Can't Get a Business Loan? A Guide to Alternative Business Financing

by Elizabeth Palermo, BusinessNewsDaily Contributor | June 03, 2014 10:52am ET

In the wake of the Great Recession, getting a small business loan from a traditional lender is no easy feat. But if your loan application doesn't get approved by the bank, don't worry; there are plenty of other places to look for funding.

Business News Daily recently caught up with Ty Kiisel, a small business financing expert at Lendio and author of the new book "Getting a Business Loan: Financing Your Main Street Business" (Apress, 2013), who explained the most sought-after alternative financing options for small businesses.

Armed with Kiisel's list of top alternative financing options, we reached out to small business experts in a range of fields, who weighed in on the pros and cons of each alternative and provided some insight into what options work best for certain kinds of businesses.

Here's what the experts had to say about the most popular alternative financing options for small businesses.

Option 1: Factoring

What is it? Factoring, or accounts receivable financing, is a transaction in which a business sells its accounts receivable (i.e., invoices) to a third party. The third party, or "factor," typically pays about 80 percent of the value of the receivable up front. In other words, if you sell a $100 invoice to a factor, you'll be paid $80 immediately.

The factor then collects payment from your client when the invoice is due, deducts its fees (usually 2 to 6 percent of the total invoice) and forwards the rest of the cash to you. So, if you agreed to pay a factor 5 percent, the total amount you would collect on your $100 invoice would be $95.

Pros: Unlike obtaining a loan from a bank, which can take months, factoring gives you immediate access to funds. This is particularly useful for businesses that are trying to expand but lack the cash flow to do so successfully.

Another advantage of using this financing method, Kiisel said, is that you can approach factors even if you don't have perfect credit. Factors are generally more interested in the creditworthiness of your customers (those responsible for making invoice payments) than they are in your creditworthiness as a business owner.

Cons: While obtaining financing through factoring is easier than getting a bank loan, not everyone can use this method, said David Bakke, a financial contributor to personal finance website Money Crashers. Businesses need to have a decent profit margin built into whatever they're selling — usually at least 25 percent — to get approved by a factor, he added.

Bakke also noted that, unlike a traditional bank loan, factoring is a short-term financing method.

Who should use it? Factoring is best for businesses with a lot of cash tied up in accounts receivable, Bakke said. Wholesalers, distributors, drop shipping companies or other resellers fall into this category.

Kiisel noted that factoring might be a good option for small clothing manufacturers and other specialty manufacturers, and that it has a long history as the financing method of choice in the import industry.

The bottom line: "There is a wealth of purchase order financing companies out there," Bakke said in an email interview. "Take a look at three or more companies, carefully review all quotes and make your choice from there. As with everything, research is the key."

Option 2: Merchant Cash Advance

What is it? A merchant cash advance (MCA) or business payday loan is a cash advance made to a business based on the volume of that business's monthly credit card transactions. Businesses can typically receive an advance of up to 125 percent of their monthly transaction volume averaged over the previous 120 days, Kiisel said.

The terms for repaying a merchant cash advance vary from lender to lender. Some lenders take a fixed amount of money out of a business's merchant account every day until the advance is repaid with the agreed-upon interest. Other lenders take a percentage of the credit card sales paid to a business each day. Lenders that fall into the latter category may take an average of five to 10 percent of every debit or credit card transaction a business processes until the advance is paid back with interest.

Pros: MCAs provide a quick and easy way for businesses to access cash. Businesses that choose to use this financing method can receive funding within a few days, Sabrina Parsons, CEO of Palo Alto Software, a company that creates business planning and tracking technology for small businesses, told Business News Daily in an email interview.

Businesses can attain MCAs relatively easily because, unlike traditional loans, merchant cash advances aren't heavily regulated. Therefore, businesses do not need to complete the time-consuming loan application process associated with obtaining a bank loan.

And, as Kiisel pointed out, merchant cash lenders aren't as concerned with credit scores as traditional lenders are. Instead, these alternative lenders focus on sales volume.

Another advantage of MCAs, Parson said, is that they're paid back directly from credit card sales. This means that if your business is experiencing fewer sales in a given month, you won't have to pay back as much money during that time period.

Cons: The biggest downside of using an MCA is that it's expensive. Kiisel said the average interest rate for MCAs is 5 to 10 percent per month, but as Parsons pointed out, MCA interest rates aren't always as low as 10 percent per month; some lenders offer interest rates of 30 percent per month and higher.

Who should use it? The best candidates for merchant cash advances are businesses with strong credit card sales, Parsons said. Retail merchants, restaurants and service businesses all fall into this category.

Businesses that don't have strong credit card sales and those that have access to more traditional methods of financing should look elsewhere, Parsons said.

The bottom line: "Do the math, and understand how much the advance is actually costing you," Parsons said. "In some cases, while [an MCA] looks like the only option, it may be a losing option and one that only gets the business into trouble."

Editor's Note: Looking for a small business loan for your business? If you're looking for information to help you choose the one that's right for you, use the questionnaire below to have our sister site, BuyerZone, provide you with information from a variety of vendors for free:

Option 3: ACH Loan

What is it? Much like a merchant cash advance, an automated clearinghouse (ACH) loan is a cash advance made to a business by an alternative lender. However, ACH lenders base advances on the funds available in a merchant's bank account, rather than on the amount available for an advance on credit card revenues.

And much like an MCA, the terms for repaying an ACH loan vary from lender to lender. Some lenders take a fixed amount of money out of a business's bank account every day until the advance is repaid with the agreed-upon interest. Others deduct a percentage of daily sales from the merchant account. Regardless of how merchants pay back the advance, ACH lenders typically require a monthly payback of 10 to 40 percent of monthly deposits.

Pros: ACH loans might be a good option for businesses looking for cash in a hurry, as merchants can typically be approved for this type of funding in as little as 24 hours. And because these advances aren't based on credit card sales but on cash revenue, even businesses that don't accept credit cards can utilize this alternative financing method.

Another advantage of ACH loans is that business owners typically do not need to have good personal or business credit in order to be approved for an advance. Furthermore, some ACH lenders will advance money to businesses that have been in business for a very short time (as little as six months), making this alternative a viable option for brand-new companies in need of quick access to capital.

Cons: While ACH loans are a quick way to get the cash you need for your business, they carry a hefty price tag. ACH loans often come with exorbitant interest rates, and business owners can end up paying back close to 50 percent more than the amount they borrowed, said Manny Skevofilax, a business financial consultant with Portal CFO Consulting in Baltimore.

Who should use it? Businesses that don't have access to other sources of financing because of bad credit, bankruptcy or little time in business may want to consider an ACH loan.

The bottom line: "Simply stated, before you commit to this type of loan, make sure you have the cash flow to pay it back," Skevofilax told Business News Daily. "I would call it a last-resort option of financing."

Option 4: Business Credit Cards

What is it? Unlike some other alternative financing options, credit cards don't require much of an explainer. Like personal credit cards, business credit cards can be used to pay for supplies, inventory or equipment with credit obtained through a bank or credit union.

Business owners typically have 30 days to pay down their credit card debt, and if the balance isn't paid off within that time, businesses will be required to start paying interest on the money they borrowed for purchases. As Kiisel explained, the average annual percentage rate (APR) for variable-rate credit cards is 15.36 percent. Fixed-rate cards have an average APR of 13.2 percent.

Pros: Perhaps the biggest advantage of using credit cards to finance business expenses is that the financing is readily available, said Joel Pruis, senior business consultant for the global information services group Experian. Kiisel agreed, saying that obtaining a credit card is often the easiest way to start building credibility with traditional lenders.

In addition, business credit cards (not personal credit cards) serve as an audit trail, allowing businesses to conveniently keep track of their expenses, Kiisel said. Many business cards offer attractive reward programs, like cash back or discounts on supplies, travel or other services. Some business credit card providers even offer a 60-day grace period, which allows business owners to use the card as a temporary cash-flow solution without having to pay back what they've borrowed right away.

Cons: One downside of credit cards is that they can be expensive if you don't pay your balance on time, every month. Pruis said borrowers need to have discipline when using credit cards and make sure that the balance on a card doesn't build up over time.

Kiisel also pointed out another problem that business owners often face when using credit cards: the fine print. In other words, the laws that regulate personal credit cards do not apply to business credit cards. This means that you need to be particularly careful about things like introductory interest rates and grace periods when signing up for credit.

Who should use it? Brand-new companies that don't have access to other forms of financing might want to consider using a credit card to get their business off the ground. Businesses experiencing a cash-flow crunch might also want to consider financing growth with a credit card.

The bottom line: Restrict your use of credit cards to the short term, Pruis said.

Option 5: Commercial Real Estate Loan

What is it? While some alternative financing options fulfill a general purpose, like increasing working capital or generating positive cash flow, commercial real estate loans are designed for a more specific purpose: helping businesses purchase office buildings, warehouse space, retail shops or some other form of real estate.

Although commercial real estate loans are different from home mortgages, the two loan types do share certain features, Kiisel said. For example, like a home mortgage, commercial real estate loans typically have longer payment terms than other alternative financing options.

Commercial real estate that you already own can also be used to obtain a general-purpose loan.By leveraging the equity they've established in previously purchased real estate, businesses can improve their chances of obtaining a traditional bank loan or a line of credit, Kiisel said. There are also alternative-type loans that can be secured with commercial real estate, as well as real estate secured loans for refinancing an existing commercial mortgage.

Pros: One advantage of commercial real estate loans is that they typically require a lower down payment than other types of loans, and can often be used to finance a larger part of a purchase, said Levar Haffoney, a principal with New York-based investment advisory firm Fayohne Advisors LLC. Haffoney also noted that, in some cases, the closing costs associated with commercial real estate loans can be added to the loan amount or can be financed separately.

Cons: Commercial real estate loans aren't necessarily an alternative to traditional loans — they're more like a subcategory of traditional loans. Kiisel said that means that these types of loans typically require businesses to have three things: collateral, cash flow and a solid credit rating. If your business doesn't meet these requirements, it might not qualify for a commercial real estate loan. Furthermore, if you don't already own equity in commercial real estate, you can't obtain a real-estate-secured loan or line of credit.

Who should use it? These types of loans are best for owner-occupied businesses, such as professional services businesses, convenience stores, gas stations, day care and assisted living facilities, auto dealerships and manufacturing businesses, Haffoney said.

The bottom line: "There aren't many businesses that would not benefit from commercial real estate loans," Haffoney said. "The only businesses that would not benefit are those that do not have a physical location."

Option 6: Equipment Loans

What is it? Both banks and alternative lenders offer equipment loans, which are business loans that can be used to purchase equipment. Depending on your business, you may be able to obtain an equipment loan to purchase machinery, vehicles, telephones, computers and a range of other necessary items.

Alternatively, businesses that already own equipment can use these assets to secure a more general loan for other purposes.

Pros: Kiisel said equipment loans are easier to obtain than some other types of loans because the equipment you're purchasing with the loan serves as collateral. In other words, if you fail to make your loan payments, lenders can seize your equipment to satisfy repayment.

Moreover, these types of loans are also ideal for businesses that want to preserve cash flow, Haffoney said. Because equipment loans don't typically require a large down payment, he said, businesses can save the cash they have on hand for other purposes. Certain types of equipment loans may also come with tax advantages, like write-offs, Haffoney added.

Cons: The biggest disadvantage of using equipment loans to finance a business is that these loans can be used only to purchase equipment, not for working capital or some other purpose. Furthermore, some equipment-loan agreements may be impossible to back out of, Haffoney noted. That means that, even if you end up not using the equipment you purchased, you'll still have to pay for it.

Who should use it? Haffoney said any business that requires equipment should consider applying for an equipment loan. This includes medical businesses, like doctors' and dentists' offices, construction companies, accounting and legal firms, restaurants and light manufacturers.

The bottom line: "Entrepreneurs should discuss equipment financing with their tax adviser," Haffoney said."There may be significant tax benefits for the business."

Option 7: Business Acquisition Loans

What is it? Banks and other lenders offer business acquisition loans to businesses that are seeking to purchase an existing business. Many business acquisition loans are asset-based, so the amount available for the loan is contingent on the available assets that you have as an individual or existing business owner or the assets that are available within the business being purchased, Kiisel said.

Pros: Skevofilax said business acquisition loans are a very cost-effective way to finance a new business. If the business you choose to acquire is successful already, it can likely pay for itself, allowing you to use the cash you have on hand for other things.

Getting a loan to purchase a business that already exists is typically easier than obtaining a loan for a new business, Kiisel noted.

Cons: As with any type of financing, there's always a risk that acquiring a pre-existing business won't work out. If you choose to take out a loan to purchase a business and that business fails, you'll still be responsible for paying back the money you borrowed, Skevofilax noted.

However, businesses should be wary of using an alternative lender to obtain a business acquisition loan, Kiisel advised. He recommended that businesses apply for this type of loan through a bank,which has certain disadvantages. If you can't prove that you have sufficient cash flow, collateral and credibility to secure a loan, you may not be able to obtain a business acquisition loan from a traditional lender.

Who should use it? This type of loan is readily available from commercial lenders for any kind of business, Skevofilax said. However, he also noted that, if your existing business (or the business you're purchasing) doesn't have sufficient collateral to cover the loan, you might want to look into other options for financing the purchase of an existing business, such as owner financing or equity partnerships.

The bottom line: "Conduct an analysis of your collateral and how you are going to pay the loan back," said Skevofilax. "Make sure that the commercial bank you are considering has experience in your industry and lends to the type of business you are trying to buy."

Option 8: Crowdfunding

What is it? Crowdfunding sites like Kickstarter and Indiegogohave become increasingly popular sources of small business funding in recent years. These sites allow consumers to donate money to a "business idea" (i.e., a business that hasn't gotten off the ground yet), in exchange for early access to that business's future products.

Recently, changes in U.S. federal law have also made it possible for investors to trade equity for an investment in fledgling companies via crowdfunding. Thanks to such sites, startups now have access to a wider range of investors than ever before.

Pros: Traditional crowdfunding sites, like Kickstarter, let you raise money for your business without handing over control to an investor or taking on growth-debilitating debt, said entrepreneurJeff Hays, an independent filmmaker and crowdfunding expert.

As Hays pointed out, crowdfunding often serves as a launchpad for future equity financing options. After all, if you can prove that your business is successful on Kickstarter, it will be easier to prove that same point to investors. If, on the other hand, your crowdfunding efforts aren't successful, you might receive the feedback you need to improve your concept or strategy.

Cons: Although crowdfunding has benefits, it might not work for everyone. Hays said that although many Kickstarter campaigns he's familiar with have been very successful, 80 to 90 percent of crowdfunded campaigns fail. Failure in a public arena like crowdfunding can be bad for your reputation, as well as hurt your chances of securing other kinds of financing in the future, he added.

Who should use it? Hays thinks all businesses should consider having a crowdfunding campaign. But businesses that are still testing out ideas, prototypes, business models or marketing strategies might especially benefit from the feedback and insight that crowdfunding provides.

The bottom line: "The history of every successful campaign and every failed campaign remains for all to see on Kickstarter, Indiegogo, etc.," Hays said. "Everything you need to know is there. Just review the successes and failures that are close to your offering, and then get started."

Option 9: Peer-to-Peer Lending

What is it? Along with crowdfunding, another small business financing option revolutionized by the Internet is peer-to-peer (P2P) lending. In its simplest form, peer loans are loans made directly from one person to another, without the involvement of a bank or other financial institution.

Kiisel described today's peer-to-peer lending scene, which typically takes place on an online network, in three steps:

1. Borrowers apply for loans on the network, and investors can choose to invest in them.

2. Borrowers get the funds they need, and investors create a portfolio of investments.

3. Borrowers repay their loans, and investors earn interest and reinvest their money in a different borrower.

Pros: P2P lending sites often offer better interest rates than other alternative lenders, such as factors or merchant cash advance lenders, Parsons said, noting that the average P2P interest rate is less than 10 percent.

P2P lenders don't place as much emphasis on credit scores as traditional lenders do, which makes them more attractive to businesses with less-than-perfect credit, Kiisel noted. Additionally, these loans can be obtained much faster than traditional loans, with some lenders providing funding within 10 days.

Cons: While some peer-to-peer lenders offer the low interest rates that Parsons mentioned (10 percent or less), others charge much higher rates — as high as 30 percent, Kiisel said. Furthermore, unlike traditional lending institutions, P2P lending networks aren't regulated by federal agencies, which means that borrowers need to conduct their own research and make sure they understand the terms of a loan before signing on the dotted line.

Who should use it? Parsons said peer-to-peer lending is a particularly good option for businesses that need a lot of cash to grow and operate. Retail, restaurants, inventory-heavy businesses, businesses with high capital expenses and businesses with a lot of money tied up in accounts receivable might consider P2P lending as an alternative financing option.

The bottom line: "Do your homework," Parsons said. "There are many, many, many peer-to-peer lending sites. You can find the reputable ones, but you can just as easily end up somewhere that you don't want to be."

Option 10: Friends, Family and Fools

What is it? Another category of peer-to-peer loans involves loans received from what Kiisel calls the "3 F's": friends, family and fools.[8] While the funding that some new businesses receive from friends and relatives are really more like gifts than loans (i.e., they might not be paid back), these personal loans should, nonetheless, be taken seriously as a way of financing a new business.

Pros: It's not easy to approach people you know for a loan, but chances are, you'll have an easier time getting money from friends and family than you would from the bank. This is especially true if you don't have great credit or are just starting out in business. And as Money Crasher's Bakke points out, the interest rates and repayment terms offered by friends or family members are usually much more attractive than those offered by alternative lenders.

Cons: Of course, there's a downside of borrowing money from people you know: Namely, if your business fails, your relationships could fail with it. Furthermore, Bakke said, if the person who lends you money suddenly decides they need that money back for their own personal use, you might end up paying back a loan much sooner than you'd like to.

Last, but certainly not least, generous friends and family members may believe that because they lent you money, they now have a say in how your business should be run. If you'd rather not deal with unsolicited advice, this alternative financing method might not be a good option for you.

Who should use it? Brand-new businesses might approach friends and family members for loans just to get the ball rolling, but Bakke believes that this type of borrowing is best done in moderation. If your business needs serious capital, you should consider approaching a more formal lender.

The bottom line: "Get the agreement in writing, no matter how close you are to the friend or family member," Bakke said. "Spell out in clear language the terms of the agreement, especially the repayment schedule. If you go this route, make every effort to make timely payments on your loan. If, for some reason, you fall behind, communicate often with the friend or family member so they don't think you're avoiding them."

Originally published on Business News Daily.