

Summing Up the 504

Know the criteria of SBA 504 loans to offer them at the right time to the right clients

By **Phil Sblendorio**, senior vice president and regional business manager, Farmers & Merchants Bank

YOU HAVE THE FOLLOWING commercial real estate deals on the table. Do you know which ones are good candidates for the U.S. Small Business Administration's (SBA) 504 financing?

1. The owner of a profitable gas station is buying his building.
2. A hair-salon owner wants to purchase a small building but can only put 10 percent down.
3. A small manufacturing firm is acquiring a large facility to handle its anticipated growth in the next 15 years. Initially, it will rent out 40 percent of the building and occupy the rest.
4. A real estate investor is obtaining financing to buy an office building.
5. The owner of a popular restaurant has made a bid on a 25,000-square-foot building. She plans to occupy 5,000 square feet and lease out the rest.
6. A nonprofit organization seeks to purchase a warehouse from which to distribute food to the needy.

SBA 504 financing should be explored for the first three deals. The last three deals do not meet the lending criteria.

What is it?

Founded in 1953, the SBA is an independent agency of the federal government that helps small businesses succeed. One of the main ways it accomplishes this is through its loan programs, such as the SBA 504 program.

The SBA 504 program is a mixture of government and bank lending designed to allow small-business owners to purchase their business's facilities with minimal capital injection.

With SBA 504 financing, borrowers usually only need a 10-percent down payment (although in some circumstances, this can go up to 20 percent). Traditional 20- to 25-year-amortization bank financing is obtained for 50 percent of the project value. SBA 20-year second-trust-deed financing covers the remaining 40 percent.

When should you use SBA 504 financing?

You should consider the SBA 504 program any time you want to get financing for an owner-occupied property. Be sure to ask the following questions when considering such funding:

- Is this loan for a building that will be at least 51-percent occupied by the owner; or is it for the construction of a building that will be at least 60-percent owner-occupied? To qualify, the answer must be "yes."
- Does the buyer have the cash to cover the down payment?
- Can the business meet the minimum required 1.25 to 1 debt-service-coverage ratio? Cash-flow projections can be used to meet this requirement.
- Are any of the business's associates incarcerated, on probation or on parole, or have they ever been indicted for a felony? A "yes" answer here may disqualify the borrower.
- Is the organization an ineligible business type? Ineligible business types include: nonprofit institutions; real estate developers and other speculative businesses; and businesses or organizations principally engaged in teaching, instructing, counseling or indoctrinating religion or religious beliefs.

What are the benefits?

For small-business owners who want to purchase their own facilities, the SBA 504 loan program offers them the chance to save a lot of money. SBA 504 loan advantages include:

- **A low down payment:** The typical 10-percent down payment frees money for the borrowers' working capital.

- **Great rates and terms:** The SBA's second-trust deed on 40 percent of the project cost comes with a 20-year term and attractive fixed rates. The terms of the bank's first-trust deed can vary, but are always for at least 20 years. In many cases, loan payments are less than what the business was previously paying in rent.
- **Funding for hard-to-finance properties:** Owner-occupied buildings, single-use or special-purpose facilities such as restaurants, gas stations and carwashes are all great candidates for SBA 504 financing.
- **Eligible "project costs":** Loan proceeds are not limited to the purchase or construction of a building for the business's operations; they can also be used for tenant property improvements. This inclusion of tenant improvements frees up even more working capital for the business.
- **Ongoing tax benefits:** The property-owner is generally eligible for a tax write-off for building depreciation and interest expense.
- **Assumable loans:** The SBA portion of these loans is generally assumable (subject to borrower eligibility). With today's rising interest rates, this can be a huge benefit down the road.

Let's consider Steve, the owner of a successful local tire store. Steve has a five-year lease on his building. Although his monthly lease payments are \$8,000, they are scheduled to increase \$500 per month each year.

Steve, therefore, decides to buy the building for \$1.4 million using SBA 504 financing. He makes a \$140,000 down payment and gets 20-year, fixed-rate financing on the balance at 6.5

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percent. His monthly loan payments now total \$9,394 (\$5,219 for his bank-financed \$700,000 loan and \$4,175 for his SBA \$560,000 loan).


Over the 20-year life of the loans, Steve will make a total of \$2,254,560 in payments. If he had continued to lease, his monthly payments for 20 years (assuming rent increases of \$500 per month per year) would have totaled \$3,060,000. Steve's net total savings of \$805,440 works out to \$3,356 per month throughout the life of the loan; in just three-and-a-half years, his net savings will be equal to the amount he spent on the down payment.

In addition, Steve will reap the benefits of equity appreciation on the property and a possible tax write-off of the depreciation and interest expense. Plus, he will own the property free and clear in 20 years. Quite a winning deal.

The well-protected 50-percent first-trust-deed loans are also a great relationship-building tool that banks can use as a springboard for selling your customers other financial products.

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SBA 504 loans provide an attractive way for small-business owners to buy facilities for their business. These really are win-win-win-win products.

Business-owners win because the program offers a means through which they can enjoy the benefits of property-ownership. The lending banks win because SBA 504 loans can be a terrific way to grow the loan portfolio with long-term commercial real estate loans. The community wins because the loans help stimulate or increase the local tax base and create new jobs. And mortgage brokers win because the deals get done. 

What are the drawbacks?

Of course, SBA 504 financing is not a perfect solution. Some of its downsides include:

- **Prepayment penalties:** The SBA portion of the financing includes prepayment penalties for the loan's first 10 years. The bank loan may have prepayment penalties as well.
- **Extra fees:** In addition to the usual fees associated with getting a loan, the SBA charges a 504-debenture-guarantee fee. It also charges the lending bank a 0.5-percent "SBA participation fee," which many banks pass on to the borrower.
- **Difficult paperwork:** The documentation for SBA 504 loans is specific and detailed.
- **Long timelines:** The SBA portion of the financing can take more than 75 days from submission of paperwork to financing. This is in addition to the nearly 30 days it takes to complete the paperwork.

Who do you call for SBA 504 financing?

When looking to place an SBA 504 loan, always work with an experienced, knowledgeable SBA lender. SBA paperwork is extremely specific. To avoid the nightmarish delays or rejections that can stem from paperwork issues, you should find a lender that is well-versed and able to move the process along in a timely manner.

Because the loans qualify for the Community Reinvestment Act, local banks are great candidates to fund these loans. These banks are under pressure to reinvest their depositors' money back into the local community, so they're hungry for local deals.

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