
Using the SBA Program to Execute M&A

Rules, Strategies, Calculations, Case Studies



SBA for M&A: General Appeal of SBA Loans

General Benefits of SBA Loans

- Low down payment (as low as 10%) - keeps personal liquidity accessible for new business owner
- Loan decisions are not collateral dependent if none is available, so many “asset light” sectors become bankable (software, professional services etc.)
- Better structures - blended amortization period (up to 25 years on CRE & 10 years on business acquisition) - preserves cash flow with lower monthly payments
- Typically no cash required for partner buyout with pledge of existing equity reflected on balance sheet
- Can be used for acquisitions, since SBA now allows lenders to finance substantial “goodwill” in accordance with SBA SOP guidelines
- Expansion financing available to start/buy second/third location



SBA for M&A: Two Primary SBA Programs

Two primary programs: 7(a) and 504 platforms

7(a) – General Commercial Lending, including Real Estate

- As low as 10% down payment
- One lender, one loan decision, one payment
- As long as 25 year fully amortizing (CRE) - No Balloons
- Minimal 3 year prepayment penalty
- Use of proceeds can include purchase, construction, leaseholds, refinancing, and non RE uses such as working capital, equipment, & business purchase
- No financial covenants

504 – Specialized Real Estate Lending

- As low as 10% down payment
- As long as 20 year straight term on Bank & CDC mortgages (bank mortgage can go 25 years for General purpose property)
- Accommodates Larger Project Sizes average size above \$5MM
- Use of proceeds can include purchase, renovation & construction options
- Low combined bank & CDC rate will be benefit borrower
- No Financial Covenants



SBA for M&A: General SBA Lending Rules

Qualifications and Borrowing Capacity

- Must be a for-profit business with less than \$15MM in book value and less than an average of \$5MM of net income over the last two years
- Minimum Debt Service Coverage current year, interim and / or projected > 1.25 to 1 and can be up to 1.45 to 1 if a collateral shortfall exists
- Personal Guaranty's from all owners with > 20% ownership required with minimum of 51% ownership required to guaranty, and personal liquid assets of each principal/guarantor not to exceed the total project costs of the proposed loan.
- Business revenue/cash-flow trends should be stable, should be profitable and leverage should be reasonable (generally should have at least one year and one quarter of cash flow profitability)
- At least 51% ownership must be in hands of U.S. citizen or resident aliens, individual FICO Score > 640, and no bankruptcy in the last 7 years and no unsatisfied judgments,
- All 7A loan structures will limit the unsecured exposure to < \$1,200,000



SBA for M&A: What's Changed?

October 2009 - Change to SBA SOP regarding Goodwill Financing

- **No more limits on financing goodwill:** Under the old SBA guidelines, lenders were prohibited from financing more than \$250,000 of goodwill. Under the new SBA guidelines, there is no technical limit on the amount of intangible assets that can be financed. If the value of the intangible assets purchased exceeds \$500,000, the borrower and the seller must combine to provide an equity injection of at least 25% of the purchase price of the business.

Small Business Jobs Act of 2010 - Funding Increases

- Increased the maximum loan size for 7(a) loans from \$2 million to \$5 million; Increased the maximum loan size for the 504/CDC loans from \$1.5 million to \$5 million for regular projects, from \$2 million to \$5 million for projects meeting one of the program's specified public policy goals, and from \$4 million to \$5.5 million for manufacturers;
- Authorized the SBA to use maximum tangible net worth and average net income as an alternative to the use of industry standards and established an interim size standard of a maximum tangible net worth of not more than \$15 million and an average net income after federal taxes (excluding any carryover losses) for the preceding two fiscal years of not more than \$5 million; and
- Allowed 504/CDC loans to be used to refinance up to \$7.5 billion in short-term commercial real estate debt each fiscal year for two years after enactment (through September 27, 2012) into long-term fixed rate loans



SBA for M&A: M&A Funding Rules & Requirements

Summary of Rules Regarding Acquisitions

- “Goodwill” of \$500,000 or more = 25% down payment
- “Goodwill” of less than \$500,000 = 15% down payment
- Business Valuation required on all deals \$250,000 or more
- Down Payment must be non-borrowed funds (source can be 50% personal cash and 50% Gift from family member. “Additionally borrower could “borrow” from a HELOC as the source only IF the spouse guarantees and can evidence he/she has sufficient income from outside of the subject business to cover the repayment of the loan”)
- SBA requires all loans be 100% secured “if they can be”. This includes business and personal assets.
- Business with tax liens are not eligible
- Earn out provisions are not eligible
- Seller cannot remain with company more than 1 year
- Seller debt must be seasoned 24 Months before SBA refinance



SBA Loans for M&A: Financing Goodwill

Rules regarding the Funding of Goodwill Acquisitions

An SBA-guaranteed loan may be used to finance a change of ownership that includes intangible assets (goodwill, client/customer lists, patents, copyrights, trademarks and agreements not to compete);

- If the purchase price of the business includes intangible assets in excess of \$500,000:
 - Borrower must provide an equity injection of at least 25% of the purchase price (minimum 10% required from borrower and seller can take a note of 15%)
 - Note - Seller equity is defined as seller take-back financing that is on standby (principal and interest) In most cases interest will accrue but the payments will be deferred for minimum 2 to maximum 5 years. The formal seller note structure is determined by the bank on a per deal basis but is typically 8 to 10 years in total term. The borrower and seller will agree how much equity each will provide.
- If the purchase price of the business includes intangible assets of \$500,000 or less, 15% equity is required (minimum 10% required from borrower and seller can take a note of 5%)
- The purchase price of the business includes all assets being acquired such as real estate, machinery and equipment, and intangible assets. *Goodwill = Total Purchase Price - Real Estate at FMV - Cash and Equivalents - A/R at NBV - Inventory at Cost - Fixed or Other Assets at NBV) + Any Assumed Liabilities at NBV



SBA Loans for M&A: Must be 100% Purchase

M&A Change in Ownership Requirements:

- **Eligible** - The Small Business Applicant is purchasing 100% of the ownership interest in a business (either an asset purchase or a stock purchase), though the business must be the borrower; or
- **Eligible** - One or more existing owners are purchasing the stock of a selling owner or owners resulting in 100% ownership by the purchasing owners.
 - The seller is not remaining as an officer, director, stockholder or key employee of the business. (If a short transitional period is needed, the small business may contract with the seller as a consultant for a period not to exceed 12 months including any extensions.)
 - If there is business real estate as part of the change of ownership, the real estate cannot be financed separately by a non-SBA guaranteed loan unless the SBA loan receives a shared lien position (pari passu) on the real estate with the non-SBA guaranteed loan. This provision does not apply if the business real estate is being financed as part of a 504 project.
- **Not eligible** - A non-owner who is purchasing only a portion of the ownership of the business from a selling owner; or an existing owner who is purchasing the ownership of another existing owner that will not result in 100% ownership by the purchaser.



SBA for M&A: Sample Transaction Structure

Sample Transaction:

Purchase Price	\$1,000,000
- Tangible Assets (Net Book Value)	\$175,000
= Intangible Assets (“Goodwill”)	\$825,000
+ Soft Costs	
Working Capital	\$100,000
Closing Costs & SBA Fees	<u>\$40,000</u>
Total Project	\$1,140,000

Possible Structures:

• Equity Injection (25%)	\$285,000
• Seller Carry (0%)	\$0
• Wells Fargo SBA Loan (75%)	\$855,000
Or	
• Equity Injection (10%)	\$114,000
• Standby Seller Note (15%)	\$171,000
• Wells Fargo SBA Loan (75%)	\$855,000

SBA for M&A: Fixed Charge Coverage

Calculating Fixed Charge Coverage Ratio

Compare your ordinary income before interest & taxes to your fixed charges. Add these back to adjust EBIT:

- Income Tax
- Interest Expense (unless debt will remain)
- Depreciation and Amortization
- Non operating income or expenses
- Rent (future rent expense will be added back later)
- Any rents paid to owner
- Pension and profit share for owner
- Any insurance paid for owner
- Owner's excess compensation
- Other payroll benefits
- Capital replacement or maintenance reserves
- Non essential and non recurring expenses

Fixed charge coverage ratio formula =
$$\frac{\text{EBIT} + \text{fixed charges before taxes}}{\text{fixed charges before taxes} + \text{interest}}$$

You should be at a ratio of approximately 1.2-1.4x at a minimum.



SBA for M&A: Documents Needed

Needed for prescreening:

- Three years of company tax returns, including all schedules
- Interim Financials with previous year comparison
- Interim Balance Sheet
- Owner three year personal tax returns and personal financial statement

Needed for loan commitment

- W2's and Payroll detail for all Owners



SBA for M&A: Calculating Enterprise Value

- Determining the value of a business (not including real estate which is separately valued through an appraisal) is the key component to the analysis of any loan application for a change of ownership. Note: Any amount in excess of the business valuation may not be financed with the SBA guaranteed loan.
- An accurate business valuation is required because the change in ownership will result in new debt unrelated to business operations and create an intangible asset.
- A business valuation assists the buyer in making a determination that the seller's asking price is supported by historic operations and permits the buyer to make a reasonable return on his or her investment.
- Lender Verification of Business Valuation Financial Data - Lender must obtain a copy of the financial information relied upon by the individual who performed the business valuation and verify that information against the seller's IRS transcripts to ensure the accuracy of the information.



SBA for M&A: Collateral Valuation Rates

Note: SBA Loans are not collateral dependent until borrowing exceeds \$1.2MM

- 50% on A/R & 20% on INV for 504 loans (0% for both on 7A loans)
- Up to 85% on general purpose medical office R/E
- Up to 85% on general purpose R/E, 60-70% for special purpose R/E
- Up to 80% on Personal Residence
- Up to 60% for hospitality / Up to 55% for c-store/gas station
- Up to 50% - 90% on Marketable Securities, depending on investment grade
- Up to 80% on New Equipment (60% on loans > \$2MM)
- Up to 70% of 3rd party invoice on Used Equipment, or
- Up to 100% of Orderly Liquidation value on purchased Equipment
- Up to 100% of Forced Liquidation value on Equipment for debt refinance

