

THE COMPLETE

Guide to Alternative Finance Options in a Downturn

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Introduction

As we embark on this journey outlining the role the alternative finance sector plays in the much broader, and lucrative, finance industry, let's first return to a pivotal moment in time.

More than 4,000 years ago, humble Mesopotamian farmers were the first humans to perform lending transactions—arrangements that would lay the foundation for what centuries later would become a trillion-dollar industry.

We don't have to explain how far we've come since then. The reason for this trip back to the early days of Western civilization is to underscore the significance of lending as a vital—actually, essential—practice, however imperfect. That financing dates back nearly as long as civilization itself—and well before the first-ever minted currency was adopted in the kingdom of Lydia, which is now western Turkey—is, if nothing else, a remarkable historical nugget.

Fast forward to the 21st century, and the banking industry as a whole is a colossus. In the United States alone, it reportedly held \$124 trillion in total assets as of 2018.

Across the country, financial institutions of various sizes, including community banks, credit unions, and national firms, serve as literal lifelines for consumers and businesses, including many small-and-medium (SMB) enterprises. According to the U.S. Small Business Administration, banks possessed [\\$600 billion in outstanding loans](#) as of 2015.

Small business lending also performs a vital function, particularly because smaller employers are responsible for the majority of job creation in the United States. The SBA reported that there were 30 million small businesses in the United States in 2015. Between 2000 and 2017, these operations were responsible for 8.4 million net new jobs, double that of large companies.

To put small business financing in perspective, the SBA's 7(a) loans—the agency's primary lending program—reported more than [\\$20 billion in loan disbursements](#) in five of the last six years. Still, that's just but one option small businesses have at their disposal.





Increasingly figuring into the equation are alternative lenders—many of which are in the fintech space—offering organizations with more access to much-needed capital.

Not only are they providing new lending opportunities, but the hallmark of many of these loan providers is the speed by which they process and disburse funds, allowing organizations to maintain consistent cash flows, execute short- and long-term plans or maintain payroll, among other priorities.

Alternative financing is also paramount during an economic downturn. Serving as a not-too-distant reminder, small businesses saw lending dry up and access to credit disappear in the aftermath of the 2008 financial collapse. However, a lot has changed in the intervening years—mainly alternative lenders carving out a unique niche in the market, with technology serving as, if not the great equalizer, a democratizing power.

This guide will help explain the alternative financing industry, various lending options, the role of fintech outfits, and more.

What is Alternative Financing?

As we mentioned in the introduction, community banks, credit unions, and larger institutions have long served as the primary outlet by which businesses accessed loans.

Over the years, however, the industry has seen new models emerge, coinciding with substantial advances in technology and sweeping changes to consumer behavior.

Alternative financing is the process by which consumers receive funding outside of the traditional banking system. Alternative lenders increasingly serve small businesses with limited access to conventional lending markets.

Their emergence comes amid an estimated \$5 trillion finance gap for micro, small and medium businesses, according to a report produced in 2018 by [SME Finance Forum](#), a global network that seeks to expand access to financing.

Meanwhile, more than [40 percent of consumers surveyed](#) by Oracle Financial Services Software, which provides IT solutions to banks, said alt financiers provide better services than their long-established counterparts.

“Consumers are becoming increasingly receptive towards new digital platforms,” Oracle reported, “hence bank businesses may face risk of erosion should they not meet their consumer’s expectation.”

Consumers in the United States, along with Canada, Brazil, United Kingdom, Germany, China, and India, were found to be more receptive to digital platforms, potentially putting pressure on traditional banks to embrace emerging technologies.

Tech-based alternative lenders perform many of the same functions as conventional banks but offer an easier path toward lending. Due to less restrictive regulations and their embrace of modern technologies, including artificial intelligence (AI) and machine learning, these new entries can process loans quicker—sometimes within days—which is critical for small businesses shaken by broader economic upheaval.

THE BASICS

- Small businesses, including those with poor credit, are increasingly embracing alternative lenders as they become locked out of conventional banks.
- Alternative lenders offer various types of funding options, including small -and medium-business (SMB) loans. These lenders operate outside of the established banking system.
- Alt lenders provide quick access to capital and utilize technology, including AI, to expedite the application process and create a more user-friendly experience.

CHAPTER 2

Why Consumers Explore Alternative Financing

Alternative lending institutions may be a relative newcomer to the finance system but they've quickly become a vital resource for small businesses.

To show how far such institutions have come, alternative lenders approved 55.9 percent of small business loans in February 2020—a rate of approval that exceeded that of small banks, [according to biz2credit.com](#).

“ This perfect storm affected funding for small businesses, and only recently has the tide begun to turn for this critical segment of our economy.”

These operations have established themselves as serious players in the lending game, with businesses increasingly leaning on them for support. Much of the shift away from traditional banks to these institutions can be tied to the fallout from the Great Recession, among other factors.

As [Moody's Analytics](#) reported in 2017: “Post-2008, capital access available to these small businesses diminished for a number of reasons. Many banks did not survive the economic downturn, and those that did took a variety of measures to prevent any potential recurrence. Credit standards were fine-tuned, with even the most solvent companies struggling to secure capital for both survival and growth. Banks had to contend with increased regulatory oversight, which resulted in higher operational costs and significantly reduced margins. This perfect storm affected funding for small businesses, and only recently has the tide begun to turn for this critical segment of our economy.”

With credit drying up, smaller businesses—which generate 44 percent of economic activity in the United States, according to the SBA—shifted to alternative lenders, including the ever-growing fintech sector.

Beyond displaying a willingness to work with smaller companies, these lenders proved they could process and finalize loans quicker than established banks—sometimes within a few days.

For alternative lenders, **speed is their calling card**, in addition to providing small businesses with the ability to maintain cash flow, as well as equity and control. With a merchant cash advance—which is technically not a loan, but instead a lump-sum transfer of cash—businesses have more flexibility because MCAs are based on business revenue, not the equity or valuation of your company. To learn more, [read our article on the 10 reasons to get a merchant cash advance](#).



THE BASICS

- Alternative lenders have established themselves as serious players in the financial service sector, recently approving a higher percentage of small business loans than small banks.
- The Great Recession was a disaster for the economy as a whole, including SMBs. However, with funding drying up, SMBs were able to reenter the lending market via alternative lenders.
- SMBs prefer alternative financing options over conventional methods because of expedient loan disbursement and flexibility, among other reasons.

Alternative Financing Options

Just as banking institutions offer a wide range of financing options for SMBs, so do alternative lenders.

For businesses suffering from a broader economic downturn, any type of financing may offer a much-needed respite and provide peace of mind, however fleeting.

The purpose of emergency financing is to buttress businesses, allowing them to satisfy payroll, cover the cost of equipment and other ancillary services, and maintain operations.

Financing takes on greater significance when you consider many small businesses are on a precarious financial footing even when the economy is humming along swimmingly. According to the SBA, only about half of all small businesses survive after five years or longer, and only a third do so after a decade.

So, let's talk about what alternative financing options are available. These include a merchant cash advance, short-term loan, installment loan, and revolving line of credit, among others.

Merchant Cash Advance

As we mentioned earlier, a merchant cash advance is a lump-sum payment that's tied to future profits.

The advance is repaid through automatic debits that lenders refer to as an Automatic Clearing House (ACH) payment. It's important to understand that these debits occur daily, and could have a significant impact on how much your business earns. So if you're considering going this route, you need to be confident that you'll receive steady business—or at least generate enough sales to have the debt repaid without defaulting, which could prove disastrous.

Pros: Merchant cash advances provide immediate financial relief and funds are typically dispersed in a few days. Businesses can use the funds for a variety of purposes, including paying employees.

Cons: Along with a daily repayment schedule, the annual percentage rates (APRs) on advances are very high, and sometimes reach three figures, which you may find too risky. A merchant cash advance is often considered a last resort, so make sure you've exhausted all options before going this route.

Short-Term Loan

Short-term loans are among the most common alternative lending options for small businesses seeking emergency relief. The application process isn't considered onerous and funding can be made available in as little as 24 hours. Another hallmark of this type of funding is the truncated repayment schedule, which typically lasts a few months to a year—hence the origin of “short-term.”

Pros: You're going to begin to sense a theme here. As with other alternative financing options, businesses can obtain short-term loans in a few days—which is crucial if you're indeed in an emergency situation. Its abbreviated repayment schedule may also be appealing to businesses who don't want to be tied to long-term debt.

Cons: These loans carry potentially excessively high interest rates, which may seem too onerous. The inability to pay the loan back could have devastating financial repercussions.

Installment Loan

Installment loans for small businesses boast fixed payments for the length of the loan, which includes the principal and interest. And unlike a merchant cash advance or short-term loan, repayment is longer in duration. To be specific, this is a secured loan—which means a physical asset is used as collateral, such as your business.

Pros: Installment loans are processed quickly, putting funds in your hands within a couple of days. Additionally, interest rates are fixed, eliminating any surprises down the line.

Cons: An installment loan can be a risky proposition if you're not confident you'll be able to repay the loan. Since it's secured, you can lose the asset you use as collateral.

Revolving Line of Credit

You've likely heard of a line of credit. Well, this version works in much of the same way but for one key distinction: Once you repay the amount you've used, you get to reuse the funds again. For example, if you receive a \$40,000 credit, you can spend half on payroll, repay it with interest, and access the funds again for another expenditure. It's similar to having a business credit card but likely with a more generous credit limit.

Pros: With a revolving line of credit, you'll have repeated access to funds, so long as you satisfy repayments.

Cons: You don't want to bite off more than you can chew. If you max out the line of credit without having a plan to repay the debt, your credit can take a significant hit.

[Read more about alternative financing options.](#)

THE BASICS

- Businesses have various alternative financing options to choose from.
- Most of these financing options can be processed quickly, sometimes within a few days.
- As with any type of loan, it's important to have a plan in place to make debt payments. Failure to do so could lead to considerable repercussions.

Are Fintechs Trustworthy?

Fintechs are alternative financial institutions that operate outside of the traditional banking sector and leverage technology to improve the customer experience.

Individual fintechs still may not boast the name recognition of conventional banks, but the industry as a whole is gaining influence.

By 2022, fintechs are estimated to have their [value grow to \\$309.98 billion](#)—representing a 25-percent bump.

In essence, fintechs are everywhere. These lenders issue various loans, including mortgages and small business funding, and provide credit to individuals as well as help college graduates consolidate student loan debt.

Powered by artificial intelligence (AI) and machine learning, these online lenders have taken financing to the next level. Not only have they proved efficient, but they're seen as a reliable source of funding for small -and medium-businesses.

Consider the gains made by the online payment transfer company PayPal. In 2019, the online platform announced that it had provided [\\$10 billion in loans](#) to small businesses, a considerable sum considering its lending program was only about five years old at the time.

Kabbage, another notable fintech startup that issues up to \$250,000 in small business loans, had reportedly provided [more than \\$7 billion in funding to nearly 200,000 firms](#) by July 2019. That came on the heels of Kabbage's much-ballyhooed announcement that it secured \$700 million in funding—reportedly a record amount raised by any online lending platform at the time.

As we mentioned in the first chapter, alternative lender small business loan approvals recently exceeded small banks, which is impressive since the industry is still relatively young. Judging by their growing influence and ability to raise funding themselves, online lending platforms are becoming a force in the marketplace.

[**Learn more about how SMBs are increasingly relying on fintech operations for financing.**](#)

THE BASICS

- Fintech institutions are online platforms that leverage artificial intelligence (AI) and machine learning to improve the customer experience.
- These platforms are becoming more influential and their collective value is expected to hit \$309.98 billion in a few years.
- Two of the most notable fintech lenders—PayPal and Kabbage—have together provided more than \$15 billion in loans.

CHAPTER 5

Fintechs & SBA Loans

Now that you understand the basics of the fintech industry let's see where they fit in the widely popular SBA loan programs.

Up until the most recent downturn, spurred by the collapse of the global economy amid the COVID-19 pandemic, fintechs were blocked from government-based SBA funding.

However, with businesses shuttered indefinitely due to state bans on nonessential industries, and millions of workers out of jobs, the SBA approved several fintech outfits to participate in its Paycheck Protection Program (PPP).

Businesses are eligible for PPP if they maintain pre-pandemic employment levels during the crisis.

As soon as the program opened, the SBA was flooded with applications, and funds earmarked for the program evaporated in short order. Many prosperous firms, including public companies, walked away with millions of dollars during the first wave of applications, even as millions of desperate small businesses were left out in the cold.

Congress then approved a [second round of funding](#) and the SBA pledged to ensure small businesses would reap the benefits.

As is standard practice with SBA programs, applicants can only receive funding from approved lenders, all of which you can find on the agency's website.



“ Businesses are eligible for PPP if they maintain pre-pandemic employment levels during the crisis.”



That the SBA added fintechs to its list of intermediaries during the COVID-19 crisis is a significant shift in policy, one that may open the door for more online platforms to assist with government-backed loans in the future.

Whatever the case, these tech-powered financial institutions have other loan options at their disposal, which could benefit SMBs suffering from the fallout of an economic downturn.

As always, it's important to weigh the pros and cons of any loan that comes your way. And as you navigate the world of finance, you'll likely notice fintech companies that you didn't know existed previously. But unfamiliarity shouldn't be a reason to hold back. According to a report in banking news and trends site [Banking Dive](#), fintech companies, which are competing with conventional banks in the consumer sector, are increasingly focusing on SMBs. In one analysis Banking Dive cited, fintech companies serving SMBs raised more than \$4 billion in 2019.

[Read more about fintech firms & SBA loans.](#)

THE BASICS

- SBA loans provide critical funding to SMBs struggling as a result of broader economic upheaval.
- Amid the economic crisis caused by the COVID-19 pandemic, the SBA approved several fintech firms to participate in its Paycheck Protection Program (PPP).
- While it's unclear whether the SBA will enable fintechs to act as intermediaries in the future, these online platforms are increasingly serving SMBs in other ways.

CHAPTER 6

Understanding Personal Guarantees

Before agreeing to funding, you want to do your due diligence to ensure you're aware of how the loan—and potentially defaulting—will impact you, your business, and your family.

One condition you might come across in the loan process is a personal guarantee, which essentially says you, as the business owner, agree to pay the full amount of the loan, plus any other fees, in the event you default.

According to the SBA, any business owner with a stake of 20 percent or more in a company must sign a personal guarantee in order to secure a loan.

If that's not enough, you may also notice different types of guarantees, such as unlimited personal guarantees or limited personal guarantees.

Unlimited Personal Guarantee

When you sign an unlimited personal guarantee, you are making a legally binding commitment that you will allow your lender to collect 100 percent of the loan amount plus any legal fees that might be associated along with it.

Limited Personal Guarantee

Limited personal guarantees set a dollar amount on how much can be collected from you if you ever default on your loan. These guarantees are often used when multiple owners of a business seek to take out a loan for their shared company because they define exactly how much each owner is responsible for, should the business fail. There are two types of limited personal guarantee—a several guarantee and a joint several guarantee.

[Learn more about personal guarantees and how they could impact you.](#)

THE BASICS

- It's important to scrutinize loan terms carefully to avoid any surprises down the road.
- Personal guarantees are an agreement establishing that borrowers repay the full loan amount, plus any other fees associated with the agreement.
- There are a variety of personal guarantees, so do your research to ensure you're aware of the differences.

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