



# Rocky Mountain Capital

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## General Underwriting Criteria and Rules of Thumb for SBA-Backed Acquisition Financing

NOTE: SBA itself sets minimum guidelines which banks must adhere to, but banks are free to (and typically do) impose more stringent criteria than the minimums that are specifically required by SBA. The following outlines credit standards that will meet BOTH the SBA's and typical Lender's guidelines.

1. CASH FLOW: Repayment Ability
  - a. **Debt Service Coverage Ratio (DSCR):** ratio of cash available for debt service divided by cash required for debt service. "Cash required" is principal and interest for new debt plus P&I for all continuing prior debt (all debt not refinanced by the new loan).
  - b. CONVERTING SDE to CASH AVAILABLE for DEBT SERVICE: from Seller's Discretionary Earnings (SDE), subtract incoming owner's salary (market rate), and normal owner perks (cell phone, health insurance, life insurance). Add back current rent being paid and subtract future rent (zero, if property is being purchased in the transaction.) Subtract any new manager salary that may be required (e.g., to replace more than one owner).
  - c. STANDARDS: cash available / cash required: **1.45 : 1** for latest tax year, **1:20 : 1** for previous tax year.
  - d. **Support of Repayment Ability**
    - (1) Historical coverage, as above.
    - (2) Stable or upward trend in gross revenue, through the current interim.
    - (3) A one-time drop historical drop in revenues may be acceptable, if at least a 9-month YTD interim demonstrates stabilization (no further decline) in the current year (not trailing 12-mo)
    - (4) Established downtrend (eg, last year continuing through interim), or a sharp drop in the current interim versus same period, previous year, usually disqualifies.
2. CAPABILITY: Business Management/Ownership Experience

**Standard:** Significant ownership or general management experience in same or closely-related industry (3 yrs or more, full P&L responsibility). Generally, relevant, experience must be in an independent business (not corporate middle management.) Buyers must be active managers in the target business, not passive investors.

**Exceptions:**

  - (a) Franchises often mitigate lack of industry experience.
  - (b) For some industries (typically, restaurants, hotel/motel, construction, auto dealerships) there is NO substitute for same-industry experience.
  - (c) Rarely, for very simple businesses (eg, coin-operated car wash) general business management education or experience in a non-related industry may suffice.

**Mitigants:**

For buyers lacking experience in a related industry and/or experience in independent (small) business: generally, buyer must either

  - (a) partner with someone having the experience—in which case the partner usually must either be a full or limited guarantor of the purchase loan; or,
  - (b) demonstrate that key management employees are already in place, and that their continuation with the business is locked in by either (i) their personal guarantees of the acquisition loan, or (ii) by means such as deferred compensation plans and "stay bonuses" that assure their retention for several years. NOTE: relying on employees who are not loan guarantors is difficult with the banks, and, at minimum, requires that the transaction must be solid

on all other credit criteria, and should be exceptionally strong on one or more of them. Alternative to bank financing: a partial (less than 50%) buyout now, financed by seller—followed 2-3 years later by bank take-out financing.

3. CHARACTER: Personal & Business Credit and Legal History.

**Clear credit history** of buyer (above 650 FICO score); may be able to tolerate a bankruptcy 7 years or more in the past. Judgments, collections or frequent late payments are often disqualifying, regardless of FICO score, but may be OK if: they are an isolated instance, due to uncontrollable causes (illness, divorce); 2 or more years in the past; absolutely clear history since then; all other credit criteria are met or exceeded.

Absolutely disqualifying: (1) any prior loss to the government (default or settlement on taxes or government-guaranteed debt, including student loans), and (2) business borrower that is currently delinquent on payroll taxes.

**Legal**: 1 or 2 misdemeanors, distant in time & unrelated to business, can usually be waived; any felony arrest requires clearance through SBA in Washington, DC.

4. CAPITAL: Cash Injection (Required Down Payment)

Typical owner cash injection, or "down payment" should be 20%, for costs other than real estate; minimum of 10% for real estate. In addition, Seller is normally required to finance 10% or more of the transaction. Percentages are calculated on "total project costs": purchase price, plus required working capital, plus loan costs & fees.

Typical financing structure: 20% down, 10% seller note, 70% bank financing.

For many banks, up to half the required cash injection may come from sources other than borrower cash: (1) **seller note on full standby** (no payments allowed until the senior SBA debt is paid off); (2) **family gift**, with no repayment required during term of senior debt; (3) **Rollover of 401(k), IRA** or other sheltered funds (can be accomplished with no taxes or penalties); (4) **home equity line of credit** or other borrowing against outside real estate ONLY IF borrower can show a separate income stream, independent of the target business, capable of fully servicing this debt (such as rental or spousal income).

At least 10% of total project costs must always come from borrower's own injection.

**Large goodwill transactions—new (Oct. 1, 2009) SBA guidelines**: if total goodwill and other intangibles in the purchase price exceed \$500,000, SBA requires a minimum of 25% in buyer and seller equity, where "seller equity" is defined as a seller note that is on standby (receives no repayment) for at least 2 years. Typical structure for large goodwill transactions: 20% buyer injection, 10% seller note, with half of seller note (5%) on full standby for 2 years.

5. COLLATERAL:

"True" acquisition lenders have no specified minimum collateral coverage requirements. At the limit, for an exceptionally strong deal, it can be possible to finance up to \$5 million for up to 100% good will, with no significant collateral at all. In practice, most lenders will more favorably view proposals with at least 20% collateral coverage (hard assets only, at bank liquidation value). The universe of available lenders expands greatly for deals with real estate as 51% or more of total project costs.

6. LOAN AMOUNTS:

\$5 million is the SBA limit for non real estate. Up to \$13 million in loan amount can be available for 100% real estate transactions (using the SBA's "504" program. SBA finance can be combined with seller financing, current-asset-based lending, and with equipment leasing, to accommodate larger finance requirements.

*Since the start of the financial crisis in 2008, Rocky Mountain Capital has routinely been able to obtain business acquisition finance satisfying the above criteria.*