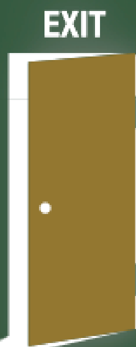
How to Fund Ownership Transfers Using the SBA

How the SBA Can Help You Successfully Exit Your Small Business



David Ryan, Sherrill Stockton and Scott Ford

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Here's What's Inside…

Why Don't More Businesses Have Success Transferring from One Generation to the Next....3

The SBA Guarantee....7

The Reasons Deals Don't Get Closed and Common Misconceptions about the SBA....9

Who Is Most Likely to Buy a Business....17

The Misconceptions About SBA Loans....23

How Working with a Lender Familiar with the SBA Is Critical for Your Success....28

SBA Success....32

Have a Financial Plan Before You Sell....38

How the SBA Can Help You Successfully Exit Your Small Business....41

About the Authors....43

Introduction

Chief Executive magazine stated that 80% of business owners want to pass the family business to the 2nd generation. However, the problem is that only 33% of these businesses will succeed as a going concern after the transfer. Since a business owner's company often represents up to 70% percent of their overall wealth, it is critical that when they transfer ownership, it is successful.

The majority of small family businesses in the $1–$5 million value range will someday face the challenge of an ownership change between family, partners, or employees; sometimes it is all three at once. With one business owner turning 65 years old every minute, this reality is becoming more and more commonplace.

As you will learn, selling to a third party is not always a viable option- in fact, approximately 80% of all small businesses that go to market are not sold.

The Small Business Administration's program discussed in this book enables business owners to transfer their businesses in a way that maximizes the value that they've created and allows the businesses to continue generating economic revenue and providing employment.

Unfortunately, there are a lot of misconceptions about using the SBA loan programs to help business owners transfer ownership. This book will educate you on how to use the SBA program effectively, so you can work through the three most common reasons transactions fail to close.

Enjoy the book!

We hope this book inspires you and gives you the confidence to see a clear way that you can transfer your business from one generation to the next and take care of any children working in the business and any children working outside of it.

To Your Success!

David, Sherrill, and Scott

Why Don't More Businesses Have Success Transferring from One Generation to the Next

Business owners only get one chance at successfully selling their businesses. Very often, they have never attempted to do so. Throughout our years of experience, we've seen what works and what doesn't when it comes to transferring businesses.

Often, business owners try to self-finance the transaction. While this is admirable, it can lead to financial disasters for families for many generations because there is such a high failure rate.

Many business owners have learned (or will learn once they have tried to sell their businesses on their own) that the majority of businesses for sale will not be sold. The database on Bizbuysell.com represents the Internet's largest database of businesses listed for sale. It states there are 45,000 listings at any one time, yet the highest number of businesses that have sold in one year on the site is less than 8,000, which represents less than 20% of the total listings.

When surveyed, more than 70% of business owners indicate that they want to transfer their

businesses to family members, yet the majority of these businesses will fail after transfer. In our experience, too many businesses owners self-finance the transactions. While the intention of this method is good and often justified by the interest rate stated on the return, it has proven time and again to be a financial disaster for the family ultimately destroying the family estate.

Here's an example: Business owners Nick and Judy are ready to retire and would like to sell their company to their daughter, Kim. The business has a value of $3 million. It is not likely that Kim, on her own, has the credit to purchase the business.

One of two things would typically happen in this situation. Nick and Judy co-sign on a loan at the bank for $2 million and then accept a five-year employment agreement for the remaining five years for the $1 million balance, being paid $200,000 per year. Now say an economic downturn occurs, and Kim cannot afford to pay the obligations to her parents. Nick and Judy now have their retirement at risk, they have the proceeds from the $2 million bank loan but they have guaranteed the loan and if Kim defaults they must pay it back. Depending when this happens they may be short and will have to dip into their savings because they received the $2 million net taxes. They will also lose the

$200,000 income they were being paid from Kim.

As you can see selling to children this way causes a financial increase of risk for both generations.

The parents have their retirement at risk, the parents' financial estate is diminished, frequently to such an extent that other siblings, college education for grandkids, and level of retirement are all disrupted. There is no need for this to happen.

A conventional note to be co-signed with Kim with reasonable terms and conditions is really not going to be available from conventional lenders. Most banks are not comfortable with loans to fund business transfers, so they require a large portion as a down payment and will make the terms short and interest rate high. As we discussed, they will make the seller personally guarantee and have secondary assets as collateral. As a business owner who has created value over many years approaches the sunset of their involvement with their business, they typically do not have much new business acquisition debt which, in turn, can allow the business to support the debt. In this particular instance, Nick and Judy have a business that's worth $3 million based on revenues.

In general, if you borrow money to buy a business, the longer you can stretch out the repayment term, the smaller the loan payments will be and the more likely that the business is going to be able to repay the debt over the course of the loan. In these types of transactions, where you typically don't have much in the way of collateral, such as equipment and fixtures, you usually have a significant amount of goodwill. A conventional lender might do a five-year term on this loan, whereas the 7A loan from an SBA lender could extend the loan to 10 years. This will provide a significant amount of debt-service relief by terming out the loan for that longer period.

One of the other challenges that business owners face when preparing to transfer the ownership of the business is dealing with their emotions. Selling a business to which you are very attached can bring up a lot of emotions. Warren Buffett says emotion is far more important than intellect. A book called Crucial Conversations speaks to the emotional component of business ownership and transfer. If you're looking to pass a business on to the next generation, it is imperative that you have a conversation that is not about emotion but is a dialogue of shared meaning in order to get to the best answer for all parties.

The SBA Guarantee

The SBA 7A loan program is The Small Business Administration's largest lending program. Many people don't understand how SBA loans work. As part of the SBA 7A program, the SBA does not directly lend the money in the transaction. Participating lenders who are involved in the program lend their money to the borrowers. The SBA provides a percentage guaranty on these lender-funded loans, thereby mitigating some of the risk inherent in financing business acquisition transaction. The SBA loan program provides for longer loan terms which helps with cash flow for the new owner.

When someone like Kim, from our earlier example, hasn't built up a long credit history or doesn't have much in the way of financial wherewithal or net worth, a bank will not normally take on her risk; however, with SBA involvement, they often will.

The maximum loan size in the program is $5 million. For a business acquisition—a change-of-ownership loan—the loan can be amortized for up to 10 years. Sometimes, if the change of ownership involves the business and some real estate and depending on the largest portion of the use of proceeds of the loan, the bank can amortize up to 25 years.

The typical reasons that people need an SBA loan are: they don’t have as much cash as a conventional lender might require them to put down in this type of transaction, the business can’t afford the shorter three- to five-year term that a conventional lender would require, and they simply cannot find financing to sell the business. Involving an SBA lender gives them more options than they would have when trying to sell their business without the SBA’s help.

The Reasons Deals Don't Get Closed

The Misconceptions by Sellers:

- Buyer must be a bad credit risk;
- It takes too long to get a loan through the SBA;
- I do not want an SBA; I want someone who can pay cash;
- SBA loans cannot be used toward goodwill;
- You must be declined by three banks in order to apply for an SBA loan;
- I cannot sell my business to a family member using and SBA loan.

Some of the common misconceptions about SBA is that if you're getting an SBA loan, the buyer must be a bad credit risk. That's not true. SBA was created in 1953 to be a gap-financing vehicle; essentially, it's for borrowers who are not quite qualified to be conventional borrowers. The idea was to benefit small businesses because conventional lenders don't lend to small businesses, especially in their early stages or in a change of ownership.

An SBA borrower is not a bad credit risk; it's simply a borrower that appears to be risky because of what a conventional lender's "box" looks like. An SBA guarantee allows banks to

make these loans, with the certainty that in the event of a default, SBA will share pro rata in any loss. This mitigates a bank's loss given default.

When speaking in front of business groups we often ask for a show of hands from people who have heard horror stories about getting SBA loans. Usually, a lot of hands go up. The reality is that most SBA lenders are preferred lender providers. SBA has delegated approval, authority, servicing, liquidation—just about everything that you would do with an SBA loan—to that SBA lender. The only interaction that happens with SBA when a bank gets a business loan approved is that they enter information into the SBA's system and the lender receives a loan number. The rest of the process is handled internally by the bank.

When it comes to change-of-ownership lending, there is some complexity and the rules, especially recently, have changed a bit. An SBA lender must maintain program expertise as it relates to all facets of SBA lending, especially eligibility requirements. An inexperienced lender may inappropriately be denied.

For instance, if a lender is trying to help Kim get a loan and doesn't realize some of the idiosyncrasies of the eligibility, they might get deeper into the organization only to speak with someone who is a little more knowledgeable

about the rules inside their bank who says, “You can’t do that. This is structured incorrectly.”

Typically, that loan officer doesn’t go back to the borrower saying, “Sorry, I made a mistake,” or, “My bank made a mistake.” They usually blame it on SBA. They may even blame a slow underwriting process on SBA, but the reality is, none of it is the SBA; it’s the internal workings of the bank.

We always coach potential borrowers to make sure that they do some due diligence surrounding their lenders, those lenders’ experiences doing change-of-ownership transactions, and how long they’ve been doing SBA lending. Potential borrowers should answer the questions: Is your lender the person that you deal with most? Are they knowledgeable about the program, and are they giving you the right information?

Many sellers don’t want to do business with someone who has to get an SBA loan; they want someone who can pay cash. When selling to a third party, there aren’t many buyers who have $3 million in cash to buy a business.

People also think you cannot finance goodwill with an SBA loan. In fact, in change-of-ownership situations, typically the bulk of loan proceeds fund the goodwill of the business, which the banks determine with an independent valuation.

Over the years, small businesses have created goodwill as a result of their operations. While this is true, sellers oftentimes have an unrealistic idea of the value of a small business.

When using the SBA loan program, an outside third party comes in and says, “You don’t get to determine what the value is. You may have an idea, but we require an independent, third-party evaluation of the business that reviews the financial information over the past three years and then performs an analysis to determine the business’s value.” The financial information is all that the bank and their third party valuation expert are able to use to determine the value of a business. This, in fact, helps to keep emotions out of the process because it’s ‘just the facts’.

Another misconception that business owners have is that they can’t sell their business to their families. This is because, many years ago, you were not allowed to sell to family members, but this too has changed. The independent third party evaluation ensures the bank is lending based on an arm’s length value.

The Misconceptions of Buyers:

- Because the SBA guarantees this loan, the lender doesn't care if it's a good deal;
- The SBA application is over 100 pages;
- I have too many assets to qualify;
- SBA is only for Main Street Liquor stores and gas stations;
- Friends told me the SBA would finance 100% and I won't need a down payment.

Buyers have misconceptions about the process too. For instance, buyers think that if SBA guarantees the loan, the lender doesn't care if it's a good deal. That's not true. The beauty of the public-private partnership between SBA and the participating lenders is the lender has capital at stake, as does SBA, because they guarantee a portion of the loan, typically 75%. The lender has 25% at stake, and lenders don't put 25% at stake for what they perceive to be bad borrowers.

Banks take seriously the underwriting and analysis of a transaction and determining whether or not they will be repaid from the cash flow of the business. Risk is perceived because of new ownership, not necessarily bad borrowers.

The SBA application is not over 100 pages, although people think it is. The forms you fill out are similar to what you would fill out for a conventional commercial loan. Because an SBA lender prepares a fair amount of paperwork

internally, the applications the borrowers fill out are usually tailored so the borrower has to provide some basic information in one format. Then the lenders, transfer that information into the different forms they need to use in SBA lending process, a few of which are different than conventional lending.

Some people continue to believe they have too many assets to qualify for an SBA loan. Many, many years ago, one of SBA's eligibility tests was the "personal resource test." It said a borrower could not have a certain threshold of liquidity. If you were trying to get a $1 million loan, for instance, you could not have $1 million of liquidity.

The personal resource test was eliminated about three years ago. Now borrowers don't have to worry about too much liquidity to get SBA loans. That being said, if you're looking for a $1 million loan and have a $1 million cash, there is potentially a credit issue elsewhere, otherwise why do you need to finance 100% of the business? A borrower credit profile remains a very big deal in SBA lending.

If banks can qualify for conventional financing on reasonable rates and terms, then there is no need for an SBA guaranty.

People still believe that SBA loans are only for Main Street liquor stores, gas stations, or

businesses that have a lot of tangible collateral, but that is not true.

SBA considers 100% financing to be inherently risky. One-hundred percent financing on a change of ownership would position the business to have a lot of leverage on it. Usually, a selling owner has paid off debt; oftentimes, the business is relatively debt-free. Leveraging on 100% financing oftentimes doesn't make the most sense. Of course, there are a few exceptions and it certainly can be done if it's reasonable for the business and for the borrower.

If Kim is buying her parents' business, but she doesn't have any personal liquidity to inject into the transaction, a lender might say, "We're going to do a loan for 75% of the purchase of this $3 million business, and we'll have Mom and Dad carry back a seller note." Mom and Dad can get the bulk of the cash, and have a seller note that gets paid back over time. That's additional cash flow for them, but they have still received a significant chunk of cash right from the start, when the transaction happens. The cash received upfront is not subject to the creditors of the business nor has Mom and Dad co-signed on the loan. This significantly reduces the family's overall financial risk as it relates to the success or failure of the business.

In a change-of-ownership transaction that involves a business with a value in excess of

$500,000 in goodwill, there is a minimum 25% equity injection required. Most of the time buyers don't have 25% in cash, so SBA has allowed, in these types of transactions with these characteristics, the seller to carry back up to the entire 25% or, if the borrower has 10%, for instance, and the seller carries 15%, this combination would make up the 25% required.

That seller equity can be counted towards the equity requirement of 25% as long as the seller note is on full standby for the first two years. It can accrue interest, but no payments can be paid for those first two years. This is a carve-out of sorts that SBA has allowed in these transactions, realizing that many of the buyers don't have 25% cash to put down on a $3 million purchase.

Who Is Most Likely to Buy a Business

	Under $500K	$500k-$1M	$1M-$5M	$5M+
1st Time Buyer	48%	44%	27%	7%
Existing Company	19%	21%	32%	35%
Individual who previously owned a business	33%	34%	31%	3%
Private Equity Firm	0%	1%	10%	54%

What would a traditional business sale, which is not using SBA, look like if the business was sold to someone outside the business, and who might that person be?

The first thing to consider is who is likely to buy a business. Pepperdine University and the Graziadio School of Business and Management does a quarterly survey with two M&A trade associations, M&A Source and IBBA, and compiles results from over 300 business intermediaries. One section analyzes *who* bought the businesses sold during the quarter and *how much* they paid for the businesses. Also included

is *how* the transactions were structured, and whether or not they included working capital.

Who's most likely to buy a business? For a business under $500,000 in value, the buyer is most often an individual and a first-time buyer. The number one reason an individual and first time buyer buys a business, according to the survey, is because they are essentially looking to "buy a job" and because of this and the fact that it's a small business, the buyer is going to come in with their own equity, often up to 60% or 70%.

For a business between $500,000 and $1 million in value, 44% of the time the buyer is also a first-time buyer. The second most frequent buyer, at 34%, is an individual who has already owned a business. Both of these buyers are individuals looking for a job and paycheck as their primary motivation. The structure of the transactions in this price range reflects that a buyer will put 40% of their own money down and a commercial bank will finance 40% with the balance being finance with a seller carry note or an earn out.

These facts are important when financing because it helps you understand the strength of the using the SBA. When buyers purchase a business at this value, they come in with 40% of equity, bank financing of about 40% and a seller-financed note for the remaining 20%.

TYPICAL DEAL STRUCTURE

	Under $500K	$500k -$1M	$1M- $5M
Buyers Equity	67%	44%	40%
Senior Debt	16%	42%	40%
Seller Financing	14%	13%	15%
Earnout	1%	1%	5%

For a business from $1 million to $5 million dollars, the buyer comes in with 40% of equity in the form of a cash contribution. The buyer goes to the bank, and the bank matches that 40% with a loan. The seller is usually obligated through either a seller finance note, earn-out, or some other contingency to finance 20% of the transaction.

It is interesting to note that the buyer of a business over $5 million in value is most often a professional buyer, either from an existing business or a private equity firm. You can understand this because there are very few individuals with the money to buy a business valued greater than $5 million dollars.

To summarize, a buyer of a $5 million business will come up with $2 million of their own equity, $2 million from a bank, and the owner is going to have to carry $1 million in the form of a seller note or earn out, or combination thereof. When you consider a business with a value of $5 million, how many people are really going to be able to come up with $2 million?

Employees who want to buy the business certainly are not going to have $2 million; nor is a family member.

As you can see in the results of completed transactions through June 30, 2015, in a typical deal structure for a business valued between $1 and $5 million, a buyer's equity would need to be 40%. The senior debt needs to be 40%, and seller financing or earn-out traditionally reflects 20%. This was the average at the time in which the survey was conducted; the structure doesn't always necessarily need to follow this structure.

The chart below shows a comparison between a traditionally structured transaction and an SBA-financed transaction for a business valued at $2.8 million, as found by the Pepperdine survey.

Sample Structures	Traditional Per Survey		SBA Scenario	
	Assumption Factors	Commercial Loan Details	Assumption Factors	SBA Loan Details
EBITDA	700,000		700,000	
Valuation Multiple	4.0		4.0	
Purchase Price	2,800,000		2,800,000	
Transaction Assumptions:				
Required Buyer Injection	60%		25%	
Buyer Injection - Cash	*40%*	**1,120,000**	*10%*	**280,000**
Seller Carry	*20%*	**560,000**	*15%*	**420,000**
Loan Assumptions:				
Principal	40%	1,120,000	75%	2,100,000
Interest Rate - fixed	5.25%		5.25%	
Amortization years	7		10	
Monthly Principal & Interest Payment		**$ 15,962**		**$ 22,531**
Annual Debt Service		$ 191,543		$ 270,375
Seller Carry Note Assumptions:				
Interest Rate	7.0%		7.0%	
Standby Period years	0		2	
Amortization number of years	5		7	
Initial Loan Balance	560,000		420,000	
Accrued Balance				
Yr 1 Accrued Interest	-		29,400	
Yr 2 Accrued Interest	-		31,458	
Accrued Principal	560,000		480,858	
Principal and Interest Payment		$ 11,089		$ 7,257
Annual Debt Service		$ 133,064		$ 87,089
Annual Debt Service yrs. 1 & 2		**$ 324,607**		**$ 270,375**
Annual Debt Service yrs. 3-10		$ 324,607		$ 357,464

In this example we are showing a company with an EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) of $400,000 and applied a 4X multiple, which happens to be the average multiple over a number of deals for this size range per the Pepperdine survey. Using this multiple of EBITDA, you would come up with the purchase price of $2.8 million. In our example we are using the average deal structure represented in the survey which requires the buyer to inject $1,120,000, the seller to carry or finance $560,000 and the lender to provide a loan for

$1,120,000. This structure would deliver a business value of $2.8 million to the sellers.

You can see why so many businesses that reach $5 million and above in transaction value are purchased by corporate buyers or private-equity backed enterprises. The buyer would go to their bank and get a loan for about 40%, which is $1.12 million in this example, and, using the average terms and conditions for the market right per the survey, they would have about 5.25% interest rate. The amortization for that loan, however, is 7 years due in 5 years.

Compare that to an SBA loan, which is a 10-year amortization, where the traditional is at 7- year amortization. The other problem with this is if you can get a seven-year amortization conventionally, you're going to have a balloon payment, usually anywhere from three to five years. This often requires the business to go through another round of bank financing to refinance the balance due. With the SBA loan, there are no balloon payments. The SBA provides a much more stable environment for the business to operate, additionally there are no prepayment penalties with a SBA business ownership change in control loan.

The Misconceptions About SBA Loans

One of the complaints people have about SBA loans is there are too many fees, but often this does not compare apples to apples. You need to look at the fees of a loan due in three to five years, compared to an SBA loan with a 10-year amortization, because they could double or even triple during the life of a traditional loan due to the need to get reapproved one to two more times over that 10-year period.

Because there's such a large amount down, a borrower would expect the monthly payments to be significantly less with a conventional loan; because of the lower loan amount, however, the debt service payments are not significantly different. In our example, the payments for years 3-5 with a conventional loan would be approximately $324,000, whereas an SBA loan's payment would be $357,000. With a conventional loan you would need to refinance in three to five years and have the loan reevaluated to be refinanced. It will be subject to new cycles, so you have to continue with the trends. All your ratios have to be in order, and it could ultimately be a high-risk situation because no one can foresee the future or the ability to refinance a conventional loan.

Then you have a seller carry note, which is typically 20%—$560,000, in this case. That's typically amortized for five years, and that note is usually subordinate to all the other expenses in the company, so the seller is the last person to get paid if something goes wrong.

Let's further compare the above traditional bank loan scenario to the SBA's structure. Most of the people to whom you are looking to transfer your business, be it family members, partners, or employees, do not have that 40% equity, $1,120,000 in our example, yet they're probably the best buyers to keep the business going, especially when it comes to keeping your customers, who have become part of your family. They already know the employees and the management and are in the best situation to provide continuity for the business.

With the SBA, these buyers need to put down 25% and there are a lot of ways for them to come up with that money- it does not have to be a cash down payment of $700,000.

While the 25% equity infusion required in change-of-ownership transactions, it is the only type of loan transaction for which SBA has a hard-and-fast equity requirement, and that is because the bank is financing goodwill, which is an intangible asset.

Understanding that these borrowers typically do not have the 25% in cash, the SBA lender will look at the wherewithal of the borrower and whatever they have to put in as part of their consideration. While the SBA requires 25% of the purchase price of the business as equity, they allow the seller note to comprise a portion of that 25% equity. Let's say my borrower has 10% to put down, and the seller is willing to carry back 15% of the purchase price. If the seller structures that note to be on full standby for two years, it can accrue interest, but it's on full standby for two years. Coupled with the 10% the borrower came in with, that can make up our 25% equity requirement in these types of transactions. In the example above, the borrower will need to come in with $280,000 and the seller would carry a note for $420,000 which is less than they would be required to carry with a traditional transaction where the seller would carry $560,000. In this case, using the SBA is good for both the buyer and the seller. If the buyer, the family member, or the employees can come up with 10%, the seller will actually come out ahead, with more cash out.

The 25% can come from a number of other sources. For example, think of a borrower who has equity in their home and is able to get a HELOC (home equity line of credit) on their home. If they have other outside sources of income—for example a spouse who works or

investment properties that produce income—the borrower can show the repayment of that HELOC is not reliant on the business profits to service the debt associated with the HELOC and the money borrowed can be counted towards their 25% equity requirement. Any amounts they borrow that they can repay outside of the business cash flow are considered as equity and can help the borrow reach the 25%.

Another situation that we see are sellers who are willing to carry more than 25%. These sellers may, for one reason or another, be willing to carry 40% of the purchase price. One reason for this is that the sellers have other funds for retirement and they are not ready to touch these funds for a few years while they continue to grow, these sellers are happy replacing their current income with the monthly note payment.

For example, let's say in this case we're dealing with a borrower who doesn't have any money to put in. The seller could do two notes: one note for 25% that they put on full standby so we meet that threshold and another note for 15% that would allow them to start receiving principal interest payments right after the close of escrow. This is because only 25% of the seller notes need to be on standby- the other note can receive payments immediately. There are many different ways to put things together to make it work.

If, for some reason, you have a transaction for which you can't get the 25% from the seller or from the buyer, but you feel that there's a compelling reason that the transaction still makes sense, you can send it to the processing center. In that case, SBA reviews the file and looks at your rationale for doing a loan with less than 25% equity, whether it be borrower equity or seller equity.

In one case, a banker worked with a borrower who only had 5% cash to put down on the transaction. The borrower happened to own a home free and clear that they were pledging for the transaction. The banker reasoned that their home was a significant personal asset contributing to the overall transaction; it was akin to skin in the game, much like a cash injection. The SBA was fine with that rationale. It's really all about the borrower's skin in the game of the transaction and the skills of the lender.

How Working with a Lender Familiar with the SBA Is Critical for Your Success

A lot of lenders think of this 25% rule as a hard-and-fast rule without realizing technically the rule is simply the threshold under which you can do it as a delegated lender. There are a lot of nuances in SBA lending, and it is important to work with someone who understands them.

The equity injection can be a gift from a direct family member, or it can be an injection from a minority partner. Anybody under 20% ownership does not have to provide a personal guarantee.

There are firms that help facilitate rolling a buyer's retirement account into a corporation, which then funds the purchase of the business or the down payment for the purchase of the business. Essentially, you invest your retirement in your IRA (individual retirement account) into the business.

There are firms that manage all of that paperwork to make sure that it's not a taxable event. We have seen many borrowers use this method to come up with their 10% or whatever amount they need. Additionally, people can sell homes or other personal assets to come up with the cash, and then, as discussed previously, a

seller note on 2 year standby can be considered equity.

Injection from a minority partner is being discussed more and more. In our society right now there's a trend toward 'crowdfunding'. This is a way for a community to help fund the down payment so a potential borrower can buy a business.

A borrower may reach out to family and friends and say, "I have an opportunity to buy a business, and I need to come up with a down payment." Several family members or friends may become minority partners and invest certain amounts in that person's endeavor. It's an investment like any other investment, but they're investing in someone that they know and believe in. We see that quite a bit.

For instance, we structured a transaction for two borrowers with great backgrounds and great educations, but who were very inexperienced as business owners. All of their minority investors had significant professional careers and wherewithal, and they were going to come on as the board of directors.

They would advise these borrowers, but they were also funding the injection; therefore, they got equity in the business commensurate with what their investment was in the business. The minority partners with their cash injection and

significant business experience helped the bank feel comfortable with the transaction. What those minority partners brought to the table helped the bank to be comfortable with that transaction. Most of the minority partners did two different notes. Some of them just invested money, and they received a percentage interest in the business, but they also did notes that they put on standby for two years to help the young borrowers get the business up and running. There are lots of creative ways in which you can cobble these transactions together.

If you're a professional working with a borrower who happens to be talking to somebody who's trying to sell to their family, employees, or a third party, make sure that you start talking to a knowledgeable SBA lender early on in the transaction so you understand some of the bright-line eligibility issues. You must understand what can and cannot be done from a structural standpoint. When parties negotiate these types of transactions, there's a lot of emotion involved. You haggle back and forth to come to an agreement.

If you haven't talked to your lender, you may be structuring your transaction with components that don't work with SBA financing. If that happens, your lender may say, for example, "We have to unravel what you've done here and this earn-out is not allowed," or the seller will want

to stay on for two years to help with the transition. SBA only allows a seller to stay on in a significant role for no more than a 12-month period. As you're negotiating, go over any drafts of documents you're preparing before everybody agonizes over the final deal; it's not fun for either party to have to go back to the other and say, "We have to negotiate this again." This tends to lead to 'deal fatigue' which is a major factor in deals falling apart.

SBA Success

Returning to the chart above, let's do a final review in our comparison of what the SBA loan would look like with a 10% buyer injection and a 15% seller carry back note compared to a traditional transaction. In the figure above, you will see that now the person only needs to come up with $280,000 for the down payment, which is 10% of that $2.8 million. The seller is carrying 15%, so instead of carrying $560,000, they're carrying $420,000.

The big difference appears in the amount financed. Because of the 25% SBA guarantee, the bank feels more comfortable lending $2.1 million. We're going to use the same interest rate at 5.25%; however, the amortization goes up to 10 years versus 7 years. This is not going to be due in three, four, or five years; it's a full 10-year amortization.

The seller-carried note is still 7%, has a two-year standby, and amortizes for five years after that, but, again, it's $420,000. Because of the interest that gets accrued for the first two years, when it starts amortizing, it's $480,000.

It's also worth noting that there is no prepayment penalty here, so if the business cash flow is robust and the borrower wants to pay the loan off sooner, he or she can do that.

In years one and two, the annual debt service in the SBA scenario is actually less. Even though you're borrowing substantially more from the bank, because of its structure, the annual debt service is much smaller. Years three to ten are not much different. When you consider that the SBA borrower did not have to come up with an additional $840,000 (which is the difference between the 40% down of $1,120,000 with the traditional transaction and the $280,000 with the SBA sample), it is because of this cash preservation that the business is in a much more financially secure position. This helps protect the "golden goose" for the next generation.

Part of the rationale for requiring a seller carry note that is put on standby is that the transition risk is greatest during the first few years and having the notes on standby helps with the cash flow during this time. When it comes to the debt service being $54,000 less in years one and two, SBA deliberately decided on that to help with the cash flow during the first few years. Their thought process is that if they can minimize the debt service in those first couple of years, when the transition risk is greater, then they're doing a service to the small business and are helping to ensure its chances of success. That's accomplished by having a lower debt service requirement in those first two years.

SBA bank lending is a lot more covenant light than traditional bank lending. Traditional bank lending may require that your accounts payable, your accounts receivable, or your equity stay within certain ratios. With the SBA, once the loan is made and you're making the payments, you're all set- there are no potential covenants that a business may trigger which could cause the loan to be in default. Borrowers are required to provide periodic financial reports to the lender.

What's the reason for allowing the loan to be covenant light? The SBA is providing a guarantee to the lender making the loan to protect them in case of a loss which would only happen if loan is in default for failing to make a payment. The lender can then go back to the SBA and say, "The loan defaulted; they didn't pay us back". The lender would liquidate whatever collateral they had, and in these particular transactions, the bank typically doesn't have much collateral. The lender would then tell the SBA "Please pay us our pro rata share of the loss." A default boils down to the borrower failing to make payments; therefore, a payment default is the only type of default that a lender can use to say to SBA, "Please honor my guarantee."

Let's say as an SBA lender I want to put in covenants, like a liquidity covenant, a changeable net worth covenant, or a debt service coverage covenant. I put a covenant on my loan, which is

what a conventional lender would do, and the borrower has a dip in debt service coverage and doesn't meet the 1.5 or 2.1 debt ratio that a conventional lender might require. The conventional lender has remedies. They can tell the borrower to bring that up or bring more cash in and true up that balance sheet. If they don't, the lender can implement a default interest rate and can call your loan if it chooses to.

An SBA lender has none of those remedies at its disposal if it creates covenants and the borrower can't meet them. If an SBA lender calls the loan because the covenants aren't met, and, because it called the loan, the business fails, it can't go to SBA and ask for a pro rata share.

Because of the lack of the lenders ability to enforce the covenants you do not see covenants on SBA loans. An SBA lender may look at a transaction and decide to put in the authorization to limit the owner's compensation to $200,000 per year because they see an owner taking what they consider to be excessive compensation out of the business. In that case they can put that in as a covenant and put the borrower on notice. That may be good business sense in a particular instance, but the lender would typically never call the loan because they have no remedies that wouldn't invalidate their SBA guarantee.

If you hear someone say they are “covenant light,” this is what they mean. The lender could, in fact, include these covenants, but it wouldn’t behoove the lender to do so because then they’re stuck not being able to do anything about it without voiding their SBA guarantee.

The SBA does not allow for contingent payments such as an earnout, and this prohibition can help to keep a transaction structure cleaner. A seller who is negotiating with family members, an outside party or employees, for example, often sees a bright future for the business because of their own current actions in the company. Their actions—their “secret sauce”— is what created value. Because of this, a seller oftentimes says, “I’m going to sell the business to you for $4 million, but I want to structure the contingent payment or earn-out so that if the business hits $6 million in revenue next year because of all the contacts and everything I’ve done this year, I can increase the amount that I earn from the sale of this business.” This prohibition is a really valuable tool for a buyer who is negotiating with a seller who is trying to impose that type of an earn-out since they believe their legacy will continue to generate increased revenue because of what they’ve done.

This can also be a helpful tool when dealing with a buyer that wants an earn out to help provide a way to reduce the purchase price by making

payments contingent on the future results of the business.

Both the buyer and seller may agree to a contingency payment, but they are prohibited in SBA lending. The SBA’s stance is that the business owner ran their business for all these years and benefited from all of the revenue that they were able to take out of that business, making themselves a good life. Now they’re selling the business and handing the keys over to a new buyer, who gets to add their own secret sauce and create value and revenue based on their efforts.

Two other rules that help with an orderly transition is that an owner must sell 100% of their interest in the business and only remain in a significant role for a 12-month period. During this time the seller can stay on as a consultant, and receive compensation for doing so, in order to aid in the transition from seller to buyer with no contingent payments. That’s really powerful when you’re trying to buy out a partner because a partner doesn’t want to miss the next year’s work or is having a hard time fully letting go of the business. These rules ensure an arm’s length transaction. There’s a complete transaction upfront, and that’s it. The seller doesn’t get to keep coming back for a second bite of the apple.

Have a Financial Plan Before You Sell

Before you sell your business, determine the number you need to be able to live the life you want for you and your family. Determining this number is what a wealth plan/financial plan is all about.

Then it's important to determine your "family benchmark". Instead of chasing markets and taking on more risk than you're comfortable with, get clear on what rate of return you and your family need to live in order to feel balanced, fulfilled and have the money you need for the rest of your life.

Once that's decided, don't take on any more risk than you need to in order to hit that number. Business owners often take on risk, which is how they grew their company. We have heard it said and believe it to be true that you *concentrate* to create wealth, and you *diversify* to keep wealth. By starting a business, you're concentrated; all your risk is in one spot.

You seek to diversify to potentially keep your wealth. (Note: There is no guarantee that diversification will enhance overall returns or outperform a non-diversified strategy. Diversification does not protect against market risk nor does it assure a profit or protect against

a loss.) Therefore, it's key to get clear on the number and then not take on any more risk than you need to. There is a simple way to gauge that number. First, determine the income that you're living on now, if you're comfortable and you're living well. Let's say that income is $150,000.

Let's assume you can get a 5% rate of return after retirement. Multiply your income of $150,000 by 20, and $3 million is your number. You could be kicking off a $150,000 income stream based on a 5% rate of return. That's a simplified way—or a starting point— get some professional help to fine tune that number.

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing. No strategy assures success or protects against loss.

Next figure out the approximate value of your business and remember that change-of-ownership transactions are complicated, and SBA rules around them can be complicated. Dealing with a lender that is learning as they go is not good for the buyer or the seller. There is risk involved for the banks and, even with the 75% guarantee which encourages the bank to make these loans, they are not a sure thing. While many banks claim they make these loans,

they are simply not versed enough in SBA lending or familiar with the characteristics of a relatively collateral-free transaction. A $5 million commercial real estate loan is quite different from a $5 million change of ownership loan.

The real estate may not be worth $5 million at the time that the loan defaults, but there is some collateral to liquidate which makes traditional bankers comfortable. Despite the SBA guaranty, many lenders are unwilling to take the risk of lending on significant goodwill.

We recently worked with two buyers named Alex and Eddie who talked to more than 40 lenders before we helped them, and some of them couldn't figure out how to make their scenario SBA-eligible because of the structure that they put together. They had done their homework and created a structure that hit on a lot of eligibility considerations- so many so that they overwhelmed most of the lenders.

Some of the lenders couldn't figure out how to make it eligible. Some of them felt it was too risky and didn't bother to figure out how they could tweak the structure to make it less risky. We share this with you because not all SBA lenders are the same and you need to make sure that you work with a good lender who understands these types of transactions and can help you navigate them.

How the SBA Can Help You Successfully Exit Your Small Business

“Knowing your number” before you get ready to sell your business is key. Think about the questions: What do I have now, and what do I need? Most people do not have their number figured out, but with a little work, you can get there quickly.

In addition to knowing what your number is when you decide to exit your business, an important question is, “Am I ready to retire?” Some people are not. You need to plan and understand what should and would happen if you did not show up to work tomorrow.

If you are looking to get a realistic idea of what your business is worth when you decide to sell it, there are scaled-down business valuations that you can utilize. It’s a good idea to do so in order to have a realistic idea of what your business is worth, if for no other reason than to compare to it to the number you need to comfortably retire. It’s a good tool for planning and to help with starting the process. Just remember that when you decide to sell your business, a bank will need an independent valuation they can’t use that same valuation for underwriting.

If you are interested in transferring your business to family members, partners, or employees, send an email to scottf@cornerstonewealthgroup.com. We'll respond with a list of resources to get you started that will include a list of valuation experts that we know are employed nationally by SBA lenders and other articles that you might find helpful.

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David Ryan has more than 25 years of experience in the Mergers & Acquisitions industry. He has initiated and completed a wide range of mergers, acquisitions, sales and financings for an extensive range of clients.

David's previous experience as a practicing CPA (Certified Public Accountant), CVA (Certified Valuation Analyst) and investor has proven to be an ideal background to work with buyers, sellers and their representatives in structuring and completing transactions. David was the 2015 recipient of the Darrell Fouts Award, an award granted by the M&A Source for his visionary leadership and exceptional contributions to the professional association.

David's activity in professional organizations include past chair of the M&A Source (the largest association of middle market intermediaries), past co-chair of the Midmarket Expo (where he worked with over 150 private equity groups), and member of the American Institute of Certified Public Accountants. David has been published in Forbes, CNBC and other publications and is currently an active member of the Market Pulse Survey, a quarterly report of

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Sherrill has over 25 years' experience in SBA lending. She joined Live Oak Bank in 2015 after spending 20 years working in Northern California. Sherrill is nationally recognized as an industry leader and is serving her second term as a member of the Board of Directors for the National Association of Government Guaranteed Lenders (NAGGL). Sherrill has also served on the Executive Committee, and chairs the Technical Issues Committee of NAGGL. She is a frequent panelist and instructor at association events.

NAGGL serves the needs and represents the interests of the small business lending community that utilizes SBA's 7(a) government guaranteed lending programs. NAGGL has helped grow the SBA lending industry and America's small business sector as whole, helping 7(a) lending not only to survive, but to flourish: burgeoning from $1 billion in 1984 to $23.5 billion in loan approvals in FY 2015.

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Scott Ford is Founder and CEO of Cornerstone Wealth Management Group, an independent Registered Investment Advisory firm serving entrepreneurs, business owners, executives, and their families. The firm specializes in comprehensive wealth management, business liquidity strategies, and SBA education. It is Scott's mission to help his clients pursue financial freedom and live a balanced and fulfilled life.

Scott is a registered principal at LPL Financial and a Registered Financial Consultant (RFC). He is ranked in the top one percent of all LPL Registered financial advisors based on annual production. He was recognized as one of the 20 Rising Stars of Wealth Management by Private Asset Management Magazine in 2008 based upon assets managed of $1 million or more per client. Since 2005, Scott has been an active financial technical analyst and is currently a Chartered Market Technician (CMT) candidate.

Clients often choose to work with Scott because of his experience with the challenges business owners and executives face as well as his firm's disciplined wealth management process. His personal and proactive approach is designed to

bring clarity and simplicity to the complex issues of financial management. For over 20 years, he has been helping his clients define and pursue their own unique version of “True Wealth.”

Scott is the author of three books: Financial Jiu-Jitsu: A Fighter’s Guide to Conquering Your Finances, The Widow’s Wealth Map: Six Steps to Beginning Again, and the New York Times Bestseller, The Sustainable Edge: Fifteen Minutes a Week to a Richer Entrepreneurial Life. He and his wife, Angie, reside in Hagerstown and have two wonderful children as well as a dog and a cat. In addition to spending time with his family, Scott is a voracious reader and enjoys woodworking, Brazilian Jiu-Jitsu, golf, hunting, permaculture and beekeeping; basically anything outdoors.

Scott offers securities through LPL Financial, Member FINRA/SIPC. Investment advisory services offered through CWM, LLC, a Registered Investment Advisor. LPL Financial is under separate ownership from any other named entity. Scott does not provide business valuations. LPL Financial is not affiliated with David Ryan and Sherrill Stockton.

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Could an SBA Loan Help You Achieve Financial Freedom?

Nearly 80% of all business owners who aim to sell their businesses fail at completing the sale. Why is this? Often times, small business owners want to sell their company to a family member, partners, or loyal employees. This may make it difficult to secure financing in order to avoid the business owner taking on personal risk, which could jeopardize their retirement.

That's where the SBA comes in. For companies valued between $1million and $5 million, using the SBA loan program may provide business owners with the solutions needed to exit their company successfully. In this book, we review the myths and misconceptions about the SBA loan process and explain how it may help business owners today.

Could an SBA Loan Be Right for You?

Take our quick assessment quiz at **cashingoutbook.com** to see how well you fit the parameters for working with the SBA. The site also features a resource page of experienced SBA professionals that may be able to help get your business evaluated. To learn more now, email Upton Financial Group at **sbabook@uptonco.com**.

What Is Your Financial Freedom Number?

The first step for business owners to achieve true financial freedom is an assessment to determine how much their version of freedom will cost. Once they have identified their "financial freedom number," many owners have more clarity and confidence about how to achieve true financial independence. To get started determining your own financial freedom number, take our short survey at **cashingoutbook.com** today. To learn more about your financial freedom number, contact Scott Ford with Cornerstone Wealth Management Group at **(301) 739-8505** or email **scottf@cornerstonewealthgroup.com** today.