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Taking it to the bank

Financing an accounting practice sale with an SBA 7(a) loan
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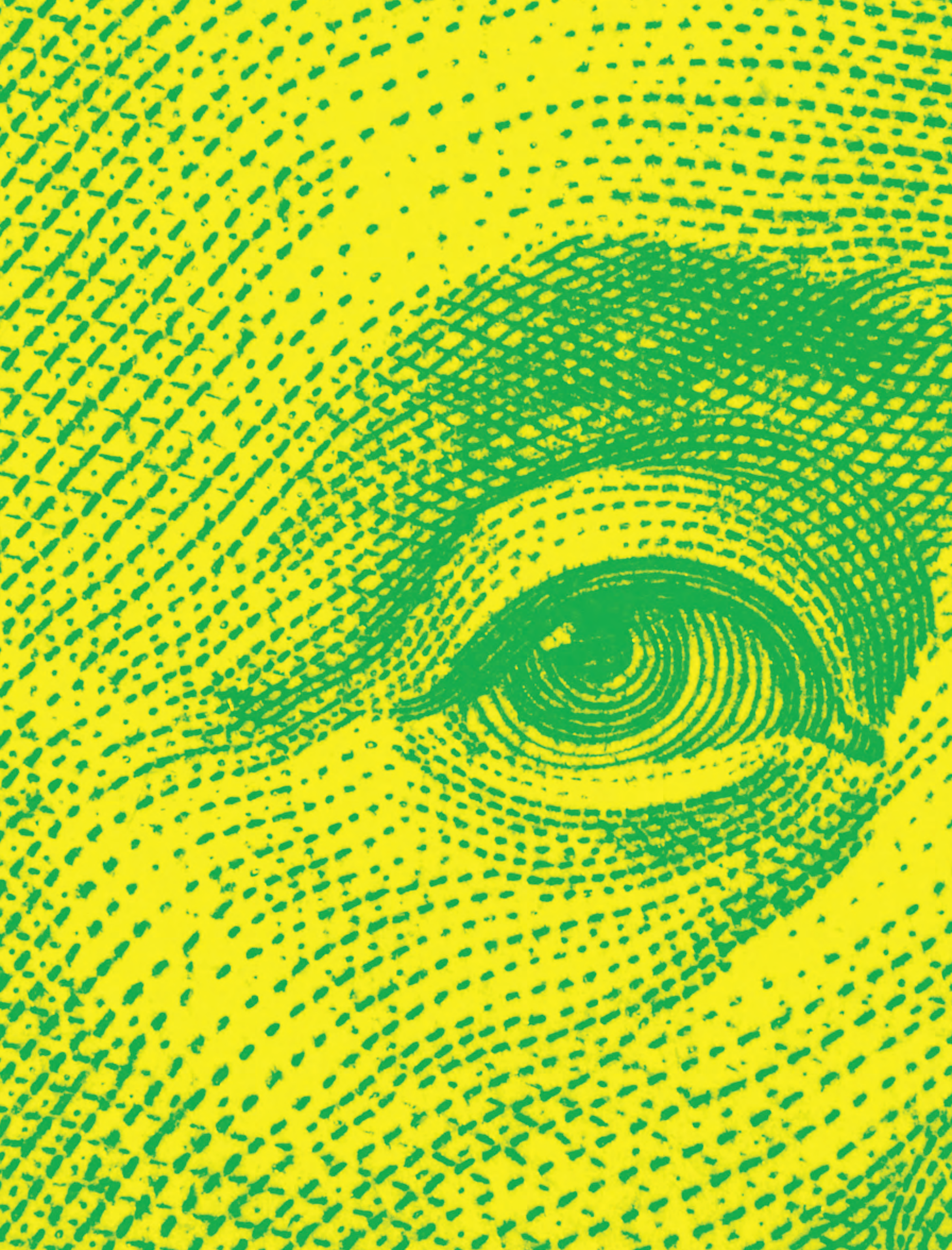

Bank-financing an accounting practice sale

Want maximum cash at closing? An SBA 7(a) loan might be your firm's best bet.

By Harry L. Olson, CPA

If you own an accounting practice, you will likely sell or merge it within your lifetime. For many Baby Boomers, the time for such a transaction may be just around the corner. Before you are ready to transition to the next phase of your life, it will be necessary to seriously consider how the sale of your accounting practice will be financed. This is true whether you intend to sell your CPA firm to an employee, a family member, or a third party.

Imagine that you have just received an offer to purchase your CPA firm from an exceptionally experienced and financially qualified buyer. A detailed review of the offer reveals that the buyer wants you to accept a deal containing a 10% cash down payment with the remainder payable on an earnout basis. You immediately recognize this type of deal as highly risky to the seller because it provides the buyer essentially no incentive to perform — as discussed in my previous article, "Maximize Proceeds in Accounting Firm Sales," *JofA*, Nov. 2015, tinyurl.com/ydylexyy.

Negotiations ensue. You let the buyer know that you need significantly more cash at closing and that you are not interested in the proposed earnout deal structure. You and the buyer meet with a local banker to discuss the fact that the buyer has good credit and enough cash for a 10% down payment. Unfortunately, the banker declines to finance the transaction because of a lack of available tangible collateral. After much soul-searching and negotiation, you reluctantly accept final terms of 10% cash down and an installment note from the buyer for 90% of the purchase price. You were successful in eliminating the earnout component, but the deal did not fulfill your need for substantially more cash at closing.

That scenario is far too common. After being turned down for a loan in similar situations, buyers and sellers often reach the erroneous conclusion that the lack of tangible collateral will be a problem for every lender in the marketplace.

Despite what some financial institutions may tell you, there is a way to bank-finance most accounting practice sales. This article provides buyers and sellers information about the availability, requirements, and terms applicable to bank financing for CPA practice acquisitions. This information can also be useful for financing myriad other types of service businesses.

CHOOSING THE RIGHT LENDING PROGRAM

Most conventional business lenders are willing to underwrite loans for business acquisitions in situations where adequate tangible collateral exists. Tangible collateral can include — but might not be limited to — equipment, real estate, marketable securities, accounts receivable, and inventory.

However, of the hundreds of CPA practice sales I have negotiated, a majority did not involve adequate tangible collateral to meet the requirements of most conventional lenders. A few conventional lending programs that do not require significant tangible collateral do exist for professional practice loans. However, most bank lending for CPA practices where minimal tangible collateral exists involve the U.S. Small Business Administration's 7(a) Loan Program.

The SBA established the 7(a) program to provide lending when market conditions preclude or limit conventional business lending for loan amounts up to $5 million. (Note that the AICPA

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and SBA have a strategic alliance that helps CPAs advise and advocate for small businesses seeking relief from undue regulatory burdens. For more information, visit tinyurl.com/y8go3k93.) The SBA guarantees 7(a) loans to the extent of 75% to 85% of the loan amount depending on the size of the loan and subject to conformity with SBA policy. This guarantee substantially reduces the risk to SBA lenders in financing business acquisitions, resulting in a greater willingness to underwrite these loans. This reduction in lender risk is particularly vital to acquisition lending for CPA practices and other service businesses, where tangible collateral represents only a small percentage of the purchase price.

The majority of accounting practice sales can be financed with an SBA 7(a) loan — provided that the practice being purchased is profitable and the buyer has good credit and an adequate down payment for the loan. In addition, a 7(a) loan can result in most (or all) of the purchase price being paid to the seller in cash at closing. This is great news for CPAs who have been refused a loan by a conventional lender to finance an accounting practice sale.

CHOOSING THE RIGHT SBA LENDER

SBA 7(a) program lenders fall into two categories.

Some lenders are required to use standard submission, which mandates that the SBA review the loan prior to approval by the SBA lender. This process essentially requires the loan to be underwritten twice — once by the lender and again by the SBA.

Other lenders qualify under the Preferred Lenders Program, which allows "preferred lenders" to underwrite the loan without sending it to the SBA for a second approval. The Preferred Lenders Program process is much faster than standard submission. Thus, it is optimal to choose a preferred lender.

It is always best to talk with a number of preferred lenders before applying for a loan. Vast differences exist in underwriting programs among SBA lenders. Some lenders impose more stringent standards than the SBA program dictates. This is often because the lenders have underwritten very few, if any, CPA practice acquisition loans and are unfamiliar with the profession.

Therefore, it is often best to choose a preferred lender who has underwritten many loans for accounting practice sales — and possibly a lender with a team that specializes in accounting practice acquisitions.

SBA 7(A) LOAN REQUIREMENTS AND TERMS

The SBA has a number of requirements and terms for its 7(a) loans (see the sidebar, "SBA 7(a) Loan Requirements and Terms").

Following is a dive into the details of those terms and requirements that CPAs should know.

Credit standards for SBA 7(a) loans

The minimum credit score varies by lender. Some lenders accept credit scores in the low to mid-600s; others require much higher credit scores.

Minimum equity injection

SBA 7(a) policy now requires a minimum equity injection of 10% of the "total project costs" of the transaction — typically in the form of a cash down payment from the buyer. This is a major change in SBA policy compared with the 25% minimum equity injection requirement mandated prior to Jan. 1, 2018. Total project costs must include, but are not necessarily limited to, the following:

- Purchase price;
- Working capital;
- Attorney fees;
- SBA fees;
- Cost of any required business valuation; and

IN BRIEF

- The Small Business Association's 7(a) Loan Program provides an alternative for CPAs whose loan request to finance an accounting practice sale has been rejected by conventional lenders.
- An SBA 7(a) loan can finance most accounting firm sales when the firm being sold is profitable and the buyer has good credit and an adequate down payment.
- One of the best features of SBA 7(a) loans for CPAs selling their practice is that they can lead to most, if not all, of the purchase price being paid in cash to the seller at closing.
- CPAs looking for an SBA 7(a) lender should look for those that participate in the SBA's Preferred Lenders Program.

To comment on this article or to suggest an idea for another article, contact Jeff Drew, a JofA *senior editor, at Jeff.Drew@aicpa-cima.com or 919-402-4056.*

- Any other closing costs applicable to the transaction.

Depending on the parameters of the transaction and the financial strength of the borrower, some lenders may require an equity injection greater than 10%. In addition, others may allow the preexisting equity in a firm owned by the buyer to be used for the equity injection requirement, while many lenders will not.

Liens and collateral related to SBA loans

The SBA lender will always secure a first-position blanket lien against all assets of the practice being purchased.

For most 7(a) loans, the lender will also secure any available additional assets of the borrower as collateral. These include the borrower's preexisting business, personal residence (depending on the state), investments (excluding retirement accounts), other real estate, and any other asset of significant value the borrower owns. The lender is not required to secure a lien against the applicant's real estate when the equity in the real estate is less than 25% of its fair market value. The lender may also limit the lien taken against real estate to the loan amount.

Importantly, this does not mean that additional tangible collateral must exist to secure most 7(a) loans. SBA policy mandates that the lender secure liens against the borrower's additional collateral *if it exists*. However, the existence of this collateral is not required. This is the supreme advantage of SBA 7(a) lending.

Partial seller financing

Many (but not all) SBA lenders may require a seller-carried note payable from the buyer to the seller for as much as 10% to 30% of the purchase price — to ensure seller performance of relevant obligations during the transition. This is particularly relevant to larger transactions, where most lenders would make further efforts to minimize risk by lowering the deal's loan-to-value ratio. The seller-carried note can be "fully performing" under SBA policy — meaning the seller can receive payments on the note from the first month after closing, as long as the cash flow of the practice allows and the lender does not have more stringent requirements than the SBA.

Possible 5% buyer down payment with seller participation

When a buyer can provide only a 5% equity injection, SBA policy will allow the 10% equity injection requirement to be shared between the buyer and the seller. The lender must receive a minimum equity injection from the buyer of 5% of the total project costs. The remainder of the equity injection may be satisfied with a seller-carried note payable from the buyer to the seller — limited to a maximum seller participation of 5% of the total project costs.

It should be noted that any portion of the required 10% equity injection that consists of a seller-carried note must be "on full standby" for the entire term of the SBA loan, which is typically 10 years. This means that the seller cannot receive any payments on any seller-carried note that apply toward any portion of the equity injection for the SBA loan's entire outstanding term.

Thus, it is best to split a single seller-carried note into two notes when partial seller financing equals an amount greater than 5% of the total project costs, assuming a seller wishes to participate in the equity injection. In most cases, only the seller-carried note that applies toward the equity ▶

SBA 7(A) loan requirements and terms

The following is a list of current SBA 7(a) loan requirements and terms.

Primary SBA 7(a) loan requirements

- Adequate borrower credit score.
- Adequate debt coverage ratio for the borrower to meet all obligations.
- Minimum 10% equity injection.
- Personal guarantee of any borrower with ownership equal to or greater than 20%.
- First lien against the practice being acquired.
- Liens against certain of the borrower's assets to the extent such collateral exists.
- Business valuation to support the purchase price and/or the loan amount.

Major SBA 7(a) loan terms

- 10-year amortization (shorter terms are available with some lenders).
- Floating interest rate typically quoted at prime plus 2%–2.75% depending on the buyer's credit, the size of the loan, and the strength of the deal.
- SBA guarantee fee (paid by the purchaser based on the loan amount).

The Preferred Lenders Program allows 'preferred lenders' to underwrite the loan without sending it to the SBA for a second approval.

injection would be on full standby. The additional seller-carried note (unrelated to the equity injection) may be fully performing from day one, subject to lender approval.

Business valuation requirement

SBA policy requires a qualified third party to perform a business valuation related to any business the borrower is acquiring if the amount being financed (including any lender, seller, or other financing) minus the appraised value of real estate and/or equipment is greater than $250,000 — or if there is a close relationship between the buyer and the seller (e.g., transactions between current owners or family members). The lender will choose the expert to perform the business valuation. If the business valuation for the CPA practice arrives at a value lower than the purchase price agreed upon by the buyer and seller, some lenders may require the purchase price to be reduced to the value indicated in the business valuation. Other lenders may allow an additional seller-carried note and/or buyer down payment to make up the difference between the purchase price and the valuation.

Loan amortization and interest rates

Compared to shorter terms, a 10-year amortization provides a purchaser with much better cash flow net of debt service in the early years of the loan, assuming all other variables are equal. Shorter loan terms are available from some lenders when warranted. It should also be noted that if real estate is involved in the transaction, the SBA 504 Loan Program enables much longer amortizations.

Interest rates could occasionally be lower than prime plus 2%–2.75%, depending on the borrower's credit, potential collateral, and the circumstances of the acquisition. Interest rates will range higher for any fixed-rate 7(a) loan available with some lenders.

SHOP AROUND

Many CPAs remember a time when an SBA loan would take many months to be approved and closed. The SBA Preferred Lenders Program is intended to streamline the process. With preferred lenders, SBA 7(a) loans can be closed in as few as six weeks from start to finish. The process is not nearly as arduous as it may seem.

There are vast differences in policies among preferred lenders. Some exceedingly cautious or risk-averse lenders can kill deals. Thus, it would be advisable for anyone looking for an SBA 7(a) loan to shop around.

Finally, when the seller of a CPA practice is confronted with a potential purchaser who claims that he or she cannot obtain financing for the transaction, the seller should consider whether the buyer is bluffing, is not creditworthy, or has received bad information from the wrong lender. No matter the reason, it would be prudent to speak with and qualify a number of other buyers and lenders before accepting anything less than a deal that meets all of the seller's needs — including the need for the majority of the purchase price to be paid in cash at closing. ■