INSTITUTIONAL INFUSIONS

Learning some fundamental truths may help your MCA business move from the Wild West to Wall Street

ROSS

BY MICHAEL GIUSTI

Three things are standing in the way of your merchant cash advance business and a potential infusion of cash from an institutional investor: volume, trust and defaults.

That was the message from Brendan Ross, president of Los Angeles-based investment firm Direct Lending Investments when he sat down with the DailyFunder to discuss how nontraditional business lenders might graduate into the big leagues and engage institutional investors like him in potentially funding deals.

Ross said that one of the hardest things he faces when dealing with merchant cash advance companies is bridging the divide between how MCA players expect to get paid and how an institutional investor approaches compensation for a deal. One of the keys, he said, is to know that in an ideal world, you get paid when cash begins flowing in on a deal, not when the contract is first written.

He also said that like any lending relationship, there is an inherent trust factor that stands in the way of getting a deal in motion.

"The key to raising outside money is to find some way of getting me to trust your underwriting. Either you put a lot of your own money in, or we find somebody else who's underwriting I also trust and who is putting money in," he said.

But if all the details can be worked out, Ross said the potential up side of becoming a funding platform is huge, and it starts with engaging that first institutional investor.

DailyFunder: Which companies are in the best position to bring in an institutional investor to fund a merchant cash advance deal?

Ross: The first thing I look at is the organization that you have built. I'm not able to interact with a company until they emerge with some reasonable level of volume. A market leader, not a startup.

I also want to understand your story for how you are originating your deals.

If you are originating in a really boring way, like if you have spent the last 10 years rolling up credit card ISOs, then I like that a lot. If you are just another me-too player trying to originate from brokers, that is less interesting.

Different people have different concepts for how they are going to originate business. The best are the ones that have what I call "unique deal flow."

You tell me "I have a relationship with a huge ISO, and I'll be the only one in there, and my deal is unique and these guys can confirm that I am the only one in there," then I like that because it means you're getting good flow and it's not picked over, where I might be the dumb money taking the deals no one else will fund.

DailyFunder: Is that to say that only highly professionalized players should be looking at doing lending deals with you?

Ross: If they haven't created a highly professionalized operation, then that can still be fine, I just wouldn't trust them to service their own loans. We'd have to work with someone like Strategic to come in as the servicer.

If a servicer will not get in the deal, I am going to have far more concerns.

But, in an ideal world, they have a track record stretching back years and years. Maybe they even have audited financial data, but at the very least, they need some kind of track record.

DailyFunder: How important is it that they bring

audited financial records to the table?

Ross: I realize that having audited numbers is rare in the merchant cash advance world. Is it a nice thing to have? Yes, but I can't imagine I would get that almost ever. So, really, the first thing I want to look at is data on every single loan they have ever done. If they aren't keeping those numbers, and if they can't run a meaningful report, then it's probably not going to happen.

DailyFunder: Which businesses and which deals are most attractive to you?

Ross: I'm not really doing the underwriting on individual deals — I am looking for you to do the underwriting. That's why it is important for you to put money up.

If you have money in the deal, you won't want to lose it. And you are going to be better at underwriting these deals than I will, as will another syndicate partner that might be a servicer that we both trust.

If you bless it and somebody else blesses it, then I can come in for half or more of it, and I will know that it has been blessed by two people who would stand to lose money if the deal fell apart.

DailyFunder: It sounds like seeing your partners put skin in the game is important to you.

Ross: If you are sort of more mom and poppy, in order for me to work with you, what you need to do is relatively simple: we would need to find a third party servicer so you wouldn't be touching the money. And you would have to have enough capital in the deals that I would be confident that you would be hurt if a deal we did together lost money.

In a perfect world, you are taking 25 percent of the deal, Strategic, or somebody like them is taking 25 percent and I am taking 50.

Of course, this assumes you can afford 25 percent of the deal. If you can't, then what is the acceptable number? Maybe it is 10 percent. I don't know. But you have to be in the deal enough that I know you are going to personally suffer if a deal goes bad.

The more that you put in the deal, the less concerned I am.

DailyFunder: How might a typical deal between you and a merchant cash advance company be structured?

Ross: The first thing to make clear is that the investment is never in the merchant cash advance company — it is always in the loan, and that distinction is important.

Because, you may not be around long term, but I need those loans to finish being collected.

I need to be the owner of the loan. I need it sold to me in a way that is completely clean. The thing that I can't do is to give someone money to start a merchant cash advance company. What I can do is pay them as I go, based on some reasonable up-front markup plus profits earned on the loans.

When I write a deal, I am looking for bankruptcy remoteness. Bankruptcy remoteness means I own the loan. You have originated it. You have gotten the advance going, but I am the owner of it. You don't own it.

As for the specifics, well, the deal can be structured in a lot of ways. It really just depends. I just need to figure out and find structural ways to create trust that offset the natural lack of trust that comes from you getting paid up front while I get paid later.

That is everything. Everything is about trust and eliminating the need for it whenever possible.

DailyFunder: You mentioned bringing in an outside third party. Why do you see that as an important part of vetting a deal?

Ross: There are really two validation points. The first validation point is, are you in the deal. The second is, will a bigger servicer that would also like to participate as a syndicate also get in the deal. So, if the servicer will get in the deal, and you are in the deal, then obviously I am pretty comfortable with that deal.

Now if a partner comes to me who hasn't done many loans, then that is when we fall back on what I call these structural trust mechanisms. So, I should trust you because… why?

We get back to the big three, how much money do you have in, can we get a third party to come into the deals, and can we get a third party to manage the cash flow. If we can get these three things, and the better we are on these three things, then the less I need in terms of a track record.

DailyFunder: When is it just essential that you see that third party brought in?

Ross: If you are small, and you tell me, "I may be small, but I have great infrastructure in place and I can service these loans, and it is crazy to give some servicer 3 percent." I would have to say to you that it may sound crazy but that's how we are doing it because that way I don't need to trust you.

If there is one challenge in the merchant cash advance business, it is trust. That's really no particular disparagement to merchant cash advance – any lending business involves a lot of trust.

Lenders have had their trust violated for centuries. It is just actually hard to trust people with promises to repay money. That is a fundamentally hard thing, and it is doubly hard when people are getting an origination fee. Everything is about trying to work around that.

DailyFunder: You seem to keep coming back to the origination fee. Why does that part of the deal seem to give you pause?

Ross: See, the thing is, when a broker transitions to being a lender, they want to keep their origination fee and then also make fees as a lender. They are trying to add to their wallet. And that creates a tension between the person who is going to have to pay the origination fee and the lender.

The lender wants to see some of the money up front. And in a perfect world, I wouldn't have to pay anything upfront. In a perfect world, I would pay you based on a percent of what I earned on the portfolio.

But you don't want that. You as the broker becoming the lender, you still want to earn that origination fee.

And I understand that, but now the question is, how can I trust you? You want to get paid up front, and it is going to be hard to trust you because you could stick me with bad paper.

DailyFunder: Since trust is so important, how much of a role does the individual reputation and credit score of your potential partners weigh in?

Ross: I do run a background check on the members of the leadership team for lenders who I work with. It is a real criminal and credit background check.

I haven't had a situation come up yet where someone has failed a background check. And, obviously, I realize there is a difference between drunk driving and theft or embezzlement.

I also understand that people end up sometimes in the MCA space who have had colorful careers in the securities space. It doesn't make it impossible for me to work with them. But if they had been in the big house for white color crime, then that is probably a non-starter.

DailyFunder: When it comes to potential partners, how much of a role does their deal volume play in your decision to jump into a deal?

Ross: With an institutional investor, volume is very important. An institutional investor like me is not interested in working with a lender who can't keep a lot of money busy.

If you do four-month deals, and you have turnover each month of about 25 percent, and the maximum volume of loans you can do in a month is $1 million, then that means the most money you can keep busy is about $4 million a year.

As a fund manager, I don't make that much fees on $4 million. So, then the question is what are my costs going to be against managing you?

Now, if your volume is $10 million or more, then probably an institutional investor would have an interest in working with you. And if it is $20 million or more, definitely. The thing is, it is not that easy to keep $10 million busy. For most people that means writing between $2.5 million and $3 million in loans each month. That is a lot of loans.

DailyFunder: OK, so let's say an MCA business could keep that amount of money busy, how much could that kind of relationship be worth?

Ross: If you are originating $10 million a year, and you are able to keep 5 percent as an origination fee, you are making $500,000. As the lending platform for the deal, your goal is to make another $250,000 by bringing in institutional money to make the deal work — if you can keep your defaults under control. This whole business is about defaults.

DailyFunder: I'd love to talk about defaults. What is your perspective here?

Ross: First, you need to understand that I view a loan as late or dead much more quickly than most people do. If you run a merchant cash advance lending business and you don't have a payment from a borrower because they closed their bank account, and they aren't returning your phone calls, then the loan is dead then.

It is not dead in 45 or 60 days later. If you don't have access to the bank account, and they aren't returning your phone calls, then it is a dead loan.

DailyFunder: What do you consider to be acceptable when it comes to defaults?

Ross: If I have $1 million in loans, and $10,000 of them go dead in a month, that is 1 percent of the portfolio, and so that is a 12 percent annualized default rate.

If you have that same $1 million in loans, and you are writing three-month loans, and you had $30,000 die last month, then that is a 36 percent annualized default rate, and that is not going to work.

But, if we are talking an 18 percent default rate, could that work? Possibly.

Could 30 percent work? Well, now you are in a range where I am not thrilled. I am not thrilled about having three percent of the portfolio die at the end of each month.

If you can keep your defaults under control, you can make money because my investors don't need as much as your portfolio can generate.

DailyFunder: What is the bottom line?

Ross: The most important thing is the structural trust mechanisms and the volume. You can't get an institutional investor to work with you if you can't keep $10 million busy — you are just too small.

The best thing to do is to build up volume. Take your origination fee, build up volume, and focus, focus, focus on volume – get yourself a shop that has decent volume, and then give me a call and we can figure out how to get you transitioned to being a lender. You have got to have the volume.

But, the point is, if you are shopping for syndicate partners, and if your volume is big enough, you can shop for an institutional partner — someone like me.

If you are going to syndicate stuff out anyway, and your volume is good, then syndicate it to me because my yield requirements may be lower, and you can keep a piece of the profit.