Diamond Financial
NEWSLETTER

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Understanding Lending Collateral Values in 2020

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When it comes to acquisition lending that includes a "goodwill" component, the consideration always turns to collateral values and what amount a lender might secure to minimize their exposure and comply with SBA rules. The answer is not as simple as you might expect. Today I begin with a story about one of my very first transactions; my first failure to secure financing.

The year was 1997 and I had been exposed to SBA rules for about a year when I was shown a jewelry store acquisition for almost one million dollars. As you can imagine, I was excited to work on a million dollar transaction already, and who doesn't like jewelry stores? The first thing I learned is that the sellers were basically taking all the cash out of the store and showing no real profits on their tax returns. (None of us had **ever** seen this scenario before.) No problem at all, I thought, as I also recognized inventory asset values of over $900,000 included in the purchase price. I immediately expected a lender war and show this potential buyer many lender offers. I could not have been more wrong. My first major collateral lesson came as I was explaining to the lender, "but it comes with over $900,000 of jewelry, how could you possibly have less exposure, current cash flow considerations or not?" Here is where logic hit me directly in face. The lender took the time to explain to me that if something were to happen to this business in the future, they would expect to find less than 10% of that inventory remaining as they retrieve their actual collateral. They went on to ask if I had ever seen a "going out of business" sign and the major discounts retailers offer as they clear all inventory to the walls. It makes sense to me now as I better understand the term LCV (Liquidated Collateral Value). To complete the story, my inventory available to this lender after "discount" turned out to be only $90,000. An inventory discount of 90%, along with many other discounts that I learned of at that time and will share below. Considering that actual lenders are **not** in the business of repossessing assets, most true SBA lenders will understand the lack of collateral value that most acquisitions include and recognize the cash flow aspect of the transaction as the strength of the loan request. Before I explain why this is so important to understand prior to listing a business, I'll first go through a few common liquidated discount percentages, as many may shock you.

- Used equipment included in the sale is reduced by 50% of FMV
- Accounts receivables are reduced by 90%
- New equipment may only be discounted by 25%
- Inventory is reduced by 90% (including jewelry)
- Furniture and fixtures are reduced by 50%
- Commercial real estate (from 15-50% depending on usage)

What most consider valuable in a transaction, SBA lenders consider tough to liquidate and much less accessible than we might think. The real reason this matters to your transactions is that as you explore lender options, each have their own level of acceptable goodwill included in a transaction. As I thought I had $900,000 of collateral, it turned out I had only $90,000 and no cash flow. Knowing and understanding LCV's upfront can help determine what lender to consider. Lender goodwill limits should be one of the very first considerations when understanding any lender's criteria, and should be the first question you ask when solicited by them.

For more specific answers on these or any other SBA rules, please contact us at askdiamond@easysba.com. A no cost, no obligation email solution to answer all of your SBA questions.

Diamond Financial specializes in larger, goodwill type transactions and we are always happy to share the information that makes them happen. Call us and experience the power of the experts and our 3 day yes or no guaranty!

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Let's get started.