

Screening Guideline for SBA-Guaranteed Acquisition Financing

Eligibility and qualification for bank financing of a business acquisition is subject both to SBA rules (since most banks will not lend for business acquisition without the SBA guarantee), and to the credit standards of the banks themselves. The screening criteria below include both SBA rules and typical banking standards.

It is always best to consult an SBA lending professional on questions of eligibility and qualification.

These guidelines may help to identify potential issues for discussion.

1. **Loan Size Limit:** maximum SBA-guaranteed loan amount for acquisition: **\$ 2 million.**

Comment: typical borrower down payment is 20%; typical seller financing is 10% to 15%.

Bank loan, then, is typically 65% to 70% of total costs (selling price, plus working capital, plus loan fees and costs). To achieve 65% financing with a \$2 million loan limit, selling price can't exceed \$3.0 million.

In practical terms, SBA financing can play a significant role in deals with selling price up to \$5 million, and sometimes more, depending on down payment available from buyer, seller's willingness to finance a larger-than-normal percentage of the transaction; and availability of other types of financing (such as equipment leasing and current-asset financing). NOTE: legislation now before Congress may soon increase loan limit to **\$5 million.**

a. Maximum Transaction Size: given the above considerations, SBA financing is rarely practical for transactions with a sale price exceeding \$6 million; most SBA-financed transactions are priced at \$4 million and below.

b. Minimum Transaction Size: SBA specifies no minimum loan size. Most lenders active in acquisition finance find loan sizes under **\$400K** to be uneconomic.

c. Maximum and Minimum EBIDAT: following the above, at typical multiples companies with EBIDAT under \$150K or over \$2 million are likely to be too small or too large respectively.

d. Total SBA Exposure: SBA's "total exposure" to any one borrower plus all affiliates is currently 75% of the maximum loan amount, hence \$1.5 million. Guaranteed portion of any outstanding SBA debt of the borrower and all affiliates must be subtracted from the total exposure limit, to determine how much additional SBA guarantee can be available to support lending to the company. (Since existing debt is usually paid off out of seller's proceeds in an acquisition, this provision rarely comes into play in acquisition finance).

2. TRENDS in Gross Revenues and EBIDAT: downward trends in EBIDAT, continuing downward through the current year interim statements, are not acceptable for financing. This is true regardless of the absolute level of adjusted net earnings (SDE or EBIDAT), or the multiple of net earnings in relation to debt service: it is the trend which is disqualifying. Downward gross revenue trends are usually disqualifying, unless EBIDAT is stable or increasing at the same time (usually indicating shift to lower volume but higher-margin business).

Comment: a dip in gross or net revenues for a year or two can sometimes be tolerated when the trend has flattened or has been reversed for a full calendar or fiscal year (usually at least 9 months' flat or improving trend must be shown, and for such a partial-year recovery, approval will be contingent on reviewing yearend statements prior to closing). Banks typically underwrite

on the basis of the calendar or fiscal year period for which tax returns are filed, not on the basis of 12-month trailing periods, or projections.

3. Business Size Standards: borrowing business, taken together with all affiliates (any entities holding a 20% or greater interest in the applicant, and any entities in which the applicant or its principals have a controlling interest) cannot exceed either: (1) tangible net worth of \$8.5 million; OR (2) average net income after Federal income taxes (excluding any carry-over losses) for preceding two completed fiscal years of \$3.0 million. **Alternate size standards** may be met for wholesale businesses (under 100 employees) and for manufacturing (under 500 employees).

As a rule of thumb, companies listed on stock exchanges (NYSE, NASDAQ) are probably too large to be eligible.

*NOTE: in a **business asset purchase**, the applicant or borrowing company is the entity purchasing the assets; in a **business stock purchase** by individuals, the applicant or borrowing company is the company whose stock is being acquired.*

4. Change of Ownership Considerations:

a. **Exiting owners must exit completely.** A selling owner cannot retain any ownership after the transaction, and may not be an officer, director or consultant of the business for longer than 12 months after the sale.

b. **SBA will not finance a partial change of ownership.** If one or more partners are buying out another partner or partners, the transaction must result in 100% ownership by the purchasing owners. An existing owner cannot be financed to purchase the partial ownership interest of another partner (for example, with 3 partners, one partner may not buy out a single other partner.) An outside party (someone not currently an owner) cannot purchase anything less than 100% ownership (for example, if there are partners, must buy out all the partners).

c. **Business real estate involved in a business purchase cannot be financed separately** from the SBA-guaranteed loan, unless the SBA lender is given a shared (pari passu) lien position with the real estate lender. Exception: OK to use an SBA 504 loan for real estate, together with an SBA guaranteed (7A) loan for the business acquisition.

d. A **leasehold business**, as of closing date, must have a lease term plus extensions equal to the term of the SBA loan (usually, 10 years)--or else be able to demonstrate that location is not a critical factor, and that equivalent space at equivalent rent is readily available in the local market.

e. **Landlords** must be willing to sign a "landlord's consent," allowing lender to enter the premises to seize collateral in event of a default.

5. Requirements for principals (20% or greater shareholders; officers, directors):

a. All **principals must 100% personally guarantee** the SBA-guaranteed loan—no exceptions.

b. If the SBA loan is not 100% secured by hard assets of the business (real estate and FFE only) at bank liquidation value of the assets, THEN **principals must pledge personal assets** (typically real estate and significant financial assets), up to the point that the loan is 100% secured. If all available resources are pledged and loan is still not fully secured, *collateral shortfall in itself is not a reason for decline*.

c. Principals must be **active owner-managers, not passive investors**.

d. Principals must have significant, related-industry ownership/general **management experience**, with strong preference for same-industry experience in independent business (as opposed to non-related industry, or corporate middle management).

e. Principals must have **good credit history** (generally, at least a 650 FICO score) with no bankruptcies in last 7 years. Judgments, defaults, and frequent delinquencies may disqualify.

f. Principals must be of **good character**: all arrests for other than minor traffic violations must be disclosed; more than 3 misdemeanors or any felony may be disqualifying.

g. Principals (at minimum, those who will be active managers) must be **US citizens or resident aliens** with a green card.

NOTE: given the above requirements, eligible purchasers typically will be small businesses or individuals who intend to be active owner-managers. Private equity groups

(PEGS) and other investment companies, or individual professional investors, typically will not qualify because their ownership interests in numerous affiliates will violate SBA business size standards, or because principals will not be active owner/managers of the target. Also, typically, partners in PEGS and investment companies will refuse to offer a personal guarantee, or pledge personal assets.

6. Equity Injection (down payment). SBA does not specify any minimum equity requirements (except to qualify for Preferred Lender Processing—see below).

a. Buyer Equity. Banks typically require at least 20% of total project costs to be injected by the borrower. (Total project costs = purchase price, plus loan fees, plus required working capital). Usually, up to half that requirement (10% of total costs) can come in the form of **seller take-back financing that is on full standby**, receiving no payments of principal or interest for the term of the SBA note, or until that note is paid off.

b. Seller Financing. Banks will generally also require at least 10% of costs to be financed by the seller (including, not in addition to, any “standby note” such as the above.) Exception: when the borrower is a current key employee or manager of the business being acquired, seller financing may not be required.

c. SBA—PLP requirements. If the purchase price of the business includes \$500,000 or more of intangibles (goodwill, patents, non-competes, trade name, customer list, etc), then in order to qualify for **Preferred Lender Processing (PLP)**, SBA requires that there must be combined buyer and seller equity equal to at least 25% of the purchase price. “Seller equity” is defined, for this purpose, as any seller take-back financing for which payments are deferred for at least 2 years. When real estate is transferred along with the business this 25% equity rule applies to the real estate also (unless the RE is split off into a separate 504 loan).

NOTE: Under PLP, the lender makes the credit decision, without any separate review of the loan file by SBA. If a loan cannot qualify for PLP, SBA must separately review and decision the credit—adding substantial time and uncertainty to the approval process.

How to Use the Screening Guidelines

The guidelines above outline the general eligibility and qualifications that most clearly and frequently distinguish between feasible and infeasible proposals for SBA-guaranteed acquisition finance. These guidelines cover both SBA regulations, and a limited selection of bank credit criteria.

Rocky Mountain Capital recommends using these screening guidelines not to make absolute determinations of eligibility and feasibility, but rather to identify issues that should be raised immediately when approaching an SBA lending professional about a particular transaction.

SBA also has numerous specific definitions of ineligible borrowers (i.e., businesses), ineligible uses of funds, and ineligible personal guarantors (i.e., principals, officers and directors of applicant businesses.) These are listed below, as a supplement to the more general guidelines. Again, these more detailed rules may suggest items that need to be discussed early on, when introducing a loan proposal to your SBA lender or packager.

Beyond meeting SBA eligibility definitions and qualifications, a successful financing proposal also must satisfy the credit criteria of the bank receiving the application. Rocky Mountain Capital has available a more detailed outline of credit standards that satisfy both SBA and typical bank requirements, in a

separate document titled “General Underwriting Criteria and Rules of Thumb for SBA-Backed Acquisition Financing.”

Ineligible Situations (as defined by SBA Standard Operating Procedures [SOP 50-10-5(B)])

1. **Ineligible Borrowers** (Types of Businesses)
 - a. Non-profit business (for profit subsidiaries are eligible)
 - b. Businesses engaged in lending (banks, finance & investment companies, factors, others whose “stock in trade is money.”
Note: exceptions for certain kinds of companies, such as check cashing & pawn shops, when >50% of revenues are from services or activities other than finance.
 - c. Life insurance companies.
 - d. Businesses with >1/3 of revenues from SBA loan packaging.
 - e. Borrower plus all affiliates exceeding size standard determinations (each must meet own standard; all total meet the group’s main industry standard)
 - f. Businesses/Private Clubs that limit membership for reasons other than capacity
 - g. Businesses located in a Foreign Country
 - h. Businesses that derive >1/3 gross annual revenue from gambling, or whose main purpose is gambling (such as a casino) regardless of revenue proportions
 - i. Businesses engaged in illegal activity
 - j. Government-owned entities (except Tribally controlled)
 - k. Landlords, businesses primarily engaged in renting space (“passive companies”).
Exception: holding companies solely engaged in leasing real estate to eligible operating companies (holding co & operating co must both 100% guarantee).
 - l. Businesses primarily engaged in promoting, instructing, indoctrinating religion.
 - m. Businesses primarily engaged in political or lobbying activities
 - n. Consumer and marketing cooperatives (producer cooperatives are eligible)
 - o. Speculative businesses (traders speculating on gain in asset values—such as commodity or stock investors; inherently risky “speculative” businesses such as oil wildcatting, research and development; “spec home” construction).
Exceptions (eligible) include: grain elevator using a commodity future contract to lock in a price; drilling for oil in established fields; home building under contract with a buyer.
 - p. Businesses primarily sexual in nature
 - q. Pyramid sales plans and multilevel marketing companies
 - r. Business in which the Lender applying for guarantee, or any employee or associate of Lender, owns an equity interest.
 - s. Business with Franchise/Licensee/Dealer/Jobber agreement that does not meet SBA standards (imposes “unacceptable control,” thereby renders the business effectively an affiliate or subsidiary of the franchisor or licensor).
 - t. Franchise developers (master franchisees): considered passive & speculative

2. **Ineligible Uses of Funds**

- a. Payments, distributions or loans to principals: NO CASH OUT to PRINCIPALS
- b. Business relocations that cause unemployment; financial hardship to leaseholder; or nullify labor agreement
- c. Investments in real or personal property acquired and primarily held for sale, lease or investment (including remodeling of rental space)
- d. Illegal Activities
- e. Refinancing debt owed to an SBIC
- f. Payment of delinquent payroll taxes (income taxes eligible, but a credit issue)
- g. Use of funds for refinancing is allowed, but subject to numerous restrictions—consult with SBA lending professional on any proposed refinance.

3. **Ineligible Personal Guarantors / Principals** (20% or more owner/shareholder)

- a. Principal's personal liquid assets (total for principal, spouse & minor children), on a proforma basis (after the down payment is made), can't exceed the following multiples of the Total Financing Package (TFP). TFP is the total of all cash and sources of financing for the project being financed:
 - **TFP \$250,000 or less:** 2X TFP or \$100,000, whichever is greater
 - **TFP \$500,000 or less:** 1.5X TFP or \$500,000, whichever is greater
 - **TFP over \$500,000:** 1.0X TFP or \$750,000, whichever is greater.

Liquid assets = cash, deposits and negotiable (publicly-traded) securities not held in a tax-sheltered retirement plan (401K, IRA).
- b. Principal is on probation, parole or pending criminal charges, or has a legal history demonstrating poor character or "moral turpitude."
- c. Principal has caused a prior loss to the government:
 - defaulted student loans
 - delinquency on trust fund taxes (Soc.Sec, Medicare, UI, Work Comp)
 - loss, whether through settlement or otherwise, to any federal agency
- d. Conflict of interest: principal is a high government or military official, or an employee of SBA.