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Lending, With a Twist

On Deck Capital offers an unusual alternative to bank loans. Some big-name backers believe it may be on to something.

By ZORAN BASICH

As the credit crisis deepens and Wall Street roils, it's getting tougher for small companies to land bank loans. For On Deck Capital Inc., that situation spells opportunity.

The New York-based start-up lends money to small businesses that can't get funding from major banks. On Deck has distributed more than \$10 million in loans since launching in May and says the total amount of loans is growing about 35% each month.

To be sure, lots of alternative lenders have popped up lately, with a host of approaches to serve small businesses. But a couple of critical factors set On Deck apart from the crowd.

For one thing, unlike many of the start-up lenders, it has big-name backers. On Deck got funding from several high-profile venture firms -- including RRE Ventures and Khosla Ventures -- and has since partnered with a big hedge fund and a number of community banks.

What's more, the company has an offbeat system of evaluating borrowers. Instead of looking at a snapshot of performance, such as an applicant's tax returns, On Deck uses software to examine a company's daily business activity. The software figures out, among other things, how many customers the business has, how many complaints it gets and how its sales surge and sag. The idea is to gauge cash flow and see if the company is stable enough to pay back a loan.

On Deck's methods of collecting payments are just as unusual. Instead of sending out monthly notices, the company electronically debits small amounts every day from borrowers -- usually about \$100 -- to pay back the loan over a year.

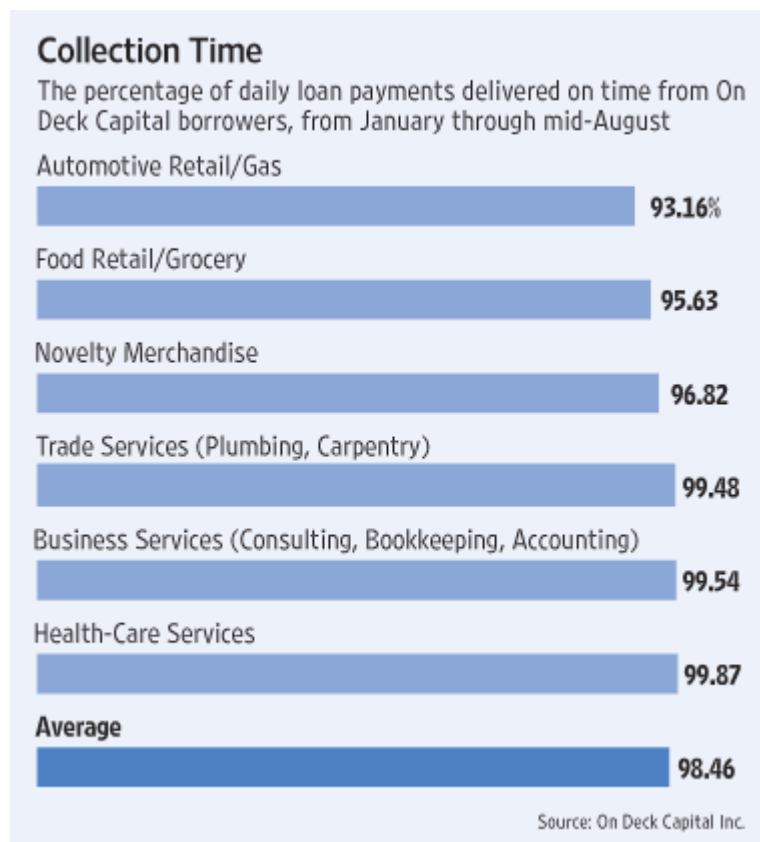
A Solid Start

Some prominent small-business advocates like On Deck's approach -- albeit with some reservations. Marilyn Landis, chairwoman of the National Small Business Association, notes that On Deck doesn't provide the personal "feet on the street" relationships banks once had with small businesses, "but at least it's a start" toward helping small companies get funding.

Some traditional lenders echo those sentiments. Bob Seiwert, a senior vice president with the American Bankers Association, says On Deck's system provides an "interesting niche product for undercapitalized, cash-starved businesses," but it doesn't provide a personal connection with a banker.

What's more, he says, "for a business that needs a permanent increase in working capital, this probably isn't the best option. If you have a short-term blip due to seasonality and can't get a bank loan, this might work."

On Deck's backers argue that the company's technology helps it get a better handle on the state of a business -- and, potentially, approve more loans. Usually, banks look at "three years of personal tax returns or a credit score," says Josh Kopelman, managing partner of First Round Capital, which has invested in both rounds of On Deck's venture funding. "But those are moment-in-time snapshots. On Deck built an algorithm that looks at the true health of a business."



That ability made On Deck an intriguing investment, Mr. Kopelman says, "especially with credit tightening and everyone talking about how to assess true risk."

Along with RRE, Khosla and First Round, Contour Venture Partners and Village Ventures have poured more than \$12 million in equity financing into the company to get it up and running.

Community banks are also signing on, according to James Robinson, general partner of RRE, and in June On Deck added \$100 million from Silar Advisors, a New York-based hedge fund and asset manager. The money will be made available to On Deck as needed to make loans.

"The market for small business and small financial companies to move upstream into the traditional bank lending space has grown," says Robert Leeds, founder and chief executive of Silar. "That's opened up huge opportunities for specialized small businesses and specialized finance businesses, and we're really excited about that."

The recent Wall Street crisis only helps On Deck by showing the dangers to investors of previous modes of loan underwriting, says On Deck founder and Chief Executive Mitch Jacobs. "The current turmoil raises the awareness of the problem and the need for our solution," Mr. Jacobs says. He adds that the liquidity crisis hasn't affected the \$100 million from Silar Advisors.

On Deck's business model faces a couple of big questions. One is defaults. So far On Deck has seen "very few," says Mr. Jacobs. But it's still early, and he expects higher default rates from businesses with high cash-flow volatility. "Small businesses are volatile -- they are subject to shifts in the economy, and there is significant potential for losses," Mr. Jacobs says. "For a certain subset of our portfolio, losses could be as high as 10% if not potentially more."

Another question for On Deck: How tough will its competition get? A host of alternative lending options have gained traction in the wake of the credit crisis, including Web sites where private individuals bid on loan requests from borrowers and services that provide small, very short-term loans at high interest rates.

Mr. Jacobs expects the field to get a lot more crowded. Small businesses that can't receive a traditional loan make up "a \$160 billion financing hole in the U.S. economy focused on trying to fuel the American dream," he says. "We have to anticipate that a lot of other parties are going to enter the market."

A Stitch in Time

For now, On Deck is betting there are a lot of entrepreneurs who will seek out its services as credit gets tighter. For one indication of how tough the lending picture has gotten, consider a recent survey by the National Small Business Association. The group found that 55% of small businesses reported difficulty securing credit in the previous six months.

Along with showing a healthy cash flow, potential On Deck borrowers must meet some other criteria. They must hold a separate business bank account, they must have been open for business for more than a year, and they must process at least \$3,000 in credit-card transactions per month.

On Deck approves about 70% of eligible applicants, says Mr. Jacobs, and provides funding within two days of receiving an application. Interest rates range from 18% to 36% -- higher than

traditional loans but significantly less than those at other alternative lending sources, which can run as high as 200%.

For some small-business owners, being judged on actual day-to-day performance and not tax returns is a relief. So is the daily micropayment system, which allows them to avoid large monthly bills that can sneak up and become crushing if one cycle is missed.

"We know exactly what is coming every day, and the exact amount that is going out," says Nancy Ebker, president of New York clothing company Montagerie LLC, who approached On Deck for financing in May.

Ms. Ebker's company had struggled through a difficult first year, and a potentially make-or-break season loomed. She and her partner had to find financing to tide them over until clients made their fall purchases. Knitters had to be paid up front to create sample outfits to show to customers. Skeins of yarn had to be purchased. "Big banks were telling us, 'We don't do that start-up thing,'" Ms. Ebker says. "All the credit was freezing up. What were we going to do?"

Ms. Ebker called On Deck, and was relieved to hear that the lender was interested in seeing Montagerie's growth trends -- which were positive, she says. "Banks don't want to hear any of that, of course," Ms. Ebker says. "They just want to see where you are at a given moment, not where you might be going."

Ms. Ebker got the money she needed to keep her business moving. Now she's looking ahead to a "totally booked" season for Montagerie and expects the company to be profitable this year, with about \$500,000 in revenue.

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