Acquiring a Company: Important SBA Considerations and Common Questions

SBA Loans: What they do, The Most Common Questions and the SBA Process.

SBA Loans: What They Do.

The SBA Will Lend Up to 75-80% of The Purchase Price

For deals less than $500,000, the SBA will guarantee up to 80% of the purchase price of the acquisition. For deals more than $500,000, the SBA will guarantee up to 75% of the purchase price.

The remainder of the purchase price is the responsibility of the buyer and seller. This is often made up of a combination of seller financing and cash from the buyer. A typical mix is 15% buyer cash injection and a seller 10% note. This varies from bank to bank and situation to situation and is negotiable.

From the SBA's perspective, they require the buyer commit to a *minimum* of 10% – 15% of the purchase price. So, for an acquisition where the purchase price is $500,000, the SBA only requires the buyer to place $50,000 to $75,000 as a down-payment. In many circumstances the seller is encouraged by the bank to extend at least 10% in financing. A bank is looking for coverage of the 25% not supported by the SBA.

The buyer does not have to limit their down-payment to 10% or 15%, though. They may decide to put in 20%, 25%, or as much as they can afford.

Any amount not covered by the SBA or by your down-payment has to be covered by seller financing. Lenders tend to prefer deals where there is seller financing participation as they believe a seller will be more motivated to provide an orderly transition if they have a financial stake in the future performance of the company. Simply put, the bank prefers both buyer and seller have some "skin" in the game.

Seller be Beware: Seller Financing Is Put On a 2-Year Standby for Loan Payments:

With an SBA deal, any seller financing is put on a *minimum* 2-year standby. This means for the **first 24 months** (sometimes more) after the acquisition, **the seller does not receive any payments on their portion of the loan. No interest, no principal.** All interest and principal payments will ultimately be factored into the final years of the loan. The SBA and Bank want to fashion a transition and go-forward financial environment that is favorable to a new owner's acquisition.

Of course, most sellers are reluctant to agree to these terms. Therefore, most buyers will try and cover as much of the purchase price as possible not covered by the SBA loan. Since this usually amounts to no more than 20-25%, you are still receiving payback on your down-payment within the first year of your acquisition.

Deal Structure Restrictions: Earn-Outs, Employment Contracts, Consulting Agreements, and Partial Buy-outs.

SBA deal structures tend to be pretty simple to understand as they are made up of just three parts: the bank loan, the buyer injection, and the seller financing.

Some buyers and sellers may want to delve into more complex deal structures, but this should be done cautiously.

In an SBA financed acquisition, the seller is not allowed to be an owner, officer, or employee of the company after selling it. This will rule out employment contracts or partial buy-outs.

Additionally, while the SBA expects there to be a consulting agreement to help with "transition" services, consulting agreements (generally 2 – 6 months, but not exceeding a year) with heavy minimum payouts or performance bonuses can have a negative impact on first year cash flows. As a result, these are also generally not allowed. Earn-outs are also not allowed for the same reason.

The Most Common Questions

Securing the Loan: What Assets Will the Bank Require?

For the bank, SBA loans are obviously guaranteed by the U.S. Government. For a "service" industry business acquisition, this is a very good thing as "service" businesses are usually "hard-asset poor" and difficult to collateralize for banks.

The SBA gives banks the needed security to extend loans on "goodwill", but even with this

security, banks will not extend loans haphazardly. If a bank has a high default rate, it can affect their ability to extend new SBA loans.

Will The SBA Take a First Lien Position on All Business Assets?

Yes. In a SBA loan, the bank and the SBA will take a first lien position on all the business's assets. What this means is if the business were to go into receivership, the SBA would have the right to liquidate and collect payments first from any assets being sold.

After business assets, the SBA may move onto personal real estate assets with at least 25% equity, then, any business real estate. Many banks, however, will extend SBA loans without real estate security.

Finally, expect your lender to require Key Person Life Insurance. This policy protects the bank and the SBA in the event of your death. When applying for an SBA loan, get your life insurance screening done early as this can take a few weeks to process.

What Is The Difference Between A Preferred Lender vs. Standard Processing Lender?

There are two types of lenders who participate in SBA lending – preferred lenders and standard processing lenders.

The major difference between the two is found in the underwriting process. When you **work with a preferred lender**, the bank can manage the underwriting process without submitting your paperwork to a regional SBA office for review.

For a **standard processing lender**, your loan request needs to be reviewed by a regional SBA office.

Working with a preferred lender is usually significantly faster. That said, even if your bank is a preferred lender, they may choose to send your loan through standard processing if there is any uncertainty on the loan.

So just because you are working with a preferred lender, you may still find yourself waiting as the loan is reviewed by a regional SBA office.

How Long Does This Take? *Most SBA Loans Are Completed In 45-120 Days*

SBA lenders will sometimes tell you they can complete your loan in 30 days or less. While this may

be possible, it is my experience that you should count on a significantly longer process. In the real world, **expect 90+ days**.

The SBA Process

The SBA process involves a number of people who need to look at and review different parts of your application. Due to this, delays are almost always inevitable. The following 6 steps summarize the SBA process.

1.) Pre-Qualification: Talk to a banker and see if business would qualify for an SBA loan. Get Pre-Qualified.

2.) Submission: Submit loan application. Gather paperwork and submit for initial bank review.

3.) Commitment: Bank either approves or rejects application for underwriting.

4.) Underwriting: Underwriting process for approval.

5.) Authorization: If approved, transaction is set to close.

6.) Closing: Congratulations. Snifter clink!

How To Speed Up Your Loan Application. What Documents Will the Buyer Need?

The main complaint about SBA loans is the amount of time it takes to process the loans and the tedious nature of these loans. A Buyer can speed up the loan process by having documentation prepared and ready to submit.

The main documents you want to have prepared are:

- **Personal Financial Statement** – all SBA lenders require a fully completed personal financial statement.
- **3 Years Personal Tax Returns** – these will be used to validate your financial records.
- **4506-T Form** – this is used to validate the accuracy and the filing of your provided tax returns.
- **Loan Application Form** – this will be bank specific, but since the loan comes from the bank (the SBA only guarantees it), they will likely have a loan application for you to complete.
- **Borrower Information Form** – this is for SBA purposes and helps them track who is borrowing and how much. This is for statistical purposes.

- **Pro-Forma Financial Reports** – the bank will want to see your projections for the company you are acquiring.

Additional Documents SBA May Request from a Buyer:

- **A business Plan** – this seems to be a very common request among banks as it helps them know you have thought your acquisition through (and if you haven't, it will force you to put some thought into it).
- **A Buyer's Resume** – this helps the bank get an overall picture of your personal qualifications and skills for this business.
- **Profit & Loss Statements for additional Buyer Businesses** – if the buyer has other businesses, and these are funding your acquisition in any way, you will need to provide P&L statements for those businesses.
- **Balance Sheets** – again, this only applies if you are using an existing business to fund your portion of the acquisition, or if you are using a business to demonstrate stronger debt to equity ratios. If you are, you'll need to provide your balance sheets.
- **Miscellaneous Forms** – your bank may have additional forms for you to sign either due to their internal practices, or because of your specific type of deal.

What the Seller Should Be Prepared to Create and Submit:

The seller also needs to be organized throughout the process to keep things moving along quickly. Here are some things the seller should be prepared to create and submit:

- **3 Years US-Based Tax Returns** – if the seller has not yet filed for the current tax year, be sure this is done *before* you go through the process as it can take some time to validate a return which has been filed.
- **4506-T Form** – the bank will need to see more than just the tax return. They'll want confirmation from the IRS that the return was filed, paid, and is in good standing.
- **3 Years Of P&L Statements** – these should be accurate and kept up to date. The bank may request new P&L statements from time to time. Make sure your seller is aware these need to be completed monthly in a timely manner. If your seller runs more than one business through the same parent company, you'll need to send P&L statements for all the businesses they run. The bank will need to verify all the numbers match the tax returns exactly.
- **A Balance Sheet** – this should be current at the time of submitting the loan.
- **P&L Before Closing** – oftentimes before the closing table, the financing institution will require a "trailing 12" P&L statement with the prior years comparison for a final update as to the business's financial status. If a downturn of 10% or more occurs be prepared for serious questions, a possible pause in the loan process (to observe the company's

performance), and/or a reconstruction of the terms.

Is Using an SBA Loan Worth It?

Buyers who have been through the SBA process often have similar feedback: it is hard work, takes a bit longer than they expected, but completely worth the headaches. Not only do SBA loans allow a buyer to leverage the deals purchase price and put less money upfront, they also help shape the acquisition's deal structure which incentivizes the seller with a more solid and competitive offer.

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