MOUNTAIN WEST SMALL BUSINESS FINANCE
MASTERS IN 504 LENDING

- Advanced Eligibility

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- Welcome to the fifth session of the Masters in 504 Lending Series, presented by Mountain West Small Business Finance
- Next Month - Affiliation, presented by Jeff Vanchiere
- Refinance Eligibility is not covered in this session, but will be in our September and October sessions
- We appreciate your taking the time to join us today, and throughout this series
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We're proud of who we are, what we have accomplished, and thank you for your continued support:

- Number 1 SBA 504 lender in Utah
- Number 1 SBA 504 lender in our SBA Region
- Top 10 SBA 504 lender in the nation
- We help hundreds of businesses grow each year
- We are leaders and teachers in our industry
- We train other CDCs but learn from others and always evolve to improve our own processes

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Advanced Eligibility

An EXHILARATING Topic

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Why does SBA care about ELIGIBILITY and why should you?

- We care about the 5 Cs of credit too, but we have an "E" to deal with
- Eligibility is crucial to the SBA's mission and to an approval of a 504 loan
- Where credit is "an art, not a science", we can make cases for many credit issues to follow SBA's mission, but eligibility is a very inflexible aspect.
- Sometimes a loan seems like a "slam dunk" in a conventional scenario but may not be eligible regardless
- We want you and your borrower to be happy, so ironing out eligibility early or any challenges we may face is always preferred. Call us or get us involved early, especially if it isn't a "clean one-owner".

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Some things to note as we get going:

- These are not in any particular order of importance or how often we see them
- We have tried to identify many issues that can derail a project as we work towards an SBA Authorization, but some can even cause issues at closing if not addressed early
- Some of these issues are relatively "obscure", and you may not run into them often
- As often as possible, we will provide real world examples so you can apply them practically

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Credit Elsewhere

- One of the more "gray" areas of eligibility.
- We have to establish that the borrower **does not** have the ability to obtain the loan on reasonable terms from non-federal, non-state, or non-local government sources without SBA assistance.
- In layman's terms, we have to make sure SBA understands the reasons why the borrower cannot finance the project conventionally.
- Our prior training covered the credit elsewhere categories we can use
- The main "catch all" we use: The loan being requested by the applicant is not available on reasonable terms from non-federal sources because the overall advance rate exceeds lender's conventional maximum for this type of property.

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Potential Credit Elsewhere Issues

Keep in mind, there are arguments to be made for each of these that may satisfy SBA

- A business has too much cash and a larger down payment to make the loan conventional would <u>not</u> jeopardize the business financially (including the business' individual owners)
- The loan to value ratio is very low, so why does the financial institution need SBA's support?

Real World Example:

- $2,000,000 project cost (refinancing an existing loan to a restaurant for better terms)
- One out of the five owners had about $4,000,000 in personal liquidity (SBA includes stocks and bonds)
- LTV was at about 69%
- SBA determined the loan was not eligible since at least one of the five owners had sufficient liquidity to reduce the loan balance to a level that could make it a conventional loan.

Potential Credit Elsewhere Issue

Keep in mind, there are arguments to be made that may satisfy SBA

- A borrower purchased a property in cash but wants to be reimbursed with a 504 loan

<u>This might be okay, depending on the circumstances, but this is an uphill battle with SBA</u>.

- Were there extenuating circumstances that required it (i.e., had to close in two weeks or lose the property, and now cash is at a dangerously low level)?

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Size Standard

- The SBA loan applicant must be considered "small" under SBA Size Requirements
  - Industry Size Standard – SBA has a chart that you search the NAICS code, and it will tell you the size requirements SBA has for that entity (employees, gross revenues, etc.)
  - Alternative Size Standard – This is what we generally use on 504 loans. The borrower, including affiliates, cannot exceed a tangible net worth of $15,000,000 and its average net income after taxes over the past two fiscal years cannot exceed $5,000,000.
- It is generally pretty rare that you will run in to size standard issues when working with borrowers that want SBA loans, but it does happen.
  - Remember, SBA counts affiliates in alternative size standard. If a borrower owns many successful operating businesses with a long history, it can rapidly reach the SBA threshold. How to determine affiliation will be covered in a later Masters in 504 training
  - Only tangible net worth counts towards alternative size standard calculations. Goodwill or other intangibles will not count against a borrowing relationship's size standard evaluation.

Eligible Entity Structuring

- Operating Company (OC)
- Eligible Passive Company (EPC, or Holding Company)
- Co-Operating Company (multiple OCs to help meet occupancy or justify repayment)
- Guarantor Affiliate (added to bring strength or because it has more than 20% ownership of the OC/EPC)

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Entity Structuring Example

- An OC is buying a building. It is owned 50% by an individual, and 50% by an LLC which is in turn owned 50/50 by two other individuals
  - Individual signs personally
  - The LLC must also sign as a "Guarantor Affiliate"
  - Any individual or business that owns 20% or more of the guarantor affiliate must also sign
  - The guarantor affiliate cannot be used to eliminate cash flow issues
  - A guarantor affiliate may be engaged in non-OC or passive activities such as leasing investment properties or hold other non-OC related entities as a passthrough

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Entity Structuring Example

- Real World Example:
  - A family looking to purchase an RV park
  - They created a new entity to run the RV Park (the OC)
  - The OC was owned 100% by a Family Partnership LLC (the Guarantor Affiliate)
  - The family partnership was owned by 11 family members, none of which was 20% or more owner
  - We required the father to sign personally (strongest personal financials) and one of the sons, who was the CEO and ran the day-to-day operations
  - The Family Partnership LLC held ownership in 30+ properties and some passive passthrough holdings. Some RV parks, some investment properties, residential real estate, etc.

This is an eligible structure. Complex, and difficult to work through, but it is eligible.

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Occupancy and Leasing

- Per SOP:
  - For an existing building, the Applicant must occupy 51% of the rentable property and may lease to a 3rd party up to 49%
  - For new construction, the Applicant must occupy 60% of the rentable property, may permanently lease up to 20%, and temporarily lease an additional 20% with the <u>intention</u> of using some of the additional 20% within 3 years and all of it within 10 years.

Example:

Business constructs a 2-unit building, 60% on one side, 40% on the other. Our business occupies the 60%, and leases the other side out with a 5 or 10-year lease to a 3rd party.

Occupancy Issue – Borrower would be out of compliance. If this lease was in place before 504 loan debenture funding, this would cause a funding issue. If this happened after the debenture had funded, the borrower is out of compliance and would not be able to obtain additional SBA funding until occupancy was brought into compliance.

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Occupancy and Leasing

- The Holding Company (EPC) must lease 100% of the rentable property to the applicant small business (OC).
  - *The OC may then "sublease" to the 3rd party tenants*
- Generally, closing and funding of the 504 loan should not take place until the OC is occupying the requisite amount of space. **However,** some circumstances may allow an OC to close prior to meeting occupancy, but the OC must meet all occupancy requirements within 1 year from closing.
  - *Example: The OC purchased the building, and there was a tenant in place that had 3 months remaining on the lease and intends to vacate. OC is still okay and is meeting the occupancy and leasing requirements.*

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Occupancy and Leasing

- Rent or Lease payments from the OC to the EPC cannot exceed the amount necessary to make the loan payments and additional amounts to cover direct expenses for holding the property (routine maintenance, utilities, insurance and property taxes).
  - SBA does not care what the market rent rates for the subject property are
  - This applies to prior SBA loans as well.

Example:

OC has an old SBA 504 loan and is looking to get a new 504 loan for a second location. On the old 504 loan, the OC is paying rents to their EPC for that building that far exceed the loan payments and direct expenses for the building and is taking some healthy distributions (generally speaking, an eligible SBA EPC should not have distributions). SBA will likely not approve another new 504 loan until the old 504 loan's EPC leasing requirements are in compliance.

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Occupancy and Leasing

- How to correct the "excessive rents" issue:
  - Borrower writes an explanation and indicates they will comply with the EPC leasing requirements going forward (I'm sorry, SBA, I really am!)
  - New lease is created and executed that meets the requirements (sometimes SBA wants this recorded)
  - MWSBF addresses the issue in their credit memorandum to SBA

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Occupancy and Leasing

- Other EPC rules:
  - An EPC may not engage in any other activities other than leasing to the OC
    - I.e., it can't own investment properties, vacation rentals, etc.
  - EPCs and other holding companies are considered in size standard calculations
  - EPCs must maintain financial statements
    - I.e., if it is not a new EPC for the project, and has prior tax returns, it must provide financials, including interim financials

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Historic Properties

- SBA has to consider whether projects they fund would adversely impact a property that is listed (or eligible to be listed) on the National Register of Historic Places (NRHP)
  - For anything over 100 years old, we reach out to the State Historic Preservation Office to get a "no adverse impact" assessment on the 504 project
    - If it is a straight purchase with no renovation, it's easy to get a "no adverse impact" letter
    - If it has renovation, it can be more involved and have some back and forth with the SHPO
  - Once the SHPO signs off on "no adverse impact to the property", MWSBF sends the info to the SBA District Counsel for their approval to proceed with submitting the project to SLPC.

Note: A project with a historic property cannot be submitted to SBA for approval until SBA District Counsel has reviewed and approved

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Business Acquisitions

- Any time our business is purchasing a property from a seller that is in the same industry as our applicant, SBA will consider it a "business acquisition", even if the goodwill itself is not being acquired.
  - This includes times when our borrower is not buying the goodwill or inventory of the seller
  - For example, our borrower is a used car dealer, and they are purchasing real estate that is owned and operated by another used car dealer, however no inventory or goodwill is being purchased
  - Another example, a dentist is purchasing the building from another dentist who is retiring.
  - Or an Asian restaurant operation is purchasing a building that a South American restaurant has historically operated from – SBA will see this as a Business Acquisition

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Business Acquisitions

- In these cases, SBA will require:
  - 3 years of business tax returns from the seller
    - If tax returns are not available, SBA will accept revenue tax receipts
  - An interim financial statement, if/when appropriate and available
  - Signed tax transcript request form (8821) from the seller so MWSBF can obtain tax transcripts

Note: If these items are not provided to SBA, they will not approve the loan.

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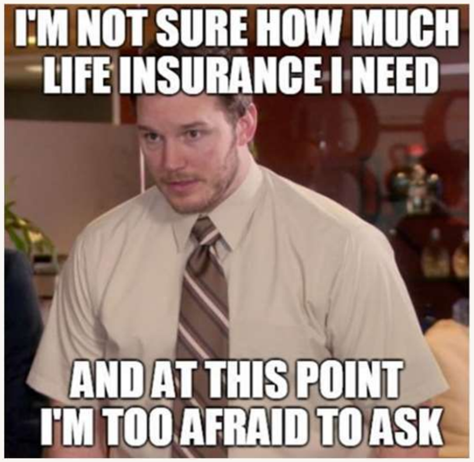
Life Insurance

- SBA requires that in some circumstances, life insurance may be needed to mitigate key person risk (based on collateral coverage calculations)
  - 100% owner
  - 50/50 spousal owners where one spouse is uninvolved or inexperienced in the business
  - Highly-qualified professional licenses (dentists, doctors, general contractors, etc.)
  - Other circumstances as determined by MWSBF or SBA
    - Such as a non-owner employee that is crucial to the business operations

If there is a concern about whether a business could continue operating in the event of an owner's untimely death, life insurance should be evaluated.



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Life Insurance

- How to get around the life insurance requirements
  - Multiple owners that are active in day-to-day management
  - A minority-percentage owner in the business (not guaranteeing) that could potentially take over for the majority-percentage owner if they were to pass away
  - Family members (with no ownership) that are active in the day-to-day management of the business (i.e. a son that has worked in the business for the past 10 years and runs the business with his father, and a well-documented succession plan is in place)
  - Collateral coverage calculations show that there is no "collateral shortfall" in a liquidation scenario (this works for 100% owners also)
  - The individual is uninsurable (get a letter from the insurance agent/company stating that)

Eligible Sources of Borrower Contribution

- The usual:
  - Business Cash (sufficient cash must be reflected on the interim balance sheet)
  - Personal Cash from the guarantors (sufficient cash must be reflected on the PFS)
- Equity in Project Real Estate
  - The business purchased land within the last two years with the intention of building on it (valued at purchase price)
  - The business has owned land for over two years, and is ready to build (valued based on the as-is appraised value)

Note: If a borrower is buying a building and the appraisal shows a higher value than the purchase price, that <u>cannot</u> be used as eligible equity injection

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Eligible Sources of Borrower Contribution

- Pre-paid Expenses Directly Attributable to the 504 Project
  - Architect fees paid a few months in advance
  - Deposits on materials
  - Payments to the general contractor made before SBA approval
- Personal Guarantor HELOC
  - Okay, assuming the new HELOC payment is accounted for in the personal or business debt service coverage calculations
- Business LOC
  - Okay, assuming the new LOC payment is accounted for in the business debt service coverage calculations

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Eligible Sources of Borrower Contribution

- Seller Financing
  - Must be subordinate to the 504 loan (3rd position)
  - May not be prepaid without SBA consent
  - Seller loan may not have a term that is less than the 504 debenture, and cannot demand payment prior to the SBA debenture length (balloon payment, etc.)

Note: If the seller financing <u>does not</u> take the subject property as collateral, then the first three bullet points above do not apply.

At least a portion of the down payment must still be made by the borrower, and not entirely made through seller financing (typically half of the down payment made in cash, the rest may be seller financed)

Eligible Sources of Borrower Contribution

- Gifts of Down Payment
  - Generally okay when they come from family members
  - If you have a potential "gift" contribution, contact your MWSBF loan officer for eligibility assessment
  - Adding the individual gifting the money as an owner of the EPC is a clean way to do this
- Other possible sources (these are heavy on the "maybe" and may not be eligible depending on circumstances)
  - Leasehold improvements made while leasing a building prior to purchase (must be easily and clearly documented)
  - Rent credits from the seller (suggest avoiding these when possible, the requirements are nearly impossible to meet for it to be acceptable)

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Miscellaneous Project Related Eligibility

- Remaining Economic Life
  - The appraiser must address the remaining economic life of the property in his report, and the SBA debenture term cannot exceed this
- Feasibility Studies
  - Large start-up projects (storage units as an example) may require a credible analysis of the feasibility of the project from a qualified party (preferably unbiased 3rd party)
- Projects on Land Leases
  - Projects on land leases can be financed through a 504 loan, but there are some unique requirements
  - The land lease must be fully arms-length (a family member cannot lease land from another family member – this would be ineligible)

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Questions?

- This presentation wasn't meant to be all-encompassing, but address some of the more mainstream advanced eligibility scenarios you may see.
- For any out-of-the-ordinary circumstances, please reach out to your MWSBF Loan Officer

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Please join us for our next Masters in 504 Lending Session

- July 28th at 11:00am
- Topic: Affiliation, presented by Jeff Vanchiere
- Please invite all of those in your offices who have any present or potential future, role in 504 lending to attend

THANK YOU!

Mountain West Small Business Finance

Masters of 504 Lending