

May 5, 2010

Providing Loans Based on Cash Flow, Not Credit Score

By ROBB MANDELBAUM

With the recession having left many banks reluctant to lend, small businesses have struggled to find other sources of credit. One intriguing alternative is [On Deck Capital](#), which promises to revolutionize lending to small businesses.

Traditional banks, says Mitch Jacobs, On Deck's founder and chief executive, know so little about their small-business borrowers that it scares them off.

On Deck, by contrast, says it scours "the cloud" for the vast information trail that every business now leaves to develop a clear understanding of a potential client's creditworthiness. It seeks businesses with positive cash flow, ideally from a lot of small-ticket transactions.

It takes no collateral, and — here's the biggest difference between On Deck and traditional lenders — the loan is repaid automatically with daily deductions from the borrower's bank account.

The capital does not come cheap: the annualized interest rates can reach as high as 36 percent. Since opening in 2007, On Deck has made 2,000 short-term loans, putting \$60 million in the hands of small-business owners, typically in increments of less than \$30,000. A condensed version of a conversation with Mr. Jacobs follows.

Q. *If the credit markets were functioning the way they should, would there still be a place for On Deck?*

A. There's been trouble in credit on Main Streets for decades. In 2006, when we launched the company and liquidity was everywhere, over five million Main Street small businesses were declined for credit because of a low personal credit score. Several million of those have the cash-flow stability in their businesses to be able to service a loan, but the existing system doesn't detect that.

Q. *What information does On Deck look for?*

A. The full picture. What cash is coming in, what cash is going out? What is the pattern and stability of their customer activity? How diversified is their customer base? The fundamental

building blocks are their online banking information, their payment processing information, and their accounting information — 60 percent of our users today have QuickBooks.

Q. *Do you continue to collect data about businesses after they have paid off their loans?*

A. If they ask us to. Because they then are credit-ready the next time they need capital.

Q. *Is this like revolving credit, then, or a credit card?*

A. No. It's very important that when a small business borrows for the purpose of some type of equipment replacement, inventory or marketing that they pay down the capital in the time period that they are using the money. Otherwise, they won't be able to borrow again the next time.

A lot of people think if you've purchased a refrigeration unit that has a five-year lifespan, then you should have a five-year loan. But that's the wrong way to look at it. The question is: what's the next big-ticket purchase and when is that going to come up?

Q. *But the interest rate you charge is pretty high, right?*

A. The average right now is in the low 20s. It's consistently below 30 percent.

Q. *How much of that does On Deck keep?*

A. Actually, the way we designed the program, businesses pay us a fee of \$500 and up to act as a virtual director of finance. One of the advantages that we have is that, since we validate all of the information electronically, we are able to share with the business owners where their strengths and weaknesses are and provide a significant amount of what would be called technical assistance. They pay us for the On Deck service, and then we pass through the cost of the capital from the market to the borrower.

Q. *What might a business learn from you?*

A. From a cash-flow standpoint, just as an example, we're providing them with ranking information — where they stand in comparison to similar businesses in their industry. And also when it looks like the rate at which their cash is going out is greater than the rate at which the cash is coming in.

Q. *Couldn't they just look at their checking account to see whether the cash going out is greater than the cash coming in?*

A. The business owner may not have really studied, on an ongoing basis, the cash-flow trends in their business, and they're also not aware of at which point the cash-flow profile of their business might concern a source of capital.

Q. *Studies show that a business is more likely to fail if it has more credit card debt, owing to the high interest rate. But On Deck's interest rates are often higher still. What does that say about the outlook for your customers?*

A. Our businesses have on average a million dollars of revenue, and what you and I are talking about right now is a \$2,000 difference, if that, at the max, on a \$30,000 loan. So everyone needs to stop talking about optimal interest rates on short-duration, small-dollar transactions, because it is resulting in businesses not getting access to capital that they can much more than afford.

Q. *But a lot of these businesses are going to be low-margin businesses, where every thousand dollars is a lot of money.*

A. We're working with businesses that have a significant amount of cash flow, and they wouldn't be qualified for our program if they didn't have it.

Q. *How often do your borrowers default?*

A. Toward the tail end of 2008, we had a peak in the loss performance of the portfolio. But it's never crossed 10 percent, and typically it operates well below that.

Q. *Payday lenders and credit card lenders often say that their loans are expensive because the borrowers are risky, and the cost of their loans reflects that risk. Why are your loans so expensive?*

A. There is a misperception about the risk, but in order to dislodge capital from underlying capital sources, the pricing of the risk is in line with their requirements.

Q. *You clearly have a higher loss rate than banks do on commercial loans. What's the misperception?*

A. We've got large pockets of businesses that consistently show very low loss rates; we've got other business groups in the middle and others that show higher loss rates. The On Deck system is helping to parse out the different populations of businesses, and they will be able to access lower and lower-cost capital as there's more history and more businesses in the system.

Q. *Presumably, if the loans weren't risky, you wouldn't need to collect a payment every day.*

A. The daily automated system of collection provides a few different benefits, one of which is to reduce the risk of serving this marketplace. It also makes it easier for the business, and it also helps the business get out of debt faster so that it can take on the next challenge.

Q. *Where do you get the capital to lend out?*

A. We have a series of family offices, institutions and hedge funds that provide capital. We've

created the pipe for them to be able to reach the small borrowers that they've never been able to reach before.

Q. *It seems what you're talking about is a transfer of wealth from poor people to wealthy people. Isn't there a way to find different sources of capital?*

A. One of our objectives is to create a sustainable and scalable availability of capital for Main Street. If we had gone and gotten a \$5 million grant, we'd have tapped out 1,700 small businesses ago. We didn't want to do that. We wanted to solve this problem once and for all.