Seller Financing Under the New SBA Rules

By Jeffrey Hunt, Senior Vice President, First Home Bank

As to be expected, the SBA released an update to its Standard Operating Procedure that went into effect on January 1, 2018, known as SBA SOP 50 10 5 (J). These updates were extensive as they relate to the change of ownership of a business, whether that be through a completely new buyer coming in to buy a company or through a current owner buying out their partner(s). The new SOP has removed the requirement for a 25% equity injection for processing a loan under a bank's SBA preferred lender processing authority when the transaction results in more than $500,000 in goodwill/intangible assets. Regardless of the type of change of ownership, the use of Seller Financing in conjunction with SBA financing has historically been a key component to the transfer of ownership. The good news is that Seller Financing can still be used as a mechanism to finance a change in ownership. The bad news is that the SBA SOP update has created a lot of confusion relating to the amount and terms of the Seller Financing. The following explanation will hopefully bring some clarity on the use of Seller Financing under the new SBA rules.

For transactions in which an outside buyer/buying entity are purchasing a business, they must buy 100% of the business from the sellers as has always been the case. However, the buyer equity requirements have changed. Now, no matter how large the transaction or the amount of goodwill created, the buyer must inject a minimum of 10% of the entire transaction value. The transaction value includes the business purchase price, any working capital or other requested financing such as new equipment purchase, and any loan fees/costs. Seller Financing can be used as a component of the minimum 10% equity required, but the Seller Financing used for the equity component must not exceed 5% of the entire transaction value (50% of the mandated equity). For example, if the total transaction value is $1 million with a minimum equity requirement of $100,000, the Seller Financing used to count toward the mandated equity cannot exceed $50,000. Additionally, the Seller Financing component of the minimum equity requirement must be on full standby (no payments at all) and fully subordinate for as long as the SBA loan is outstanding. Although we are only two months into these new SOPs, we have already seen deals negotiated with Seller Financing as part of the required equity component. We have also seen structures where the buyers, and the lender, want the sellers to have even more "skin in the game" through a larger amount of Seller Financing. Having additional Seller Financing is allowable, but it must be a separate note and be included in the debt service coverage calculation as it is now considered debt. Every SBA lender is going to view this additional Seller Financing differently, so that's where the creativeness can come in to the transaction. If there is plenty of cash flow to service the SBA loan and the additional Seller Financing, it's possible that the lender will allow payments to start immediately after the closing of the transaction. At the same time, some lenders may take a more cautious approach and want to see a year or more of adequate debt service demonstrated before payments on this additional Seller Financing can commence. Regardless, the lender will have the ability to restrict payments on the additional Seller Financing at any time.

For transactions in which an existing owner is buying out their partner(s), the selling shareholder must sell 100% of their position. In this instance, however, it is necessary for there to be a minimum of 10% balance sheet equity for the company on a pro forma basis taking into consideration the new SBA loan used to buy out the partner(s). The selling shareholder(s) may provide Seller Financing as long as there is still the required balance sheet equity on a pro forma basis. If the Seller Financing is being used for the pro forma balance sheet equity requirement, it must be on full standby and subordinate for the life of the SBA loan, and it must not exceed half of the equity required. If there is not enough balance sheet equity on a pro form basis and the selling shareholder(s) is not willing to provide Seller Financing, the remaining owner(s) must provide an equity injection that results in a minimum of 10% pro forma balance sheet equity.

The key takeaway is that Seller Financing can and will continue to be a vital component to structuring and closing change of ownership transactions. As long as the minimum SBA SOP requirements are met as reviewed above, there can be some creative negotiations among the buyer, seller, and lender. If you are seeking a creative SBA bank, or just want to discuss a potential deal structure, please contact one of our lenders to help you through the process.

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