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Merchant Cash Advance Companies: A New Breed of Factor

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Like the gunslingers of the Old West, the merchant cash advance companies (MCAs) have entered our territory and are making up new rules as they go along. With no regard for established practices, or even laws for that matter, the MCAs are booking clients by the scores in the traditional niches that heretofore were the exclusive domain of the small business factoring community. And these new funding sources are willing to take risks far beyond the norm. They will provide financing without a first position on the A/R. Heck, they'll even advance money with no lien at all. If factors think "this too shall pass," then they must also believe in fool's gold, because MCAs have the numbers (they have been multiplying like rabbits for over a decade) and they have the financial backing (several MCAs are funded by some of the largest hedge funds in the U.S.). They are truly a force to be reckoned with. It is far better to understand the enemy than it is to underestimate them.

Where Did They Come From?

The company that started it all back in the late 1990s was founded by a man who was in charge of an institutional investment in one of my start-up factoring companies. He used to complain to me that given the size of the small business market, my one year old factoring firm should be easily purchasing $100 million per month in volume and in just a couple more years should approach the $1 billion per month mark. I quickly pointed out that he clearly didn't understand that the majority of small businesses sold to consumers, and that factors only funded B2B or B2G transactions. He replied that we should start funding the consumer transactions. I then had to educate him on the fact that there was already a very efficient funding mechanism in place that handled these transactions and it was called the credit card. He countered that we should fund the credit card paper. He was a persistent sort, wasn't he? I shot back that while it was certainly possible to do so, and I actually funded credit card receipts once in my past, there was not going to be a big demand to accelerate the payment of paper that turned anywhere from one day (for large retailers) to one week (for smaller merchants). Also, the fees wouldn't be that great either.

Undeterred, he went off and started a company that factored "future" credit card receipts based on estimated credit sales to occur over the next 90 to 120 days. The estimate was based on past, documented history from the client's merchant credit card processor. And he did this at APRs over 100% per annum. I guess I wasn't nearly as smart as I thought I was. While we all could argue the legalities about "factoring" something that doesn't yet exist (future sales), the truth of the matter is that there are over a thousand MCAs in the U.S. processing billions of dollars in transactions annually, and this "factoring" niche has existed for well over a decade. Today, the average term of an MCA funding transaction has increased out to nearly 9 months, with most clients "re-upping" prior to paying off the original advance in full. Their yields have come down, but still average well over 50% a year.

The skyrocketing growth of the MCAs can be attributed to their distribution channel. All those credit card swipe machines that you see when you pay at retail outlets are sold through Independent Sales Organizations or ISOs for short. These people work a local market to sell, repair and upgrade these important tools of commerce. Since they are in the face of local merchants on a consistent basis already, why not ask if they need some extra financing.

Utilizing these ISOs, the MCAs have access to 100% of the market at a sales cost that is completely variable. Further, the MCAs have a way to control the receipt of proceeds much like the notification process we use. All credit card transactions are run through a third-party merchant card processor. These processors handle all of the data between the merchant and the credit card issuers as well as clearing the final payments to the merchant after all the fees are charged. As part of the documentation of a merchant cash advance, the MCAs instruct the processor to send a percent of all proceeds due the merchant borrower directly to the MCA for payment on their advances. As we know, the only way to survive given the risk we take is to directly get repaid by the client's customers.

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Why Should I Care if They Only Factor Credit Card Receipts?

Where there's yield, there's interest (no pun intended). Every Tom, Dick and Harry with two nickels to rub together leaped into the MCA ring to get a piece of the action. Also, since most retailers are relatively small (restaurants, dry cleaners, hobby shops, specialty boutiques, etc.), the size of the loans weren't very big. At first, MCA's wouldn't make a loan above $25,000. And why would they? All they had to do was generate 10 loans at $15,000 each to earn $150,000 per annum, a comfortable living by most people's standards. So you didn't need to have much invested and the risk seemed very manageable given the return. As the market got more and more crowded, growth got harder to come by. Some enterprising MCA realized that retailers not only have credit card sales but also cash sales. And with the advent of the Automated Clearing House (ACH) system in banking, merchant checking accounts could be easily and cheaply debited every day to repay the advances made against the cash sales. Now with daily debiting a standard process in the MCA world, it didn't take long to recognize that there was still one last area of payments that they could exploit, those B2B and B2G transactions that make up our factoring livelihood. The thundering hoard was approaching.

What This Means for the Factoring Industry

Ten years ago, virtually none of our clients accepted credit card payments. Today however, nearly all of them do. They had to purchase their processing equipment from an ISO, who is selling the MCA financing product as hard as they can because the commissions are incredibly lucrative. To make matters worse, MCAs use short online applications and just as short documentation, which makes the on-boarding process quicker and easier than dealing with us. Although our receivable factoring business is more complex and really can't run like the MCA model, this only starts to make a difference as the loan sizes increase (and the risk goes up). So I expect the biggest impact of the MCA invasion to come at the lowest deal size range (under $50,000). But remember, these guys are gunslingers. Therefore, sooner or later they'll be gunning for more. We've already seen three separate MCAs provide money to existing factoring clients in the last year. All three used Factoring Agreements (not exactly like ours, but "purchasing future receivables" none the less). Two required blanket first position liens in the documents (which of course was impossible since we were already in first and they had no intention or ability to pay us off). Only one of these two actually filed a UCC1. All three caused our clients to be in default of their Factoring Agreements with us. As pointed out earlier, these MCAs don't care much for rules.

That of course is the competitive threat. Like all clouds, there is a silver lining. MCAs will advance in second, third or even with no lien position. So we can use these providers to our advantage. If a client needs $25,000, $50,000 or even up to $250,000 quickly, but you don't have the availability, you can refer in one of these MCAs who will provide the needed money to just about any business that's been around over a year (they need bank statements to show what the average daily bank balance is so they can determine how much they can debit each day, which they then back into how much funding they are willing to provide). Plus, they'll fund even in the face of other lien holder issues. Consequently, they can help keep you from having to fund outside of your comfort zone. Otherwise, you might be stuck having to make a very difficult gamble. Additionally, let's not forget that at their yields our form of factoring looks cheap!

Conclusion

The MCAs have better access to our market than we ever did or ever will have through the ISOs. Further, some of them are also backed by the largest hedge/private equity funds in the world. These Funds have voracious appetites for growth, more so than any factoring company we've encountered before. While the market is vast, it may still not be big enough for the both of us. They're fast, they take bigger risks than we do and they can be lawless. And they're moving in. There will surely be a showdown at some point. In the words of the great Wyatt Earp at the OK Corral, "It's not necessarily the one that shoots first, but the one that shoots best."