SAN DIEGO BUSINESS JOURNAL

Peer-to-Peer Lending Gaining Traction Despite Interest Rates

FINANCE: Borrowers Don't Mind Paying More, Investors Accept Risk

By Mike Allen

Saturday, February 8, 2014

Small businesses shut out of getting loans from traditional sources like banks are finding alternatives at a slew of crowdfunding and other peer-to-peer websites.

Peer-to-peer is lending arranged by go-between entities that connect investors to borrowers seeking cash. While that isn't new, in recent years there's been a proliferation of online sites conducting such activity.

Some of these companies, such as Lending Club and Prosper, are growing rapidly and carving out a niche in higher-risk, microlending that many banks and even credit unions shun because of higher risks and meager returns.

Despite paying interest rates that are much higher than a bank would charge, many borrowers say the price is well worth it.

"I didn't care about the higher rate," said Morey Holzman, owner of Coast to Coast Tax Service in Escondido. "It was better than the 25 percent I'd pay on my credit card and the 35 percent some loan shark would be charging."

Holzman contacted Dealstruck, a San Diego online small business lending platform that matches investors to borrowers, after he failed to get approved for a $50,000 loan from six different lenders, including the bank where he does most of his business.

For the loan he obtained through Dealstruck, Holzman is paying 14 percent annually for two years. In comparison, most SBA loans carry interest rates around 6 percent. When comparing the total dollars owed, Holzman said the difference is "insignificant."

Obtaining approvals in two weeks and the relief he got from that was worth much more, he said.

Peer-to-Peer Lending Trending Up

David Ely, finance professor at San Diego State University, said the evidence is clear that peer-to-peer lending is gaining traction, as more borrowers realize they can get funding without too much difficulty and at rates that are below what credit cards charge.

Still, Ely cautions that investors providing dollars for the small businesses and consumers should be well aware of the risks, despite the attractive returns that money is generating.

“This isn’t like a bank deposit backed by the government. This is an investment with a chance it might default,” Ely said.

Brendan Ross, president of Direct Lending Investments LLC in Los Angeles, said his private investment fund buys small business loans made by a number of lending platforms including IOUCentral.com and QuarterSpot. He’s in talks with Dealstruck to do the same.

Since he launched the fund in late 2012, it’s bought roughly 900 to 1,000 loans from several platforms to bring the portfolio to about $25 million. The loans range from $10,000 to $100,000, and average about $41,000. The typical interest is 2 percent monthly. The term ceiling is one year, so that comes to 24 percent annually.

Ross said his firm is filling a gap in the financing picture today as more banks abandon providing needed capital to businesses that are the backbone of this economy.

“Banks are good at lending to people with W-2s, but they’re not good at lending to small businesses,” Ross said.

While a dentist who’s employed by another dentist has a good chance of getting approved for a small loan, that’s not true for the dentist owner because of the financial strictures that association triggers, he said.

By the way, dentists, doctors and other medical professionals make up the largest portion of the portfolio, about 20 percent. Other major users are small retailers, about 25 percent, and food and lodging outlets, about 15 percent, Ross said.

Solid Returns for Investors

Most of the loans are used to buy inventory and new equipment. While the rate may seem high, the typical $100,000 loan will end up paying about $112,000, Ross said.

Investors providing the capital to buy the loans are all accredited, meaning they have a net worth of more than $1 million, not counting their residence. Last year investors, who invest $100,000 to $3 million, got a return of 12.6 percent.

Those returns would have been higher if not for a default rate of 6 percent. That’s acceptable given credit card lending has default rates that peaked at about 11 percent in 2010, he said.

For the fund’s return to dip to zero, the default rate would have to reach 22 percent, he said.

One caveat: If you’re a startup, don’t bother seeking a loan, Ross said. A borrower should have at least two years of financials to assess.

“My average borrower has been in business for 12.1 years,” he said. “We like lending to businesses with lots of cash flow and lots of small customers. We do a lot of loans to d