A First Data White Paper

How Merchant Cash Advances Can Boost Retention and Profits

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Introduction

Financial institutions face the possibility of losing business whenever they turn down their merchant customers for loans. What is to stop declined merchants from taking their entire banking relationships elsewhere? One way to prevent this type of customer attrition is to offer merchant cash advances as a funding alternative for clients that fail to meet lending requirements—helping preserve the banking relationship while also providing incremental revenue in the process.

> "By selecting the right cash advance partner, financial institutions can assist their small business customers—cultivating a relationship for shared long-term success while generating incremental revenue in referral fees."

To be sure, many financial institutions are reluctant to work with merchant cash advance providers. Many providers have gone out of business in recent years, and there are misconceptions about how the pricing of merchant cash advances could attract regulatory scrutiny, much like subprime loans. Financial institutions also worry about being associated with these providers at all, given the unscrupulous practices of some vendors in the industry.

But much is misunderstood about the space. By selecting the right cash advance partner, financial institutions can assist their small business customers— cultivating a relationship for shared long-term success while generating incremental revenue in referral fees. The solution is often as simple as tapping their own processor. Some payment processors offer a merchant cash advance product, providing their financial institution customers with compelling advantages over third-party cash advance providers: an established vendor relationship, financial stability and funding dependability, and a portfolio of mutual merchant customers.

This white paper explains merchant cash advances, how they function, and why they are not subject to the same regulatory oversight as loans. It also offers eight considerations for choosing a provider, and highlights the differences between loans and cash advances.

Merchant Cash Advances: Outside the Purview of Lending Rules

Regardless of financial institution participation, there is strong demand for merchant cash advances, thanks in part to the conservative lending practices that define the current economic environment. Underwriting standards for loans have tightened considerably in recent years, with traditional small business lending sources virtually drying up in the aftermath of the financial crisis. Meanwhile, regulatory scrutiny in the subprime segment has dampened enthusiasm for lending to merchants with poor credit histories.

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," wherein 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.

Because the product is structured as a commercial transaction instead of a loan, it is regulated by the Uniform Commercial Code in each state—as opposed to banking laws like the Truth in Lending Act. Thus, the provider is able to avoid many of the regulations and documentation requirements associated with making loans.

Market Potential: Financial Institutions Need to Participate

Merchant cash advance providers have barely tapped the market of card-accepting small and medium-sized businesses. Nearly 50,000 small and medium-sized merchants currently carry advances in the United States, according to industry estimates—but the potential market could include as many as one million merchants.

So while financial institutions won't make loans to merchants with poor credit, they can instead offer merchant cash advances through a provider, preserving the banking relationship and standing ready for when the merchant's business grows and its creditworthiness improves. And by using their own processor as the merchant cash advance provider, financial institutions benefit from the processor's knowledge of the merchant's transaction volume history—potentially increasing the likelihood that merchants in riskier categories can obtain access to cash advance funding.

Furthermore, because merchant cash advance providers are not constrained by conventional loan underwriting requirements, they are able to provide funding to businesses that often have trouble getting loans, including restaurants, automobile repair shops, hair salons, online retailers and liquor stores.

> "While other aspects of the economy turned upward, capital markets for small businesses were marked by continuing volatility and persistent tight credit conditions compared with historical norms. As economic uncertainty persists, capital markets serving small businesses remain cautious about providing more capital."
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> *U.S. Small Business* Administration, July 2012

How Merchant Cash Advances Work

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

> "Merchant cash advances offer the vital funding small businesses need to grow and thrive, while providing revenue and customer retention opportunities to financial institutions."

Many financial institutions have distanced themselves from merchant cash advances, fearing damage to their brand. For one, there's a perceived risk of entanglement with a provider that could have troubles of its own. In fact, the industry went through a steep contraction after the financial crisis, reducing the number of providers.

Financial institutions also worry about the perceived high cost of advances. 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 offer the vital funding small businesses need to grow and thrive, while providing incremental revenue and customer retention opportunities to financial institutions. We discuss eight key considerations when comparing providers, so that you know your customers are getting into the best solution.

Eight Things to Look for in a Provider

With merchant cash advances, financial institutions stand to retain customers and gain incremental revenue in the process—as long as they choose the right provider. With so many cash advance providers in the industry, it pays to carefully scrutinize your options. Here are some guidelines to consider:

1. **Pre-Existing Processing Relationship.** Look first at the capabilities of your current processor. Your processor is already linked to your back-end systems, and also has the financial wherewithal to take on the risk of funding the merchant. In addition, since your processor operates in the merchant space, it understands the total value of the relationship.

2. **Minimum Documentation.** It is important to select a provider with an efficient application process. Using a provider that handles your merchant processing can streamline the entire process. Your merchant processor holds existing processing history documentation, which helps simplify the application process considerably. In this scenario, your customers need to provide substantially less paperwork.
3. **Flexible, Efficient Approval Standards.** A strong provider will have 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 a financial institution's established processor to get funding that may not be available from other cash advance providers.
4. **Speed in Funding.** Cash advance providers report taking a few days to two weeks to provide initial 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.
5. **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.
6. **Flexible Repayment.** Look for a provider that allows repayment to ebb and flow with how merchant business runs. 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.
7. **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. Seek 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 flexible programs to suit as many merchant needs as possible.
8. **Experience and Financial Strength.** Choose a provider that has a long track record of working with financial institutions and knows the merchant processing industry, since knowledge of both are necessary for establishing a successful program for customers. These providers also have the financial wherewithal to get capital into the hands of customers quickly.

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 receive any collateral or guarantees, accepting all risk of the client going out of business.
- **Minimal Documentation.** Often, a client can simply provide six months of processing statements, 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 changes according to the business cycle. The provider receives a set percentage or amount 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 merchants with poor credit, they face another dilemma: losing good customers and all of their deposits. Even though it might not qualify for a loan elsewhere, the rejection of a credit application might be enough motivation for a merchant customer to leave. It's just not about losing customers' deposit funds, but also forgoing the chance to cross-sell future services to these merchants, some of which will become successful, thriving businesses with good credit.

While some financial institutions have been uncomfortable embracing merchant cash advances in the past, their concerns can be alleviated with a reputable provider. It's imperative that they team up with a reliable partner to offer their customers all available financing options. Look first at your current processor, which should have the capability to provide merchant cash advances. It's a known relationship, the processor has the ability to fund the transaction, and the processor might already have customers in common with your institution. Overall, working with a processor makes strong business sense, allowing the financial institution to efficiently and profitably refer declines of credit lines, loans and small business credit cards. All told, a processor can give the financial institution the chance to retain the merchant as a customer, while receiving additional revenue in the process.

[i] Mercator Advisory Group, Credit.net/INFOGroup

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