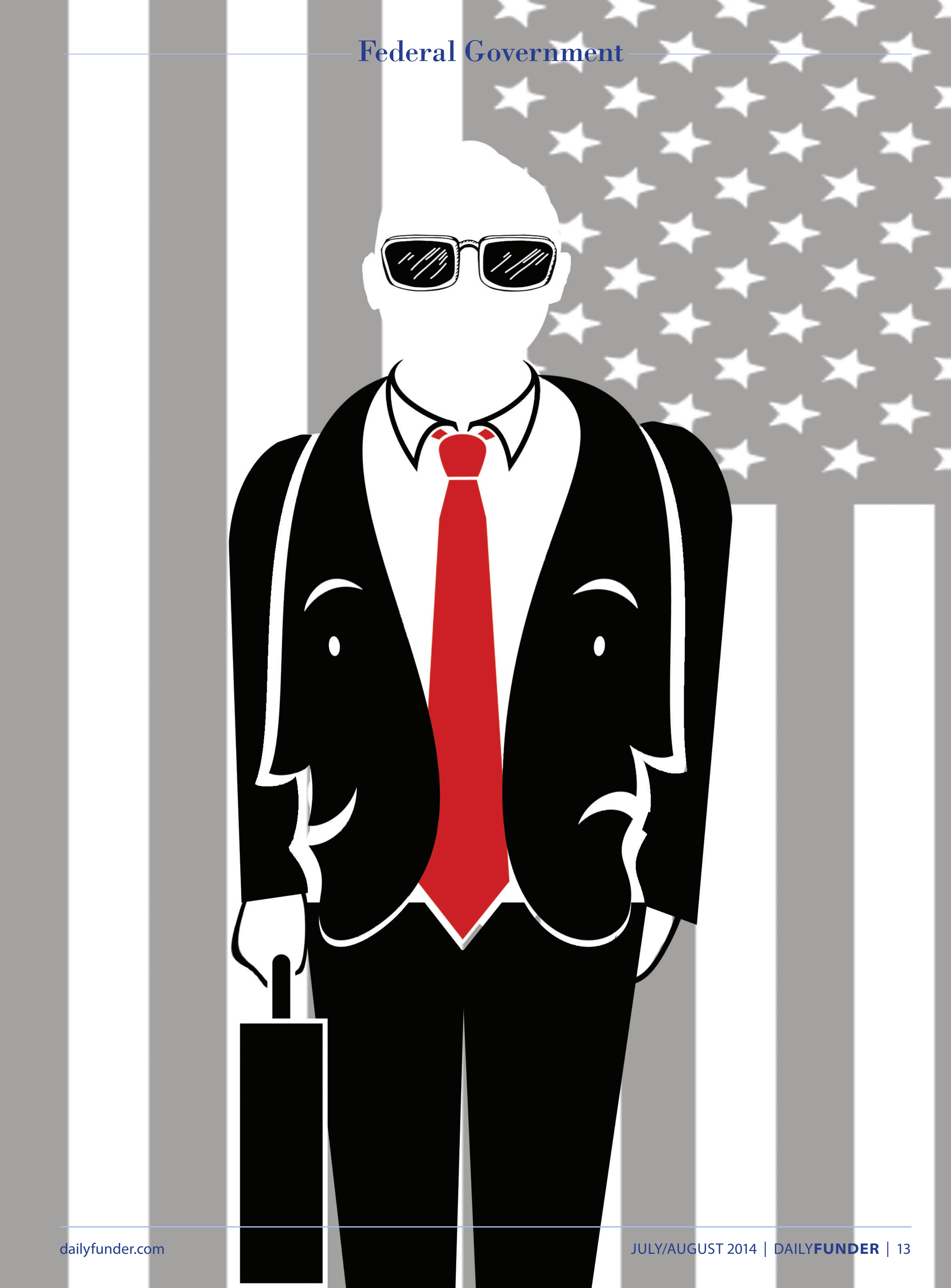
Raseman said the key, from her perspective, was to ensure that government open data was being used to facilitate innovations and to get capital flowing to small businesses.

"I don't have to tell you that small businesses are at the heart of the U.S. economy and too often they face constraints in the capital they need to grow their businesses," Raseman said. "We want to call on folks like you to take a look at the resources, the data assets we are already publishing to see how you can use those data sets to garner new insights, to build better models, to come up with new ideas to better serve that segment."

OPERATION CHOKE POINT

Perhaps the other perspective of government involvement in the lending industry can be found in the Justice Department's "Operation Choke Point."

"Choke Point is part of the Department of Justice's Financial Fraud Enforcement Task Force," said Allyson Baker a partner at Washington-based law firm Venable LLP. Baker also previously worked as an enforcement



attorney at the Consumer Financial Protection Bureau.

The program's stated goal is to root out fraud and illegal transactions in consumer lending. The Justice Department says its efforts are directly targeting fraudulent players within the financial services industry, but it is also going after the financial services companies that help those allegedly fraudulent companies operate, including banks and payment processing firms.

One of the most prominent cases coming out of Operation Choke Point is Four Oaks Bank in North Carolina. In that case, DOJ accused the bank of ignoring fraudulent activity done by its customers, while profiting from the fees generated by their actions.

"We think right now is a very promising time to tap into open data resources to better serve the small business segment."

—SOPHIE RASEMAN, DIRECTOR OF SMART DISCLOSURE AT TREASURY

★ ★ ★ ★ ★ ★ ★ ★ ★ ★ ★

Justice officials sued Four Oaks and accused the bank of allowing online-based subprime lenders to extend payday loans to customers who lived in states where those loans were illegal.

Four Oaks settled with federal prosecutors in January for more than $1 million.

This emphasis on banks, and not just allegedly fraudulent players, is where this program gets its name – by "choking off" the flow of funds to entire industries, which will then whither and die.

Insiders say Operation Choke Point grew out of, among other things, a portion of the Federal Deposit Insurance Corp.'s Compliance Manual updated in December 2012. That manual says banks are responsible for activities conducted by third-party partners engaged by those banks "to the same extent as if the activity were handled within the institution."

The manual goes on to say that responsibility for those potentially fraudulent activities flowed through the bank directly to its board of directors and managers.

And, perhaps most telling, the manual identifies as risky several industries, including many that are legal but that introduce potential "reputational risk" for the bank. It specifically identifies subprime lending programs, subprime credit card programs, refund anticipation loans, payday lending and "other alternative credit programs."

The manual warns that if banks do not properly manage risks provided by those partners, it may lead to "supervisory action, financial loss, litigation, and reputational damage."

Peter Barden, director of communication for the Alexandria, Virginia-based Online Lenders Alliance said Operation Choke Point has hit his organization's members particularly hard. Many of the alliance's members include consumer lenders who cater to under-banked communities.

"FDIC examiners were coming into banks that were working with online lending members, and started asking them questions about those online lender clients," Barden said. "They were telling the banks that they might want to get out of this space or 'we would have to place a little extra scrutiny on you.'"

BANKS 'JUST BAIL'

Because banks tend to be risk averse, many saw those visits as a signal to just exit that lending sector entirely, said Scott Talbott, senior vice president of government affairs for the Washington-based Electronic Transactions Association.

"Banks are seeing the lists of so-called risky businesses, and they are terminating long-standing relationships with legal entities," Talbott said. "It really is throwing the baby out with the bath water."

Baker said that one of the most interesting aspects of Operation Choke Point is the mechanism federal officials are using to target the merchants.

"This is a law enforcement action, not regulatory," she said. "They are doing this through the threat of court action."

All online lenders are feeling the pinch, even ones who are playing by the rules and following every federal, state and local regulation governing so-called payday loans, Barden said.

"Our concern is that this is an attempt to shut down an entire industry, not just target the rogue elements or bad apples," Barden said.

He said that all short-term lenders are getting the increased scrutiny from federal prosecutors and from their banks, even ones who are processing transactions through the ACH network that were expressly approved by the customer – transactions that he said were clearly not fraudulent.

The most disconcerting part of Operation Choke Point, according to its critics, is that it now appears to be moving beyond fraudulent lending and into other legal industries that are seen by government officials as unsavory. And they are doing it under the guise of mitigating that "reputational risk" to the banks.

Already there are anecdotal reports from across the country that banks serving industries ranging from porn stars to online firearm and ammunition retailers are getting visits from federal agents who are discouraging them to drop these clients.

CONGRESSIONAL INVOLVEMENT

Not everyone in the government supports the actions of Operation Choke Point, however. Many members of congress, including U.S. Rep. Blaine Luetkemeyer, R-Missouri, are speaking out publicly against the program.

In April, Luetkemeyer wrote a column addressing Operation Choke Point in scathing detail and ardently supported the efforts of companies trying to make credit more readily available.

"Earlier this year I learned about this operation, in which the Federal Deposit Insurance Corporation loaned investigators to the Justice Department in a hostile attempt to take down nondepository lenders they believe have no moral right to exist," Luetkemeyer wrote. He went on to write, "Consider that for a moment: we aren't talking about businesses that are breaking laws. We are talking about businesses operating legally, yet our government believes it has the moral authority to try and shutter an entire portion of the private sector which is playing by the rules based on a moral assessment made by federal bureaucrats and political appointees."

"They were telling the banks that they might want to get out of this space or 'we would have to place a little extra scrutiny on you.'"

—PETER BARDEN, ONLINE LENDERS ALLIANCE

Luetkemeyer and 30 other members of Congress signed on to a letter dated Aug. 22, 2013 and addressed to Attorney General Eric Holder and Martin Gruenberg, chairman of the FDIC.

That letter points out that Operation Choke Point's efforts to stop banks from processing what they pointed out were lawful transactions would cause major harm to entire sectors of the economy and strip a "vital lending option" from millions of low-income families.

Other members of Congress, however, have a more favorable take on the Justice Department's efforts. In a letter dated Feb. 26, 2014 to Attorney General Holder signed by 12 members of Congress, the authors supported the DOJ efforts, especially when it comes to fraudulent and illegal activities.

"We urge the Department to enforce vigorously applicable laws pertaining to payment fraud, money-laundering, and other illegal payments," the letter says.

MOVING FORWARD

The lesson many people seem to be taking from Operation Choke Point is one of fear.

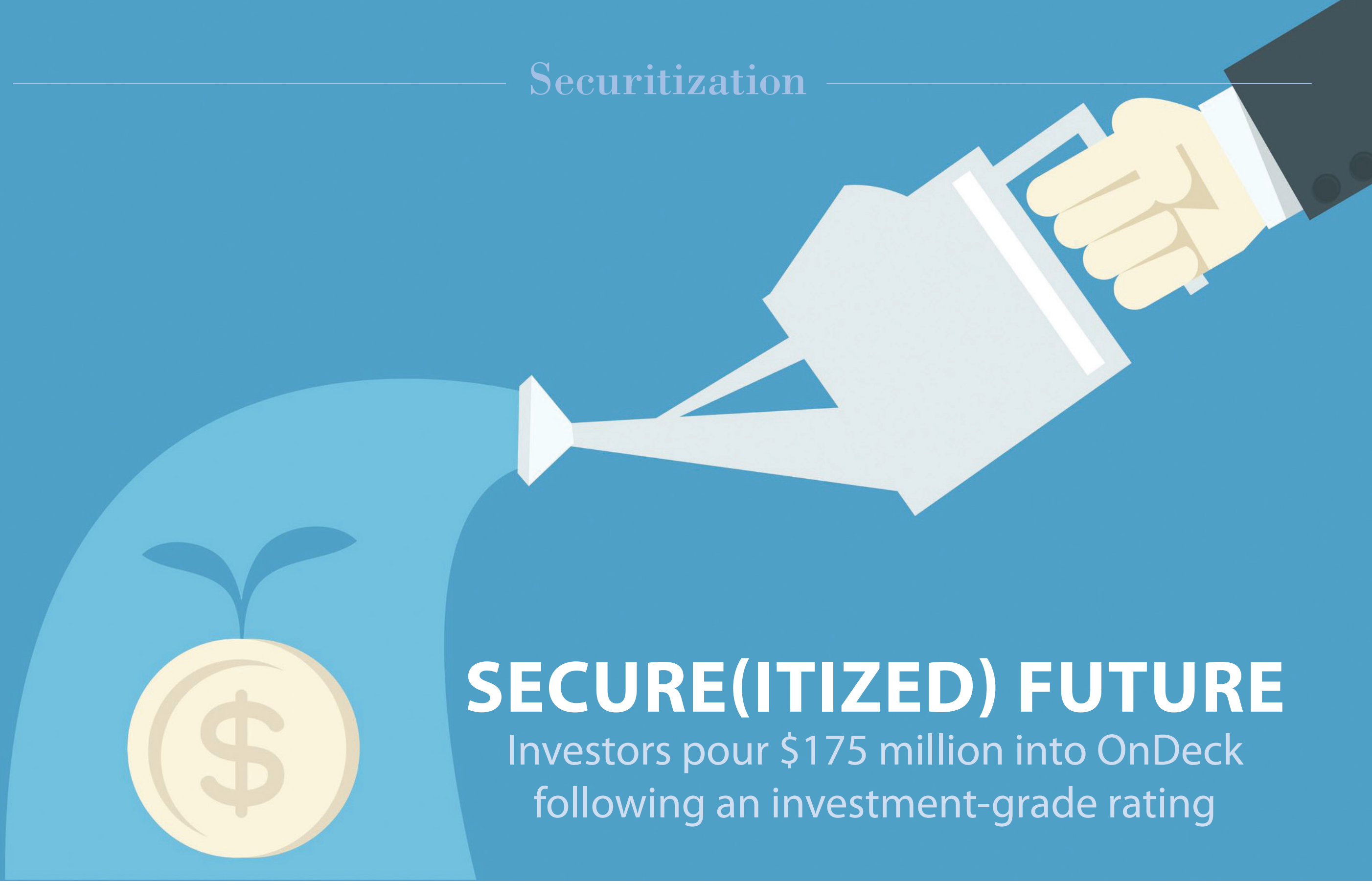
"We don't know which industry is next," Talbott said.

But Baker said that lenders focused on business-to-business transactions might not have as much to fear from Operation Choke Point than consumer-based industries might.

"Right now they seem specifically interested in consumer finance and products aimed at consumers," she said.

Baker said that when it comes to federal regulation of business lenders, it is likely the Federal Trade Commission that has jurisdiction, and that business lending is in a different jurisdiction from consumer lending. She said that one of the key triggers for the Choke Point investigators is a high chargeback rate on transactions – something that non-consumer lenders likely didn't have to deal with as often.

And presuming fraud truly is the focus of Choke Point, then legally operating players in the alternative business lending space likely have little to fear from federal oversight, but instead might find great opportunity in the data resources being released.



SECURE(ITIZED) FUTURE

Investors pour $175 million into OnDeck following an investment-grade rating

BY AUTUMN CAFIERO GIUSTI

Now that OnDeck Capital has begun packaging up its business loans and selling them off to investors, alternative business lenders have high hopes that a larger segment of the investment community will start pouring money into their industry. Financial experts expect to see more investor interest in this type of lending, not to mention more activity of this kind from competing lenders.

On April 30, New York-based OnDeck announced its inaugural securitization transaction of $175 million. In a coup for the lending company, OnDeck's Class A notes received a BBB rating from ratings agency DBRS Inc. The Class B notes received a BB rating.

The BBB rating is significant because it gives OnDeck's notes investment-grade status, signaling to other small-business funding companies that they belong to a breed of assets that Wall Street investors are starting to take seriously. That translates to less expensive capital for these lenders and greater interest from investors, who are warming up to alternative business loans as a legitimate form of lending.

For a long time, investors shunned companies like OnDeck on the belief that alternative business loans were a highly risky form of lending. The OnDeck transaction and BBB rating is evidence that investor confidence is shifting in the industry's favor.

"We got rated despite the fact that we were a new lending company in this market and a new asset class," says OnDeck CEO Noah Breslow.

OnDeck says the securitization is the first in the non-SBA direct business lending industry and described the transaction as "significantly oversubscribed." The $175 million fixed-rate notes are backed by OnDeck's loan assets.

For the past seven years, OnDeck has focused on small business lending opportunities for businesses with less than $5 million in annual revenue. This transaction marks the latest move by OnDeck toward widespread acceptance in the investment community. In 2012, OnDeck secured $100 million in debt commitments, including an $80 million credit facility led by Goldman Sachs and Fortress Credit

BRESLOW


MCGOVERN

Corp. in 2012.

Jeremy Brown, CEO of RapidAdvance in Bethesda, Md., says the OnDeck announcement is an important development for the industry because it indicates there will be more involvement from investors.

"I think it shows the continued development and acceptance of what we do becoming more and more mainstream, as opposed to five years ago when we were considered this fringe, odd industry," he says.

New asset class evolves

From the point of view of the alternative lending industry, the OnDeck announcement marks the evolution of a relatively new asset class into the capital markets, says Tom McGovern, vice president at Cypress Associates, a New York-based investment banking firm.

"It's showing that they can exhibit statistically predictable cash flow and credit performance in such a way that a rating agency will put a rating on it, and an investor can have some confidence as to what they're going to get in terms of credit performance," he says.

McGovern is also seeing a shift in attitudes among those who lend to the merchant cash advance industry. For a long time on the senior debt side, there's been a divide between traditional factoring receivables and merchant cash advance receivables.

"They don't see merchant cash advance receivables as equal quality to a traditional factoring receivable. This development will serve to shrink that distinction," McGovern says.

The announcement also serves to help lower the cost of capital for funding companies.

Having another big player in the space with securitized notes could help merchant cash advance providers obtain lending facilities at better rates, and with decent terms.

"It definitely should help facilitate the process of getting credit to make merchant cash advances," McGovern says.

There is cautious optimism among some funders, though, given the fact that securitized lending in the mortgage industry helped fuel the housing market collapse in 2008. Rohit Arora, co-founder and CEO of online credit broker Biz2Credit, contends that the alternative lending industry needs to proceed with caution. If the demand grows for securitized loans, the temptation is to lower underwriting standards in order to originate more loans.

"That's what created the whole mortgage bubble. And then it burst," Arora says.

OnDeck's scoring model


ARORA

In an effort to keep underwriting standards high, OnDeck started developing its own credit scoring system when it came on the scene in 2007. Breslow explains that at the onset of the company, there were two primary forms of lending on the market. One was a traditional bank loan, which could be a lengthy process for businesses wanting to borrow only $40,000 or $50,000, and businesses would get declined three out of four times. On the other end of the spectrum was merchant cash advance, which was much more expensive than a bank loan, and it took a couple of weeks for a business to get its money.

OnDeck's strategy was to split the difference between the two loan types, and the company came up with a system to automate the funding process.

Unlike merchant cash advance, OnDeck's funding isn't tied into the business' credit card processing. OnDeck draws a fixed amount out of the customer's bank account each business day. As long as the customer has a separate bank account, he or she can take out a loan from OnDeck.

OnDeck makes all of its loan decisions through a credit rating system it calls the OnDeck Score. Breslow says that the OnDeck Score is to businesses what the FICO score is to individuals.

The OnDeck Score relies on various data sources to create a snapshot of a business' credit. For every applicant, the score takes into account more than 2,000 data points indicative of the small business' performance. Whereas FICO looks at negative lending information such as missed payments, OnDeck looks at positive information, such as what types of credit the business already has, and whether the business owner is good at managing cash flow, Breslow says. Other factors include the type of business, where it is located and public records data.

The scoring system has helped OnDeck attract larger investors and lower-cost sources of funding over the years.

"When we started, we didn't have any investors who believed in the OnDeck Score. Fast forward to today, we've loaned more than $1 billion to small businesses around the country," he says.

About five years ago, most of OnDeck's capital came from the hedge fund community. As of a year ago, most of that capital has been coming from banks. And now with securitized lending, OnDeck has expanded its investor base to take on more than 20 new investors, including mutual funds, asset managers, hedge funds and insurance companies – and at better terms than ever before.

Diversification has helped OnDeck better serve its small business base, says Zhengyuan Lu, who facilitated the securitization deal and is head of capital markets for OnDeck

"The more diversified your funding sources are, the stronger an institution you are," he says.

Investment-grade rating validates industry

WEILAMANN

Obtaining a BBB rating is no small feat for any company, much less one in a fledgling asset group.

"It's no easy bar to clear in terms of being able to package, put together and support an investment-grade security," says Chuck Weilamann, senior vice president of DBRS. Breslow says bundling securities seemed like a natural progression for OnDeck. Last fall, the company received more than $130 million in credit facility commitments from participants including Deutsche Bank, Key Bank and Square 1 Bank. The shot of funding set the stage for OnDeck to pursue the securities market.

"We always thought securitization would be in our roadmap. And we just felt that when we closed our last credit facility with Deutsche Bank in September, that was a good step toward securitization," Breslow says.

Deutsche Bank ended up serving in an advisory role as OnDeck's banker for the securitization transaction and approached DBRS about getting a rating. OnDeck was a considerable departure from the types of companies DBRS typically handles.

"When we first met with the rating agency, they almost looked at us like we were from Mars, because it's such a different process," Breslow says.

Because OnDeck was different, Weilamann says DBRS took some of its existing rating tools and then augmented them to complete the process. OnDeck's notes still had to meet several qualitative benchmarks such as asset characteristics, as well as qualitative benchmarks such as company management.

"We can't require things as a ratings agency, but there are a lot of expectations that need to be met," Weilamann says.

The BBB rating serves as an outside validation of OnDeck's credit scoring model and servicing platform, particularly in a post-economic crisis market.

"It's not like credit cards or mortgages that are well understood by the investor community. This is a new type of short-term business loan," Breslow says.

The rating also gives OnDeck a credit opinion that's highly visible to the investment community. "When you're able to achieve an investment-grade certainty level, that attracts a fair number of investors. It opens up pools of capital," Weilamann says.

Competitors follow suit

OnDeck's leap into the securities market seems to have driven other funders to explore the option themselves. Industry observers believe many will try, but few will succeed.

Rohit Arora of Biz2Credit has been following the OnDeck developments and says his own company plans to securitize small business loans by the end of this year.

"What OnDeck has done with securitization is a good move. It helps the institutional investors to get a feel for a new product in a new asset class, which is always a good thing," Arora says.

RapidAdvance has also considered the possibility of selling its loans to investors. Brown admits that the cash advance company has had conversations with a financial sponsor about securities, although he points out that the company has less of a need for securitization because it is institutionally owned. "But we're certainly looking at it." Brown also knows of at least one other company in the space that is reportedly getting ready to start selling off its loans.

LU

DBRS has not yet rated any alternative business lending companies aside from OnDeck, but DBRS senior vice president Eric Rapp says they are in dialogue with other companies in the space.

That's not to say that securitization transactions will start coming out of the woodwork. It's likely that only the big names in the industry will have the resources to succeed in this area.

"There are a lot of guys in this space. I'm not sure that many have the financial wherewithal and experience as OnDeck. Definitely not the majority," Rapp says.

Companies need to have the systems to organize the data so it can be presented to investors, and also be subject to all the scrutiny that a ratings agency requires. And putting together a prospectus like the one OnDeck completed takes months. Only larger, more sophisticated companies will be able to do this.

Brown believes only about six to 10 companies will be able to successfully access the securitization marketplace in the coming years. "You have to be a certain size for investors to be interested. It will mainly be just the larger funding companies," he says.

McGovern points out that when he covered banks and thrifts as a research analyst on Wall Street earlier in his career, these types of securitizations were typically $1 billion transactions. "So it's not going to be something that's available to everybody," he says.

Smaller players will still be able to benefit, though. McGovern believes that having more lenders move toward securitized loans should make the investor community more comfortable with this new type of asset.

Now that OnDeck has experienced its own success with locking down a securitization deal, Breslow says the company plans to focus again on its growth strategy. OnDeck grew its revenues by about 150 percent in 2013 and is on track for triple-digit growth again in 2014.

"We have a lot of capacity in our platform to lend and are focused on acquiring more borrowers," he says.

BIZ2CREDIT sets stage for securitization

Among alternative business lenders, it appears OnDeck Capital isn't alone in its quest to go after securities. Biz2Credit, a New York-based online credit broker that connects small businesses with lenders, plans to securitize its small business loans before the end of this year.

Biz2Credit's loans would differ from those of its competitors, with the goal being longer terms and lower pricing for customers through securitization, says co-founder and CEO Rohit Arora.

Whereas typical alternative business loans come with an average APR of 50 percent or more, Arora wants to keep APRs more in line with what credit cards are charging. Biz2Credit plans to provide loans with APRs as low as 12 percent. And compared to the 12-month terms competitors offer on average, Arora expects to write loans with terms of up to five years.

"Normally in the securitization market, people are looking for products that have a medium maturity rate. Twelve months is too short of a maturity period," he says.

Offering longer-term products would also keep investors from having to constantly roll over their funds every 12 months. "Investors will allocate more money and for a longer period of time," Arora says.

Arora contends that the lower APRs would help shield investors from any potential usury laws, as it remains unclear whether these laws apply in the alternative business lending space.

Biz2Credit's strategy is to focus on the middle market, between the bank loan and the merchant cash advance. Arora estimates this middle space to be a $100 billion market annually. With the economy improving, small businesses are seeing their cash flows stabilize but are still unable to get bank loans. Yet, they don't want to get stuck with a high-cost loan, either.

"There's less desperation to borrow money at any cost. More businesses want to borrow money for growth, rather than survival now," Arora says.

Having offered small-business credit for the past six years and facilitated $1.2 billion in lending with a default rate of less than 1.3 percent, Arora believes the time is right for the company to pursue securitization.

"We want to bring more money into the space. By securitizing, we'll be able to do that," he said.

IN THE TRENCHES:
4 Elements to Running a Successful Business Funding Office

BY SIMON LOBANOV
CEO of Red Payments — www.redpayments.net

When I was 22, I started as a bankcard rep in Brooklyn, New York.

I was approached by a friend who told me that businesses need financing that's not available at banks and you can get them funded via alternative lenders using a percentage of their credit card receipts. This intrigued me and after studying the business funding industry I entered the market as a cash advance broker.

The merchant funding business has evolved over the years, where instead of withholding a percentage from credit card processing, most of the funders now use ACH as a vehicle for repayment. This expanded the market to businesses that were previously not fundable, such businesses that don't accept credit cards.

I've been in the alternative business lending industry for 10 years. I've built multiple retail operations as well as wholesale ISO channels. I've seen the business from the lender perspective as well as from the broker side. The guide below is what I've developed over the years to help people with "cash business" ventures.

STEP ONE
Focus on Your Client, the Lender

Throughout my career of training new representatives in the cash business I always ask them one question first. "Who is our client ?" Immediately a few hands go up and the most aggressive students tell me – "the business owner that we are trying to fund."

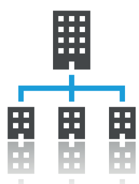
My answer to that is "IT DEPENDS."

If we were the lenders and wanted to put our money to work you are correct since the merchant would be paying us directly. In the case of our brokerage relationship, which actually represents the majority of the cash advance space, the client is the CASH ADVANCE LENDER.

A majority of the brokers conceptually don't understand this.

The brokers' focus is always to fund and get paid from any direction and lender period. Not understanding that key factor might hurt your client, the lender, and if your client is defaulting as a result of your aggressive salesforce you will be in trouble yourself because the client WILL NOT be able to pay you.

Finding the right lender relationships and close relationship with lenders is key.



STEP TWO
Create a Full Product Line

Before you do anything define your products and create a full product line. Reach out to the market and meet with all of the lenders (your clients) and see what their niches are and what product lines they are good at.

There are established lenders out there that have been in the space for a long time. Try to meet with major lenders and establish vendor relationships and ask them questions about what they like to do or can do that other lenders can't.

The more vertical products you have the better before you spend a dollar in marketing or bring your product line to your salesforce. Make sure that every angle is covered and you will be able to find funding solutions.

STEP THREE
Focus on the Marketing Channels You Know Best

The best marketing channels for your unique business are the channels you know best.

If you are coming from a phone sales environment and understand telemarketing put a little team of 1-2 telemarketers together and have them call all day and give you live transfers. If your background is in the Internet space, use it to do tests much cheaper than the other folks and use your vertical knowledge of that channel.

There are lots of free resources such as Google Analytics that you could install on your website to closely monitor traffic coming from Internet sources.

I also highly recommend originating your own leads instead of buying them from the lead providers. This way you will be investing in building more value to your business since you are controlling your destiny.

I have seen scenarios where operators bought leads and with lead quality swings they catch themselves in a very bad situation and have to continue buying them until they get a new marketing strategy and execution.

“There are lots of free resources such as Google Analytics that you could install on your website to closely monitor traffic coming from Internet sources. “

STEP FOUR
Continuously Train your Salesforce

Training is extremely time consuming and something we all must do. The more you train your salesforce, the more results, loyalty, and appreciation you will get in return.

Ideally you would want to walk in the office and expect applications coming in left and right because you provided marketing, phones, and have a nice office but things don't work this way. History shows that daily training with your salesforce will help you get more than 50% better conversions than simply relying on orientation training and expecting your salespeople to produce high funding conversions.

Every morning that I ran our brokerage operations, the first 30 minutes of my day was allocated to spending time with salespeople, teaching them new sales techniques, product knowledge, and rebuttals.

The times of pressure sales are gone. You need to create a consultative environment where your sales people are consultants and help business owners make the right decision about your funding programs.

OFFICE PAINS

Don't let coworkers derail your day

BY THE ETIQUETTE INSIDER

When the walls around us are not irritating it is the people that step in and take their place.

Many of us spend our days indoors surrounded by small cubicles, windowless walls, and florescent lighting.

When the walls around us are not irritating it is the people that step in and take their place. The jokesters, know it alls, nitpickers, smart asses, and the idiots that make you wonder how they got so far in life.

Hollywood, for example, has made multiple movies on how the workplace sucks and the characters that inhabit these areas. There have been hit sitcoms highlighting the naivety of a manger and his relationship with his employees, and a movie about how to rip off your company one penny at a time all while keeping the idiot in the basement with his red stapler wishing he could have a slice of cake.

Some weeks we see our work family more than our actual own. In these situations it is hard not for us to lose our patience or develop the workday blues.

There are ways to handle the office politics so that you don't make enemies and enjoy your work atmosphere; you just have to know the right way to handle the situations and the people that surround you.

THE JOKESTER

Lets start with jokesters. Jokesters usually are just trying to provide entertainment and lightheartedness to the workday.

They do not see that they may be obscene with their comments or alienating certain ethnicities by their jokes. After all, "One Eyed Purple People Eaters" are people too.

This type of personality also tends to get off task the most and become a distraction to the office and reduce productivity. The initial encouragement comes from obtaining laughs at their follies and comments, which then feeds their desire to continue.

They like being the center of attention and having outlets for their creativity. So how do you refocus that

energy without looking like a killjoy or better yet Dwight from "The Office"?

You can start with questions to redirect their attention back to the work task.

The infamous… "Oh hey, is that your phone ringing?" Or " by the way did that guy ever email you back?"

If this does not work you will have to start ignoring these outbursts or simply direct them to tell their jokes after work at the local pub where they will be better received.

You could also threaten sensitivity training as well that would take place on a Saturday starting at 6 a.m. and ending around 5 that afternoon.

THE KNOW IT ALL

Onto the infamous know it alls, and because they usually carry the same offenses, we will include the nitpickers, and perfectionists.

I would say they're your typical pocket protector group but since they are currently the ones making millions in this economy with their gadgets, software companies and web apps we will assume these are the people who are spending so much time worrying about others, that they are not successful in their own job.

While it is human nature to curb this behavior by highlighting the faults of these so called "Know It Alls"… that only fuels the fire for them to watch over you more closely.

You need to understand that these types of individuals have low self esteem and do not feel that they have job security. So the old saying of turn the other cheek really applies here and by merely highlighting what good they are doing and providing positive feedback you will then in turn move their attention away from you and they will move on to their next victim, which is likely "The Jokester."

THE TATTLER

The tattle tellers. Yes they exist outside of kindergarten, and they are also the ones who told the boss that he saw you in the stands on the ESPN highlight reels last Thursday when you were out "Sick."

Having this type of person on your team creates trust issues within the workplace, which will lead to tension and overall productivity loss.

So some ways to curb this type of behavior is to keep things close to the chest as they say, don't provide ammo for this guy. Make sure that you are working above your expectations at work.

If you have always received good performance reports the managers will not take notice or give merit to the Tattle Teller. If you are a manager of such type of person… well give them so much work to do that they don't have time to be a snitch.

THE IDIOT

Now to the infamous idiots. I find it funny when you Google how to deal with idiots all the response you get are what you need to change about your approach to them and not what you can instill in the idiot.

Most of the suggestions I have provided have been aimed at redirecting the behavior of the offender, as I believe that the best way to curb habits or to incite change is to be the catalyst, hold people accountable and provide the redirection.

So why shouldn't idiots be treated the same way?

The best way to handle an Idiot is show them how not to be one. For example: they are standing at the copy machine that has been flashing load paper for 20 minutes and they are unsure of how to fix it. Don't just jump in and load the paper. Produce the manual and tell them to read it.

If they send an email that is requesting the same information they asked yesterday in another email to which you responded to … redirect them to that email… don't just answer it again.

If they are licking glue or coming in with their shirt inside out… well there is just only so much help one person can give and it may take the village to help out.

If you find that after following these suggestions your issues have not been resolved, you can always take it to your HR department and have it addressed or you can search within and make sure that you are in the right place for you and that the company you work for aligns with your goals and morals.

If you are thinking to yourself that you don't have these types of people at your work or have any work issues then a) I applaud you for your positive, glass-half-full attitude, or b) You are one of these people and just don't know it.

I really only highlighted the most common types of issues in a work place, but if you have something more specific or an issue that you would like some perspective or feedback on please do not hesitate to email me at – etiquetteinsider@dailyfunder.com.

NINE QUICK STATS

1

HEY, WHAT'S A MERCHANT CASH ADVANCE?

61%
consider it to be strictly a purchase of future revenue.

32%
believe it's an ambiguous term that could be used to describe a purchase transaction or a loan.

(This might explain why outside parties have difficulty understanding the idiosyncrasies of the industry and the products offered.)

2

REAL OPPORTUNITY?

62%
reported making at least $100k per year

Almost half of the respondents in that group claimed to be making more than $200k per year.

3

TO STACK OR NOT TO STACK... THAT IS THE QUESTION

62%
said stacking is OK in the right circumstances

19%
said it's not OK.

16%
said it's the bane of the industry.

Those that claimed it to be the bane of the industry were more likely to comment in a later question that self-regulation was the one thing the industry badly needed.

4

SO THEN, WHO EARNS MORE?

57%
of respondents that were **in favor of** stacking make **AT LEAST** $100k per year.

73%
of respondents that were **against** stacking make **MORE THAN** $100k per year.

BAZINGA!

From May 24th to June 7th, DailyFunder ran an online survey geared towards alternative business lending professionals. Here's what we found:

IS IT TIME TO HAVE OUR OWN SHOW?

78%
would attend an alternative business lending conference.

4%
flat out said they wouldn't.

DID THOSE SURVEYED KNOW WHAT IT'S LIKE TO HAVE SKIN IN THE GAME?

58%
have invested funds in a merchant cash advance directly or through syndication.

IS GOVERNMENT A FRIEND OR FOE?

49%
fear future regulations could hurt their business.

25%
do not fear future regulations.

WHO'S A BIG INFLUENCER?

When asked to write in a name for the most influential person in alternative business lending or merchant cash advance, many respondents named NOAH BRESLOW, OnDeck Capital's CEO.

WHAT'S IMPORTANT TO YOU?

In this write-in question, those surveyed want to read more about:

- Regulatory issues
- Ethics, best practices
- Lead sources, lead generation, marketing strategies, sales guides
- The future, evolving products, trends

Note: This was not a scientific poll.

DISRUPTED

"Banks" and "money" take on new meanings in the modern economy

BY SEAN MURRAY

Forty percent of all Fortune 500 companies will be gone in the next 10 years.

Four hundred forty three of the original 500 have already folded.

In 2013, there were only 5,008 U.S. listed public companies, which is only slightly higher than the number there were in 1991 according to the Wall Street Journal. Contrast that against the fact that 2 million corporations are formed in the U.S. each year. But without going public, where exactly are all these businesses going to raise capital? And why are so many corporate leaders expected to fall?

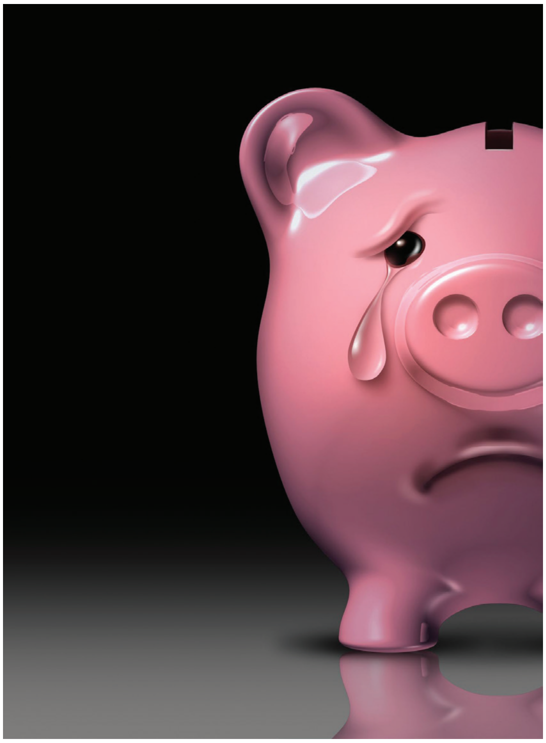
At the recent Exponential Finance conference presented by Singularity University and CNBC, bright minds from all over the country gathered to teach attendees one general truth, disruption is coming.

While the breadth of topics varied and at times befuddled my average humanoid brain, (they lost me at the mere mention of Discrete Combinational Optimization Benchmarks), the seeming chaos of alternative lending was put into incredible perspective.

The wider industry is undergoing rapid disintermediation, knowledge is being democratized, and disruptive technologies are growing exponentially.

Luan Cox, the CEO of Crowdnetic and conference panelist, said that real change was already here. For example, she explained that a startup business can go on Indiegogo to raise their initial round of capital while validating their product offering.

From there they can get funding from a peer-to-peer lender or peer-to-business lender. Next, they can land their equity round through equity crowd funders. And following that, they can go back to p2p lenders or take advantage of alternative business lenders such as OnDeck Capital.



That's an incredible capital raise life cycle. None of these steps require a bank and all of it can be done over the Internet.

Alternative lenders such as these have long considered themselves to be alternatives because banks are the first logical choice. But are they?

Staci Warden, the executive director of the Center for Financial Markets at the Milken Institute summed up the high-risk practice of having a bank account.

"Bank accounts can be frozen, taxed, or confiscated," Warden said, who was there advocating for digital currencies such as bitcoin.

On the panel she moderated immediately after, it was said that it was even possible to invest in startups using bitcoins. But that makes such transactions, which can sometimes fall under the jurisdiction of state or federal consumer protection laws, harder to keep tabs on.

Who invested in what? Where is the money going? With no central intermediary in bitcoin transactions, you can't regulate the transfer of the currency itself.

In a personal interview with Chance Barnett, the founder and CEO of Crowdfunder, he offered his own opinions on regulations. He said that he'd like to see fundraising compliance costs come down.

"Raising $100,000 can cost $35,000," Barnett said. That's expensive red tape and it's easy to imagine how much more popular crowd funding could become if those costs were significantly reduced.

While equity crowd funding might sound like the online version of the age-old lengthy struggle of seeking out investors, he explained that the process can be quite fast, particularly if the company has a prominent lead investor that other people are familiar with. Later, while on a panel, Barnett said "one company raised $600,000 in four hours."

Crowdfunder also enables startups to raise funds through revenue-

"[Banking] is the most inefficient industry in the world... banks think innovation is getting a new computer system installed."

— JAY SIDHU

Since the advent of the ACH repayment method, many merchant cash advance companies have taken the concept of buying future credit card sales and applied it to all gross sales. The advances became revenue-based.

based financing, a term that was strikingly close to some of the language being used to describe modern day merchant cash advances.

Since the advent of the ACH repayment method, many merchant cash advance companies have taken the concept of buying future credit card sales and applied it to all gross sales. The advances became revenue-based.

Barnett explained to me that in his definition of revenue-based financing, it is "forward-looking revenue sharing."

While investors similarly earn a percentage of future revenue, there is nothing like the daily repayment mechanisms put in place as there are in merchant cash advance. Instead, the business is required to submit periodic financial statements to the specific platform, such as Crowdfunder, and then are responsible on their own to deliver payments to the investors.

While "democratizing capital" was an oft-used buzzword of the speakers, even David Weild, the "Father of the JOBS Act" acknowledged in his presentation that investor protection is a bottleneck to freeing up access to capital.

But protection isn't necessarily an annoyance to be cast aside.

Karen Pascoe, senior vice president at MasterCard Emerging Payments Group made the point that on the bitcoin revolution, there was a lack of chargeback protection. Both the merchant and the consumer have no recourse options.

Even amongst leading technology innovators, there was a healthy fear of swift deregulation.

Jay Sidhu, the chairman and CEO of Customers Bank and Ben Milne, the CEO of Dwolla, both characterized regulators as friends.

"Regulators are regular people," said Milne. "They're just trying to do their jobs like everyone else."

While currencies and access to capital become more disintermediated, it seems that banks are losing their identity. The need for them as a transaction intermediary, account holder, and lender is fading away.

"[Banking] is the most inefficient industry in the world," Sidhu said. "Banks think innovation is getting a new computer system installed."

The banking business model changes rapidly and often in a reactionary manner. Every time a new law chokes off their current profit driver, they move to something else. Overdraft fees are one avenue that have been front and center.

In a personal interview with former Congressman Barney Frank, the key author of the Dodd-Frank Wall Street Reform and Consumer Protection Act that was signed into law in 2010, I asked him about disclosures surrounding overdraft fees.

Many short-term lenders have made the case that measuring the costs of their products with Annual Percentage Rates would not be appropriate specifically because of the limited time span. Since an overdraft fee is essentially a short-term loan, would it make sense to disclose an APR that would potentially register in the thousands?

"Absolutely," Frank said.

The subject of overdraft fees ignited him and he added that consumers should be required to opt-in to protection in order to receive it. Today,

Businesses follow the money so it's no wonder why tomorrow's corporate leaders don't resemble yesterday's. Where and how you can access money is changing.

as explained on the Federal Reserve's website, bank customers must opt-in if they are to receive overdraft protection on ATM fees or debit card fees, but the "rules do not cover checks or automatic bill payments."

Frank, who the Wall Street Journal has characterized as a longtime liberal voice on Capitol Hill, took a markedly different stance when I flipped the script and asked about business-to-business transactions.

Frank has long championed consumer rights and protections, most notably through the Dodd-Frank Act, but also by leading passage of the Credit Cardholder's Bill of Rights statute that limits how credit card companies can charge consumers.

When I asked if he would be in favor of a federal maximum cap on business loan interest rates, he replied with a stern, "no."

He went on to say that he supported transparency in business loan transactions, such that the borrower should be easily able to identify the terms, but that the premise behind consumer loan protections was that consumers were less sophisticated.

As liberal as Barney Frank may be considered, he explained both to me and earlier on a panel, that he opposed the Durbin Amendment of the Dodd-Frank Act, the addition that placed caps and restrictions on debit card interchange fees.

He specifically disliked the anti-free market approach of such caps. It's a refreshing perspective from an iconic former lawmarker who took a tough stance on Wall Street and banking practices.

While it was Neil Jacobstein, the Artificial Intelligence & Robotics co-chairman at Singular University that said to me, "humans have traditionally required hand-holding for big financial decisions." One has to wonder if the new hand is the invisible one envisioned by the philosopher Adam Smith.

Money is being distributed in entirely new ways and on a massively disruptive scale. The new bank is the crowd and the new money is being described as "a distributed database where the order of transactions is agreed upon by everyone." That's scientist speak for "money ain't a thang."

Businesses follow the money so it's no wonder why tomorrow's corporate leaders don't resemble yesterday's. Where and how you can access money is changing. Even the concept of money itself is being transformed. It was Satoshi Nakamoto who said, "The root problem with conventional currency is all the trust that's required to make it work."

One thing you can trust, is that if 40 percent of today's Fortune 500 companies are actually gone in the next 10 years, you'll know exactly why that happened. They were disrupted.

Sean Murray is the chief editor of DailyFunder, which was a media sponsor of the Exponential Finance conference presented by Singularity University and CNBC.

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How Will SQUARE Fare?

In late May, payments company SQUARE announced the official launch of Square Capital to provide their clients with merchant cash advances. How does their program stack up?

Square told DailyFunder that:

- Most advances are less than $10,000.
- The average holdback is about 10%
- They create their offers based on a seller's history with them and their processing volumes.

Join this year's fantasy football competition for charity!

2013:
Contributing companies: 16 AND Raised: $9,000
Winners: Business Financial Services & Financial Advantage Group
Funds donated to: Wounded Warrior Project & The Spring of Tampa Bay

2012:
Contributing companies: 16 AND Raised: $7,100
Winner: Sure Payment Solutions
Funds donated to: ALS Association

Want to participate? For suggested donation amounts, rules, and information, e-mail info@dailyfunder. Draft time and date to be announced in August.

The annual competition is co-hosted by DailyFunder and Merchant Cash Group.

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