GROWERTALKS

Features

12/1/2017

Joining the Crowd

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Small-business lending is becoming a big business, with hundreds of millions of dollars raised from unique “platforms,” such as crowdfunding, peer-to-peer lending and marketplace lending. How can a grower or retailer take advantage of these speedy financing options, while avoiding the risks associated with borrowing from these relatively unknown and unregulated lenders?

Crowdfunding employs an online platform to raises small amounts of money for a project or venture from a large number of people and only recently entered the equity arena. Peer-to-peer lending is the practice of matching borrowers and lenders through other online platforms. And, while the newer “marketplace” funding remains largely undefined, it encompasses lenders that make loans to higher-risk, lower income borrowers, micro-finance and larger-scale lenders that market their products to traditional consumers and small businesses.

The entire lending marketplace is an emerging segment of the financial services industry that increasingly uses online platforms to lend directly or indirectly to consumers and small businesses. Borrowers are able to gain access to funds quickly and typically at lower interest rates than offered by many banks, making it an attractive loan alternative for borrowers. You can take advantage of these speedy financing options, while avoiding the risks associated with borrowing from so-called “shadow banks.”

Crowdfunding growing fast

Crowdfunding platforms are most commonly known for their use to raise money for worthy causes and special projects. Popular platforms include Kickstarter, Indiegogo and Crowdrise that provide reward crowdfunding and, more recently, equity and debt crowdfunding.

Today, crowdfunding is challenging venture capital and angel funding as an alternative source of financing for many small businesses. Equity-based platforms provide backers with shares of the business in exchange for the money pledged. In fact, thanks to the Jumpstart Our Business Startups (JOBS) Act of 2012, small businesses can now raise more funds from small investors with fewer restrictions, thus creating more interest in crowdfunding.

Businesses just starting out or in their early stages can pitch an idea to ordinary people, as well as to wealthy investors, that might be interested in investing small amounts of money. In exchange, the business owner offers some small incentive to donors (e.g., a free
t-shirt) or a larger incentive (e.g., equity in the growing business).

The new Securities and Exchange Commission (SEC) rules allow businesses, and even first-time start-ups, to raise up to $1 million online from non-accredited investors over 12 months. The compliance usually required in private fundraising is waived, although borrowers must provide financial statements, which don’t have to be audited.

The amount that an investor can invest via crowdfunding will depend on the investor's income. According to the SEC, an investor with an annual income and net worth of less than $100,000, can invest $2,000, or 5%, of their net worth, whichever is greater during a 12-month period. An investor with annual income or a net worth equal to or more than $100,000, can invest 10% of their annual income or net worth, whichever is greater.

It's the crowdfunding sites, not the business, that must be registered with both the SEC and the Financial Industry Regulatory Authority (FINRA).

Peer-to-peer lending

Debt crowdfunding—borrowing from individuals and other organizations—has also grown rapidly and moved into its own category, often referred to as Peer-to-Peer (P2P) lending. Much like crowdfunding, P2P lending matches borrowers and lenders through an online platform. P2P borrowers are able to gain access to funds quickly and often at interest rates lower than offered by banks, making it an attractive alternative to more conventional bank loans.

The loans issued are comprised of funds from many different investors, ranging from individuals to institutions. P2P lenders underwrite borrowers, but don't fund the loans directly—they're an intermediary between the borrowing grower or retailer and institutional investors, such as hedge funds and investment banks. Those third-party investors can invest in the loans on online P2P marketplaces, and they take on the investment risk, not the P2P lenders.

Individual and professional investors benefit by being able to lend money at a range of interest rates based on proprietary credit scores assigned by each platform. Since investors typically fund only a portion of a loan and spread the amount they loan across many borrowers, investors can potentially receive steady, attractive returns with the risk spread among multiple borrowers.

As a borrower, you interact only with the P2P lender. After investors agree to fund the loan, the P2P lender transfers the total loan amount into your bank account. You repay the P2P lender and they deal with repaying the investors.

Unfortunately, even though it may be the most innovative source of funding, P2P lending is definitely not the most affordable. Admittedly, banks take a lot longer to issue loans than P2P sites, but a business that can wait and can qualify for a traditional bank loan or an SBA loan will find that to be a far less expensive option.

Marketplace lending

As a more diversified set of investors, especially institutional investors, become involved on lending platforms, "marketplace lending" has become a recognizable term used to describe the industry. Online marketplace lending refers to the segment of the financial services industry that uses investment capital and data-driven online platforms to lend directly to small businesses and consumers. While the volume is tiny in comparison with traditional bank lending, marketplace lending has experienced rapid growth, with new lenders originating over $12 billion in loans.

Marketplace lenders employ new, largely automated underwriting processes. Some lenders purport to rely on "big data" not evaluated as part of traditional bank underwriting processes. However, there has yet to be one consistent, concise definition of what marketplace lending truly means.

The U.S. Treasury broadly defines marketplace lending by stating that it is "the segment of the financial services industry that uses investment capital and data-driven online platforms to lend either directly or indirectly to small businesses and consumers." They go on to say, "Companies operating in this industry tend to fall into three general categories: 1) Balance sheet lenders; 2) online platforms [formerly known as Peer-to-Peer or P2P]; and 3) bank-affiliated online lenders."

In general, marketplace lenders can be best described in three parts: a non-banking financial institution that heavily leverages technology to drive simplicity and speed of process, and serves a two-sided market of consumers and investors.

The majority of alternative online lenders lack a brick-and-mortar presence with which to interact with their customers, making it important for borrowers to spend time differentiating models. As mentioned, each “type” of marketplace lender has a differing business model with varying revenue streams and diverse motivations in serving their
customers.

Marketplace lenders are currently required to comply with federal consumer financial protection laws, such as the Truth in Lending Act, Equal Credit Opportunity Act, Fair Debt Collection Practices Act and Gramm-Leach-Bliley Act. Peer-to-Peer lenders that fund loans through third-party investors (rather than from their own balance sheets) may also be subject to securities regulation.

For the most part, however, marketplace lenders aren’t subject to comprehensive federal or state supervision and examination in the same way as banks and other insured depository institutions are, nor are they subject to safety and soundness regulations, including minimum capital and liquidity requirements, under federal law.

Many marketplace lenders rely on banks to originate loans and merely purchase those loans for resale to platform investors. Therefore, for these lenders, a borrower may indirectly receive the same regulatory protections as any bank customer. In addition, a marketplace lender that acts as a service provider to one or more banks may be examined by bank regulatory agencies in connection with the services provided to the bank.

Traditional vs. alternative funding

Bank loans continue to dominate the financing space for small and mid-size businesses in need of capital. For any grower or retailer thinking about this type of funding, keep in mind that these new entities are generally not government regulated in the way banks are. While it creates potentially more risk, it also makes them potentially more nimble, enables them to operate at lower costs by not having to follow all of the same compliance and regulatory requirements, and to innovate with technology at its core.

Crowdfunding, Peer-to-Peer loans and the closely-related marketplace loans offer an often less-expensive source of the funds needed by a growing business at a much faster rate than funding from a more conventional bank or financial institution. Regulation and oversight of these alternative funding sources remains a concern for investors, although both are on the upswing.

Deciding which alternative will benefit your business and be less costly may require the services of a loan broker or other qualified professional. At the very least, all options should be thoroughly researched on the Internet they all utilize. **GT**

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