



INDUSTRY WHITE PAPER

AUGUST 2009

***Merchant Cash Advance:
Not for Every Business. Is it Right for Yours?***

Presented by AdvanceMe, Inc.

Executive Summary

Merchant Cash Advance (MCA) is a product being adopted more widely and gaining greater attention in the small business community. Especially as credit markets remain tight, the inability to access capital has become a critical problem for many small businesses. Even the relatively low number of stable small businesses that in the past could get bank financing are being declined under today's tighter underwriting guidelines. Small business is the major engine of the U.S. economy. It creates more than 50% of the non-farm jobs, and 60% of the Gross Domestic Product (GDP). These businesses are on the "cutting edge" of the economy, their success or failure dependent on their ability to seize opportunities as they arise, and re-invent themselves to respond to continuously shifting consumer trends, tastes and fashions. Access to working capital has always been critical to the health of the small business community, and arguably today it is even more critical.

For a small business, working capital accessed through an MCA can be a lifesaver in times of emergency or a catalyst enabling growth or repositioning in the face of market changes. However, any form of capital raising activity can also be a mistake if taken for the wrong reasons, without the necessary planning, or from the wrong provider.

Return on Investment, or "ROI," is a concept every business manager should apply to every investment they make. Whether it's new inventory, a new location, a new employee, or a new sign or menu, the business manager must begin with a clear picture of how much the action will cost, and how much they expect to earn because of that action. The expense of an MCA is in the difference between the dollar amount of the future card receivables sold by the business, and the amount of the cash purchase price the business receives at the time of sale. In an MCA transaction, a business might sell \$69,000 of its future card receivables in exchange for a \$50,000 purchase price today. The business might agree to allow the MCA provider to receive 15% of its net card¹ settlement proceeds until the provider receives the \$69,000. If the business does \$38,000 in card sales each month and card volume represents one-half of its overall sales, then it might take a year or more for the MCA provider to receive the card receivables it purchased, and the business will forgo about 7.6% of its gross sales volumes during that period.

¹ The cards in question may include any number of bank cards, other payment cards and media (such as credit, debit, charge, smart and "contactless" cards, as well as RFID enabled devices), the transactions with which are handled by processors and other acquirers.

To some, \$19,000 may seem like a lot of discount to pay for use of \$50,000 today. However, to a boutique that needs to refine its concept in response to a big-box retailer opening nearby, or a business with a chance to acquire inventory from a liquidator, or a restaurateur in the Florida Keys in August with a broken air conditioner, the expense may be justified by the challenge or the opportunity. In these cases, and countless others, bank financing or other traditional sources of small business capital may not be available at all, or if available, may take longer to secure than the time allotted by the opportunity. In other instances, the features and structures of an MCA may fit a business better than other forms of obtaining capital. The MCA retrieval structure, which entitles the MCA provider to receive only a fixed percentage of net card sales if and when they occur, is “cash flow friendly” in that retrieval amounts align with card sales. This consideration alone is a strong inducement for some business owners.

However, some commentators have called MCA “expensive money” and, therefore not the right solution for everyone. While we disagree with the term “expensive money,” no financial solution or funding product is right for everyone.

All business capital is “expensive.” Depending on its form, it either requires repayment (loans), delivery of future receipts or sharing of future revenue (MCA), or sharing ownership and profits (equity). No business owner should seek new capital without careful consideration and education. At a minimum, the business owner must (i) investigate all available alternatives and decide which form of capital suits their unique business best; (ii) develop a clear picture of the business’ cash flows to ensure the business can comfortably comply with the agreements associated with the new capital; and (iii) prepare and plan to maximize the benefits the new capital will bring to the business.

We present this White Paper to provide an overview of what an MCA is, how it works, and when it should and should not be undertaken. AdvanceMe believes that MCA is a valuable option for many small businesses seeking working capital. This White Paper will outline considerations that business owners and their advisors can use to make an “informed choice” of whether an MCA is an appropriate option for their businesses. MCA is not for every business, but it is right for some. By suggesting certain areas of investigation, preparation and planning we hope to help small business owners make their own educated, informed decisions.

An electronic version of this document may be found on AdvanceMe’s website at www.AdvanceMe.com.

What is a Merchant Cash Advance?

A Merchant Cash Advance (or MCA) involves the sale of a portion of a business’ future card sales at a discount. The purchase price the MCA provider pays in exchange for these card receivables is a lump sum of cash delivered to the business for its use as working capital.

A common and popular way for the MCA provider to collect its purchased receivables is through “batch-splitting” and/or closely related variations through Automated Clearing House (“ACH”) transactions. In batch-splitting, the merchant directs its processor to forward an agreed upon, set percentage of the merchant’s daily net (post-chargebacks, reserves and other processor-related charges) settlement proceeds from card sales (or “batch”) to the MCA provider’s account and to forward the remainder of the net settlement amount to the merchant’s account. In the ACH variation, debits in amounts equal to the agreed upon percentage of applicable card sales are instituted by the processor from the merchant’s bank account (i.e., demand deposit account) through ACH transactions.²

² Batch-splitting and substantially similar methods involve multiple benefits, as compared to other collection methods, including greater efficiency, lower costs, and more effective tools for managing risks and losses. By reducing the administrative burden and collection risk on the MCA provider, these methods enable providers to deliver capital to a wider range of merchant types. These methodologies also enhance the MCA provider’s willingness to provide capital by enabling the provider to monitor the card sales related cash flow of its merchant clients and to model merchant profiles within SIC codes, geographies, seasonal trends, time in business, size of business, etc. These methodologies also reduce the merchant clients’ cash flow risks (and the MCA provider’s collection risk), by facilitating a large number of smaller payments with predictable impact on the merchants’ cash flow.

An MCA is not a loan – it is a merchant’s sale of a specified amount of its card sales that have yet to occur. This distinction is more than semantics and goes straight to the benefits an MCA provides to merchants. A merchant contracts for an MCA because, among other reasons, it has no fixed term. Rather, the MCA provider is entitled to receive only a set percentage of its merchant client’s net card sales, if and when such sales occur and are settled. This means that the dollar amount received by the MCA provider on a given processing day is based on the merchant’s card sales volume. For example, if the merchant and MCA provider agree upon an 8% retrieval percentage, the provider will receive \$8.00 with respect to a day on which the merchant had \$100.00 in net card sales. With respect to a day on which the merchant had only \$50.00 of net card sales, the MCA provider is entitled to receive only \$4.00. Because of its structure, an MCA involves no “late payments” or associated charges or penalties and is better aligned with the merchant’s cash flow than traditional “fixed payment” style arrangements, in which the payment of a fixed dollar amount is due regardless of the merchant’s sales volumes. For these reasons, many MCA providers include in their marketing materials some variation of the message “We get paid only when you get paid.”

On the other hand, these aspects of an MCA (viz., the provider is only entitled to a set percentage of net card sales and the total amount of purchased future receivables is fixed) also make it a risky product for the MCA provider to deliver. If the merchant’s future card sales are lower than the MCA provider estimated, the provider’s collection of the receivables it purchased will take longer than estimated – a timing difference that may result in loss of income for the provider. Moreover, the MCA provider will bear the loss if the merchant fails to generate future card sales sufficient to deliver the total amount of receivables sold to the MCA provider. For these reasons, responsible MCA providers are careful to set the terms of their transactions based on the particular profiles of their merchant clients. Any miscalculation in the merchant’s profile, or unforeseen event (e.g., Hurricane Katrina), can change the collection curve on the MCA transaction – often dramatically.

MCA providers usually require less paperwork than traditional capital sources, and can often go from application to completed funding in a week or less. MCA providers do not require personal collateral. Most MCA providers require the merchant to provide certain non-financial covenants (e.g., to not switch or split their processing, without the provider’s consent) and owners to provide personal guarantees of performance of those covenants.

Is a Merchant Cash Advance the Best Way to Raise Cash for My Small Business?

When a business manager concludes that a business should raise cash and has completed their analysis of the expected uses and outcomes of the cash, the next thing to consider is what structure is right for that business.³

Broadly, capital can be raised using three alternative methods. A business can sell part of itself in the form of equity. In an equity financing, the business issues ownership interests to an investor who then owns the portion of the business represented by that equity interest. Equity financing is usually heavily negotiated and may include terms governing dividend payments, voting rights, board membership, anti-dilution rights, etc. Much “friends and family” financing is equity. “Taking on a partner” usually means the business is raising equity. If your mother will give you the money you need, and not demand very much, it can be an excellent way to raise cash. However, if you go to professional investors, prepare to have a partner (and quite possibly a very active one) for a long time. Most equity investors seek an “exit strategy” which means a time when they will get their investment and the profits they earned out of the business – often through a sale of the business.

The second broad area of capital raising is borrowing or leasing. While borrowing and leasing are very different in their structures, we will combine them here under the concept of “credit.” In these forms of

³ There are, of course, many questions related to the cash raise that must be answered based on the circumstances of the individual business. These three questions are meant to focus the inquiry, not to exhaust all considerations.

financing, the business gets cash today (either in-hand or to buy a piece of equipment), in exchange for the promise to make set periodic payments until a set future date. The aggregate amounts of the payments represent a combination of repayment of the amount the financing institution provided (the loan amount, or lease amount) plus interest charged for using the money. Credit is one of the most common ways for businesses to raise cash. There are an almost limitless number of credit structures and types. Most credit structures require collateral to secure the obligation and many require personal guarantees of repayment. If the borrower or lessee does not make the required payments, then the creditor can foreclose on the collateral and attempt to execute any guarantees against the assets of the guarantors. The interest charged on credit is usually pegged to the creditworthiness of the business borrower or lessee, and for small businesses, the creditor usually takes into consideration the creditworthiness of the owner. Interest rates vary widely, and many creditors also charge fees.

The third area of capital raising is asset sales. Businesses can sell equipment they are no longer using, or contractual rights, inventory or real estate not essential to their businesses. They can also sell accounts receivable through structures known as factoring. They can also sell their future card receivables in the form of an MCA. Most small businesses do not have unessential property, and if they do, often the market does not pay much. The relative lack of hard assets in small businesses is one of the reasons financial institutions often look to the personal creditworthiness, guarantees of repayment and collateral of small business owners when looking to extend credit. Factoring is an ancient financial technology, and involves selling an account receivable. If a business has extended credit to a customer and delivered the product or service, the resulting account receivable can be sold to a willing buyer – often at a substantial discount to its face value. The buyer, or “factor,” then collects the account receivable directly from the “account debtor” (the business or individual obligated to pay pays the factor rather than the business that delivered the product or service). MCA is described above, under the heading “What is a Merchant Cash Advance.”

No form of capital raise is right for every business. However, some forms are wrong for some businesses – or their owners. For instance, business owner “A” who is extremely independent, and would not work well with co-owners, might seek to avoid selling equity or taking on a partner. Business owner “B” is in a highly cyclical industry and wants to avoid fixed payment dates and fixed payment amounts may wish to avoid a bank loan or lease with fixed payment schedules. Business owner “C” may have easy access to loans or leases with low interest costs, with the excellent personal credit and lien-able collateral owned by the business often required by a bank or traditional finance company. They may also have plenty of time to do paperwork, and be unconcerned about fixed payment dates and fixed payment amounts. Business owner “C” may not be best served by an MCA.

Good Uses of an MCA

Because of the pricing ratios prevailing in the MCA market, business owners must make sure that an MCA is being used for the right purpose and under the correct conditions. Here are some examples of appropriate scenarios:

- To take advantage of an unexpected opportunity that can make the business money at a favorable ROI. Imagine that a retail store has the opportunity to buy inventory at significant discount – if it pays in cash. First come, first served. It needs \$20,000 today, or it risks losing the inventory. The business could make a \$50,000 profit, which far outweighs the \$5,000 it may have to pay for the MCA.
- To manage fast growth. Companies that are growing quickly need money fast, and are often cash-flow challenged as they wait for customer payments while investing in the business. And, they are often so busy growing the business that they don’t notice that a cash flow crunch is forecasted until it actually hits.
- To avoid the “negatives” of other forms of capital which may outweigh the costs of an MCA. For example, a fixed payment amount, pressure from friends and family who have invested in the business, the possibility that personal collateral will be lost, revolvers that compound interest and turn a small loan into a large obligation that cannot be calculated.

- To cover an unforeseen event that could severely impact the business if it is not dealt with immediately. Imagine that you own a restaurant in Miami. In the middle of the summer, your electrical system breaks. No lights, no air conditioning, no customers, no revenue. You must fix it immediately, producing \$20,000 immediately. Or, you have taxes due and are about to suffer liens that could cause you to lose your liquor license. Or the road in front of your business is about to be detoured for a short-term construction project, cutting off traffic, parking and customers. In all of these cases, you need money quickly and cannot wait for the normal turnaround times associated with a bank loan.

Bad Uses of an MCA

Likewise, it would be harder to prove an ROI on the following uses of an MCA in light of the pricing applicable to the typical MCA transaction -- they should be carefully considered:

- Setting up a “rainy day” fund. The pricing applicable to a typical MCA transaction is too high for the working capital to sit in a checking account, waiting for a need. It should be put to good and immediate use.
- Making a frivolous purchase without any ROI. 14K gold door knobs and faucets may look nice in your office, but will probably not bring the return needed to justify the investment.
- Taking money out of the business to support a personal lifestyle that is unwarranted given the health of the business. A new Ferrari may make a statement, but will not help you to meet payroll.
- Purchasing something without investigating other alternative sources of capital first. Taking the time to pursue bank financing, loans from friends or family may pay off in the long-term.
- Using the money to “float” an otherwise sinking enterprise. Taking cash flow out of the business by selling future receivables at a discount could simply hasten the demise of the business.

Hope is Not a Strategy

Before undertaking an MCA, business owners need to take a hard look at their businesses, just as an investor would. They must dissect their business plans and take action to ensure that they are positioning themselves for success. Components include market potential, competitive positioning, cost structure and revenue forecasts. For example, if you own a restaurant, have you tracked what is happening with your overall revenue? Do you know the trending of important business indicators for the restaurant industry - - average per person/per visit spend or profit margin to name a few. If they are headed in the wrong direction, have you made changes that will change the trajectory of those indicators? Have you adjusted your cost structure to meet slowing consumer spending patterns? That means cutting unnecessary spending, finding less expensive suppliers. Have you increased revenue by implementing promotions that work, speeding up collections? Have you rid yourself of unnecessary “clutter” that is not making you money? If you are a retailer, have you reviewed sales trends to ensure that inventory matches consumer need, that your price points are competitive and the layout of your store conducive to purchase?

Profile #1: Retailer “A” is in a thriving marketplace with a “hot” product. The owner has reviewed unit margins, aligned cost with revenue, and located his business in a geographically conducive market. Unfortunately, the city has just closed the road in front of the retailer’s store for 3 months to make repairs, diverting traffic. In this case, the retailer simply needs to get through the temporary slowdown. An MCA may help bridge the gap.

Profile #2: On the other hand, Restaurant “B” is in a city experiencing a major slowdown. Customers are dining out less often and they are spending less per meal. The economic tide is not forecasted to change in the next 24 months. In this case, the cash delivered to the MCA provider representing the receipts it

purchased is money the business will not receive and, in the worst case scenario, could simply hasten the demise of the business. An MCA in this case does not make sense unless the money is used to address fundamental changes that will increase the margin of the business, enabling it to successfully operate during this downturn. An MCA used to just plug holes in the proverbial dike will be money wasted, while possibly removing the owner's ability to sell or move the business. The owner of Restaurant "B" should instead look for ways to change the cost structure of the business. Instead of "wishful thinking," the owner needs to consider options that will cut unnecessary spending, increase revenue and improve margins. That may mean letting staff go, focusing on advertising/promotions with a proven return, asking vendors for more favorable payment terms to stretch out expenses, eliminating menu items that require inventory that does not provide a return. It may even require a total revamp of the concept, including décor, menu items, price points, service levels, etc.

Profile #3: Restaurant "C" is very profitable. The owner has built a very successful business and has had several offers from prospective buyers. He is looking forward to retiring in a couple of months and selling the business. He is considering taking out an MCA in order to make a few final upgrades to secure the best deal. Unfortunately, he will not be able to sell his business without the agreement of the MCA provider. He should consider if this is the best move at this point.

Long-term, successful owners invest time and effort into the review and evaluation of these aspects of their businesses, and taking the appropriate measures to address issues before accepting any kind of capital. Sometimes, that means changing the fundamentals of the business – dumping inventory that isn't moving, adding new product lines, cutting headcount if necessary. Before accepting any type of capital, ask yourself these questions:

- Have I evaluated the marketplace, my competitive standing and my operations from the eyes of an investor?
- Have I done what is needed to make this business as successful as possible?
- Am I reasonably certain that this MCA will help to make me more money? Savvy business people may pay \$10,000 to make \$30,000.
- Do I understand the contract that I am entering into and how it will help my business?

Our message to businesses that have not taken these steps, or are using money for a "bad use" as defined above, is DO NOT TAKE A MERCHANT CASH ADVANCE until you have addressed core issues in your business and you have a good use for the money. An MCA is intended to help businesses, not hurt businesses. The MCA industry does not benefit from the inappropriate use of this product. Word will spread that the product caused the downfall of businesses, and its credibility will be impacted. Responsible MCA providers are willing to trade-off short term gains for long-term stability and credibility.

Summary

An MCA may be a life-saver to some, and a burden to others, depending on a number of factors. The purpose of this White Paper was to highlight circumstances and situations that would indicate that an MCA may not be the solution. However, freedom of choice is a tenet of American society. "Informed choice" ensures that the customer's freedom is exercised in their best interest. Assuming business owners are educated regarding the pros and cons, they are capable of deciding whether an MCA is right for them.⁴ MCA providers who abide by Best Practices can help businesses, and the communities they serve, to make these decisions, which become even more critical during trying economic periods.

AdvanceMe has served the small business marketplace for 11 years. We are in this for the long term. Because of this perspective, it is in our best interest, as well as that of the businesses we serve, to educate decision makers and their advisors so that informed choice can be exercised and appropriate decisions that

⁴ Note: Before undertaking any financial transaction, consult with your accountant or financial advisor to determine tax implications.

help the business and their communities can be made with confidence. We hope that this White Paper has filled that need.