Five Questions to Ask Before Seeking an SBA Loan During the COVID-19 Pandemic?

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We will skip the "new normal" opening line with the understanding that COVID-19 has impacted our lives in many ways. This article addresses some of the changes in the lending environment due to the COVID-19 pandemic, specifically business acquisition financing. The state mandated business closures, because of the COVID-19 pandemic, adversely affected many once-stable or growing businesses. These businesses will most likely recover; however, the length of this recovery period is unknown which causes banks to be apprehensive. This does not mean that business acquisition financing is a thing of the past, there are indeed many credit-worthy buyers and businesses in the marketplace. As a business broker it is imperative you understand the questions to ask of your buyer and seller to assess the merit of the transaction in the COVID-19 lending era before sending it to a lending partner. The more information you can obtain prior to sharing the request with the lender the faster that lender will be able to make an informed decision on providing financing. The following sections will provide five simple questions to ask of your buyer and seller for you and your lending partner to quickly assess a business acquisition opportunity in the COVID-19 lending era.

Q1: Did the seller obtain a PPP or EIDL loan?

As of June 30, 2020, 4. 8 million small business owners obtained a PPP loan and 2 million small business owners received an EIDL loan. There is a high probability that a business you have listed for sale or will list for sale has one of if not both debts on the balance sheet. In most PPP and EIDL promissory notes a change of ownership without the consent of the lender may result in a technical loan default, which may require the outstanding balance of the PPP loan to be repaid at closing by the seller. This subsequently reduces the net sale proceeds to the seller who anticipated having their PPP loan forgiven rather than repaying the loan balance. According to current PPP guidelines, final PPP loan forgiveness could take up to five months from the date which the Borrower applies for forgiveness. The typical business acquisition financing process takes no longer than 60 days, which means a business could be listed, financed via an SBA loan or seller financing, and closed well before the PPP loan is forgiven. Obtaining bank consent for a change of ownership for a PPP loan borrower will be unlikely given the lack of guidance lenders have received regarding this matter. Even if the lender provides consent for a change of ownership prior to PPP loan forgiveness, the SBA has not provided any guidance on whether the PPP Borrower is eligible to pursue forgiveness after the change of ownership.

Q2: How did COVID-19 impact the business?

Be prepared to share a written synopsis with the lender and buyer detailing the impact of COVID-19 on the business including revenue trends, staff layoffs, current operating capacity, and the plan for recovery. It is true that some businesses were less severely impacted depending on the industry; however, even those businesses considered essential may have suffered adverse impact due to COVID-19 government ordinances. Businesses that fall within the most severely impacted category such as restaurants, gyms and hotels will require a detailed re-opening plan as well as insight into their respective state's re-opening phase. As of March 27, 2020, the SBA now requires an Adverse Change Questionnaire and two years of monthly projections on all SBA loans including business acquisitions in order to assess the operating capacity and recovery plan for the business prior to closing and funding of the loan. Be prepared to have your seller answer this Adverse Change Questionnaire and your buyer to complete the monthly projections for the following 24 months post-acquisition and provide these items to your lender.

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Q3: What is the post-closing liquidity of the buyer and working capital need for the business?

The post-closing liquidity of the buyer will be ever-so important in a business acquisition loan request moving forward. We are slowly recovering from a period which cash-strapped business owners had to make tough decisions to permanently close their business or take on high interest debt to keep themselves and their business afloat. In a typical 10% down payment acquisition loan structure the buyer should have at least 2x the equity injection available as liquidity. Buyer liquidity is inclusive of cash, savings, stocks, bonds, and retirement assets. Having twice the equity injection requirement provides an adequate cushion to support the buyer's living expenses and personal debt obligations. This additional liquidity can also provide a supplement to business working capital should the business be low on capital during a period of need. Beyond the buyer's liquidity, the working capital needs of the business to-be-acquired should be assessed to determine if additional working capital should be financed with the acquisition opportunity. Businesses such as general contractors will have greater working capital needs than businesses who receive payment at the time of service such as restaurants.

Q4: What is the buyer's industry experience?

Prior to the COVID-19 pandemic a buyer could obtain a loan based on indirect industry experience or transferable skill sets. In the current COVID-19 lending environment limited business ownership history and limited industry experience will pose a challenge for buyers seeking SBA financing for a business acquisition. Banks will have some trepidation lending to a buyer that needs to learn the industry and simultaneously navigate through an economic recovery as COVID-19 continues to adversely affect many businesses. This is not to say that the buyer must have owned a business within the specific industry of the business to-be-acquired, but having some direct industry experience would eliminate a potential objection to the possible approval of the business acquisition loan request. If the business requires special licensing to generate revenue, such as many service-based businesses (HVAC, Plumbing, Electrical, etc.) many banks will now require the buyer to obtain those licenses prior to closing and funding to mitigate risk during this period. A potential solution would be to partner the buyer with a current employee for the acquisition or perhaps the buyer has an interested partner with direct industry experience that can be added to the loan request to enhance the request.

Q5: How long will the seller stay involved in the business to provide support post-acquisition?

Seller involvement will be imperative in business acquisition financing requests in the COVID-19 lending environment. Short periods of transition assistance from the seller post-acquisition will not be viewed favorably by lenders in this current environment due to the pending economic recovery. Transitional assistance from the seller for three to six months post-acquisition would be preferred by many lenders. The SBA permits the seller to be paid by the buyer as a consultant for up to 12 months post-acquisition. The seller may be more inclined to extend their assistance period if there is compensation agreement in place prior to closing of the acquisition. In addition to seller transitional assistance, the seller's willingness to provide seller financing for the acquisition in addition to the SBA loan will reduce the bank's total loan exposure for the transaction mitigating the perceived risk of the acquisition.

Although the lending environment has changed, many businesses will still be successfully acquired via an SBA loan. Business acquisition financing will continue to be a mutually beneficial offering for banks and borrowers while providing a means for business brokers to facilitate the sale of a business. Your SBA lender will be able to make a prompt and informed decision on the business acquisition loan request if the answers to the questions referenced in this article are addressed prior to engaging the lender.