A First Data White Paper

Merchant Cash Advances Provide Key Financing

Merchants Can Tap Processors When Traditional Funding Dries Up

Introduction

Merchants with poor credit or lack of a credit history typically have a hard time getting financing through traditional means, such as a loan, line of credit, or credit card. Fortunately, merchant cash advances can help small businesses get the critical financing they need in order to achieve goals such as building inventory or making capital improvements. The key is finding the right provider, and the first stop should be checking to see what acceptance services are offered by your bank, acquirer or independent service organization.

To be sure, not all merchant cash advance providers are the same. Many providers have gone out of business in recent years, while other vendors have unscrupulous practices. Small businesses must do their homework in order to land the right provider.

The answer often is simple. Merchants can tap their own processor to provide merchant cash advances, with compelling advantages: it's a known relationship, and the processor's financial stability provides funding ability. By choosing their own processor, merchants stand a better chance of getting financing since a transaction history from credit and debit card acceptance probably already exists. This paper explains merchant cash advances and how they function. It also offers eight considerations when looking for a provider, and highlights the differences betwen loans and cash advances. The report is designed to take the mystery out of product, showing merchants an alternative way to get financing.

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Merchant Cash Advances: Convenient, Fast, Effective

Regardless of financial institution participation, there is strong demand for merchant cash advances, thanks in part to the conservative lending practices that now predominate. Underwriting standards for loans have tightened considerably in recent years, with traditional small-business lending sources virtually drying up in the wake of the financial crisis. Meanwhile, regulatory scrutiny in the subprime arena has dampened enthusiasm for helping out merchants with poor credit history.

Merchant cash advances are a viable alternative for many businesses because they provide needed capital that may not be available through traditional channels. Cash advances are not subject to lending regulations because they are "factoring products," whereby a business sells a portion of its future receivables in exchange for upfront cash. In structuring the product as a sale of future receivables, the provider buys these receivables at a discount, and gives a lump-sum cash payment to the merchant in return. A small, fixed payment or percentage of the merchant's daily credit card sales is remitted to repay the cash advance.

How it All Works

In a typical cash advance, merchants receive a lump-sum payment of one to four times their average monthly card volume. The provider and merchant agree on a percentage of daily card sales or a fixed daily payment that will be collected from the merchant as repayment for the advance.

Usually, cash advance providers require merchants to have a minimum monthly card volume of $5,000 a month, a good standing with their landlord, and no unresolved bankruptcies. There is minimal documentation required, typically consisting of processing statements, bank statements, and a copy of the property lease or mortgage statement. Bottom line, a cash advance requires substantially less documentation than a loan or credit line application.

Remittances are made in various ways, depending on the provider. Split funding offers ease and convenience, while escrow accounts and direct debit are more cumbersome to administer and give less control to the merchant. Here's a breakdown of how the three methods work:

- **Split Funding:** With split funding—or batch splitting—the merchant authorizes its processor to forward the agreed upon amount of the merchant's daily settlement dollars to the provider's account and remit the balance to the merchant's account. Split funding is the preferred structure because it takes less time and is less risky. It offers the most convenient option for merchants, since it makes it easier for the merchant to manage its payback activity.

- **Escrow Account:** Daily settlement amounts are deposited by the processor and the provider debits the agreed upon percentage from the escrow account as an Automated Clearing House (ACH) transaction. Thereafter, the remaining funds are transferred to the merchant's account. This causes a delay in receipt of the funds (typically a day). Additionally, the merchant has less control over its funds, since a third party is given access to all the funds to debit the amount before they are released to the merchant.

- **Direct Debit:** The merchant cash advance company directly debits the daily payment—based on the agreed-upon percentage—from the merchant's bank account through ACH. This also means less control to the merchant, and ACH debits frequently cause the merchant to overdraft.

Overcoming Concerns

Merchants must take care in their choice of a provider. Some providers went out of business after the financial crisis a few years ago, when the industry went through a steep contraction. Merchants must also look for a fair price. While costs to the merchants are certainly higher than loans, the pricing of the advances takes into account that the provider has no collateral or guarantees associated with the product. Merchant cash advance providers hold all the risk in the event that a merchant goes out of business, and the pricing must take this into account. Despite the higher cost, providers that have a strong history and knowledge of the merchant will support those businesses that have a favorable chance of succeeding.

Clearly, merchant cash advances can provide the vital funding small businesses need to grow and thrive. We discuss eight key things to consider when comparing providers, so that you know you are getting into the best situation.

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Eight Things to Look for in a Provider

Again, choosing the right provider is critical to your strategy of getting financing. With so many cash advance providers in the industry, it pays to carefully scrutinize your options. Here some guidelines to go by:

An Existing Processing Relationship. Look first at the capabilities of your existing processor. Your processor is already linked to your card acceptance process and should have the financial strength to take on the risk of the funding small-business merchants.

Minimum Documentation. Using a provider that handles your merchant processing makes the whole process easier. Your merchant processor holds existing processing history documentation, which helps streamline the application process considerably. In this scenario, you should typically only need to provide two months of bank statements, a copy of a lease or mortgage statement, and a driver's license.

Flexible, Efficient Approval Standards. A strong provider will have not only solid approval standards, but also a higher approval rate than others in the industry. A processor can offer efficiencies not found elsewhere. Small merchants, with processing volume ranging as low as $18,000 a year, can tap their existing processor to get funding.

Speed in Funding. Cash advance vendors report taking a few days to two weeks to provide funding, but often it runs on the higher range since they may be dependent on getting financing themselves through their private equity partners. Well-funded providers can supply funding in as little as three to five days. Ask for references to help find out how long it took to get them to get funding.

Split Funding. The way providers collect funds has often been a challenge for merchants. Agents have complained that cash advance companies have not mastered distribution and support of the product. Often clients are asked to set up joint accounts or lockboxes with the provider, making the process clunky and harder to manage. Split funding, or batch splitting, takes less time and is less risky.

Flexible Repayment. Look for a provider that allows repayment to change according to the ebb and flow of revenues. Repayment should be tied to the performance of the business, so if the merchant has a slow month, it pays a little less; if it has a great month, it pays more. Merchants should not be obligated to pay a certain fixed amount each month, regardless of business flow.

Program Length. Most common merchant cash advance programs range from three to 12 months. Often providers retain the right to collect remaining funds at the end of that period, which can impair cash flow for a small business. Look for a provider that does not set a time limit to the program length, but instead bases collections on processing volume. The provider should offer a wide range of programs to suit varying merchants' needs and markets.

Financial Strength. Choose a provider that has a long track record working with merchants and knows the processing industry, since knowledge of both is necessary for establishing an efficient program for customers. These providers have the financial wherewithal to get capital in the hands of customers quickly.

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How Merchant Cash Advances Differ From Loans

Merchant cash advances are classified as commercial transactions, not loans. Here are the distinguishing characteristics of merchant cash advances:

- **No Fixed Terms.** Providers estimate the term for repayment based on the business' sales history. The customer is charged a set fee—referred to as a factor—and there are no interest charges.
- **Cash Advances Are Unsecured.** The provider does not require any collateral or guarantees, assuming all of the risk of the client possibly going out of business.
- **Minimum Documentation.** A client can simply provide two months of bank statements, a copy of a mortgage statement or property lease, and a driver's license.
- **No Fees.** There are no late fees or penalties attached to the product.
- **Fast Approval and Funding.** Most cash advance providers can approve and fund an application in 10 to 15 business days. But if you partner with a merchant processor that handles transactions, approval can come in three to five days.
- **Daily Repayment.** This varies according to the volume of the merchant, and varies according to the business cycle. The provider receives a set percentage of the merchant's daily card settlement batch.

Conclusion: Look First at Your Processor's Capabilities

Keep in mind, when financial institutions take a pass on lending to you, it's not the end of the road. It's imperative that merchants team up with a reliable partner to get the financing they need. Look first at your current processor, which should have the capability to offer merchant cash advances. It's a known relationship, and the processor has the ability to fund the transaction. Overall, working with your processor makes strong business sense, giving the cash you need to help grow your business.

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