

Financing Options

Financing is Key To The Sale

Unless the sale can be financed within a structure that benefits buyer and seller, there is no deal. The Impact Group works with SBA lenders and other financial institutions to structure financing that enables the buyer to pay for the business while earning a satisfactory income. At the same time, the seller sees the highest possible amount of cash at closing. The following article provides some background on this important issue.

Financing the Business Acquisition

by Tom West

The epidemic of corporate downsizing in the U.S. has made owning a business a more attractive proposition than ever before. As increasing numbers of prospective buyers embark on the process of becoming independent business owners, many of them voice a common concern: how do I finance the acquisition?

Prospective buyers are aware that any credit crunch prevents the traditional lending institution from being the likely solution to their needs. Where then, can buyers turn for help with what is likely to be the largest single investment of their lives? There are a variety of financing sources, and buyers can find one that fills their particular requirements. (Small businesses--those priced under \$100,000 to \$150,000--will usually depend on seller financing as the chief source.) For many businesses, the following are the best routes to follow:

Buyer's Personal Equity

In most business acquisition situations, this is the place to begin. Typically, anywhere from 20 to 50 percent of cash needed to purchase a business comes from the buyer and his or her family. Buyers should decide how much capital they are able to risk, and the actual amount will vary, of course, depending on the specific business and the terms of the sale. But, on average, a buyer should be prepared to come up with something between \$25,000 to \$150,000.

The dream of buying a business by means of a highly-leveraged transaction (one requiring minimum cash) must remain a dream and not a reality for most buyers. The exceptions are those buyers who have special talents or skills sought after by investors, those whose business will directly benefit jobs that are of local public interest, or those whose businesses are expected to make unusually large profits.

One of the major reasons personal equity financing is a good starting point is that buyers who invest their own capital start the ball rolling--they are positively influencing other possible investors or lenders to participate.

Seller Financing

One of the simplest--and best--ways to finance the acquisition of a business is to work hand-in-hand with the seller. The seller's willingness to participate will be influenced by his or her own requirements: tax considerations as well as cash needs.

In some instances, sellers are virtually forced to finance the sale of their own business in order to keep the deal from falling through. Many sellers, however, actively prefer to do the financing themselves. Doing so not only can increase the chances for a successful sale, but can also be helpful in obtaining the best possible price.

The terms offered by sellers are usually more flexible and more agreeable to the buyer than those from a third-party lender. Sellers will typically finance 30 to 50 percent--or more--of the

selling price, with an interest rate below current bank rates and with a far longer amortization. The terms will usually have scheduled payments similar to conventional loans; the tax picture, however, can be better than with straight debt.

As with buyer-equity financing, seller financing can make the business more attractive and viable to other lenders. In fact, sometimes outside lenders will refuse to participate unless a large chunk of seller financing is already in place.

Venture Capital

Venture capitalists have become more eager players in the financing of independent businesses. Previously known for going after the high-risk, high-profile brand-new business, they are becoming increasingly interested in established, existing entities.

This is not to say that outside equity investors are lining up outside the buyer's door, especially if the buyer is counting on a single investor to take on this kind of risk. Professional venture capitalists will be less daunted by risk; however, they will likely want majority control and will expect to make at least 30 percent annual rate of return on their investment.

Small Business Administration

Thanks to the U.S. Small Business Administration Loan Guarantee Program, favorable financing terms are available to business buyers. Similar to the terms of typical seller financing, SBA loans have long amortization periods (ten years), and up to 70 percent financing (more than usually available with the seller-financed sale).

SBA loans are not, however, a given. The buyer seeking the loan must prove stability of the business and must also be prepared to offer collateral--machinery, equipment, or real estate. In addition, there must be evidence of a healthy cash flow in order to insure that loan payments can be made. In cases where there is adequate cash flow but insufficient collateral, the buyer may have to offer personal collateral, such as his or her house or other property.

Over the years, the SBA has become more in tune with small business financing. It now has a Lo-Doc program for loans under \$100,000 that requires only a minimum of paperwork. Another optimistic financing sign: more banks are now being approved as SBA lenders.

Lending Institutions

Banks and other lending agencies provide unsecured loans commensurate with the cash available for servicing the debt. ("Unsecured" is a misleading term, because banks and other lenders of this type will aim to secure their loans if the collateral exists.) Those seeking bank loans will have more success if they have a large net worth, liquid assets, or a reliable source of income. Unsecured loans are also easier to come by if the buyer is already a favored customer or one qualifying for the SBA loan program.

When a bank participates in financing a business sale, it will typically finance 50 to 75 percent of the real estate value, 75 to 90 percent of new equipment value, or 50 percent of inventory. The only intangible assets attractive to banks are accounts receivable, which they will finance from 80 to 90 percent.

Although the terms may sound attractive, most business buyers are unwise to look toward conventional lending institutions to finance their acquisition. By some estimates, the rate of rejection by banks for business acquisition loans can go higher than 80 percent.

With any of the acquisition financing options, buyers must be open to creative solutions, and they must be willing to take some risks. Whether the route finally chosen is personal, seller, or third-party financing, the well-informed buyer can feel confident that there is a solution to that big acquisition question. Financing, in some form, does exist out there.