A Brief Guide to the Alternative Finance Market

TMA asked me to write a piece on Alternative Finance.

2017 saw the continued emergence of Alternative Finance as more new lenders entered the market. It is difficult to believe the rapid rise of Alternative Finance which, according to UK Finance's September 2017 report, grew again in the year to September 2017 by 4% and shows no signs of slowing down and as the supply of funds from the traditional High Street Banks continues to be squeezed, the Alternative Finance market is taking advantage.

So, what has led to the emergence of an Alternative Finance market? Well firstly the High Street Banks have become a lot more risk averse following the 2008 crash, for example bank lending to UK SMEs has decreased by £13bn from 2011-2016. Demand remains though as the UK economy has picked up and therefore supply of funding has still been required since then and the Alternative Finance market has picked up the slack with the Invoice Discounters being the main beneficiaries. Secondly, the low interest rate has created a market for both cash rich individuals and companies to seek greater returns than what is on offer from their traditional methods, like savings accounts. Lending money is one such way to find significantly better returns, albeit with greater risk. The rapid rise of the Crowdfunding market highlights this growth area.

What other players are seeking to exploit the retreat of the traditional lenders from the high Street? I believe these can be split into 5 key areas:

1. Asset Based Lenders

Probably the first of the Alternative Finance market, and the largest, ABL providers initially provided just Factoring and Invoice Discounting but are now likely to provide a much greater product range covering all tangible assets. More recently we are seeing the emergence of spot factoring or single invoice finance and even facilities being provided against intangible assets. The dominant area in the Alternative Finance market.

2. Challenger Banks

The UK continues to see an emergence of challenger banks as more banking licences are given out by the FCA. As you would expect in the digital world we now live in, most of these are online and new banks are still coming online, the most recent being Atom and Monzo Banks, currently aimed more at the retail market but with plans to go into the commercial market.

However, not all challenger banks decided to go down the online only route. The emergence of both Handelbanken and Metro have shown that the High Street model isn't necessarily over for good although with more flexible opening times, a local relationship manager and incentives to go into the store (bowls of water for your dog!), this is the new version of High Street Banking.

Other challenger banks have also decided to focus on a part of the market that has been neglected by banks, SME lending, which due to increased regulation and cumbersome processes has become unlucrative for banks. Oaknorth, has managed to grow its loan book to £800m in just two years, as off November 2017, and has the aim to deploy an extra £1.5bn.

3. Crowdfunding

Probably the newest entrant to the market, Crowdfunding has become a popular way for the general public to lend money to companies seeking significantly better returns than what they will see from their Bank. However, don't be fooled into thinking it is only the public putting funds into Crowdfunding, this is a popular method of investing for High Net Worth's, family offices, Venture Capitalists and even High Street Banks!

There is a huge variety of crowdfunders ranging from debt to equity and from unsecured to secured. Some of these take securities and provide a relationship manager like the High Street Banks model of 30 years ago, others more comfortable with using algorithms and historical data to base their decision on. The largest debt crowdfunder is Funding Circle who has lent £3.2bn to UK businesses to date, a remarkable number for a business that only started in 2010. Funding circle can be classified as a technology enabled P2P lender who processes thousands of deals annually and has achieved scale but is limited to the sub £1m space. P2P lenders such as Funding Circle do not loan above £1m and focus on sub 18 months tenor and the average loan across the P2P business lending market is below £70k and is decreasing.

However, will new and improved regulation of the Crowdfunding market temper its rise over the coming months? Watch this space.

4. Bridging providers

Like most of the digital world, everybody wants everything now. Leaving it too late to seek finance may lead you to the Bridging providers, an expensive but essential market providing finance quickly against suitable security, usually property. Whilst fees are higher for this product, you can borrow against your property in difficult circumstances or at speed with large loans potentially taking less than a week to put in place.

5. Investors / Debt providers

The distressed market comes with opportunities for a number of lenders and investors who can use their own expertise to help a business through a difficult period. This help could start with the offer of debt and / or equity as well as hands on help and advice. Like Bridging Finance, this is unlikely to be cheap but could lead to all stakeholders sharing in an upside.

Over the period 2012-2017, European Direct Lending Funds have raised $76.8bn through 99 funds, the market can be described as frothy. Direct Lending funds rely on expensive finance professionals for the entirety of their transaction process, which focuses on above £20m tickets. Their reliance on high cost leveraged finance type team structures and processes limits the standard $1bn fund to only process a handful of deals annually.

The upper end of the market (targeting >£20m tickets) is getting overcrowded, with dry powder of European focused direct lending funds reaching a staggering $35bn, leading to riskier deals that are becoming “covenant-lite”.

What does 2018 hold for the Alternative Finance Market?

More of the same? Whilst new regulation is expected, particularly in the Crowdfunding market, new entrants to the Alternative Finance market continue to appear and the product range widens with each new entrant. Unsecured lending for SME's, without personal guarantees, are now available as are facilities against individual invoices, supplier finance and intangible assets. The surge of the Alternative Finance market continues.

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