Financing Small Business Acquisitions

If you are considering purchasing a small business it is essential to understand the many options for financing. The majority of financing solutions are based on the ability of the business earnings to service the debt and pay the new owner a salary.

Define What You Are Acquiring

Before determining a financing solution you must understand the historical earnings and current trends of the business you wish to acquire. Calculating the true earning power of a business can be a difficult task. Most business owners maximize tax strategies to minimize reported earnings so they pay less taxes. Therefore, when a prospective buyer looks at the net income, or "bottom line", of the financials they may not be seeing the whole story. Business sellers and their advisors will often "recast" the earnings to show the earning power of the business. This recast number is commonly referred to as Seller's Discretionary Earnings (SDE). SDE is calculated by "adding back" certain expenses to the earnings:

Earnings: Net Income of the business after all expenses

+ **Interest Expense**: Interest is added back assuming the new owner will pay off all liens and encumbrances of the business
+ **Taxes**
+ **Depreciation and Amortization**
+ **Current Owner's Salary**
+ **Current Owner's Benefits**: e.g. retirement contributions, medical insurance, owner's automobile
+ **Nonrecurring Expenses**: Large equipment purchases or improvements that are not part of normal expenses
+ **Nonoperating Expenses:** Salaries or benefits paid to the current owner's family members who are not working in the business

= Seller's Discretionary Earnings (SDE)

Once SDE is calculated you know how much cash flow is available to service the debt associated with acquiring the business as well any salary and/or return-on-investment you expect the business to pay you.

Debt Service Coverage Ratios

Lenders want to know where the cash flow is coming from to cover the debt. They will look at the SDE of the business and first subtract the proposed new owner's salary to see how much remains to service the annual debt of the proposed loan. So let's say the business reports an annual SDE of $200,000. You indicate to the bank that you will be taking a salary of $100,000 out of the business. That leaves $100,000 to cover debt. The bank will divide this remaining net amount by the debt. In the below example we will assume the annual debt is $7,000/month or $84,000/year. $100,000 divided by $84,000 in debt equals 1.19. This is called the Debt Service Coverage Ratio.

$200,000 Seller's Discretionary Earnings
-$100,000 New Owner's Salary
=$100,000 Net (After New Owner's Salary)

$100,000/$84,000 Annual Debt = 1.19 Debt Service Coverage Ratio

Banks not only require the Net to cover the Annual Debt but to also provide for a cushion. This cushion, or Ratio, gives the business the ability to cover debt in the event future revenues or profits decline. Many lenders like to see a Debt Service Coverage Ratio of 1.10 - 1.20 or higher. They also want to see that these ratios work on the last three years of SDE and that the SDE trends in the current year also look positive. Although lenders look at many factors in making a business acquisition loan, if the earnings of the business will not pay the new owner a salary and service the debt, they will not make the loan.

SBA Loans

The Small Business Administration (SBA) guarantees billions of dollars in loans to America's small businesses through approved SBA lenders. Many of these loans are made to existing businesses looking to expand. Getting approval for a business acquisition loan is often more difficult because a new owner is stepping in. SBA lenders have a rigorous underwriting process that will examine the buyer's net worth, credit history and experience in the industry. SBA underwriters are very concerned with the ability of the new owner to run the business so communicating your direct or indirect experience, or transferable skills, is very important.

The lender will also require a minimum injection of capital from the buyer, typically 20% of the purchase price. Although the bank may even allow the buyer to use borrowed money for the down payment (such as home equity), they will include any debt related

to it in the Debt Service Coverage Ratio calculation above. If this additional debt is too high it will cause the deal to fail the Debt Service Coverage Ratio test.

Because SBA loan requirements are complex it is best to deal with a SBA Preferred Lender. Essentially most banks have access to SBA financing but unfortunately very few have the experience or focus to do business acquisition loans. You can find more information on SBA lenders at www.sba.gov or through a local business broker who knows the lenders in your area.

If the business you wish to acquire meets the Debt Service Coverage Ratio test, and you have transferable experience, SBA financing can be an excellent financing option. It allows the Seller to maximize the cash at closing while allowing the Buyer to lower the down payment percentage and retain more cash for working capital. Again, working with a SBA Preferred Lender who regularly does business acquisition projects is essential.

Seller Financing

Because SBA financing is complex, hard to secure and often has high closing costs, seller financing is quite common in business acquisitions. Seller financing has the unique ability to be as flexible as the buyer and seller need it to be and is only limited to what the buyer and seller can agree on. The seller, like a bank, will still be concerned about the buyer's net worth, credit history and experience in the industry. The seller is also likely to want a higher percentage in down payment from the buyer since a loan on the sale of their own business is probably their only loan so they are at more risk than a bank. Most buyers like the idea of the seller financing since it simplifies the financing and keeps the seller vested in the businesses future success.

Sellers often prefer to cash out if they can, but the right down payment, a more favorable price, the right buyer, sufficient buyer guarantees, security agreements and interest earnings often ranging between 6 – 10% can generate more interest.

The terms of the financing are totally negotiable. However, a seller and buyer would do well to consider the same Debt Service Coverage Ratio guidelines that the SBA uses. Do the terms allow the new owner to take a salary, service the debt and still have a "cushion"? If not, the buyer and seller have put together a deal that will never make it to the closing table.

Sources of Down Payment Capital

The buyer's available capital for a down payment is an enormous factor in how large of a business they can buy. Since most businesses are sold for multiples of earnings

(SDE), the more business you can afford, the more earning power it probably has. Therefore, most buyers seek to maximize their down payment money. Most buyers know that real estate equity, securities and savings are sources for down payment capital. Many do not know that programs exist to use retirement funds to start or buy a business without penalties and taxes. A business broker can refer you to firms who specialize in these programs.

Working Capital

Don't forget about working capital! When small businesses sell they typically deliver the business free of all debts but they also keep the cash in the bank as well as the accounts receivable. So even though you are buying a business that has customers walking in the door on day one, you need to have enough working capital to cover the immediate operating expenses such as payroll, supplies and rent. A retail establishment with mostly cash sales will need much less working capital than a manufacturer that has 30 day terms with vendors but does not get paid by customers for 60 days. Start out by calculating the historical monthly expenses of the business and then calculate how much working capital you need in reserves to cover these expenses.

Summary

There are many options for financing a business. A professional business broker can assist you in understanding which ones may work for you. Remember these important points:

1. Define the Seller's Discretionary Earnings (SDE) of the business
2. Subtract from the SDE what you need as a salary or return on investment. The Net amount is what you have left to service any debt.
3. Is the seller offering financing? Do the terms allow you to take a salary and service the debt?
4. Do you have enough down payment capital for the size business you are looking at? Examine all sources of down payment capital. Are your salary or return-on investment expectations in line with your down payment?
5. Is SBA financing available which may allow you to leverage less money down? Do you understand all the closing costs?
6. Have you allowed for working capital?

Chris Jones is a business broker and Vice President of Sunbelt Business Brokers of the Midwest, with offices in Minnesota, Wisconsin and Illinois. www.sunbeltmidwest.com cjones@sunbeltnetwork.com