Pros and cons of merchant cash advance

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August 25, 2013

There is fierce competition in merchant cash advance industry. These companies are always private companies with private money or funds borrowed from the principals' lines of credit. They are willing to assume higher risk in return for higher return. Just as in any contractual obligation, once you sign the contract and receive the funds, you will have assumed full liability. But how will you know if you should sign? Show you even apply for one? This article will help you evaluate a cash advance offer and its ramifications so you could make a more objective and intelligent decision. Paying attention to this chapter could save you thousands of dollars in fees.

Pros:

- Cash advance companies offer as low as $1,000 and as high as $500,000. It is not uncommon for a few lenders to work together and offer amounts as high as $2 million.
- Underwriting criteria are more relaxed than banks partly because of the following:
- These types of lenders do not have to abide by stringent banking rules and regulations.
- The extra cost to merchants resulting in greater profit to these lenders more than offsets the risks associated with issuing cash advances.
- Unlike a bank loan, cash advance is not mainly based on the borrower's personal credit score.
- Tax liens and discharged bankruptcies may be overlooked.
- Other factors such as credit card processing volume, gross sales, and the lender's ability to collect on a daily basis are considered.
- Funds could be delivered very quickly between 3-5 days after the initial submission date of an application. Upon successful repayment, renewals could be funded within 24 hours if not on the same day.
- Up-to-date balance sheet and other accounting records of the business is usually not required for advances close to and less than $100,000.
- Some lenders consider seasonal and high-risk businesses.

- Unlike banks, existing personal and business loan and home mortgage obligations do not translate into an automatic decline for cash advance lenders.
- Payments are made on a daily basis and with a predetermined amount or percentage of the daily gross or credit card transactions volume.
- Cash advance costs far more than a regular bank loan. However, when banks turn down the vast majority of loan applications, it can make the difference between staying in or going out of business for a person in dire need. Operating with financial stress is not healthy and could further create strain on the business and make you lose more sales and opportunities to generate more sales or expand as well as affect your personal health, which may cost money in terms of added health care costs.
- If your plan will result in a good return on investment (ROI), the extra cost may well be justified. Every day costs you money if you don't have funds to grow, invest in inventory and equipment, pay your bills on time to vendors, pay taxes and (potentially) incur tax liens, which will adversely affect your credit score, and more.

Cons:

- Cash advance always has a short-term payback period ranging from one month to 18 months. Typically, most of them have a payback period of less than one year. This can place a strain on the business' ability to climb up and move from red to black. This also means the effective cost on the money obtained increases with a shorter-term cash advance.
- You must account for your daily fluctuations in your cash flow and make sure your bank account will have sufficient funds to make the daily payment.
- The effective cost is always high. Because the term "loan" is not used, cash advance lenders operate within an unregulated industry and a great amount of impunity, which confers disadvantages to its end users, the merchants. They are not allowed to use the term "interest rate" because the product offering is (simply) not called a loan. The common term used on the cost of cash advance is "factor" because they are essentially purchasing your future revenue (account receivable) today instead of offering you a loan, which needs to be amortized on a daily basis. The difference between the borrowed funds and the total amount paid back is the profit, or the "factor amount." The finance discussion aside, which is beyond the scope of this article, as an example, a factor of

1.35, which is very common, means the payback is $3,500 on a cash advance of $10,000! If the payback period is for one year, the cost (converting it to interest rate) is presumably 35%. But the cost on the money could skyrocket as the term decreases.

I am going to share with you a highly guarded secret in cash advance industry: the"APR equivalency table." APR stands for "Annual Percentage Rate." This information is available only to the institutional investors and some principals of cash advance companies. Even agents do not have access to this information. I know the information in this table will shock you!

Term	Factor	Sample Funding	Sample Payback	Annualized Interest Rate or APR
3	1.40	$10,000.00	$14,000.00	227.50%
6	1.38	$50,000.00	$69,000.00	120.59%
7	1.35	$75,000.00	$101,250.00	97.50%
9	1.35	$100,000.00	$135,000.00	77.50%
12	1.30	$100,000.00	$130,000.00	51.42%
12	1.20	$100,000.00	$120,000.00	35%
12	1.15	$500,000.00	$575,000.00	26.55%

Table 1. Cash Advance APR equivalency

So, a lower payback period pushes the actual interest rate higher and through the roof!

I am not suggesting that higher cost on the borrowed money makes the cash advance totally unsuitable. On the contrary, because banks have stringent guidelines and are risk averse, availability of cash advance makes it accessible. What matters most is your return from the use of the funds. If it is going to further drag your feet into the financial mud and then into a big hole, you should not do it. But if you are certain your return will be justified despite the high cost, your decision is an easier one to make. I had one merchant who obtained nearly $300,000 in cash advance over three years and on four rounds. He paid off his back taxes, invested in his business, took a well-deserved vacation with his family, and opened a second business. He doubled his return. So, the cost of nearly 50% was not an issue. He got IRS and State off his back and was able to refinance his house mortgage because the lender did not report it to national credit bureaus.

- Before you sign onto a cash advance agreement, you may need to consult your CPA or CFO after you are properly informed of the following: the amount borrowed, factor, the payback amount, and any other fees, i.e. origination, application fee, processing fee, and other fees.
- The cost on a cash advance may or may not be considered a business expense because cash advance is not a loan. If not, it may not be tax deductible regardless of what you use it for. You must seek an expert advice from a CAP with tax expertise in your state.
- You may have to change your current merchant processor. This is often because of what is called "split-funding", which means a predetermined percentage or dollar amount is deducted daily from your gross transaction processing volume before the funds are deposited into your bank account. This may or may not cause issues. Be diligent in evaluating the new processor and ask the tough and relevant questions from your sales representative. Make sure you do NOT sign into a new long-term contract with the new credit card processor just because you need the funds. If you do, follow the road map laid out in this book.
- Insist on an ACH-only advance, which means the cash advance lender will debit or ACH the daily predetermined amount from your bank account directly. This method does not require a processor switch.

I would like to offer the following advice:

1. Ask if the lender offers loans instead of cash advances. A handful of lenders do offer loans too nowadays. However, ask for documentation that it is indeed a loan. I know of only three cash advance lenders in the U.S., of nearly all of them, that actually offer loans. A few claim they offer loan products, but they are not being truthful.

2. Ask for a longer-term cash advance or loan because it will lower your overall cost.

3. Ask for a lower daily deduction amount or percentage. You will be in the safe zone if you hover around 10% and below. The farther north from it, the less your cash flow, which may strain your resources. Do NOT accept an offer of 15% and higher.

4. Ask an experienced CPA about tax and cost implications of obtaining a cash advance versus a loan. If you have to pay for this service, spend the money because it may cost you more if you don't. This is the least and may be the best upfront money you could spend to feel most comfortable making a decision instead of blaming yourself in future for not doing it. This action alone may save you thousands of dollars and then some.

5. Ask an industry expert you may know for an objective review. If you don't know one, ask your existing or past credit card processor account executive(s).

6. Last, but not least, do NOT believe every statement or promise a sales person and/or the lender makes to you verbally. Read the entire lending contract word by word. Ask for any given promise or change of terms to be included in the agreement. This will protect you against any misfortune or potentially unscrupulous conduct.

I hope you will obtain the funds you need. By paying close attention to these pros and cons, I equally hope you will avoid some major pitfalls.

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