INDUSTRY WHITE PAPER **APRIL 2008**

"Best Practices for Merchant Cash Advance Providers: Assessment of Risk"

Presented by AdvanceMe, Inc.

Executive Summary

As the industry matures, more merchants and potential salespeople have become aware of the Merchant Cash Advance (MCA) product and how it can help their businesses --- and commission checks. Increased awareness has driven additional word of mouth sales and recruiting momentum, as well as an influx of new Providers believing that they can take advantage of a unique opportunity.

Many MCA Providers have entered this business because of the perception that it has wide margins and therefore room for error, falsely believing that there was no need for sufficient capital, or even proven and effective risk, scoring and underwriting models and processes. Responsible MCA Providers do not have any recourse against a merchant as long as a contract covenant is not breached, and merchant incompetence in running their business does not qualify as a breach of one of those covenants. These factors, combined with the realities of today's economy, make risk management imperative.

Our previous White Paper entitled, "Know Your Customer, and Other Guidelines for Responsible Merchant Cash Advance Providers", invited the Merchant Cash Advance industry to establish Best Practices that would ensure ethical competition within the industry by Providers in a self-regulated environment. We once again urge the industry to use our initial suggestions that are intended to reduce losses and improve portfolios as a launchpad for dialogue that could strengthen us individually while protecting our mutual interests. Indeed, AdvanceMe is now in discussions with other Providers regarding sharing data as a means of reducing merchant fraud risk. In today's economic environment, it is even more important than ever for MCA Providers to share Risk Best Practices to ensure continued access to sufficient, appropriately priced capital, for deserving MCA Providers.

An electronic version of this document may be found on AdvanceMe's website at www.AdvanceMe.com or www.MCABestPractices.com

Why is a Merchant Cash Advance Risky for Providers?

A Merchant Cash Advance (or MCA) is the purchase of a specified amount of a business' future card sales at a discount. The purchase price paid by the MCA Provider is a lump sum of cash delivered to the business for its use as working capital.

An MCA is not a loan – it is the purchase of a specified amount of card sales that have yet to occur. There is no fixed term. Rather, the MCA Provider is entitled to receive a set percentage of its merchant client's daily net settlement batch. The dollar amount received by the MCA Provider on a given processing day is based on the merchant's card sales volume. MCAs from responsible Providers do not have any recourse against a merchant as long as a contract covenant is not breached. Merchant incompetence in successfully running their business does not qualify as a breach of one of those covenants.

These aspects of an MCA make it a risky product for the MCA Provider to deliver. If the merchant's future card sales are lower than the MCA Provider projected, the Provider's collection of the receivables it purchased will take longer than projected – a timing difference that may result in loss of income for the Provider. If a natural disaster occurs, or a competitor opens up across the street and puts the merchant-client out of business, there is no recourse. The obligation is not backed by personal collateral in the event the business closes – there is no recourse for the MCA Provider by contract unless a covenant is breached. The risk intensifies when merchants apply for fundings with contract arrangements that they cannot or do not intend to honor, or salespeople submit requests for merchants that should not be considered for an MCA, or the merchant sells more of its future receivables than the business can afford to spare..

Risk Management

The goal of good risk management is the quantification of risk, not its complete avoidance. Individual Providers need not only to employ strong underwriting processes and portfolio monitoring processes, but they also must possess a clear understanding of their risk/reward targets and how the underwriting and portfolio monitoring processes are impacting the achievement of the desired risk/reward ratios. Collection, management and analysis of data concerning business profiles by SIC codes, traditional margin rates, seasonality trends, geographical factors, and owner histories must be ongoing, and the systems and technology of the Provider must be designed to integrate the insights provided into daily operations.

Risk management processes need to be designed and employed throughout the underwriting and collection lifecycles of any MCA. Underwriting management processes designed to assess risk before the MCA is funded focus on approving those transactions that fit the desired portfolio profiles while screening out applicants and situations that do not. The desired overall risk profile of the portfolio is established at the outset, then reviewed continuously to ensure that the underwriting processes are screening appropriately. What is reviewed as part of the screening process, and the weight given to each variable underlie the scoring models used in the decisioning process; however, common elements usually include credit card sales volumes, gross volumes, time in business, SIC codes, business information, references and credit reports. These scoring models vary by Provider and are (or should be) tied to the portfolio profile sought by the individual Provider. Not only do the models create product and Provider differentiation in the marketplace, but they also should anticipate the eventual loss rates seen in the portfolio. Robust portfolio monitoring processes should detect macro and micro economic trends as well as portfolio performance so that deviations from expected collection speeds and loss rates can be addressed in the underwriting processes. While good asset management processes can positively impact portfolio performance, the purchase and sale nature of the MCA product means that responsible Providers have few tools to address poor performance of a badly originated existing portfolio. However, the relatively quick turning nature of the MCA means that portfolio performance trends, if promptly addressed in the underwriting processes, will allow the MCA Provider to quickly migrate its weighted portfolio to reflect new underwriting guidelines. This "virtuous circle" of "portfolio monitoring/feeding underwriting process changes/leading quickly to new portfolio dynamics" puts a tremendous premium on understanding the dynamics of the existing portfolio. Extremely robust data collection and analytical systems must be employed to understand loss rates, seasonality trends, SIC code differentiation, and dozens of other variables, as well as the relationships between various merchant profiles and the weights to assign each variable based on the applicant profile.

Good risk management protects not only the Provider but also benefits all participants – from merchants, to processors, acquirers and salespeople. A merchant who sells a responsible amount of their future receivables and puts the proceeds to good use in their business, helps processors continue processing and receiving the payments related thereto, and helps acquirers and salespeople keep their commission residuals. Responsible funding means knowing your customer. Each business has a maximum percentage of its receivables it can afford to spare for a time, and it risks going out of business if the MCA Provider takes more. AdvanceMe believes that every MCA provider must know the traditional margins of every SIC code in which they operate, and size its deals based on the business's anticipated ability to afford the retrieval rate.

Today's Business Environment Reinforces Need for Best Practices

For the past year, the media has headlined stories about the struggling economy, the sub-prime mortgage crisis and the resulting "credit crunch". Financial institutions impacted by losses must now minimize their own future risk by tightening their lending parameters for FICO based loans to both consumers as well as small business owners. Owners that could once count on financing from a bank (credit cards, home equity loans and lines, business lines of credit, etc.) are finding that access is harder and approval amounts smaller. Small business owners that relied on their personal financing resources no longer have access to those same financing vehicles.

Similarly, MCA Providers are being squeezed. Most Providers are reliant on lines of credit, from which they borrows funds which will in turn be made available to small business customers in the form of MCAs. Commercial lending institutions, seeing rising losses from companies with lax controls, in turn increase interest rates, require additional capital and collateral or withdraw their financing altogether. While this process weeds out weaker MCA players, their performance may be perceived as an industry trend that then affects the rates charged to and capital availability of other more solvent and responsible Providers, many of which may in fact have exemplary controls and well anticipated defaults and losses.

Best Practices that Anticipate Risk

AdvanceMe previously proposed that a series of "Best Practices" be developed for MCA Providers if we are to grow successfully. This is the second White Paper in that series, the issuance of which will signal to the financial community that risk factors are being identified, handled and mitigated.

We strongly urge everyone with a stake in the future of the MCA industry to contribute to this discussion as means of creating a strong, positively perceived industry demonstrating a capacity for contained risk, accurately and consistently forecasted growth and returns worthy of investment.

1. *Define Your Risk/Reward Targets*
   Every business should define the amount of risk it is willing to take for a certain reward level. Analytics should be employed to quantify the risk levels associated with certain underwriting criteria as well as the anticipated return levels. New or less sophisticated Providers may be enticed into "kickstarting" sales by taking on riskier customers. However, less information and data history means increased risk potential, which may outweigh the long term expected reward.

2. *Define and Follow Rigorous Underwriting Processes*

MCA Providers collect a fair amount of documentation from prospects, but not everyone in the industry diligently checks the information. Make sure that your process includes a verification step on key data. Do your due diligence up front, not after the MCA is completed. Ask for and check references. Ensure the validity of the business itself, and the owners, with a variety of lawfully used screening tools – processing history, credit reports, site visits, previous MCA history, etc. Not all screening tools need to be employed for all requests; as the amount of money requested increases, so should the level of verification. This approach will help keep the risk/reward ratio in favorable balance.

Once the underwriting guidelines and processes are in place, follow them. If underwriting is not done systematically, then it becomes much more difficult to assess cause and effect relationships in the portfolio performance dynamics. Not all business is good business. If a deal is borderline from a salesperson with a sketchy history in a geographic area that is in a depressed state, then have the conviction to pass it up. The losses from one bad underwriting decision can wipe out the profits of many good ones.

Treat each deal on its own merits, even with repeat customers. Risk profiles, whether they be macro-economic, or merchant-specific, change constantly. Re-underwrite each new funding – even new fundings with existing customers.

3. *Employ Robust and Continuous Portfolio Analysis and Asset Management*
   After the funding has been completed, keep tabs on performance. Ensure that the data collected is employed in refinement of the underwriting standards and guidelines. Understand the relationship between the portfolio performance dynamics and the resulting risk/reward ratios achieved.

   Know the reasons you may not be collecting receivables at the speed you expected. "Slow pays" may be the result of business-related issues, or may indicate fraudulent behavior. "No pays" may be related to terminal issues or seasonality, but could also indicate other issues. In either case, it is important to act quickly. Implement an active "customer service" process that starts automatically when volumes differ from expectations. By making a call to the customer, you may learn of a terminal issue that can be fixed easily – at a minimum you are letting them know that you are watching their activity closely, which may be enough to encourage good merchant behavior. If you can't explain the volume discrepancy, employ a documented, consistent, legal and ethical asset management process to determine whether there has been a contract breach that would give you recourse.

4. *Avoid Fraud*
   Successfully guarding against fraud requires knowing how fraud is committed. Fraud can be committed by merchants, salespeople and/or employees. Merchant fraud cannot be completely eliminated as a risk, but good analytics and underwriting should screen out many cases prior to funding. Also, data sharing about fraudulent merchant behavior between and among Providers is another method of screening out fraud that has been used to good effect in many industries. AdvanceMe is in discussions with other Providers on how to best share this data in mutually beneficial and legally compliant ways.

   Salesperson fraud can be committed together with a cooperating merchant, and/or separately through the use of "dummy" merchants and forged documents. Providers must employ, and continuously improve their underwriting processes to weed out bad salespeople. By ensuring that the portfolio performance analytics and asset management functions are attuned to sales origination correlations with merchant losses, Providers can employ originator variables in their scoring models.

5. *Know Your Customer*

   Know enough about your customer to protect the merchant. Protecting the merchant's business is not only sensible risk management for the Provider, but also protects the interests of processors, acquirers and salespeople in that merchant. Merchant's are sometimes willing to sell more of their receivables than their businesses can spare without running into serious, if not fatal, cash shortages. Responsible funding means knowing your customer and using commercially reasonable efforts to ensure that your funding does not harm the merchant's business. AdvanceMe's data, gathered during 10+ years as an MCA Provider has led us to the conclusion that there is a strong correlation between the traditional margins associated with a particular type of business and the amount of receivables that can be safely sold by that business.

   AdvanceMe believes that only by knowing a great deal of data about the merchants they intend to fund can a Provider know the margins of the businesses types they intend to fund. Without that knowledge, irresponsible fundings will cause merchants to fail – causing losses for the Provider, the business owner, and the related processor, acquirer and salesperson.

Summary

The industry has a tremendous opportunity to demonstrate that it is able to provide an alternative product that can serve small businesses in spite of a difficult financial markets environment. With 10 years of history behind it, AdvanceMe is using the data, knowledge and perspective it has gained to implement systems and controls that we are confident will position us well for the future, and with reputable and reliable financial partners, as evidenced by our ability to recently close $100 million in additional funding capacity in addition to our previous facilities. This knowledge will serve customers as we make decisions about funding amounts and retrieval rates that are in the best interest of the merchant. However, not everyone participating in this industry is as well positioned. The promotion of Best Practices that mitigate risk while providing responsible funding will help customers, ISOs that sell the product and the industry as a whole. The purpose of this White Paper is to outline a few initial Best Practices that responsible Providers can implement for the betterment of all. We once again offer this White Paper to start the discussion and invite response.