

A Lender's Guide to Successfully Marketing SBA 504 Loans

by Thomas Wallace

The Small Business Administration 504 Loan program is a way to provide low down-payment financing to small businesses with both long-term rates and amortizations, under a collateral and security structure profoundly favorable to a lender. Recent changes to the allowable loan structure and the delivery mechanism of the product make this a much more viable and interesting product to borrowers.

Marketing credit products too often focuses on “how” to sell or close a product—a discussion better suited for used-car lots. It is more effective, as well as more ethical, to ask “what” and “who”:

- *What* defines and differentiates this product.
- *Who* identifies the best prospective borrowers, from the point of view of both lender and borrower.

Defining the Product

The SBA 504 program provides both project and permanent financing for capital assets through loans of either a 10- or 20-year term for equipment and real estate, respectively. A 504-financed project involves three loans: 1) a bridge or “interim” loan made by a private-sector lender; 2) a senior position permanent loan from the private sector; and 3) an SBA-backed junior position permanent loan.

Small businesses eligible to participate are defined basically as those having a tangible net worth of less than \$7 million and average after-tax net income of less than \$2.5 million over the past two years. There also are certain restrictions on the principals of the small business, largely relating to character and available liquid assets. Although there are additional requirements, they are generally less extensive and exclusive than those of the SBA 7(a) program.

Lenders eligible to participate in the program include virtually any financial entity operating legally within the U.S. The broad scope is allowed because the counterparty to the SBA is not the private sector lender, but rather a certified development company (CDC), specifically licensed by the SBA. The CDC is responsible for managing all aspects of the SBA-backed junior position loan

process from approval, to closing, to funding, as well as subsequent loan and portfolio servicing. Historically, the approximately 270 CDCs around the country were limited to specific geographic territories and operated as quasi-monopolies within those territories. However, in the past two years, these regulations have changed to allow any CDC licensed within a given state freedom of operation within that state. Lenders now have a significant choice to make from among CDCs in most states. This enhanced competition has forced CDCs to become much more efficient in their operations and vastly more effective in their role as providers of credit services.

The private sector lender's loan is not guaranteed by SBA. Thus, compliance with SBA regulations is the bailiwick of the CDC, not the lender. The lender is simply making a conventional

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loan in a senior security position on certain given assets. The lender agrees to the following conditions that limit the senior secured loan:

1. It must not allow future advances except those made for the reasonable costs of collection, maintenance, and protection of the lien.
2. It must not be cross-collateralized with other financing provided by the lender.
3. It must not have an early call feature.
4. It must not be payable on demand unless the note is in default.
5. It must have a term of less than seven or 10 years, respectively, for 10- or 20-year SBA-backed debentures.

None of these conditions is particularly onerous, especially in the context of a 50% LTC ratio and no specific requirements or limitations on the lender's pricing. (The lender must, however, remit to the SBA a one-time fee of 0.5% of the permanent loan amount.) Given that the lender's senior-position debt is extremely secure, a secondary market has developed that provides a wide range of pricing and amortization options, as well as significant profit and capital management alternatives for lenders.

At this point, the explanation of the actual mechanics of the process becomes complicated for even experienced bankers.

Consider the various moving parts:

- A bridge or interim loan.
- A borrower contribution that is, at least in part, determined by SBA regulations.
- Permanent financing from a lender that may or may not be

the "interim lender" and may or may not involve a secondary market option.

- Permanent financing supported by the SBA but delivered through a CDC.

Explaining this to the typical small business's principal would seem to require a degree of artistry. However, technology can, in this narrow confine, substitute for art with satisfying results—both aesthetic and pecuniary.

A financial spreadsheet model, which is both replicable and adaptable, helps make this explanation straightforward. The model breaks the process down into six steps:

1. Listing the proposed uses of funds to determine the overall project cost.
2. Determining the amount and makeup of the borrower contribution.
3. Determining the amount and source of the interim loan.
4. Determining the debenture size, pricing and fees, and prepayment premium.
5. Determining the amount and source of the permanent

third-party loan.

6. Comparing the loan to other financing options.

Listing the proposed uses of funds to determine the overall project cost.

Project cost is the total of all costs directly related to the asset being acquired, excluding any use of proceeds that could be defined as working capital for operations. In other words, virtually any cost is eligible—including traditional soft costs—that can be tied to the turnkey operation of the asset being acquired. Note the term *acquired*, as refinancing of existing assets is largely disallowed. There is no upper limit on the size of the project being financed.

The use of loan proceeds determines whether the 504 project is structured as a 10- or a 20-year amortization. The appropriate amortization is determined by the CDC/SBA, based on the useful life of the assets financed. Absent a significant difference in the useful life, the longer amortization is allowed. The definition of *significant* is subjective, and any application with a heavy allocation of

Uses of Funds		
	Amount Requested	% Project Cost
A. Land (and purchase of existing building, if applicable)	\$2,000,000	51.75%
B. Building (new construction, remodeling, L/H improvement, etc.)	\$750,000	19.40%
C. Machinery & Equipment (purchase, installation, etc.)	\$1,000,000	25.87%
D. Professional Fees (appraiser, architect, legal, engineer, etc.)	\$15,000	0.39%
E. Other Expenses (contingency, interest, etc.)	\$100,000	2.59%
Total Project Cost (Not including 504-related fees)	\$3,865,000	100.00%

machinery and equipment, as seen in Table 1, should specifically address the useful life of the financed assets.

Determining the amount and makeup of the borrower contribution. Under most circumstances, the borrower's equity injection goes in first, and the private-sector lender makes an interim loan that funds either the acquisition—or completion—of a capital asset under an end-takeout commitment supported by the 504 program. The level of equity contributed by the borrower is minimally 10% of the total project and increases in 5% increments to 20%, depending on whether the borrower is an established or start-up enterprise and whether the asset is single or multipurpose.

There is no restriction to injecting additional equity; interestingly, in the area of equipment financing, there is no discussion of alternative purposes and thus no requirement for equity above the 15% level. The borrower's equity may even come into the project as an asset—for example, land already owned—and, under certain circumstances, appreciated values may be used in the calculation of the contribution, thus creating the possibility of a fully debt-based project. (In fact, the SBA's regulations specifically state that the full equity injection may be borrowed!)

Determining the amount and source of the interim loan. After we define the borrower's equity contribution, the interim loan falls into place, as it is the difference between the borrower's equity contribution and the total

project cost. Once the interim loan is fully funded and the asset is properly titled in the borrower's name, the 504 debenture funds (in a junior security position on financed assets) reduce the interim loan to the desired level of the permanent financing. However, it is first necessary to calculate the amount of the debenture.

Determining the debenture size, pricing and fees, and prepayment fees. The amount of the SBA debenture, which funds the reduction of the interim loan, is limited. This becomes tricky because within those limits it must also account for the issuance costs. Recent legislative changes have increased limits to \$1.5 million, in most cases, and to \$2 million for public policy goals, such as loans to veterans, minorities and women, rural businesses, exporters, and certain others. Beyond this, legislation promoted by Congressman Donald A. Manzullo (R-Ill., chair of the House Small Business Committee) has created a special higher limit for small manufacturers of \$4 million. These increases are particularly helpful as the 7(a) program now operates under a maximum loan size of \$2 million. Funding occurs after the completion of the project and requires various certifications by all parties.

All things being equal, funding occurs within 45 to 60 days of the project's completion. The CDC enters the required paperwork into a regularly scheduled auction, through which debentures

backed by a federal government guarantee are sold and the proceeds are used to reduce the existing interim loan to the level contemplated by the permanent financing. The issuance costs are added to the debenture and—though not “out of pocket” to the borrower—can, on smaller issues, exceed 3%. Issuance costs are automatically calculated by the spreadsheet, and error messages show up if the program financing limits are breached.

Table 2 shows a typical 504 loan after the conversion to permanent financing, and Table 3 shows the calculation of the debenture issuance costs.

The actual interest rate on the debenture is set by the auction process. The steps involved include 1) a coupon rate to the investor; 2) a guarantee fee paid to the SBA, as well as servicing fees to both the financial transfer agent designated by SBA and the CDC; and 3) the final all-in rate paid by the borrower. There is at least a visual correlation to the movements of the 10-year Treasury note; nonetheless, there are variables at play, and the quoting of a

Sources of Funds		
	Dollar Request	% Project Cost
A. Net SBA Debenture (VIII.A.)	\$1,352,750	35.00%
B. Private Sector	\$1,932,500	50.00%
C. Other Financing	\$0	0.00%
D. Borrower Injection	\$579,750	15.00%
Total Project Financing	\$3,865,000	100.00%

Table 3

Debenture Pricing

A. SBA Share of Project Cost	\$1,352,750	35.00%
B. Administrative Costs		Rate
1. Reserve Amount	\$6,764	0.50%
2. Funding Fee	\$3,382	0.25%
3. CDC Processing Fee	\$20,291	1.50%
4. Closing Costs	\$2,500	
Subtotal	\$32,937	
		Term in years
5. Underwriters Fee	\$5,568	20
Total Administrative Costs	\$38,505	
C. Total Debenture Amount (A plus B rounded up to next '000)	\$1,392,000	
D. Balance to Borrower (C minus (A+B7))	\$745	

debenture rate, as well as the justification of the issuance cost, is likely best left to the CDC. (Figure 1 shows the rates of the debenture and the 10-year Treasury. Two aspects of this funding mechanism should be noted:

maintenance agreement. However, while the amount of the premium is derived from the coupon rate of the underlying issue, this can be discussed only indirectly with a borrower at the

1. It involves selling to investors a long-term fixed-rate product.
2. Pricing is set after the project's completion for a specific issue by a specific auction.

Investor appetite for fixed-rate products is significantly driven by the expected duration of the issue. To increase the viability of the debentures in the marketplace, there is a significant prepayment premium, which is calculated similar to a yield

outset, as the rate of the debenture is not established until after the specific auction at which it is funded. This highlights an issue that goes beyond prepayment costs—the exposure to rate risk during a construction or installation period, a risk that all creditors need to underwrite and that borrowers must be willing to bear.

Determining the amount and source of the permanent third-party loan. The permanent third-party loan also falls neatly into place because the two other variables (the borrower equity and the debenture) are now fixed. One concern is that, by regulation, in certain situations the permanent third-party loan must be no less than 50% of the total project cost. This must be balanced with the need to keep the debenture within the limits imposed by the SBA and the borrower's contribution to market-competitive levels. The model we use accomplishes this by logic statements that flash error messages when regulatory limits are breached.

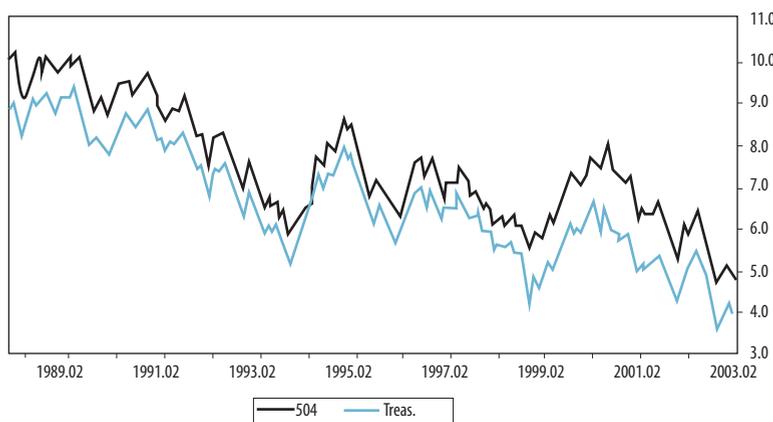
The strength of a straightforward exercise in spreadsheet modeling (see Table 4) is that, in fewer than 10 minutes, the borrower has an easily comprehensible description of the project financing structure and fees. The spreadsheet, which allows room for comments, can be e-mailed to the borrower and the borrower's financial advisor to serve as a basis for a decision.

Critical Product Differentiation

This overview of the 504 project financing product brings out several immediate differences from either conventional commer-

Figure 1

SBA 20-Year 504 Rate and 10-Year Treasury Yield (%)
Sources: DCFC, Bank of NY, Federal Reserve



cial lending products or other risk-mitigated products, such as the SBA 7(a) guaranteed loan.

The level of equity required of a borrower is largely lower than what would otherwise be the case. This is particularly true for both equipment financing and larger real estate projects, since SBA has determined that combination, or "piggyback," financing under the SBA 7(a) program is no longer eligible. To a borrower, this translates into the preservation of working capital, the continued funding of tax-deferred savings plans, and the preservation of personal liquidity.

The fixed rate of 10 to 20 years is, both in pricing and duration, vastly superior to what most borrowers could achieve. This advantage is strengthened further by the availability of up to 25-year amortizing loan structures with a wide range of pricing formats for the senior position permanent loan through the secondary market. The options for the first-position loans structure also include several ways to deal with prepayment penalties that reduce the significance of the SBA-backed loan's prepayment premium. The assumption provision of the SBA-backed loan should further reduce this issue, though at this writing, there is a regulatory interpretation of the assumption mechanics that reduces the viability of this option.

Two other advantages are gained from having two loans with virtually no limitations on pricing the senior loan and a requirement that the term be superior to generally available products:

1. The rate and amortization structures can be tailored

specifically to the needs of the situation, such as the perceptions of future interest rate movements or the borrower's time horizon for occupancy or use of the financed asset.

2. A degree of pricing flexibility comes from the first loan's clearly senior position, which exceeds the requirements for any definition of *well collateralized*. This flexibility allows strong borrowers to obtain truly exceptional rates while giving weak borrowers the opportunity of access to capital.

Defining the Target Market

Lenders are generally encouraged to lend money to enterprises run by individuals whose decisions are based on a well-defined sense of self-interest and rationality. If a credit product is explained effectively, there will be a natural self-selection among those prospective borrowers who recognize the product's advantage to their particular enterprises. The results are a lender having the "pick of the litter" and the rare event of appeasing the powers that be in both credit and marketing. The essential benefits of the 504 product are the preservation of capital, the long-term nature of the product, and flexibility in pricing and structure. Knowing this, we can define several markets that should be well suited to the product.

- Any capital-intensive business is a likely candidate. Manufacturing immediately comes to mind, although any business requiring significant levels of equipment or space would be in a comparable situation.
- Dental offices or outpatient

surgical centers that require significant buildout and finish are likely candidates.

- Any professional practice that has multiple partners with varying levels of financial strength. The 504's low down-payment requirement allows all financial levels of the membership to participate, thus strengthening the professional association.
- Any company attempting to grow aggressively will value preservation of capital and the long-term aspects of the financing package. For most firms, growth rates above the inherent rate of growth in the economy require additional working capital; for most smaller or near-inception companies, this means the retention of earnings. Any means to preserve after-tax cash will enhance the working capital position of the firm and thus support a higher growth rate.
- If a borrower expresses strong opinions about the direction of interest rates, the 504 provides a strong riposte. The debenture-backed portion of the 504 provides excellent protection against rising rates. However, the wide range of pricing and options to the first-position loan can be used in either rising rate or falling rate environments. Given the excellent security position of the 504, the lender can be aggressive in pricing, whether the rate is fixed or floating. The secondary market also provides a wide range of base rates with fixed or floating options for a variety of time frames. Most

A Lender's Guide to Successfully
Marketing SBA 504 Loans

Table 4			
Sample Project Overview			
504 Source, Uses, and Debenture Issuance Costs			
Public Policy Company? (Y/N)	N	Gross Debenture Cap for Nonpublic Policy Co.	\$1,500,000
		Gross Debenture Cap for Public Policy Co.	\$2,000,000

Source of Funds			Uses of Funds		
	Dollar Request	% Project Cost		Amount Requested	% Project Cost
A. Net SBA Debenture (VIII.A.)	\$1,352,750	35.00%	A. Land (and purchase of existing building, if applicable)	\$2,000,000	51.75%
B. Private Sector	\$1,932,500	50.00%	B. Building (new construction, remodeling, L/H improvement,	\$750,000	19.40%
C. Other Financing	0%	0.00%	C. Machinery and Equipment (purchase, installation, etc.)	\$1,000,000	25.87%
D. Borrower Injection	\$579,750	15.00%	D. Professional Fees (appraiser, architect, legal, etc.)	\$15,000	0.39%
			E. Other Expenses (contingency, interest, etc.)	\$100,000	2.59%
Total Project Financing	\$3, 865,000	100.00%	Total Project Cost (Not Including 504-related fees)	\$3,865,000	100.00%

Debenture Pricing			Comments
A. SBA Share of Project Cost	\$1,352, 750	35.00%	<p>The assumption is that the total project cost includes direct closing costs such as document stamps, intangibles tax, etc. However, if these costs are omitted from the total project cost (choice made by the borrower/creditor) then the total cash out-of-pocket at closing for the borrower will increase accordingly.</p> <p>The information herein has been obtained from sources we believe to be reliable, but we do not guarantee its accuracy or completeness. SRD Corporation, June 2005. All rights reserved.</p>
B. Administrative Costs		Rate	
1. Administrative Costs	\$6,764	0.50%	
2. Funding Fee	\$3,382	0.25%	
3. CDC Processing Fee	\$20,291	1.50%	
4. Closing Costs	\$2,500		
Subtotal	32,937		
		Term in Years	
5. Underwriters Fee	\$5,568	20	
Total Administrative Costs	\$38,505		
C. Total Debenture Amount (A plus B rounded up to next '000)	\$1,392,000		
D. Balance to Borrower (C minus (A+B8))	\$745		

secondary-market participants will allow qualified partial prepayments of the first-position loans, which removes a major stumbling block for borrowers faced with prepayment premiums in the debenture-backed portion.

With these comparative benefits defined and with the use of a spreadsheet model of this type, a comprehensive conversation can be directed at clearly identifying the critical concerns of a borrower and thus leading to a viable decision for all parties.

Table 5 offers a comparison between a conventional commercial loan and the 504 project financing laid out on the first page of the model. The model allows for inputs on fees, closing costs, interest rates and structure, term, amortization, and down-payment

A Lender's Guide to Successfully
Marketing SBA 504 Loans

Table 5

Comparison with Conventional

SBA 504 LOAN versus Conventional Loan

SBA 504 Loan Program			Conventional Loan		
	Dollar Amount		% of Total Funds	Dollar Amount	% of Total Funds
Owner Injection	\$579,750		15.00%	\$773,000	20.00%
Bank Loan	\$1,932,500		50.00%	\$3,092,000	80.00%
SBA 504 Debenture	\$1,352,750		35.00%	\$0	0.00%
Other Financing	\$0		0.00%	\$0	0.00%
Total Project	\$3,865,000		100.00%	\$3,865,000	100.00%
	Bank	SBA 504	Total	Bank	
Loan Amount	\$1,932,500	\$1,352,750	\$3,285,250	\$3,092,000	
Interest Rate	7.05%	6.50%		6.75%	
Int. Rate Readjustment Period	10-year fixed	20-year fixed		Floating	
Points or SBA Guarantee	1.00%	0.00%		1.00%	
Amortization (years)	20	20		20	
Loan Closing Costs	\$43,823	\$16,161	\$59,983	\$71,491	
Collateral Verification Costs	\$5,300	\$0	\$5,300	\$5,300	
CDC Processing Fee @ 1.5%	\$0	\$20,291	\$20,291	\$0	
Debenture Issuance Costs	\$0	\$18,214	\$18,214	\$0	
Total Fees	\$49,123	\$54,666	\$103,788	\$76,791	
Fees Rollup into Loan (Y/N)?	Y	Y		N	
Total Loan Amount	\$1,981,623	\$1,407,416	\$3,389,038	\$3,092,000	
Cash Impact					
Weighted Avg. Interest Rate	7.05%	6.50%	6.82%	6.75%	
Monthly Payment	\$15,423	\$10,493	\$25,916	\$23,510	
Cash Down Payment		\$579,750	\$773,000		
Closing Costs Paid by Borrower			\$0	\$76,791	
Total Cash Out-of-Pocket at Closing			\$579,750	\$849,791	

Difference with 504: \$2,406 higher monthly payment and \$270,041 less to pay at closing

Note: All costs are estimates and are understood to be non-binding. Actual costs will vary according to lender, title insurance co., etc.

requirements. It then compares the results on payments, weighted average interest rates, and borrower cash requirements for the project. Similar sections of the model perform the same process for comparison to 7(a) loans and to other types of common financing alternatives.

Conclusion

The 504 provides an extraordinary degree of flexibility in

financial structuring to meet borrower needs. While it accomplishes this through a multistep mechanism, the product is only as daunting and complicated as the lender chooses to make it. With a modicum of effort, the lender has a tool that clearly defines the decision-making process. It is a reasonable expectation of lenders that the CDC they choose to involve in their projects should

have both access to and the ability to use basic financial skills to support and further the institution's marketing goals. Paramount among these is the ability to assist a borrower in making financially rational decisions that lead directly to stronger borrowers and better loan portfolio performance. □

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