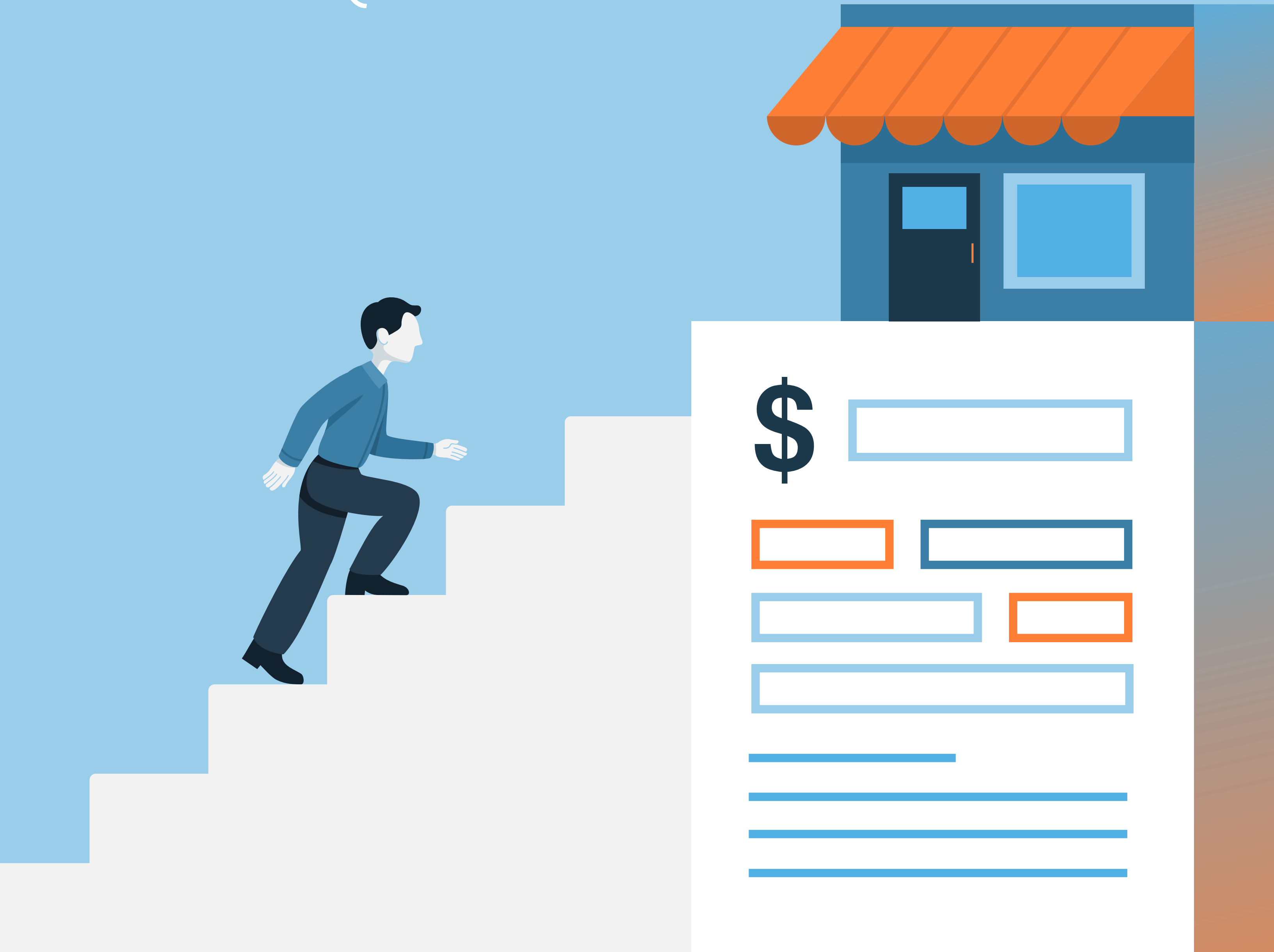
HOW TO USE

SBA Loans

to Buy an Existing Business

ACQUIRA



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CHAPTER 1

What is the SBA?

Since 1953 the SBA or Small Business Administration provides assistance to small businesses in the US.

OK, so what is a small business? There are two common metrics the SBA will use:

1. Under 500 employees (manufacturing & mining)
2. Under $7.5m in total sales (nonmanufacturing industries)

However, the size varies for all industries, you can download the full table here.

So, while your business with a couple of hundred employees and boasts $3 million in sales each year might not feel small, the government still says you are.

Most entrepreneurs are familiar with the SBA in the way they offer access to capital, which is what we will focus on in this guide. However, they also assist with:

- **Entrepreneurial development**
  With over 1,800 locations throughout the US, the SBA provides free one-on-one counseling for small businesses and low-cost training.
- **Government Contracting**
  Section 15(g) of the Small Business Act requires federal departments and agencies to award 23% of prime contract dollars to small businesses.
- **Advocacy**
  Ever since 1978, the office reviews and testifies in congressional legislation on behalf of all small businesses in the country. They help assess the impact of new regulatory changes and conduct a variety of research.

CHAPTER 2

Types of SBA Loans

1 MicroLoan

The MicroLoan program can be a great option if you are starting or expanding an existing business. While the average amount is around $13,000, this SBA program can provide loans up to $50,000.

These loans are usually used for things like:

- Working capital
- Inventory/Supplies
- Furniture and fixtures
- Machines/equipment

Keep in mind you cannot use these loans to pay off debt or buy real estate.

The maximum repayment term is up to six years, and interest rates would be between 8% and 13%.

2 SBA Express

SBA Express loans tend to have a faster turnaround than 7(a) loans but have a smaller maximum loan amount and can still take up to 90 days to receive funding.

This type of SBA loan could be good if you are purchasing a smaller business or just need a line of credit.

SBA Express loan facts:

- Up to $350,000
- 36 hour approval time
- A maximum interest rate of prime + 6.5%
- The term depends on the type but ranges from 5 years for a line of credit to 25 years for real estate
- No collateral is required for loans under $25,000, but anything over that, the banks will most likely use their existing policy

3 CDC/504

The 504 program (Certified Development Company) is geared towards companies wanting to invest and grow their business.

Funds can be used for things like:

- Purchasing land
- Existing buildings
- Long-term equipment
- Improvements to an existing property
- Build new facilities
- Renovate or convert existing facilities

Unlike the other loan types, you cannot use these funds for working capital or inventory

4 7(a)

The 7(a) loan program is the most popular type of SBA loan and can be used for a variety of business needs, such as:

- Purchase land (including construction costs)
- Repair existing capital
- Purchase or expand an existing business
- Refinance existing debt
- Purchase machinery, furniture, fixtures, supplies, or materials

This is the program we recommend for purchasing an existing business, and we will get into more detail later on.

However, in general, 7(a) loans are term loans with a fixed interest rate and monthly payments. Rates and term lengths can vary depending on the size and use of funds.

CHAPTER 3

Pros and Cons of SBA Loans

Pros Of Using SBA Financing

Low-interest rates

Here is the term schedule for a 7(a) loan:

Loans less than 7 years:

- $0 – $25,000 Prime + 4.25%
- $25,001 – $50,000 Prime + 3.25%
- Over $50,000 Prime + 2.25%

Loans 7 years or longer:

- 0 – $25,000 Prime + 4.75%
- $25,001 – $50,000 P + 3.75%
- Over $50,000 Prime + 2.75%

As you can see, the interest rates are favorable compared to online lenders or even traditional types of lending that can climb to 36% or higher.

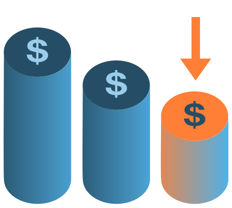
Favorable Repayment Terms

In general, SBA term lengths tend to be longer and more favorable for entrepreneurs.

7(a) loans can have terms up to 10 years and even 25 years for real estate compared to 3-5 years for a traditional bank term loan.

This allows you to really stretch your capital with lower payments, as you will see later on in our example.

Low Down Payment



Ordinarily, banks will require a 20-30% down payment. However, with an SBA loan, they may only require as little as 10%. This is known as an equity injection and is required for changes in ownership transactions.

Banks and the SBA both agree that if you have some skin in the game, you are more likely to follow through with your business plan and your commitments.

Low down payments, low-interest rates, and longer repayment terms all combine to really stretch your capital so that it works for you and not the other way around.

In addition, up to half of the down payment can be in the form of seller financing as long as they are willing to wait until the SBA loan is repaid first.

This might be a hard sell, but it allows you to offer higher multiples to buyers, and they will still get 85-90% of the purchase price upfront. Plus, they will earn interest over the life of the seller note.

Cons Of Using SBA Financing

Long Process

As you might have guessed, there are many forms to be filled out and plenty of paperwork to turn in.

It may take you a decent amount of time just to complete the application and gather all of the documents needed.

Then the bank runs its analysis, which will take even more time (assuming you have sent in everything they need)

It then has to go to underwriting and the SBA itself for approval.

You should expect the whole process to take 60-90 days and even up to 120 days to complete in addition to several hours of your own time. However, some preferred lenders can close the financing in 45 days if you have all of your paperwork in order.

Good Credit

While the minimum credit score depends on the individual lender you go to, you will need a good or great credit score to take advantage of the 7(a) loan program.

Most lenders will require a credit score of at least 680, so it is essential to know your score ahead of applying for the loan.

If you check your score and find it is less than 680, you should thoroughly review the report to check for any errors that you may be able to dispute.

Otherwise, you will need to work on paying off debt and find other ways to increase your score.

Personal Guarantee & Collateral

By far the biggest con to be aware of is that a personal guarantee is required when purchasing a business with an SBA 7(a) loan.

There is also a good chance the lender will require you to put your primary residence up as collateral.

It's for this reason that many acquisition entrepreneurs choose to work with a group like Acquira since we dramatically lower that risk.

CHAPTER 4

Purchasing An Existing Business With SBA Financing

Now let's look at the process and potential returns that using an SBA 7(a) loan can bring to your deal.

Imagine you find a business that is earning $450k over the last 12 months. After performing your diligence, you decide you want to try to close a deal using SBA financing.

Let's walk through the necessary steps to close this deal!

Structuring The Deal

There are several ways you can structure a deal when purchasing a business. However, when using SBA financing, you may find your creativity stifled as they only allow certain structures.

Business Valuation

The first thing you need to think about is your offer to the seller. While using an SBA loan allows you to offer higher multiples because of the benefits we have already discussed, the business still has to pass a third-party valuation.

That means the bank is going to send your purchase agreement along with the company's financials to another company and see if they agree with the valuation.

So how do you come up with an offer? Let's take a look:

1. Total the assets – this is probably the simplest way to value a business, but most likely, the company is worth more than this, and most sellers would not go for it.

2. Multiple of revenue – this is another simple calculation, but if you are not calculating profit into the equation, you could end up overpaying for your business.

3. Multiple of earnings – this is what we use, and this is the way we recommend valuing a business. Using earnings allows you to predict how long it will take to get your investment back. 3x or below is fairly standard but can be higher or lower depending on many factors.

4. Other considerations – sometimes you have to go beyond using formulas and consider things like location (for brick and mortar businesses) or the ability to cross-sell with other companies you own.

For this example, we are going to assume we found a company that is earning $450,000 a year. After performing thorough due diligence, we decided to offer a 3x multiple ($1,350,000) to purchase the business.

However, after factoring in fees and a working capital budget, the total purchase price comes to $1,525,500.

Because we offered such a great price, the seller has agreed to issue a 10% seller financing note, knowing that he won't receive that until after the SBA portion is repaid.

Since this loan falls under a change of ownership, we, as the buyer, must inject at least 10% into the deal however, it could be more, based on the judgment of our lender.

The equity injection can come from personal cash, borrowed cash (as long as repayment is made from a source other than the business), other assets, or standby debt.

We will put 15% down in cash in this example leaving $1,144,100 to be financed.

Allowable Structure

When purchasing a business with an SBA 7(a) loan, you must acquire 100% of the business. Even if you are buying out existing partners, the change in ownership must result in 100% ownership; otherwise, the SBA loan will not be approved.

Because of this, earnouts and other performance-based financing are not allowed.

This also means the seller cannot remain as an officer, director, shareholder, or key employee of the business.

The only thing that is allowed is a short-term (12 months or less) consulting agreement with the seller.

So as you can see, the way you structure the deal is limited, but the benefits can certainly outweigh the cons.

Possible Returns

Now for the fun part, let's take a look at what your return on investment might look like.

With our example above, we put down $228,800 (15% of $1,525,500) to purchase a company that is earning $450,000 per year.

Now, a good portion will go towards your new SBA loan. Assuming a 7-year note and a 6.8% interest rate, your payments will be around $210,000 per year.

That still leaves $240,000 (~$20,000 per month) in cash flow available to you, the new owner in the first year. So you have successfully made a 105% return on your money in the first year.

Assuming you can grow the company by just 5% a year, a reasonable goal, then your returns for the next 4-5 years look like:

	Year Ending December 31						
	0	1	2	3	4	5	6
	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
Free Cash Flow		450	473	496	521	547	
Exit Value							1,477
Owner's RoE		**105%**	**115%**	**125%**	**136%**	**147%**	**397%**
Owner's IRR	**115%**						
Owner's Cumulative Return		**1.0x**	**2.2x**	**3.4x**	**4.8x**	**6.3x**	**10.2x**

Most people would probably be happy with that, it looks pretty good.

But what if you sold the company after four years of operations for just the same multiple you purchased it for?

This is where things get interesting. You are now earning $547,000 per year at a 3x multiple gives you a sales price of $1,641,000; however, you will most likely need the help of a business broker to sell. They typically charge a 10% commission.

Still, after the commission plus paying off the SBA note and the seller note, you still net over $900,000 in cash after the sale.

This is almost a 400% return on your investment for the year but over a 10x cumulative return…

Now what? Should you reinvest your earnings to repeat the process?

What if, instead of selling, you purchased a similar size business that compliments this one and rolled them into a single entity?

Companies with higher EBITDA tend to sell for higher multiples. What if you had over $1m in earnings that sold for 4 or 5x?

Using SBA financing really opens up many possibilities and allows you to stretch your cash further than traditional financing.

CHAPTER 5

SBA Loan Requirements

As we mentioned, obtaining SBA financing can potentially be a challenging process, but not impossible. At the end of the day, it will be well worth the effort.

Personal Requirements

Keep in mind the following are required for all partners that have over 20% ownership.

Credit – While it will depend on the lender, most will require a credit score of at least 680 for the primary business owners.

Down Payment – As we mentioned earlier, for changes of ownership, this will be at least 10%, with the possibility of the lender requiring more.

Collateral – This will vary by lender, but since the SBA guarantees a portion of the loan, they don't need to be 100% collateralized.

Experience – The SBA will want to see that you have management and industry experience, although it is usually not a deal-breaker. However, credible degrees are normally not enough, they will want to see real-world experience.

Business Requirements

Operational History – Usually, lenders and the SBA will want to see at least two years of operations, three is better. Startups can receive funding, but it is much more difficult.

Profitability – When looking at the history of the business, your lender will want to see stable or growing sales and earnings. If you have recently suffered a drop, it may be difficult to obtain financing.

Ability to Repay – This is probably the most important ratio the lender will look at. The business needs to have a debt to earnings ratio of at least 1.25:1. So, the business needs to earn at least $1.25 for every $1 of loan payments it has. You should have a pretty good idea of what your loan payment will be before submitting the application.

CHAPTER 6

Application Process

Preferred Lender vs. Standard Lender

You should try to work with a preferred lender if possible. They are able to underwrite the loans in-house, which helps reduce the time to get your funding. Standard lenders will send your application to a regional SBA office which obviously adds time to the process.

Even if you work with a preferred lender, they may still have to send your application to an SBA office if they can't get it approved in-house.

However, they have the experience to help you through the process faster. Some preferred lenders can close financing in 30-45 days, whereas standard lenders may take 60-90 days.

Required Documents for SBA Loans

Due to the rigorous criteria and extensive documentation required for evaluation, obtaining SBA Loans can be quite challenging. Before submitting their applications, business owners need to ensure they have gathered the necessary documents.

1. Borrower information: You must complete the SBA Form 1919, which details all business information, including all officers, directors, and equity holdings.

2. Personal background and financial statement: In this case, you must fill out the SBA Form 912 and SBA Form 413 to provide an accurate detail of your financial status

3. Business Financial Statements: While applying, business owners must include the following documents to support their applications:

- Year-End Profit and Loss (P & L) Statement for the last three years
- Year-End Balance Sheet for the previous three years, including a detailed debt schedule
- Reconciliation of Net Worth
- Interim Balance Sheet
- Interim Profit & Loss Statements
- Projected Financial Statements

Applying for an SBA Loan

The process of applying for an SBA loan is straightforward:

Step 1: Identify Your Small Business Project

Determine whether you are starting up a business, opening a franchise, or buying an existing business.

Step 2: Determine the Finances Need

It is essential to remember the amount of money needed depending on the nature of the business.

Step 3: Find an SBA Loan Lender

Various SBA lenders are in the market. Therefore, one should conduct an in-depth analysis to settle on a lender who can issue the best terms for an SBA loan.

Step 4: Complete the SBA Loan Application Process

Once you’ve identified a lender, make an application while providing all the required documentation depending on the loan you are applying for.

Step 5: Underwriting with the Lender

Once an application is made, the SBA loan lender will review everything and decide on the application.

Step 5: Closing

Once an application is reviewed and everything checks out, the lender is to release the loan amount with all the terms

CHAPTER 7

Case Studies and Success Stories

One of the most successful stories on the use of SBA loans is JH Green & Son. The construction company made a successful application for a $350,000 SBA loan.

As part of the application process, the company wanted to use the funds to buy equipment for business expansion and hire additional staff.

The company has since become one of the biggest construction companies in Hatboro, Pennsylvania, utilizing the most efficient construction methods and equipment to deliver value to clients while taking on significantly more projects.

CHAPTER 8

FAQs

Who Issues SBA Loans?

SBA loans are issued by financial institutions authorized by the Small Business Administration. Therefore, one can apply for one at a bank, credit union, or any approved institution. Using an SBA-approved lender ensures one enjoys faster processing times and less paperwork.

Why Get an SBA Loan?

SBA Loans are some of the most reliable financial resources for small businesses looking to carry out big purchases or refinance debt. The loans come with longer terms, flexible repayment options, and lower interest rates than conventional loans. Additionally, the favorable terms on offer makes SBA loans ideal for purchasing existing businesses, in addition to assets, given the limits of up to $5 million always on offer.

Which is the most popular SBA Loan?

The SBA 7(a) is the most popular SBA loan for small businesses struggling to secure conventional loans. Businesses can apply up to $5 million under the program at some of the lowest interest rates with a repayment period of up to 25 years.

How is the interest rate determined for SBA loans?

The interest rate on an SBA loan depends on the specific characteristics of the person applying for one. Some factors include credit history, the amount requested, and the repayment period.

What is the biggest downside of an SBA Loan?

The biggest disadvantage of an SBA loan is the longer application process and stricter qualification requirements. It can take up to 90 days, or longer, to secure the loans; therefore, it is not ideal for businesses needing money as soon as possible.