

Business Acquisition Financing Through SBA

504 & 7(a) Combinations

It's not uncommon for the price of a small business to exceed \$2 million, creating a problem for a lender seeking to use the SBA 7(a) loan to meet a borrower's needs. Combining the 7(a) with the SBA 504 loan solves this and other potential problems.

by **Thomas Wallace**

Lenders face unique challenges in financing the acquisition of a small business, even when the business itself is doing well by financial standards. When the price of a small business exceeds \$2 million, financing options become limited as buyers rarely have sufficient liquidity and assets to accomplish conventional financing and sellers are rarely willing to or capable of providing financing at these levels. With broader capital market alternatives not particularly feasible without substantially higher purchase valuations, all parties face a difficult set of choices, and lenders are able to present only limited options. The structures and relative benefits of the two major Small Business Administration (SBA) loan programs, the 504 and the 7(a), can be combined in a way that can greatly expand these options.


Goodwill, Capital Requirements, and Debt Capacity

The conditions leading to a decision to sell a small business may include untenable relations between partners, personal or family illnesses, the desire to retire, or even actual commercial challenges. Regardless, the conditions themselves can magnify the risks present in any credit extension. Furthermore, a business pending a sale frequently slips into a state not unlike that of absentee ownership. The result can be a loss of management focus, of commercial position, of financial strength, or something even worse.

Another hurdle is financing the goodwill inherent in many transactions. This is less of an issue for larger firms because the capital markets recognize the value of their intangible assets. The intangible

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assets of a small business—local reputation, community standing, and individual relationships—are at best fragile and rarely capable of being accurately valued, much less conventionally financed. The problem is magnified by the dramatically increased valuations of certain asset classes, such as commercial real estate, over the past several years. This gives the prospective lender in a small-business acquisition challenges in evaluating capital requirements and debt capacity issues, beyond those already posed by the goodwill issue. Clearly, financing the acquisition of a small business is made vastly more feasible by the availability of risk mitigation such as that offered by the SBA.

The 7(a) Loan

Traditionally, small-business acquisition financing was handled largely through the 7(a) program. The SBA guaranteed the loan to a specific percentage of the outstanding principal and interest. There was an allowance for the financing of working capital that covered the needs of both actual acquisition costs and possible working capital needs in a single loan. Now, the 7(a) program operates under a cap of \$2 million, which could leave a lender with the ability to finance an acquisition but little or no ability to provide working capital financing—a near surefire recipe for disaster. A better solution lies in using the two programs, the 504 and the 7(a), jointly to structure the credit exposure.

The 504 Loan

The SBA 504 program provides permanent financing for the acquisition of capital assets—buildings and equipment—through fully amortizing loans for 10 and 20 years, respectively, for equipment or real estate.¹

A 504-financed project initially involves three loans:

- A bridge, or interim, loan made by a private-sector lender.
- A senior-position permanent loan from the private-sector lender, who may also be the interim lender.
- An SBA-backed junior position loan.

The borrower is required to inject between 10% and 20% into the transaction, based on several criteria. Except in very unusual situations, the borrower's equity is first into the transaction.

When the interim lender's loan has been fully funded and title to the financed assets is in the borrower's name, the SBA-backed junior-position loan is funded, reducing the interim lender's exposure to not less than 50% of the total acquisition cost. The resulting permanent loan is in a senior-collateral position at a very strong loan-to-cost ratio. Given their strong collateral and priority positions, these loans are readily salable in an active secondary market. The SBA-backed permanent loan is made through a certified development company—an SBA-licensed local economic development entity that manages the credit process with the SBA's consent. There is no upper limit on the size of the total project financed or on the size of the first position loan; however, the SBA-backed junior position loan is limited to \$1.5 million, \$2 million, or \$4 million, depending on various factors.²

Small businesses eligible to participate are basically defined as those having a tangible net worth of less than \$7.5 million and average after-tax net income of less than \$2.5 million over the past two years. (The SBA 504 program bans financing intangible assets.) There also are certain restrictions on the principals of the small business, largely relating to character, citizenship

or visa status, and available liquid assets. While there are additional requirements, they are generally less extensive and less exclusive than those of the SBA 7(a) program.

The 504 provides three critical advantages: a higher overall exposure limit; long-term, below-

market fixed rates on the SBA-backed junior loan; and an injection of borrower equity that is lower than what is typically required for a commercial loan. In acquisition environments, these advantages can be essential to structuring a loan with the potential to satisfy both the prospective

borrower and the lender's credit approval process.

Combining 7(a) and 504

The key to structuring the proposed credit is to work within the regulatory limitations of the two programs, starting with the differentiation of asset types to be

Table 1

504 Sources, Uses, and Debenture Issuance Costs

Public Policy Company? (Y/N)	N		Gross Debenture Cap for Nonpublic Policy Co.	\$1,500,000	
			Gross Debenture Cap for Public Policy Co.	\$2,000,000	
Sources of Funds			Uses of Funds		
	Dollar Request	Project Cost %		Amount Requested	Project Cost %
A. Net SBA debenture (VIII.A.)	\$598,400	40.00%	A. Land (and purchase of existing building, if applicable)	\$1,200,000	80.21%
B. Private sector	\$748,000	50.00%	B. Building (new construction, remodeling, L/H improvement, etc.)	\$0	0.00%
C. Other financing	\$0	0.00%	C. Machinery & equipment (purchase, installation, etc.)	\$250,000	16.71%
D. Borrower injection	\$149,600	10.00%	D. Professional fees (appraiser, architect, legal, etc.)	\$46,000	3.07%
Total Project Financing	\$1,496,000	100.00%	E. Other expenses (contingency, interest, etc.)	\$0	0.00%
			Total Project Cost (not including 504-related fees)	\$1,496,000	100.00%
Debenture Pricing			Comments		
A. SBA share of project cost	\$598,400	40.00%	The assumption is that the total project cost includes direct closing costs, such as document stamps, intangibles tax, etc. However, if these costs are omitted from the total project cost (choice to be made by the borrower/creditor), the borrower's total out-of-pocket cash at closing will increase accordingly.		
B. Administrative costs		Rate			
1. Reserve amount	\$2,992	0.50%			
2. Funding fee	\$1,496	0.25%			
3. CDC processing fee	\$8,976	1.50%			
4. Closing costs	\$2,500				
Subtotal	\$15,964				
		Term in years			
5. Underwriter's fee	\$2,468	20			
Total administrative costs	\$18,432				
C. Total debenture amount (A + B, rounded up to next 1,000)	\$617,000				
D. Balance to borrower (C - [A + B7])	\$168	100.00%			

Table 2

“ZYX Enterprises” Acquisition Financing Overview

Financing Need		Source of Funds			
Real Estate	504 Structure				
	1st REM	2nd REM-CDC	Equity	Seller (Sub.)	
	\$1,496,000	\$748,000	\$598,400	\$149,600	-
		50%	40%	10%	0%
	7(a) Guarantee Loan				
Business Acquisition	7(a) -Gross	7(a) GP	Equity	Seller (Sub.)	
	\$2,000,000	\$1,240,000	\$930,000	\$760,000	-
		62.0%	75.0%	38.0%	0.0%
		\$1,988,000			
		56.9%			
			\$598,400		
			17.1%		
					Total Gross Bank Exposure
					Total Net Bank Exposure
					\$1,058,000
					Secondary Market Option Funds
					\$1,678,000
					SBA Direct Exposure
					SBA Regulatory Exposure*
					\$1,528,400
				\$909,600	Borrower Equity Retirement
				26.02%	
					- Seller Financing
				0.00%	
Total Funds Needed	Total Funds Sources				
\$3,496,000		\$3,496,000			100.0%

*SBA exposure must be adjusted for debenture issuance costs. In this case, these amount to \$18,432.

financed. To illustrate this, we may consider a proposed acquisition with a total purchase price of \$3.25 million.

- The first step, which should almost always be available from the buy/sell agreement, is to allocate the costs of specific assets. In our example, the allocation is \$1.2 million to business real estate, \$250,000 to business equipment, and \$1.8 million to the value of the business itself.
- The borrower expects to need \$200,000 for working capital and closing costs, bringing the total acquisition cost to \$3.45 million.
- Finally, we will assume that

we have 1) a creditworthy and SBA-eligible prospective borrower, who has approximately \$900,000 to invest; and 2) a seller who, in the euphoria of the moment, might consent to “hold paper” to a limited degree.

The first observation is that with a \$2 million maximum for a 7(a) loan, the financing cannot be accomplished through this vehicle alone, unless the seller is willing to provide financing in the range of \$1 million, which rarely happens. The \$1.45 million in capital assets would be eligible for financing under the 504 program. Table 1 provides a basic sources-and-uses schedule for a 504 loan to support

this part of the acquisition.

Most immediately apparent in Table 1 is that the borrower has financed 43% of the total purchase price, while using less than 15% of the equity available to support the total transaction. It is also worth noting that even with a substantial equipment portion to the proposed 504 loan, the 20-year term can be maintained under SBA regulations, thus providing a far more manageable level of debt service without a noticeably detrimental effect on the collateral. The debt service requirement of the 504-financed assets would also be very favorably impacted by the below-market rates available for the SBA-supported junior debt.

Table 3

"ZYX Enterprises" Acquisition Financing Overview

Financing Need		Source of Funds			
Real Estate	504 Structure				
	1st REM	2nd REM-CDC	Equity	Seller (Sub.)	
\$1,496,000	\$748,000	\$598,400	\$149,600	-	
	50%	40%	10%	0%	
	7(a) Guarantee Loan				
Business Acquisition	7(a) -Gross	7(a) GP	Equity	Seller (Sub.)	
\$2,000,000	\$1,008,000	\$756,000	\$760,000	\$232,000	
	50.4%	75.0%	38.0%	11.6%	
	\$1,756,000				Total Gross Bank Exposure
	50.2%				Total Net Bank Exposure
					\$1,000,000
					Secondary Market Option Funds
					\$1,504,000
		\$598,400			SBA Direct Exposure
		17.1%			SBA Regulatory Exposure*
					\$1,354,400
			\$909,600		Borrower Equity Retirement
			26.02%		
				\$232,000	Seller Financing
				6.64%	(Total Project)
Total Funds Needed	Total Funds Sources				
\$3,496,000	\$3,496,000				100.0%

*SBA exposure must be adjusted for debenture issuance costs. In this case, these amount to \$18,432.

That said, the proposed 504 loan also used most of the available hard assets that could collateralize a conventional loan. However, the 7(a) program's credit criteria allow the lender to finance the business value if the borrower injects adequate equity and pledges all available collateral in the context of an acceptable appraisal of the business. The proposed 504 loan structure has preserved a significant amount of the prospective borrower's cash reserves for the equity injection. Likewise, any paper that the seller can be induced into holding can be applied against the business purchase need as well.

As mentioned, the 7(a) pro-

gram is limited to \$2 million in total loan proceeds. If the total 7(a) loan is below the regulatory maximum, the issue becomes how much federal guarantee benefit is being applied to a single borrower. The total amount of guarantee benefit allowable to an individual borrower is the maximum SBA-backed 504 permanent loan, which can vary from \$1.5 to \$2 million—and, in specific circumstances, up to \$4 million—but usually represents only 30-40% of the total financed in a 504 project. The guarantee benefit of a typical 7(a) program loan is 75% of the total loan. In our example, the proposed 504 loan has used \$0.617 million of the guarantee benefit.³

We have assumed that the maximum guarantee benefit will be \$1.5 million, thus leaving \$0.883 million available to support a proposed 7(a) loan. With the 504 loan amount established and an absolute maximum established for the 7(a) loan amount, we have set up a "financial algebra equation" to solve for both the 7(a) loan amount and a minimum amount of seller financing required. In part, the objective is to preserve both available equity and SBA "guarantee benefit" to support the financing of the intangible assets of the business acquisition. Table 2 shows how this will lay out.

The spreadsheet shown in Table 2 sets the seller financing at

zero and the borrower's equity contribution at the approximately \$900,000 indicated to be available. The result is an SBA regulatory exposure that exceeds the indicated maximum of \$1.5 million. This exposure must be reduced by increasing the borrower's equity, increasing the seller-held paper, or reducing the selling price or total financed. Bear in mind that this only addresses the regulatory limitations of the proposed financing. A further consideration is the lender's evaluation of a need for seller financing to reduce the lender's exposure to what must be a limited collateral position. (This will further play out in a 7(a) regulatory discussion of available collateral and the subordination terms of whatever seller note is finally agreed upon.)

To complete the illustration, we can assume that 1) the SBA exposure must be reduced to below \$1.5 million and 2) the lender wishes to reduce its exposure, net of the presumed SBA guarantee on the 7(a) loan to \$1 million. This is set out in Table 3.

The final transaction as laid

out in Table 3 meets the basic regulatory requirements of the situation. As implied in several places, there are significant regulatory assumptions: basic SBA program eligibility, demonstration of prudent lending, and asset valuation and adequate collateralization. The lender has made a loan that has opportunities for income realization either as a portfolio asset or a secondary market sale opportunity.

A Viable Counterbalance

In closing, this combination of the current SBA loan programs is a particularly worthwhile effort. It is indisputable that business ownership transfers represent particularly treacherous waters for small business concerns; on the other hand, not navigating those waters tilts the risk/return analysis to entrepreneurs in a direction that unduly limits opportunities for economic growth.

The SBA's 504 and 7(a) programs provide a viable counterbalance without shifting undue risk to the federal government.

Default and loss statistics for the 504 program over the past several years indicate a basic competence

in underwriting and thus a reasonable risk exposure. The 7(a) program has begun a distinct effort to require lenders to adhere to prudent lending guidelines; in the event that a lender fails egregiously to do so, the possibility of denying the federal liability under the guarantee is very real. In addition, both programs function as "zero subsidy"; thus, credit losses are accounted through program fees as opposed to subsidies from the taxpayer.

In sum, the SBA provides a valuable service in a cost-effective fashion. □

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Notes

¹ In contrast, a 7(a) loan can support most legitimate credit needs for terms ranging from five to 25 years. Generally, in business-acquisition situations, such loans are made for a term of 10 years and are fully amortizing.

² For further information on SBA 504 loans, see the October 2005 issue of *The RMA Journal* for "A Lender's Guide to Successfully Marketing SBA 504 Loans."

³ Note that the gross debenture figure is used for this calculation, as the SBA backing applies to the final debenture amount issued to the investor, inclusive of issuance fees.

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