Online Lending: Market Disrupter or Late Cycle Dealmaking?

The current restaurant financing cycle is merry for now, especially for established restaurant chains, including large multi-unit franchisees. Financing is cheap, widely available and comes with fewer strings attached. Bank of America's head of restaurant lending, Cristin O'Hara, told the Monitor's Nick Upton at the recent Restaurant Finance & Development Conference that she doesn't "expect things to slow down" in 2016.

Boefly's Mike Rozman, a financier who connects commercial banks with franchisee borrowers through an online portal, told attendees at a "FinTech" workshop at this year's Restaurant Finance & Development Conference, that financing is as simple as "finding the cheapest cost of capital with the least amount of brain damage."

That loans become easier to procure with less hoops to jump through is typically a sign of more lender competition, not necessarily better borrower credit profiles.

For the smaller restaurant operator with fewer than three locations, capital is usually more expensive and loaded with an extra dollup of brain damage. Banks have generally played an insignifcant role in the capitalization of small restaurant companies and startups over the years, especially since the recession, unless the loan is secured with an SBA guaranty.

The Wall Street Journal reported last month that large banks are making fewer loans to small businesses than they did a decade ago—$44.7 billion in 2014—down 38% from a peak of $72.5 billion in 2006. By contrast, loans to larger companies increased 37% during that time.

Lately, a trifecta of technology, big data and investors chasing yield is shaking up the lending market for small business. It's referred to in the finance world as FinTech, alternative lending, peer-to-peer lending, or if you prefer, marketplace lending. We'll call it online lending. It's a mix of subprime, CRM, FICO scoring and algorithmic modeling. It delivers the credit experience over an electronic platform.

Companies such as On Deck Capital, Can Capital, Prosper, Kabbage and others, have brought together institutional capital and individual investors to fund other individuals' or business loan requests. They promise to replace the stodgy, bank credit officer, inclined to say no, with instant loan approval.

While still small in scale, personal, student and commercial online lending is generating roughly $12 billion a year in loans, according to Charles Green, a former banker and now managing director of the Small Business Finance Institute. John Hecht, a specialty finance analyst at Jefferies, says the annual market for small business lending is approximately $300 billion a year and feels it is reasonable to eventually expect a 5% online penetration, or roughly $15 billion per year in online small business loans.

Online lending is getting the attention of the banking community, especially for the technology in scoring loans. Just last week, JP Morgan announced a strategic partnership with On Deck to use their platform to underwrite loans for their small business customers.

For now, Rozman says many online borrowers aren't a good fit for conventional bank financing and couldn't qualify for an SBA loan even if they wanted one. "Online lenders generally are funding working capital for expansion, inventory, seasonal cash flow shortfalls, or other operating purposes," said Green.

Green points out online lenders don't provide the same pricing and repayment maturities that are available for an SBA loan and can be quite expensive. He provided an example of a restaurateur generating $100,000 in monthly credit card receipts borrowing $50,000. Assuming the operator pays an online lender a 2% origination fee and 15% of the daily credit card proceeds until a total of $60,000 is paid back, Green calculates the annual per annum interest rate at 72%.

Ron Feldman, chief development officer of FranData, sees the general online debt marketplace as a merchant advance option. "The rates with most online lenders are so high that I don't see much traction unless there is a distressed situation," said Feldman.

On Deck's yield on the total of average loans held by them at September 30 was 37.7%. Conversely, a 10-year bank loan with an SBA guaranty with roughly 3% to 5% in origination and closing fees, costs a borrower approximately 6.5% per annum.

Online lenders say they charge higher interest rates to cover potentially higher loan defaults becasue of riskier underwriting and fraud. That's in stark contrast to most commercial bank policies which stress keeping loan losses to a minimum. High rates haven't stopped borrowers in need.

"One of the mistakes many borrowers make is they aren't concerned about the cost of capital for their own self-preservation," said Green.

Online lender ApplePie Capital has gone beyond the typical working capital loan and is financing fixed assets over a longer term. And, it is offering lower rates, too. The San Francisco-based lender offers fixed-rate loans to franchisees between $100,000 and $1 million for new units, or to recapitalize existing loans. ApplePie attracts capital from institutional investors, as well as accredited investors who can invest as little as $1,000 in the debt of approved franchisee borrowers.

Since ApplePie started making loans this year, it's signed up 25 franchise brands and has arranged one or more loans for 15 of those brands. Its average interest rate on loans is 8.34%. The online lender's CEO, Denise Thomas, told conference attendees she personally invests in every single loan on her firm's alternative lending platform to reinforce her belief in the firm's underwriting and approach.

Feldman believes some online lenders can be an alternative to SBA guaranteed bank financing. "Alternative lenders like ApplePie offer an 'easy button' solution for franchisees that costs more, but doesn't disrupt your life or require your first born," said Feldman.

—John Hamburger