Course Materials

GOVERNMENT LOAN PROGRAMS – SBA TO USDA: IMPROVE YOUR BANK’S ROE SAFELY!

David G. Lucht
Director Risk Manager
Live Oak Bank
Wilmington, North Carolina
lucht75david@gmail.com
216-337-7414

August 10 & 11, 2017
Govt. Loan Programs

SBA to USDA: Improve Your Bank’s ROE Safely!

Background on David Lucht

► Chief Credit Officer of Michigan/Illinois markets, National City Bank
► Chief Credit Officer Capital Markets, National City Bank, Cleveland, Ohio
► Chief Credit Officer FirstMerit Bank, Akron, Ohio
► Live Oak Bank, Director, Founder, President, Chief Credit Officer, Chief Lending Officer
► lucht75david@gmail.com; (216) 337-7414
Background on Live Oak Bank

- Chartered May 2008
- Small business bank, focused on certain industries, nationwide market
- Until recently almost exclusively a government guaranteed lender.
- 2016 Production $1.5 billion ($1.3 billion SBA 7(a), $200 million USDA, $50MM SBA 504).
- 2017 projected $1.8-1.9 billion.
- ROE has historically been above 25% until IPO, now trending towards 15%.
- 10 year average NCO of unguaranteed portion of loans 60 basis points

Class Survey

- How many of your banks are active in government guaranteed lending: SBA 7(a), SBA 504, USDA B & I?
- How many of you have dedicated government lending resources in either lending or closing?
- How many believe that these programs don’t work in your market due to their high fees and program hassles?
- How many of your banks have been “burned” by a declined government guaranty?
- How many of your banks are very satisfied with their performance in these areas?
- How many banks want to expand in these programs?
The “Bible” of SBA Lending

- [https://www.sba.gov/sites/default/files/sops/SOP_50_10_5_1_FINAL_Clean_Highlighted_Changes.pdf](https://www.sba.gov/sites/default/files/sops/SOP_50_10_5_1_FINAL_Clean_Highlighted_Changes.pdf)
- 342 pages, covers both 7(a) and 504 programs.
- Changes at least annually, with updates throughout the year.
- Not the regulations themselves. Those are found in Section 13 of the Code of Federal Regulations.

Overview of SBA 7(a) Program.

- Authorized for $26.5 billion for FYE 9/30/17.
- Maximum loan $5.0 million, with 75% guarantee. (85% for smaller loans)
- Fees range from $0 (loans under $150,000) up to 3.75% of the guaranteed amount. On $5.0 million loan, fee is $138,125.
- SBA charges lender ongoing fee of 55 basis points. Fee changes based on subsidy model.
Overview of SBA 7(a) Program.

- Collateral split pro-rata between guaranteed and unguaranteed.
- Maximum pricing depends on loan term and size of loan, but generally Prime +2.75% on larger loans. Maximum fixed pricing based on monthly Fixed Base rate established by SBA, plus 2.75%. (8.86% as of May, 2017).
- Guaranty is contingent, on proper closing, servicing, and liquidation of loan. Industry experiences a 3-7% declination or repair (partial decline). Live Oak Bank has never had a declination in 10 years, and only one $25,000 repair.

The SBA Contract

- All federally insured financial institutions in good standing are eligible to participate in SBA lending programs.
- Applications are approved by SBA and a 750 Agreement is executed between the institution and the SBA which lays out basic duties and responsibilities of each party.
Processing a 7(a) Loan

- Over 4,000 banks have made an SBA loan, but only a small percentage make over 10 loans per year.
- Most banks have their 7(a) loans approved by SBA under “general processing”. The bank’s complete loan package is sent to one of SBA’s regional Loan Processing Centers, where a loan officer reviews, asks questions, and issues a “Loan Authorization” if the loan is approved. Process once a complete file sent to SBA takes 3-5 weeks. A new program called SBA One aims to automate this somewhat.
- For banks that demonstrate a high knowledge level of the SBA program, they may become Preferred Lending Program (PLP) status, making their own loan decisions and generating their own Loan Authorization.

Advantages of “General Processing”:
- SBA reviews file, so questions of eligibility (impact on guarantee being honored later) answered upfront.
- For banks unfamiliar with program, the SBA issued Loan Authorization is a great roadmap to close the loan.

Advantages of PLP
- Speed!
- Conditions relayed to customer by bank not changed by SBA.
Eligibility requirements of 7(a) Loan

- Credit Elsewhere Test. The Small Business Applicant must demonstrate a need for a guaranty on the loan. Lender must document the specific credit weaknesses that substantiate this credit elsewhere eligibility test.
- Applicant must be for-profit.
- Applicant must be an active business, non-passive. A shopping center would be an example of a passive business.
- Small under size standard. Each industry different based on # of employees or dollars of revenue, but alternative size standard may be used for all industries. (Tangible Net Worth no more than $15MM, Average Net Income over past two fiscal years may not exceed $5MM).
- Various other requirements in SOP.

Eligibility requirements of 7(a) Loan Refinancing

- For refinancing debt must be on “unreasonable terms”. SBA defines unreasonable very specifically in SOP.
- New terms must improve monthly payment by at least 10%.
- Debt refinance by SBA loan must include same collateral position.
- Be careful not to refinance debt of a borrower in poor financial position. Could endanger guarantee.
- Refinancing debt from the same financial institution requires more documentation, and submission to processing center.
7(a) General Credit Worthiness Standard

- Lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. The cash flow of the Small Business Applicant is the primary source of repayment, not the liquidation of collateral. Thus, if a lender’s financial analysis demonstrates that the Small Business Applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available or outside sources of cash.
- SOP 50 10 5(i) pg. 148

What this means to a lender:

- You can truly be a cash flow lender. In Live Oak’s view, a great business with a stable cash flow, good management, but lacking collateral coverage or wealthy guarantors is a perfect SBA 7(a) loan customer.

- Rather than wrap a poor quality borrower with an SBA guarantee, use the guarantee to enhance a loan that you would not do based on poor collateral or guarantor position.

- Key question: Will your credit person view SBA guarantee as your second source of repayment?
All Available Collateral Rule

- Although the SBA 7(a) program does not require a loan to be fully collateralized, all collateral available must be taken until fully secured.
  - 85% LTV Real Estate
  - 75% New Equipment
  - 50% existing equipment
  - 10% working capital assets

7(a) Equity Requirement

- Needs to be “adequate” to insure long term survival of the business.
- Cash, standby debt (two years no payments) or other appraised assets may be considered equity.
- Need to document where it came from, and that it is not borrowed money, unless principal can support that debt with outside income.
- If intangible portion of business acquisition is more than $500,000, need a minimum of 25% in injected equity. (Can be accounted for by value of existing equity in business making acquisition)
Personal Guarantees

- Any owner with 20% or more ownership must guarantee.
- If the loan is not fully secured, and the guarantor has more than 25% equity in personally owned real estate, that real estate must also be pledged.

Other Credit Underwriting Standards, Up To $350,000

- Small Business Credit Score (above 140)
- Brief description of business, management team
- Guarantor analysis
- Collection of business tax returns and 4506 verification
- Determination that equity and NW are acceptable based on bank’s non-guaranteed policy
- List of collateral and value if secured
- Effect of affiliates on ultimate repayment ability.
Other Credit Underwriting Standards, Over $350,000

- Financial analysis of repayment ability. EBITDA must exceed debt service by at least a 1.15x ratio. Historical cash flow may be adjusted for non-recurring items.
- Global cash flow above a 1.00x coverage.
- Pro-forma balance sheet.
- Ratio analysis (Current, D/TNW, DSC, others as appropriate.)
- Working capital adequacy.
- Brief description and history of business, management team
- Guarantor analysis
- Lender’s rationale for approval, discussion of risk factors.
- Collateral adequacy assessment.

Advantages of 7(a) Guaranteed Portion
Balance Sheet Flexibility

- Guaranteed portion of loan typically not “counted” towards 300%/100% of capital guideline.
- Part 365 of FIRREA created a 30% of capital bucket for CRE LTV exceptions.
- However, there is an exclusion for the government guaranteed portion of any loan. Therefore, only the unguaranteed portion needs to meet the LTV limit.
- (Example:
  - $2,000,000 SBA 7(a) loan on CRE, 75% guaranty.
  - Appraisal is $1,900,000.
  - Unguaranteed portion of loan is $500,000 (25% * $2,000,000)
  - LTV calculation under Part 365 = $500,000/$1,900,000 = 26.3%. )
Advantages of 7(a) Guaranteed Portion

Capital Efficiency

- Guaranteed portion of loan given 20% risk weighting on balance sheet. So for 75% guaranteed loan, capital requirement is 40% on total face amount.
  - $2,000,000 SBA 7(a) loan on CRE, 75% guaranty, Prime +2%, 1% COF.
  - Risk weighting on loan is $800,000. Equity requirement, assuming 10% capital requirement is $80,000. (vs. $200,000 for conventional loan)
  - Annual NIM 5%, NII $100,000.
  - Pretax ROE $100,000/$80,000 = 125%.
  - Pretax ROE (unguaranteed loan) $100,000/$200,000 = 50%.

Non-Interest Income Potential

- Active secondary market exists for guaranteed portion of SBA loan.
- Loans are sold for premium, expressed as percentage of guaranteed amount. Lender also retains a 1% servicing spread. Annual on going lender fee is passed through to SBA.
- Premiums are variable based on market conditions, pricing, and term of loan. In general, longer term, higher priced loans bring better premiums.
Advantages of 7(a) Guaranteed Portion
Non-Interest Income Potential: Example

- $2,000,000 75% SBA 7(a) loan, 25 year maturity priced at Prime + 2.25%. Premium quoted as 1.10.
- When lender sells $1.5 million guaranteed portion, receives cash of $1,650,000. In addition, lender will receive a 1% servicing fee, initially $15,000.
- Calculate the ROE in Year 1 and 2. Assume no amortization for ease of calculation. Assume the $150,000 premium is taken into income in Year 1. Assume a 2% COF and 10% capital requirement.

Advantages of 7(a) Guaranteed Portion
Non-Interest Income Potential: Example

- Yr. 1 Income
  = $150,000 fee + $15,000 servicing income + $20,000 NII ((6%-2%) * $500,000) = $185,000 income.
- Yr. 2 Income
  = $15,000 Servicing + 20,000 NII = $35,000 income.
- Capital Needed = $500,000 * 10% = $50,000.
- ROE Yr. 1 = $185,000/$50,000 = 370%
- ROE Yr. 2 = $35,000/$50,000 = 70%. (Note, effective rate on remaining balance is Prime + 5% including servicing.)
Common Borrower Objections to 7(a)

- Takes too long! (GP vs. PLP)
- Fees too high! (See advantages)
- I do not want to pledge my house!
- Government interference in my business!

Borrower Advantages to SBA 7(a) Loan

- Full term, no balloon payments.
- Typically, no financial covenants.
- No requirement to have full collateral coverage. Truly a cash flow lending product.
- Longer amortization than conventional products, 25 for CRE, useful life of equipment. Can have a significant positive impact on borrower's cash flow.
- Modest prepayment penalties (5,3,1 if loan has 15 year maturity or longer)
Dr. Todd Johnson, veterinarian, wants to sell his practice to his current associate, Dr. Marsha Jones. The sale will include all practice assets, including the building (appraised for $1,500,000), as well as the inventory, client records, and general intangibles for $1,000,000. Total purchase price $2,500,000.

The practice has gradually been growing revenues, and is currently generating $2.4 million in revenue, with a 25% EBITDA margin. Dr. Johnson currently takes a $150,000 salary. Dr. Jones will need to replace him with an associate who will make $100,000, her current salary.

Dr. Jones is three years out of vet school, and has $100,000 of student debt, $20,000 of cash, and a 740 credit score.

This is a business acquisition with intangibles over $500,000, so 25% equity requirement comes into play. Total purchase price is $2.5 million, so equity required is $625,000.

Dr. Jones can contribute her $20,000.

Where will other $605,000 come from?
Example 7(a) Loan
Stable Cash Flow, Low Collateral

Dr. Johnson agrees to provide a $605,000 seller note, subordinate to the bank’s position. Per SBA regs, this must be on full standby for two years (no cash payments of P or I). He provides at 7% fixed, five year balloon, with 15 year amortization ($5,406 monthly payment).

Bank provides loan for balance of purchase price ($1,875,000) plus $150,000 for working capital, plus $80,000 for fees and closing costs, total of $2,105,000 (with 75% SBA guarantee). What term can the bank provide?

Example 7(a) Loan
Stable Cash Flow, Low Collateral

Since biggest portion of banks $2,105,000 loan is CRE, bank can offer 25 year term on entire loan. With a Prime +2% rate, monthly payment is $13,495. Could also use weighted average for maturity, 25 years on $1.5 million CRE being financing, 10 years on balance (20.7 years)

Can small business afford the total monthly payment of $18,901? Assume Dr. Jones’ $100,000 salary easily covers her personal debt service and living expenses.
Example 7(a) Loan
Stable Cash Flow, Low Collateral

- Review: Vet practice does $2.4MM in revenue with a 25% EBITDA margin, producing $600,000 in EBITDA.

- Adjustment should be made for elimination of Dr. Johnson salary, partially offset by new associate salary. Net positive adjustment of $50,000 ($150,000 - $100,000). Adjusted EBITDA is $650,000.

- EBITDA/DS = $650,000 / $226,812 = 2.87x DSC.

- Key question in cash flow lending: How stable is cash flow?

Example 7(a) Loan
Stable Cash Flow, Low Collateral

- How much money will bank lose if practice fails? Assume door closes, CRE sold for $1MM, equipment for $10,000.

- Costs to liquidate total $30,000. (SBA shares pro-rata)
Example 7(a) Loan
Stable Cash Flow, Low Collateral

- Net proceeds = $1,010,000 less $30,000 cost to liquidate, $980,000.

- Loss on loan is $2,105,000 - $980,000 = $1,125,000.

- Bank portion of loss is 25%, $281,250, 13% of original loan balance.

Example 7(a) Loan
Stable Cash Flow, Low Collateral

- Profitability of loan (assume guarantee sale at 1.12 premium on sale of $1,578.750 guaranteed portion)
  - Premium is $173,662.50 (SBA gets 50% of premium when over 10%)
  - First year servicing fee $15,787.50
  - First year NII (4% of unguaranteed) $21,050.

  Total Income $210,500.
Example 7(a) Loan
Stable Cash Flow, Low Collateral

- Total Income $210,500. With potential loss position of $281,250, this loan has a much more favorable risk return than most. **BUT: beware the crack cocaine nature of sale for premium.** Loan quality always has to be in forefront.

- SBA lending history is littered with lenders that failed (CIT) based on chasing premium at the expense of quality.

SBA 504 Loan program
Collateral Based Program

- Authorized for $15 billion for FYE 9/30/17, with $7.5 billion of authorization set aside for refinance.

- The loan is processed and approved through a Certified Development Company (CDC), who acts as an agent for the SBA on their piece of the financing.

- Program is a fixed-rate, long-term loan designed to provide gap financing of long term assets.

- Owner Occupied RE.
504 Program Overview

Financing has three parties involved:
- Equity (10-20%)
- SBA Issued Fixed Rate Debenture in 2nd lien position (up to 40% of project costs). Debentures issued monthly, may require bridge to SBA takeout. Can be 10 year or 20 year.
- First mortgage, conventional loan by bank, 50% LTV.

Benefits:
- Low equity requirement, 10% for general purpose. Non-start-up.
- SBA debenture is 20 year maturity with low fixed rate, 4.82% as of May, 2017.
- Larger projects possible, debenture piece (2nd mortgage) may be up to $5MM.
504 Program Overview

- Benefits:
  - Bank sets its own terms and rates. Bank maturity must be at least 7 years if debenture is 10 years, and 10 years if debenture is 20 year.
  - CDC deals with SBA for lender.
  - Fees to borrower generally less than 7 (a).

CDC Key to good experience

- Level of expertise varies fairly widely.

- Look for a CDC in your area that has done a lot of volume.

- Introduce yourself to the CDC prior to having a deal to gauge receptivity.
504 Loan Example

- Borrower has ability to buy the property they currently rent for $5,000,000. Property appraises for $5,250,000, and the borrower's current rent is $35,000/month, plus utilities, taxes, and insurance.

- Borrower wants do $200,000 of renovations.

- Assume all soft costs are 2.5% of both debenture and first mortgage, financed into loan. Fees for first mortgage are negotiable.

504 Loan Example

- Project costs:
  - Building $5,000,000
  - Renovations $200,000
  - Soft Costs $117,000
  - Total $5,317,000
504 Loan Example

- Source of Funds:
  - Equity $531,700
  - SBA debenture $2,126,800, 20 Yr. Amort, 4.82% Fixed Rate
  - Bank first mortgage $2,658,500 10 Yr. balloon, 6.50% Fixed Rate.

Monthly Payment $33,484 vs. Rent of $35,000

When to use 504?

- Great for fixed asset financing. Gives borrower a long-term low fixed rate.
- Controls exposure of bank to client by limiting bank to only 50% of project being financed.
- Use when property types are not in favor with bank, e.g. hotels.
EB5 Program

The Immigrant Investor Program, also known as “EB-5,” was created by Congress in 1990 to stimulate the U.S. economy through job creation and capital investment by immigrant investors by creating a new commercial enterprise or investing in a troubled business. There are 10,000 EB-5 immigrant visas available annually.

EB 5 Program

- Foreign Investors invest $500,000 each in job creating projects in US. Money must be at risk for 5 years, and results in a Green Card for the investor. Most common users of program are Chinese families looking to get their young adult children into a US college.

- Program has had its share of problems with unscrupulous middlemen taking foreign money and putting into unsafe or even phony projects. Banks need to be careful in using this source of funds with only reputable “Regional Centers”.

EB 5 Program

- Unique Structure: Combining 504 and EB5 programs.
- Example: $15MM Hampton Inn project.
  - $3MM Equity
  - $4.5MM SBA 504 Debenture in 2nd lien position
  - $3.75MM EB5 “B” note with shared first lien position, but first loss to bank note
  - $3.75MM Bank “A” note in first lien position, (25% LTV).

USDA B & I

- Loans up to $25MM.
  - Under $5MM, 80% guarantee
  - $5MM to $10MM, 70% guarantee
  - Over $10MM, 60% guarantee
- 3% guarantee fee, .5% annual renewal fee.

- Financing in defined “rural” areas, MSA’s under 50,000 population. Easily checked by putting address in USDA website.

- Emphasis on job creation or job preservation.
USDA B & I

- Must be fully secured on advance rates set by USDA. (80% of real estate, 70% of equipment, 60% of inventory and accounts receivable)

- Maximum term on Real Estate is 30 years, 15 years on equipment or useful life, 7 years on working capital.

- Key underwriting requirement is 10% Tangible Balance Sheet equity, 20% if start-up.

USDA B & I

- Key to getting loans done is the USDA Office in the state where the project is located. Contact the USDA Rural Development Business Programs Director.

- USDA has own set of application forms. Same information every loan requires, just in their format.

- State office typically can approve up to $10MM. Above state level goes to National Office. Point system in large part determines whether it gets approved there.
Structure of Govt. Guaranteed Lending Program in Bank

- Branch Model: Leads come from branch system. Any credits deemed “undoable” are sent to internal SBA Department, to see if they can figure out a way to do. After structuring, loan is closed by branch, in conjunction with closing instructions prepared by SBA Department.

- Small Business Generalist Lender Model: SBA loans are one product in lender’s tool kit. Bank may have resource for training lenders on product features, but it is just one product of many. Bank may utilize Lender Service Provider to help on processing loan. (cost 2-3% of loan amount)

- Govt. Guaranteed Lenders who focus exclusively on these products. Usually only within the bank’s footprint.

- National Model: Govt. Guaranteed Lending treated as “business”, usually targeting a specific niche nationwide, thought to be lower risk.

Structure of Govt. Guaranteed Lending Program in Bank

- Advantages/Disadvantages of each approach?
Structure of Govt. Guaranteed Lending Program in Bank

- Costs involved of in creating SBA unit within bank.
  - Need subject matter expertise in unit manager. Experienced SBA/USDA lender. ($100,000 - $200,000).
  - Need experienced SBA/USDA underwriter. ($55,000 - $90,000).
  - Need experienced SBA/USDA closer. ($55,000 - $90,000).
  - Lending officers ($100,000 +). Beware the typical SBA commission structure!
- Respond to leads generated within bank, plus targeted opportunities sourced within unit.

Additional Resources:

- NAGGL: Lobbying group for SBA 7(a).
- NADCO: Lobbying group for SBA 504.