

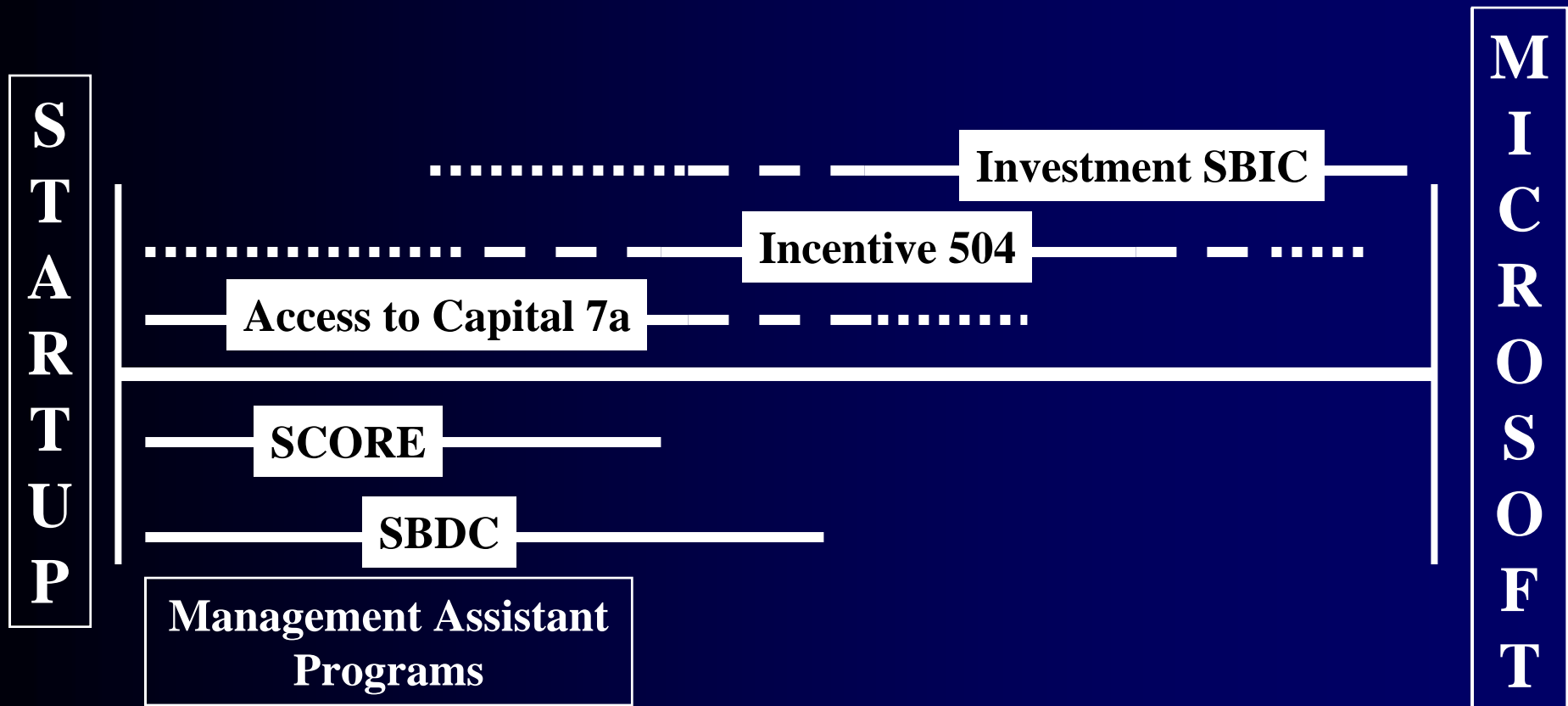
NADCO

504 Loan Program

First Mortgage Lender Training

Why 7a and 504?

SBA programs are suited to businesses in various stages of development



Why 7a and 504?

Access to Capital vs. Incentive Financing

7a Access to Capital (Lender of Last Resort)

- **Businesses that cannot access conventional financing**
- **Typically undercapitalized**
- **Lacking in experience/track record**
- **Specialized collateral**
- **Marginal historic cash flow**

504 Incentive Financing (Economic Development Financing)

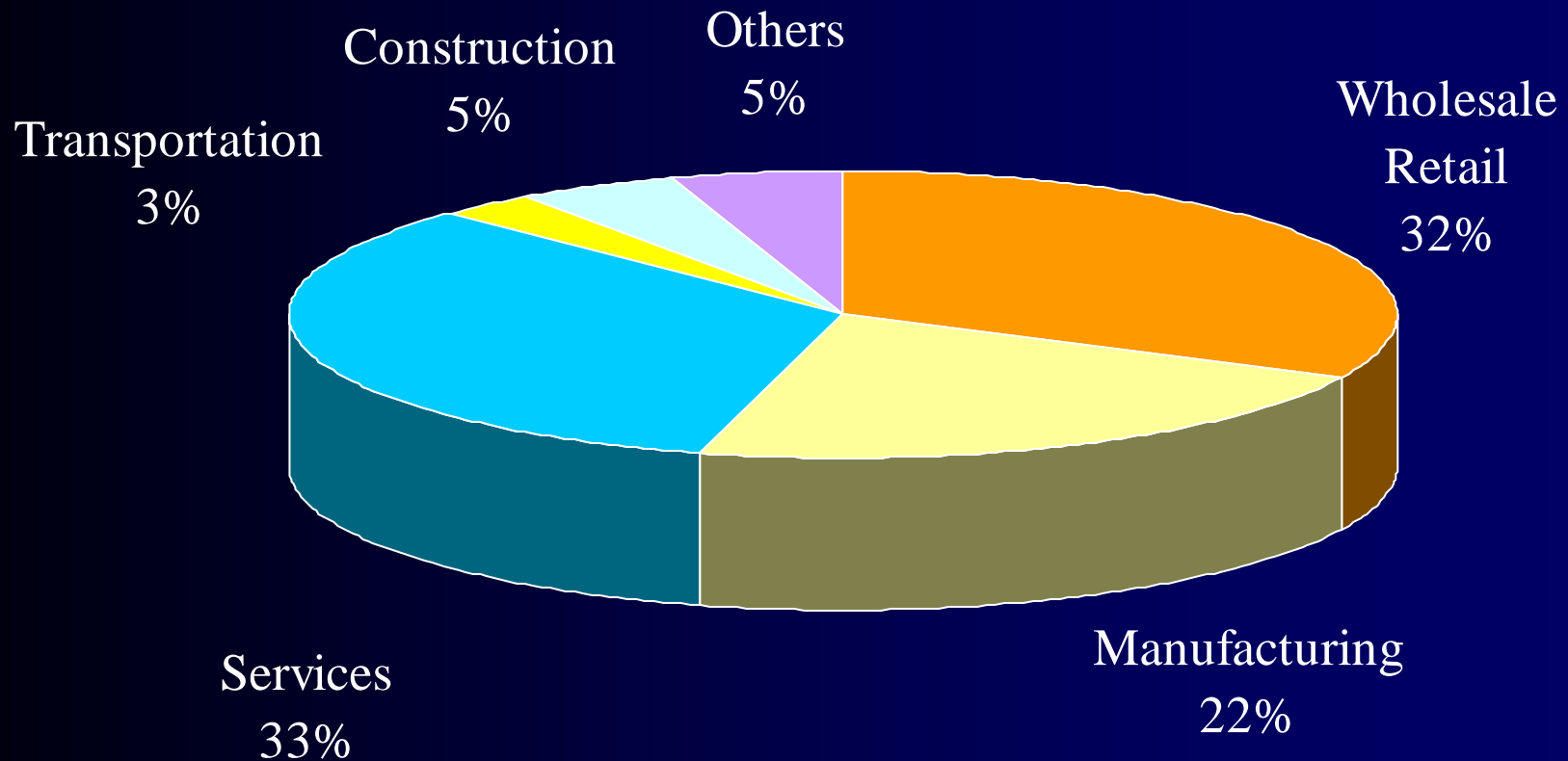
- **Stimulate private sector investment in long term fixed assets**
- **Increase productivity**
- **Create new jobs**
- **Increase and/or stimulate local tax base**

Long term, low down payment, reasonably priced financing to healthy , expanding businesses that have a high probability of successfully creating new jobs.

History of the 504 Program

- **Created in October 1980; Section 503 of the Small Business Investment Act**
- **503 Program funded loans through the sale of Debentures to the Federal Financing Bank (a part of the U.S. Treasury)**
- **504 Program funds loans through the sale of Debentures to the Private Capital Markets**
- **Since 1980, over 40,000 loans have been made representing financing of over \$20 Billion, resulting in the creation or retention of over 1 million jobs**

503/504 Loans by Industry Type



Certified Development Companies (CDC)

- **Licensed and regulated by the Small Business Administration (SBA)**
- **SBA grants geographic boundaries**
- **Most are non-profit organizations**
- **Some are affiliated with public entities, or other non-profits**
- **CDC's have a Public Purpose - Economic Development**

CDCs . . .



- **Must have professional staff available to:**
 - **Market the Program**
 - **Package and Process Loans**
 - **Close Loans**
 - **Service Loans**
 - *Liquidate Loans*
- **Many CDC's administer other finance programs**
 - **CDBG Revolving Loan Funds**
 - **SBA 7a Loan Packaging**
 - **Rural Development IRP**
 - **Other State and Local Programs**

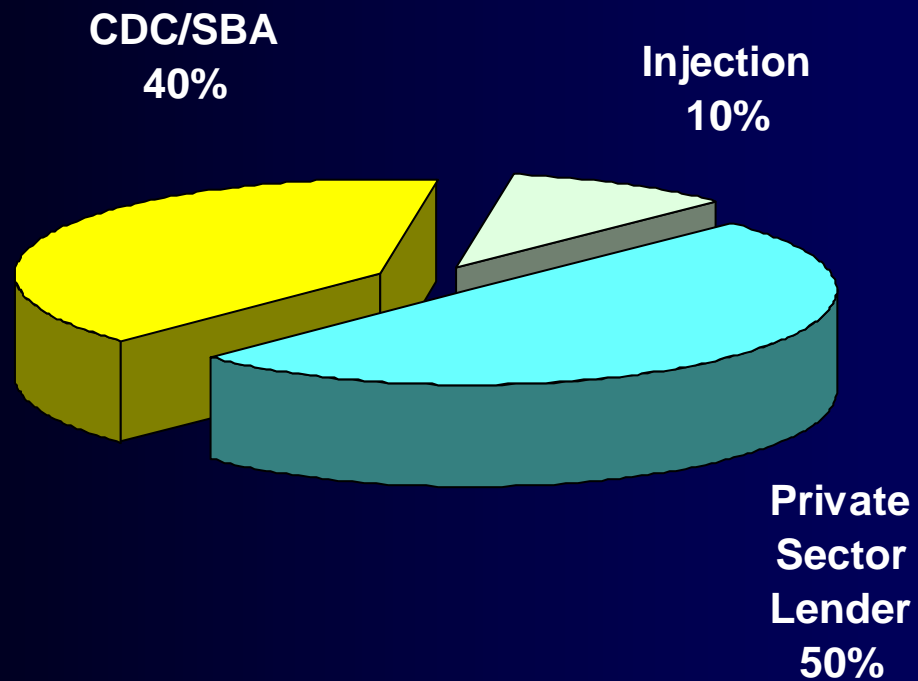
Goals of the 504 Program

- **Create Economic Development Opportunity in a Community**
- **Provide Affordable Long Term Financing For Business Expansion**
- **Give a Financial Incentive to encourage Private Lender Participation**
- **Give A Financial Incentive to Stimulate Business Capital Investment**
- **Provide Access to Public Capital Markets for Small Business**



**DEVELOPMENT COMPANIES ASSIST SBA BY
STRETCHING SBA'S LIMITED RESOURCES**

Model 504 Financing Structure



Higher Collateral Risk In Exchange For Economic Development

The 504 loan program was created to meet economic development financing objectives. Its structure is specifically designed to be an incentive for lenders to participate in financing those businesses that will meet certain economic development criteria.

Higher Collateral Risk In Exchange For Economic Development

Because of the unique economic development purposes of the program, it is appropriate to have different collateral requirements for 504 loans than those imposed on 7(a) financings. Generally, the primary CDC/SBA collateral will be a lien, subordinate to a third party lender, on the project property.

Higher Collateral Risk In Exchange For Economic Development

SBA will go out on the collateral “limb” farther than a conventional lender or than allowed under 7(a), in exchange for the economic development benefit that results from the financing.

Structure Guidelines

- Private Sector Participants
 - Usually a Bank; must have experience at this type of lending.
 - May take the priority lien on assets pledged as collateral.
 - Must offer term of 10 years if debenture is 20 years (or 7 if debenture is 10 years) – balloon notes discouraged.
 - May set rate and fees (legal and reasonable).
 - Their loan **cannot** be guaranteed by SBA.

Structure Guidelines

- CDC/SBA Participation
 - Maximum is usually 40% of eligible project costs
 - Takes a lien subordinate to the private sector lender on assets pledged as collateral for the loan
 - Can offer either a 10 or 20 year term (depending on the assets financed)
 - Provides a fixed interest rate loan
 - CDC issues a debenture (bond) that is guaranteed 100% by SBA.

Structure Guidelines

- Equity or Local Injection
 - Minimum is usually 10%
 - Limited use or Start Up 15%; Both 20% ***
 - In the form of cash or equity in real estate
 - Usually required of the borrower
 - Can however be subordinated debt (interest only)
 - May be a loan from CDC or other lender (rare); if secured, it must be subordinate to CDC/SBA and private sector lender. (Term should be same or longer)

Advantages of a 504 Loan



- For the Borrower
 - Low Down Payment
 - Fixed interest rate second mortgage loan
 - Long Term Financing
 - Rate of private sector financing usually more favorable (Low LTV)
 - In credit crunch - getting a loan at all
 - Collateral usually limited to project assets

Advantages



- For the Community
 - JOBS
 - Capital Investment; Tax Base Increase
 - Stimulation of Other Development
 - Greater Access to Capital for “underserved” markets
- For the Private Sector Lender
 - Excellent LTV
 - US. Government as Subordinate Lender
 - No restrictions on rates as their loan is NOT guaranteed by the SBA
 - Less paperwork and “red tape” than a 7a loan
 - 504 first mortgage secondary market

What they may not like .



- For the Borrower
 - Prepayment Penalty for the first half of term of CDC loan and for 3, 5 or 10 years on a securitized loan.
 - 504 financing limited to fixed assets
- For the Private Sector Lender
 - Bank Participation Fee

Prepayment Penalty (20 Year)

YEAR	%	% Of Principal Outstanding
1	100%	105.90%
2	90%	105.31%
3	80%	104.72%
4	70%	104.13%
5	60%	103.54%
6	50%	102.95%
7	40%	102.36%
8	30%	101.77%
9	20%	101.18%
10	10%	100.59%
After 10	0%	100.00%

Prepayment Penalty (10 Year)

YEAR	%	% Of Principal Outstanding
1	100%	105.90%
2	80%	104.72%
3	60%	103.54%
4	40%	102.36%
5	20%	101.18%
After 5	0%	100.00%

Basic Eligibility For 504 Financing

- **Be an Operating Business (Except for loans to Eligible Passive Concerns)**
- **Be organized for Profit**
- **Be Located within the United States**
- **Be “Small” Under the Program Size Standards**
- **Demonstrate the need for the desired financing**
- **Meet an economic development objective of the program**

Liquid Personal Resources

EXCESS PERSONAL RESOURCES MUST BE INJECTED INTO THE PROJECT PRIOR TO DISBURSEMENT OF ANY SBA FINANCING

- If the Total Financing Package
 - Is \$250,000 or less, liquid personal assets in excess of TWO TIMES the Total Financing Packaging or \$100,000, whichever is greater...
 - Is between \$250,000 and \$500,000, liquid personal assets in excess of ONE AND ONE HALF TIMES the Total Financing Package or \$500,000, whichever is greater...
 - Exceeds \$500,000, liquid personal assets in excess of ONE TIME the Total Financing Package or \$750,000, whichever is greater

Additional Personal Resources

- LIQUID ASSETS:
 - Cash or cash equivalent
 - Savings Accounts, CD's , Marketable Stocks and/or Bonds
 - Cash Surrender Value of Life Insurance
- Applies to personal resources of owner(s) of 20% or more
- IRA or other Retirement Accounts; Real Estate and Other Personal Property are Exempted.
- Consider each owner separately.

Additional Personal Resources

Total Financing Package =

- + First Mortgage
- + GROSS Debenture
- + Equity Injection
- + Any other financing associated with but not included in 504 project

Credit Not Available Elsewhere

SBA requires Lender or CDC to show that the desired credit is unavailable to the applicant from non-Federal sources without SBA assistance.

Credit Not Available Elsewhere

– **FACTORS WHICH MAY PREVENT FINANCING FROM BEING AVAILABLE WITHOUT SBA ASSISTANCE.**

- Repayment capability requires maturity period that exceeds bank's policy.
- Bank's legal lending limit would be exceeded
- Bank's liquidity is insufficient without proceeds of secondary market sale of the loan, which is made possible by participation with SBA
- Uniqueness or value of available collateral is unacceptable to the bank
- Risk associated with the start-up nature of the business exceeds the bank's normal credit policy
- Any other factors relating to the credit in the lender's opinion cannot be overcome except for participation with SBA

Bank Commitment Letter

- Must decline customer request for conventional financing and state reason for doing so.
- Decline can be in the commitment letter or in a separate conventional decline letter.
- Failure to do this will hold the application up at SBA and possibly get it declined.

ECONOMIC DEVELOPMENT CRITERIA

- JOBS
and/or
- Community Impact
and/or
- Public Policy Goals



Community Impact and Public Policy Goals can only be used for Economic Development Eligibility when the CDCs' Portfolio as a whole creates One Job per \$50,000 or better.

JOBS

- Create or Retain One Full Time Equivalent Job for every \$65,000 of SBA Guaranteed dollar in the project (One job per \$100,000 for manufacturing companies).
- Job Creation would take place in the first TWO YEARS after project placement.
- Retained Jobs are jobs that would be lost BUT FOR the project.
- CDC can “loan” jobs to a project if it meets an SBA Public Policy Goal.

Community Impact

- Improve, diversify or stabilize the economy of a locality
- Stimulate other business development
- Bring new income into the community
- Assist Manufacturing Firms
- Assist businesses in a a Labor Surplus Area (check with CDC for list of Labor Surplus Areas)

Public Policy Goals (aka National Objectives)

- Revitalize a Business District of a community with a written and defined Revitalization or Redevelopment Plan
- Expand Exports (10% or more of annual gross revenues from exporting)
- Expanding Minority Enterprises Development (51% ownership; 8a definition)
- RURAL Development (communities under 20,000 or with District approval)
- Increase Productivity and Competitiveness (retooling, robotics, plant modernization, competition with imports)
- Modernizing or upgrading facilities to meet health, safety and environmental requirements
- Assisting Communities affected by Federal Budget Reductions including Base Closures or loss of Federal Contracts
- Expanding business ownership opportunities for veterans and women

Maximum Loan Amount

- **An eligible entity may borrow up to 40% of the project or a total SBA guaranteed portion of \$1.5 million.**
- **Unless, the project meets a Public Policy Goal, then maximum SBA guaranteed funds can go up to \$2.0 million or \$4.0 million on energy efficiency projects.**
- **Maximum debenture on for manufacturing companies is \$4 million and job creation requirement is 1 job per \$100,000 of 504 debenture funds.**
- **If applicant (or affiliates) has existing SBA loans, the total guaranteed portion must not exceed the maximums stated above.**
 - **504 loans carry 100% guaranty**
 - **7(a) loans usually carry 75-85% guaranty**

7A Companion Loans

- An SBA 7A loan can accompany the 504 loan to provide funds for non-504 eligible costs (i.e.- franchise fees, inventory, working capital, goodwill).
- The total of the 504 debenture and the 7A guaranty cannot exceed \$1.5 million (\$2 million for loans meeting a Public Policy Goal).

Business Acquisition Loans

- Business acquisition loans must have both a real estate appraisal and a “business valuation”.
- Business acquisitions require a determination of the value of the assets being purchased (real estate & equipment vs. current assets and goodwill).
- The fixed assets will be financed with the 504 loan and the current assets and goodwill with the 7A companion loan.

Minimum Loan Amount

- **The debenture should be no less than \$50,000. That translates to a project size of about \$125,000.**
- **With special permission from District Office, the debenture can be less, but can never be less than \$25,000.**



504 Size Standards

Tangible Net Worth of no more than \$8.5 million AND Net Profit after Tax (2 year average) of no more than \$3 million

-or-

Use 7(a) size standards as an alternative

(Size standards increase by 25% in Labor Surplus Areas)

Ineligible Types of Businesses



- Non - Profit Institutions
- Finance Businesses (Banks, Finance Companies, Insurance Companies, etc)
- Real Estate Development and other Speculative Business
- Business Located in a Foreign Country [Legal Permanent Resident – LPR]
- Pyramid Sales Distributions
- Businesses deriving more than 1/3 of Gross Annual Revenues from Legal Gambling
- Businesses that limit membership for reasons other than capacity

Ineligible Types of Businesses



- Government Owned Entities (Except Tribal)
- Businesses Principally engaged in Teaching, Instructing, Counseling or Indoctrinating Religion or Religious Beliefs
- Consumer Marketing Co-ops (Producers Co-ops OK)
- Businesses earnings more than 1/3 of income from packaging of SBA loans
- Businesses in which the Lender or CDC or any of its associates owns an equity interest
- Businesses primarily involved in political or lobbying activities.

Ineligible Types of Businesses



- Businesses which present live performances of a Prurient Sexual Nature or derive more than de minimus gross revenues from the sale of products or services of a prurient sexual nature
- Unless, waived by SBA, Businesses that have previously defaulted on a Federal loan or Federally-assisted financing
- Businesses where an associate is incarcerated, on probation or parole, or has been indicted for a Felony or crime of moral turpitude
- Businesses engaged in any illegal activity

Eligible Use of Proceeds



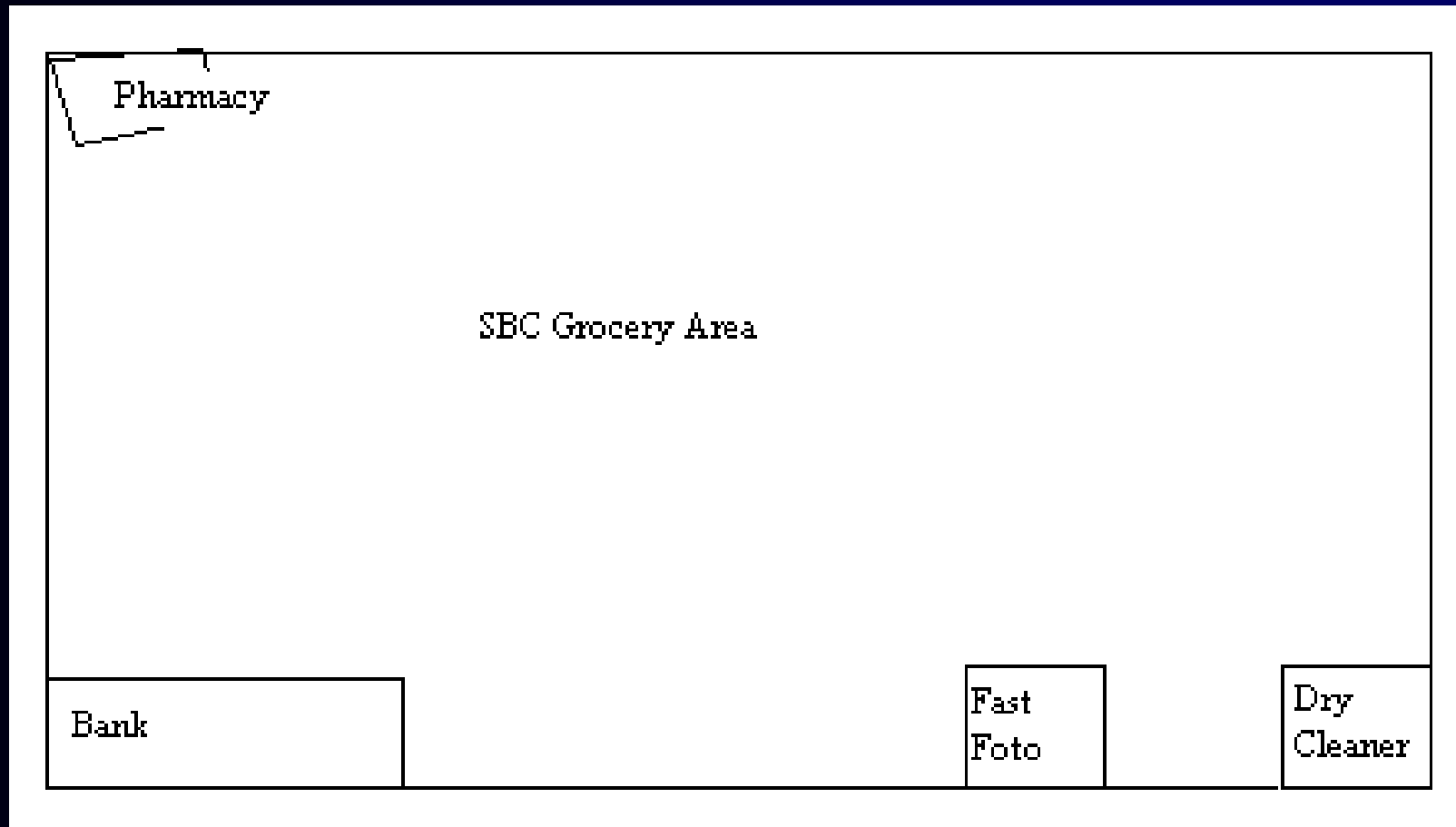
- Acquisition of Land
- Land Improvements
- Purchase of one or more existing buildings
 - OC must occupy at least 51% (initial use)
 - 504 Projects funds cannot make tenant improvements (except for standard building components)
- Remodel, convert, expand or renovate existing building(s)

Eligible Use of Proceeds



- Construction of New Building
 - OC needs to occupy at least 60% with plans to occupy more of the space within 3 years and 80% within 10 years. Can lease up to 20% indefinitely (C-Store rule).

CAN I DO THIS?



Eligible Use of Proceeds



- Acquisition of Machinery & Equipment (generally with a 10 year useful life)
- Contingency Reserve, not to exceed 10% of construction costs
- Professional Fees (architectural, engineering, appraisal, environmental, survey)
- Repayment of Interim points, bank fees and interim interest (cannot include Permanent points except in a one time close situation)

Eligible Use of Proceeds



- **NINE MONTH RULE:** Costs incurred within 9 months of the date of application to SBA can be included in project costs.
 - **Waivers available for good cause**
 - **Land costs can always be included.**
 - **After two years ownership, land equity injection can be determined by appraisal. Otherwise, cost is always the basis.**

Ineligible Use of Proceeds



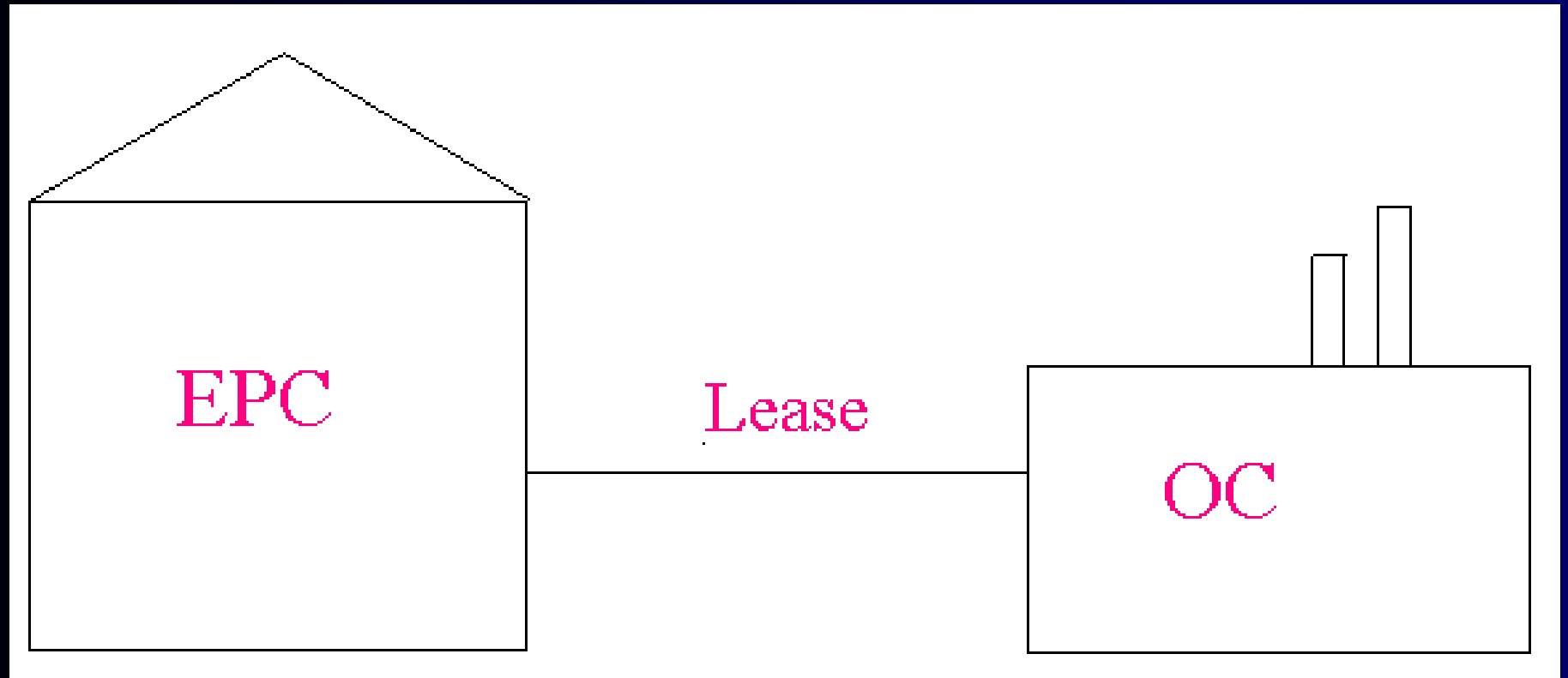
- Working Capital
- Debt Refinance (except for eligible interim financing)
- Counseling Fees
- Incorporation or Other Organizational Costs
- Commitment Fees; Finance Broker Fees; Origination Fees for Private Sector Financing
- Franchise Fees

Ineligible Use of Proceeds



- Equipment or Furnishings with less than a 10 year useful life, unless . . .
 - They are an integral part of the project and/or
 - They are a minor portion of the project
- Automobiles, Trucks, Airplanes (exception for on site use only)
- Advertising
- Borrower Closing Legal Fees

CAN I DO THIS?



Eligible Passive Concern (EPC)

A small entity or trust which does not engage in regular and continuous business activity, rather it leases real or personal property to an Operating Company for use in the Operating Company's business.



Eligible Passive Concern (EPC)

- An EPC must use loan proceeds to acquire or lease and/or improve real or personal property that it leases to an Operating Company
- Any ownership structure or legal form may qualify as an EPC
- The EPC (with the exception of a trust) and the operating Company each must be “small businesses” under the appropriate size standards. They may or may not be affiliates depending on circumstances.

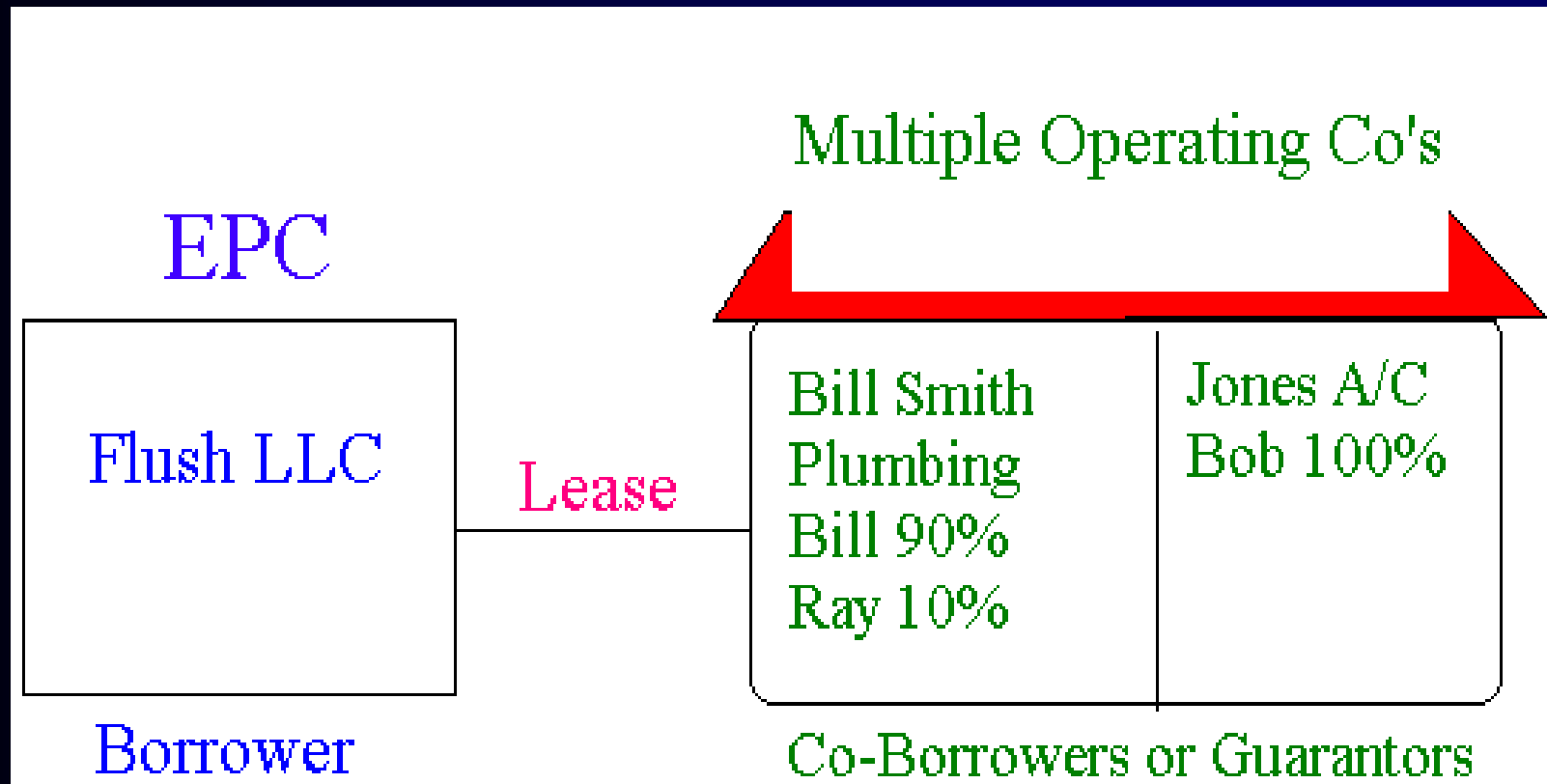


Eligible Passive Concern (EPC)

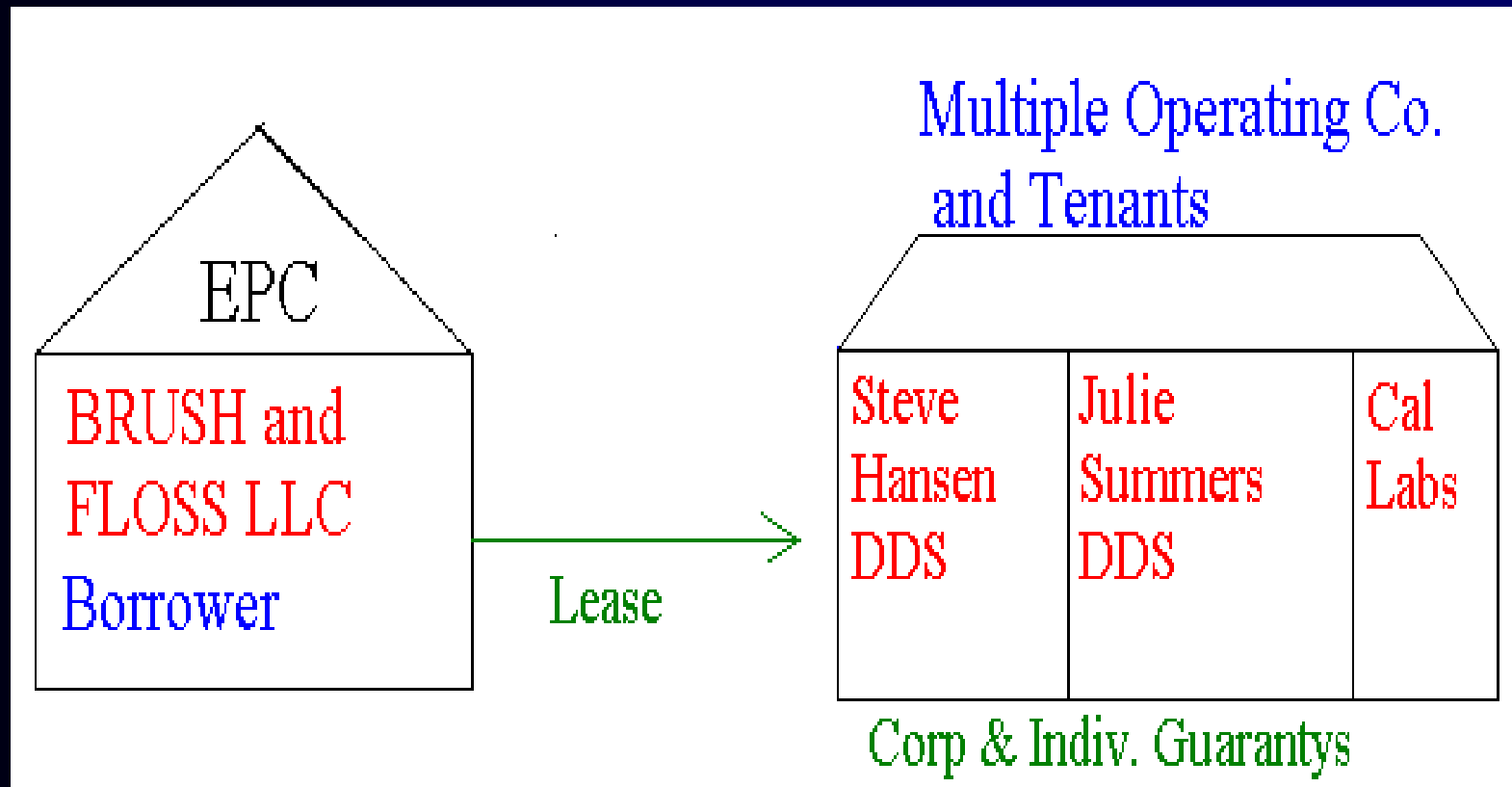
- Lease including options must have a remaining term equal to the term of the loan
- Operating Company will be a guarantor unless the loan proceeds are used to acquire personal property - then the OC is a co-borrow
- Each holder of an ownership interest of 20% or more of the EPC and/or the OC must guaranty the loan. Trustee shall execute a guaranty on behalf of the trust
- Rent paid by OC to EPC limited to PITI & maintenance



CAN I DO THIS?



CAN I DO THIS?



Additional Injection Requirements

Effective 10/1/1996, statute requires
ADDITIONAL INJECTION to reduce the
SBA's exposure for projects with perceived
higher credit risk, namely. . .

- New businesses
- Limited-use property

Additional Injection Requirements

NEW BUSINESS BORROWER

- Business in Operation less than 2 years
- Add an additional 5% injection

50%	Bank	\$ 500,000
35%	CDC/SBA	\$ 350,000
15%	Local Injection	<u>\$ 150,000</u>
Total Project Costs		\$1,000,000

Additional Injection Requirements

LIMITED USE FACILITY

- Facility being financed by the 504 loan is a Limited Use or Special Purpose Facility
- **“A limited market property with unique physical design, special construction materials, or a layout that restricts its utility to the use for which it was built”**
- Add an additional 5% injection
- Now a specific listing in the SOP stating what businesses are limited use or special purpose.

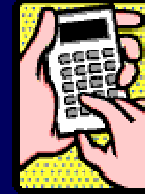
Additional Injection Requirements

For a project for both a new business & a limited use facility, add 10% to the minimum injection, for a total of 20% (Max CDC participation drops to 30% and bank must provide 50% of project costs, regardless of borrower injection)

(racetrack example)

50%	Bank	\$ 500,000
30%	CDC/SBA	\$ 300,000
20%	Local Injection	<u>\$ 200,000</u>
Total Project Costs		\$1,000,000

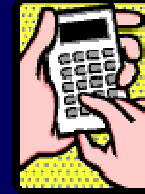
504 Credit Criteria



- **Repayment Ability**

“The overall strength of the borrower, including its track record and cash flow, will generally be more important than the value of the project collateral. . .”

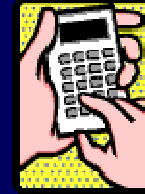
504 Credit Criteria



- **Repayment Ability**

- Based upon existing financial statements of the applicant. Can the additional debt be paid based on historical cash flow?
- Generally a cash flow coverage ratio of 1.25:1 or better is considered desirable.
- Historical debt coverage ratio can be lower than this IF income and profitability trends support the exception.
- Lease income may be included but should be verified
- Non-recurring expenses and discretionary officer salary may be added

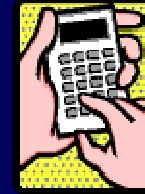
504 Credit Criteria



- **Collateral**

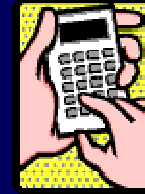
“Generally if the 504 loan is being made to an existing business with proven management and a strong consistent cash flow that is more than minimally adequate to support the new debt, and if the project is a logical extension of the applicant’s current operations, you may approve a loan without requiring an equity injection greater than the minimum required by statute or collateral other than the appropriate lien(s) on the project assets being financed . . .”

504 Credit Criteria



- **Collateral**
 - SBA/CDC takes a Second Mortgage (Trust Deed) on Real Property
 - Second lien on Personal Property (SBA would prefer a first lien on mixed use projects)
 - Personal Guaranty required of any 20% or more owner (of EPC and OC)
 - SBA will now approve up to a 10% shortfall in collateral value, due primarily to economic conditions.

504 Credit Criteria

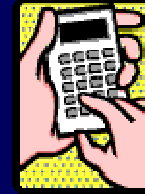


- **Secondary Collateral**

If above conditions are not met, SBA must consider these alternatives:

- Pledge of additional collateral including personal residence or other real property
- Borrower to inject more equity than statutorily required minimum.
- If Borrower is unable or unwilling to provide additional collateral, loan may be declined

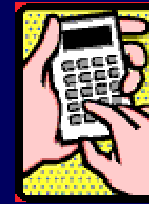
504 Credit Criteria



- **Secondary Collateral**

Avoid taking a lien on inventory, accounts receivable and assets not eligible for 504 financing in order to preserve the firm's ability to finance working capital.

504 Credit Criteria



- **Other Issues**
- **Life Insurance:** May be required if management does not display appropriate depth and succession.
- **Appraisals:** Usually addressed to Lender, SBA and CDC. Ordered by Senior Lien holder.
- **Environmental Issues:** Environmental Questionnaire, Transaction Screen Analysis or Phase I/II necessity is determined by Lender and CDC.

Appraisal / Environmental Issues

- **Appraisals:** Should be addressed to Lender, SBA and CDC. Usually ordered by Senior Lien holder.
- **Environmental Issues:** Environmental Questionnaire, Transaction Screen Analysis or Phase I/II necessity is determined by Lender and CDC.
- Environmental also must include SBA/CDC as a user, including a reliance letter.
- Environmental professional must have liability insurance.

Professional Requirements

- Appraisal must be performed by a State Certified Appraiser.
- Must obtain and “as constructed” appraisal on new construction prior to funding.
- SBA must review and approve appraisal (and environmental) prior to debenture funding.
- Appraisal shortfalls can usually be overcome with SBA for cause.
- CDC can get provisional SBA approval on a 504 loan prior to ordering the appraisal or environmental.

New Debt Refinance Rules

- Relatively new development for 504 lending.
- Can refinance certain existing fixed asset debt of the business into a new 504 loan.
- Must be adding substantial new 504 project costs to the business (expansion or new location).
- Can refinance no more than 50% of the new project costs.
- Must prove cash flow benefit to the small business.
- Can use existing property equity as new project down payment.

New “Green” Energy Initiatives

- Allows energy savings and production to be included as Public Policy Goals. Three distinct goals:
 - 1) Increased use of sustainable design. (\$2 MM)
 - 2) Production of renewable energy (\$4 MM)
 - 3) Reduction of energy consumption 10% (\$4 MM)
- Energy study required to substantiate energy savings.
- Energy savings PPG not available for startups but can be used for expansions or relocations.

Legislative Proposals

- Extension of government “stimulus” funds through the end of the year.
- Increase in debenture size to \$5 million and \$5.5 million for Public Policy Goals
- SBA Reauthorization Bill
- Other Legislative Issues