What Are Merchant Cash Advances and Working Capital Loans?

By Adam Uzialko

Could a merchant cash advance or working capital loan be the answer for your cash flow problems, or a potential pitfall?

- Merchant cash advances offer an immediate lump-sum payment in exchange for future credit card sales.
- Working capital loans offer a variety of financing options for short-term funding to cover operational costs.
- There are risks associated with each type of financing that should be avoided.
- Strategic planning for repayment can make each type of financing a viable option for many businesses.

Many small business owners have experienced a time when they need more cash on hand. Cash flow management is everything in business, but sometimes even the savviest small business owners find themselves with money tied up and unable to cover operational expenses. In these times, there are a variety of financing options available to small business owners that can help tide them over with liquid capital delivered directly to their bank accounts. However, these financial products come with their own set of risks that must be properly managed to avert disaster.

When handled properly, these tools can keep a cash-hungry business running. When misused, they could lead to a vicious cycle of debt. This guide will

introduce you to funding tools like merchant cash advances and working capital loans and provide advice from financial experts on how to use them to your benefit. Good planning and financial record-keeping is key to repaying loans successfully and keeping your business profitable.

What is a merchant cash advance?

A merchant cash advance is a form of financing that isn't truly a loan. Instead, it is a financing option that provides immediate cash in exchange for a business's future credit card sales receipts. In essence, when a business accepts a merchant cash advance, they are selling the revenue of future credit card sales for immediate payment.

Merchant cash advances are often used by seasonal businesses or those with cyclical sales to keep cash flow circulating during slow times of the year. Business owners can pay operating expenses and wages when sales are slow; then, when sales volume picks up, the business can repay the merchant cash advance and generate a profit. Since merchant cash advances are backed by projected sales, businesses with a less-than-perfect credit score also often rely on them for an injection of short-term working capital.

Besides operating expenses and wages, businesses use merchant cash advances for things like equipment financing, marketing campaigns, hiring new employees, expanding inventory, buying needed materials and acquiring property.

How do merchant cash advances work?

A merchant cash advance traditionally offers an influx of capital based on a business's expected credit card transactions over the course of a specified term. For example, if a business receives a $100,000 merchant cash advance with a 52-week term and a factor rate of 1.25, the business would have to pay back $125,000 in credit card sales over the course of the next year.

Merchant cash advance repayment is generally broken down into weekly payments, said Randall Richards, the director of business development at RFR Capital. According to Richards, cash advance companies will often draw the payment directly from a business's bank account rather than its merchant account associated with credit card transactions.

"Weekly payments would be based on sales and a multitude of factors," Richards said. "Someone who is only doing $20,000 per month in sales won't qualify for a $100,000 [advance.] The sales have to support the payment or else the lender is at risk of losing money."

Since merchant cash advances are based on sales, borrowers with poor credit can usually access them even when they can't obtain a traditional loan. Of course, this flexibility means that merchant cash advances are more expensive than bank loans as well.

"[Merchant cash advances] are one of the alternatives today for people as they move down and become less and less creditworthy," said James Cassel, co-founder and chairman of Cassel Salpeter and Co. "Merchant cash advances could [carry] the equivalent of 40% interest rates."

Cassel clarified that merchant cash advances don't carry an interest rate of their own, but the cost of a cash advance can be measured against the interest rates associated with a traditional loan. For example, in Richards' hypothetical of a $100,000 merchant cash advance that costs a business a total of $125,000 over a 52-week term, the interest rate equivalent would be 25%. That is much higher than the interest rates on many bank loans, which might cost a business with great credit between 2% and 5% of the loan's principal value, Cassel said. Understanding your factor rate and whether you can negotiate it is useful in reducing the cost of a merchant cash advance.

What are the pros and cons of a merchant cash advance?

Merchant cash advances can be useful tools for many businesses. Whether you are a seasonal business weathering the slow season or a business with cyclical sales, such as a manufacturer that makes most of its sales in Q4, merchant cash advances offer support. However, for struggling businesses, relying on a merchant cash advance to stay afloat could be the beginning of a death spiral.

"Sometimes it's a business that's so excited and thinks it can't lose but does. Other times, it's a business that's in deep trouble and just trying to stay afloat, waiting for the one more sale … just trying to survive, because then they believe they will thrive," Cassel said. "Sometimes you have to question the viability of the business."

Like all forms of financing, merchant cash advances come with a unique set of pros and cons. If you plan accordingly, they could be an effective tool for maintaining healthy cash flow and operating your business profitably. However, they can also expedite the demise of a failing business when used improperly. Managing a merchant cash advance to the benefit of your business means understanding the pros and cons and how to best navigate them.

Pros

- **Immediate lump-sum payment:** Merchant cash advances are useful because they deliver a lump sum payment to a business immediately. That means when cash flow is low, a business can bolster it with a quick influx of capital.

- **Based on sales, not credit score:** Merchant cash advances are based on sales instead of credit score, meaning even borrowers with poor credit or no credit can make use of them.

- **Easy to qualify:** Qualifying for a merchant cash advance is relatively easy. It requires a few months of bank statements, a one-page application and some basic information about the business, such as its tax identification number, website and address.

- **Fast approval process:** Merchant cash advances can generally be approved more quickly than bank loans, which often take several months for approval. In some cases, merchant cash advances deliver funding within a few days of approval.

Cons

- **Expensive:** Merchant cash advances are generally very expensive, ranging from a high 40% equivalent rate to an astronomical 350% equivalent rate in extreme cases. The cost depends on several factors,

including the lender a business partners with, but a merchant cash advance is always significantly more expensive than a traditional loan.

- **One-time influx of capital:** Merchant cash advances offer a one-time injection of a modest amount of capital. For many businesses, this isn't a problem. For example, the seasonal business that needs to cover its operational costs in the lean months until business booms again will likely do well with a merchant cash advance. A struggling business using a merchant cash advance to hold itself over in hopes that sales eventually increase, however, could be backing itself into a corner.

- **Restrictive requirements:** To accept a merchant cash advance, a business must sign an agreement with a lender. In many cases, these agreements include provisions that require the business to abide by certain rules. For example, your business might be precluded from moving locations or taking out an additional business loan. Cassel said you can avoid this problem by having an attorney review any agreements before you sign and negotiating the details of the contract.

What is a working capital loan?

The term "working capital loan" refers to a small business loan or alternative financing option designed to cover near-term costs with a short repayment date. Working capital loans are often used by businesses to cover a wide range of operational costs. There are many different types of financing that could be considered a working capital loan, including:

- **Lines of credit:** A line of credit isn't a loan but rather a predetermined amount of money a business could borrow from at any time. Much like a credit card, lines of credit only incur interest on the balance borrowed, not the total value of the credit limit. Lines of credit are primarily extended by banks or credit unions, though sometimes businesses with enough leverage can negotiate a line of credit directly with their supplier. The amount of a line of credit is generally based on a business's credit score.

- **Short-term loan:** A short-term loan is generally a small dollar loan to be repaid in one year. Short-term loans range up to $100,000, providing borrowers with an injection of capital to cover operational expenses immediately. Interest rates on short-term loans can vary but tend to be higher than longer-term conventional loans due to their quick maturity period.

- **Invoice factoring:** Invoice factoring, also known as accounts receivable financing, is similar to a merchant cash advance as it is not related to credit but instead a business's sales. A business sells a lender (or "factor") their uncollected accounts receivable for a significant portion of the total value upfront. The factor then works to collect the outstanding payments and keeps the remaining percentage of the total value not paid to the business. Invoice factoring is generally considered less risky than a merchant cash advance for one simple reason: Invoice factoring is based on existing accounts receivable that have not yet been collected, while merchant cash advances are based on projected future sales rather than an existing asset.

- **Equipment loan:** Equipment loans are specifically intended for the acquisition or lease of equipment needed for a business to operate. Generally, these loans are backed by the equipment itself as collateral rather than a business's credit; if the business fails to repay the loan, the equipment can be repossessed.

Borrowers that require a working capital loan might need them for the same reasons a company seeks out a merchant cash advance, including covering wages, financing the purchase of equipment, acquiring new properties and expanding inventory. They are also commonly used by seasonal businesses or those with cyclical sales.

What are the pros and cons of a working capital loan?

Working capital loans tend to be less risky than merchant cash advances but often serve similar purposes. However, it's not uncommon for the qualifying requirements to be stricter, since working capital loans are often based on creditworthiness or some other form of collateral more tangible than projected future sales. Here's a closer look at some of the pros and cons associated with working capital loans.

Pros

- **Short repayment period:** Working capital loans, by nature, have fast repayment periods, which are useful to businesses that want to quickly clear the debt from their books. Repaying a loan within one year means businesses aren't forced to pay interest on the loan for years to come.

- **Flexible:** Depending on the type of working capital loan, funding is relatively flexible. Certain loans, like equipment financing, are more restricted; however, lines of credit, short-term loans and invoice factoring can all be used to cover a wide range of costs.

- **Fast approval process:** Short-term loans generally have a faster approval process than conventional loans because they are designed to fill an immediate need for a borrower.

Cons

- **Expensive:** A short-term loan matures more quickly than traditional loans, so borrowers should expect to pay higher interest rates. The interest rate on most working capital loans varies depending on the precise type of loan, but they are generally more expensive than a longer-term loan.

- **Short repayment period:** While the short repayment period is a blessing to companies that want to clear debt from their books, it can be a challenge for businesses that struggle to repay their loans. Since

working capital loans have a much narrower window than longer-term conventional loans, businesses have to pay back the principal much more quickly.

If you need cash fast, consider a merchant cash advance or working capital loan

Many businesses need help to support their cash flow. After all, cash flow is oxygen to a business, and without oxygen, it won't be long before the business chokes and operations stall. Merchant cash advances, lines of credit and working capital loans are methods that can help buoy businesses while they await future sales. However, without a clear plan in place, these forms of financing can spell disaster for a business.

To make the most of any type of financing, have a clear road map to repayment and the ability to execute that plan successfully. Good record-keeping and a strong understanding of your business are critical.

Accepting a loan in hopes that you might generate future sales to cover it is a major risk. When in doubt, consult with an accounting professional before accepting any money from a lender of any kind. With a bit of planning, though, merchant cash advances and working capital loans could be precisely the support you need to get through the lean times until you're back on track to profitability.