The Changing **MERCHANT CASH ADVANCE** Landscape

New entrants and innovative products redefine the industry

Janinne Dall'Orto
First Annapolis Consulting, Inc.

Thad Peterson
Aite Group

Even as financial institutions begin loosening up their small business lending credit standards and opening up their pocketbooks, there continues to be a need for small businesses to look outside traditional bank lending for capital. According to the Small Business Credit Survey by the Federal Reserve Bank of New York, 57% of small businesses that either were turned down by a bank–or didn't bother to even try for a bank loan–are interested in exploring new financing types.[1]

The reasons for denial, according to the FRB of NY, include insufficient collateral (43%), weak business performance (37%), and low credit score (23%). As a result, small businesses are looking for capital id not dependent on these criteria.

Alternative lenders are increasingly picking up the slack from financial institutions, growing the space into an estimated $4 billion in annual funding, estimates Janinne Dall'Orto, Senior Manager, First Annapolis Consulting, Inc. "Banks have been relaxing lending guidelines, but there is still a big vacuum that alternative lenders are filling," she says.

Another advantage of alternative lending products is speed. Aite Group Senior Analyst Thad Peterson says that for small businesses, the amount of time it takes to get a loan has gone up dramatically. Small businesses spend an average of 33 hours applying for a loan, contact three financial institutions, and submit three credit applications.[2] In contrast, alternative lenders can provide credit quickly–often within a few hours of receiving a one-page application.

Merchant Cash Advance (MCA), a type of alternative lending in which the funder provides a cash advance in return for a portion of daily credit card sales until the advance is repaid, continues to gain traction.

"Alternative lending such as MCA is booming and changing the way that capital is distributed in this country," says David Rubin, founder and CEO of eProdigy, a FinTech holding company serving the alternative lending industry. Rubin estimates that when he entered the market in 2010, there were less than 40 firms offering MCA. Today, he estimates there are more than 1,000.

(Continued on page B8)

[1] http://www.ny.frb.org/smallbusiness/Spring2014/pdf/summary-of-key-findings-SPRG2014.pdf
[2] http://www.ny.frb.org/smallbusiness/Spring2014/pdf/summary-of-key-findings-SPRG2014.pdf

 (Continued from page B6)

Big Name Entrants

There's a new generation of firms offering merchant cash advance. In addition to firms such as Kabbage, which states that it has funded more than $550 million to businesses, and AdvanceMe (now CAN Capital) that boasts providing more than $5 billion in working capital to businesses during its 17 years in business, firms including PayPal and Square are entering the fray.

PayPal entered the alternative lending marketing in September 2013. Its Working Capital product resembles an MCA, says Dall'Orto, in that there is no fixed payment term, a fixed fee rather than interest rate, and payments are deducted daily from merchant sales processed by PayPal.

Square launched Square Capital in May 2014 to offer cash advances to existing merchant customers. In May, Square announced that it had extended more than $100 million to more than 20,000 businesses in one year. More than 80% of merchants who have completed a Square Capital advanced applied to an additional round of capital.

While PayPal and Square obviously see revenue opportunities in MCA, they are also interested in increasing customer stickiness by providing value to their existing customers," explains Rubin.

For Square, MCA provides a way to capture the small business market in addition to the micro merchant market the firm has already been successful in, explains Peterson. "You want to make the product sticky by having the customer indebted to you," says Peterson. "Adding lending capability makes sense."

But even traditional banks are taking note of the space. Rubin relays that Goldman Sachs Group Inc. recently hired Harit Talwar, the former head of Discover Financial Services U.S. cards division, to help develop an online lending effort for individuals and small businesses. Although unclear what that offering will include, it wouldn't be surprising if alternative lending was in the works.

Product Innovations Extend Reach

MCA continues to evolve. In the past, MCA was only available to businesses that accepted credit cards. Today, businesses that accept automated clearinghouse (ACH) payment transfers can also participate. Rubin estimates that while 5 million businesses accept credit cards, as many as 25 million accept payments online via ACH.

"ACH has transformed our business," says Rubin. "Rather than restricting lenders to credit card receivables, you can look at the total gross sales of the business. This opens the pool of merchants that can qualify for MCA."

While new entrants are changing the landscape, existing funding providers are also looking to diversify their offerings with more traditional loans as well as risk-based products. "Most MCA products don't take risk into account; the product and the price are the same for everyone," says Dall'Orto. "That's beginning to change."

Potential Risks

For ISOs and agents with existing merchant relationships, MCA offers opportunity. As a sales channel for MCA, Dall'Orto encourages ISOs and agents to perform due diligence on MCA providers before recommending a firm to their merchant customers, including understanding the MCA's underwriting guidelines, approval rates, and target markets.

While established MCA providers are serious players and implement best practices, notes Dall'Orto, there is always a danger that newer entrants will engage in aggressive sales strategies to capture market share. "You don't want to lose a merchant due to a bad MCA deal," she adds.

The alternative lending industry has talked about self-regulation for years, notes Rubin. "As our industry grows, we want to make sure transparency and proper procedures are in place to catch unscrupulous behavior. We want to implement best practices that will nurture our business for the future."

Peterson is watching the alternative lending industry for signs of a bubble. He notes that while the payback model based on receivables does lessen the risk for funders, the potential for losses exists. "I'm concerned that as an unregulated industry, MCA is currently flying under the radar. As with all lending products, there is a natural tendency for people to get greedy and take bigger risks."