The Best-Kept Secret in Commercial Real Estate Financing

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What SIORs Need to Know About the SBA 504 Loan

By Chris Hurn

It's no secret that commercial credit is hard to come by these days. More than a few lenders remain reluctant to lend, even to borrowers with A++ credit scores. Whether they can't lend or simply would rather not, it's not getting any easier for business owners to get financing from conventional commercial lenders. It's clearly a big problem for commercial real estate brokers. If your clients can't get funding to purchase the facility you've helped them find, then nobody gets paid.

If your small business clients have had trouble securing financing for their commercial real estate projects, they may be looking in the wrong place. While conventional lending is still a bit "frozen," loans from SBA lenders are plentiful. Now, I know that SBA loans have been viewed as "second-class" for a number of years for multiple reasons, but hear me out on this. There's a strong argument for helping your small business clients see the benefits of SBA financing, and I'll even dispel some of the common myths surrounding this much-maligned government agency.

SBA Lending on the Rise

In case you haven't noticed, there's not much good news being reported about our economy these days. We mostly hear about how bad things are, and how it'll get worse before it gets better. Well, here's some good news for your small business clients: SBA lending is not only on the rise, it's at all-time high levels.

The SBA's fiscal year 2011 (which ended September 30th) was a record-breaking one during which the Agency supported $30.5 billion worth of small business borrowing. The previous record for SBA lending was $28.5 billion, and it was set back in 2007 — you know, before the "Great Recession/Panic." The 2011 total is 35 percent more than the total for 2010, which is quite a jump these days. Armed with these statistics, a good number of small business lending experts believe conventional lending is going to continue its slump for a while. In the meantime, it's widely held that SBA lenders will fill the gap and be the go-to sources for the foreseeable future. If this is the case (and I happen to believe it is), it will pay off big time to be familiar with SBA financing — especially the SBA 504 loan program.

The Best-Kept Secret

When it comes to commercial property financing for small business owners, the smartest option available is the SBA 504 loan. This loan program was created specifically for the purpose of financing fixed assets — commercial real estate and equipment — and it does its job very well. So what makes these loans so special?

First of all, unlike most commercial bank loans, SBA 504 loans are designed to finance total project costs. Conventional commercial loans typically finance a percentage of either the appraised value or the purchase price of the property, whichever is less. With a 504 loan, the total project cost includes land and existing structures; hard construction/renovation costs; furniture, fixtures and equipment; soft costs; and closing costs. The ability to roll these additional costs into the loan instead of paying them out-of-pocket is a big deal for most small business owners.

Second, SBA 504 loans have lower equity requirements than conventional commercial financing. These loans are structured with a conventional mortgage for 50 percent of the total project cost and a government-guaranteed bond for 40 percent. The remaining 10 percent is the borrowers' equity, and since the total project cost includes traditionally-out-of-pocket expenses, it's a true 10 percent (special-purpose properties and startups will require slightly more equity). This lower equity requirement allows your small business clients to keep more of their hard-earned capital to deploy elsewhere in their business while still getting all the wealth-creating benefits of commercial property ownership.

Third, the terms of these loans are more advantageous for small business owners. The first mortgage typically has fully-amortizing, 25-year terms at market rates. The second mortgage has a 20-year, fully-amortized term with a below-market, fixed interest rate. The rate on the second mortgage is what makes this the most inexpensive financing available to small business owners. For most of 2011, the rate on this portion has hovered between 4.5 percent and 5.5 percent and it's fixed for 20 years. That's cheap money, and it's hard to find a better deal than that anywhere in the commercial mortgage industry.

Who's Eligible?

The 504 loan is for commercial property owner/users. Borrowers must occupy a simple majority (at least 51 percent) of the property within the following year to qualify. This is not an investment loan product per se, but there's a bit of flexibility here.

Since the occupancy requirement is only 51 percent, a business owner could purchase more real estate than needed and rent out up to 49 percent to offset the mortgage expense. Two operating companies can also come together to form a real estate holding company to take title to the property. In other words, a 504 loan doesn't have to be just one small-business owner purchasing a commercial property. It could be a physician and an attorney each using part of an office building, or an office/warehouse facility divided between a staffing company and a distributor. In each case, an eligible passive corporation (EPC, often known as a real estate holding company) is created with shared ownership.

Contrary to popular belief, the eligibility requirements for SBA 504 loans aren't very restrictive. The following list outlines how to determine if a business owner qualifies. To be eligible, a business must:

- **Be for-profit and not a publicly-traded business.**
- **Have a tangible net worth (including affiliates) not to exceed $15 million.**
- **Have an average net income not more than $5 million over the previous two years.**
- **Have the personal liquidity (non-retirement, unencumbered) of each principal/guarantor not exceed the total project costs of the proposed 504 loan.**
- **Have ownership comprised of 51 percent U.S. citizens or resident aliens (Legal Permanent Residents), though there is some flexibility on this as well.**

Under the above guidelines, over 98 percent of incorporated entities in the United States are qualified small businesses and eligible for an SBA 504 loan. In fact, many "small" businesses that get 504 loans would be better described as "mid-sized." Only the absolute largest companies get tripped up on these criteria. Anecdotally, my firm has closed 504 loans north of $11 million dollars in total project costs, so don't get stuck thinking these loans are only for mom-and-pop operations.

As for **ineligible borrowers**, the following is an exhaustive list:

- × **Non-profits (except sheltered workshops).**
- × **Passive holders of real estate and/or personal property.**
- × **Lending institutions (mortgage brokers and correspondent lenders are eligible).**
- × **Life insurance companies (however, franchised agents are eligible).**
- × **Businesses selling products/services through a pyramid plan.**
- × **Gambling concerns.**
- × **Businesses which restrict patronage.**
- × **Businesses that have previously defaulted on a Federal loan.**

If your client's business doesn't fit any of the above categories, then you probably have a 504-eligible project on yours hands. But maybe you still have some reservations about the 504 being an SBA loan product. Let's look at some common misconceptions about SBA loans.

Common Myths Debunked

SBA loans mean tons of paperwork. This was certainly the case in years past, but not now. The SBA has done a lot to streamline its processes, and lenders that specialize in 504 loans have helped make the application and approval processes no more involved than any other conventional commercial loan. While the documentation is specific and detailed, borrowers who are organized and prepared have nothing to worry about.

SBA loans have extra fees. When all closing costs are considered, 504 loans usually average about 25 to 50 basis points more in total loan fees than a conventional commercial loan. For borrowers with stronger credits, these fees can usually be negotiated down. Most small business owners have no problem paying these slightly higher fees to get longer-term, below-market, fixed-rate financing and the highest cash-on-cash return from their commercial property.

SBA loans take forever to close. Again, this is a myth from the past. Best-case scenario, a 504 loan can take only 35 days from the first phone call to the closing table (I've seen it done in 26 days by my company previously, and the appraiser wasted many of those days). Typically, these projects should take an average of 60 days to close, depending on the borrower and the lender, perfectly in line with most commercial property contracts.

You may have some other objections in mind (I can think of at least three more that I hear regularly), but I have limited space here. Suffice to say that SBA loans are really not much different from conventional commercial loans, except for the obvious benefits they offer small businesses. And given the dearth of conventional commercial lending and the proliferation of SBA lending, these old, outdated misconceptions are moot anyway .

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Recent Changes: 504 Refinance Program

With the Small Business Jobs and Credit Act of 2010, it became possible to use the SBA 504 loan for refinancing. On October 12, 2011 the SBA released new changes to the program making it possible for more businesses to qualify for the SBA 504 Refinance Program.

Proceeds from an SBA 504 refinance can now be used for: owner-occupied commercial real estate; machinery and equipment; itemized business expenses (such as salaries, rent, utilities, inventory, paying-down payables, and other business obligations); and closing costs associated with the project. The debt being financed must have been in place for two years prior to the application date, and it must have been current for the past year with no past-dues more than 30 days. The most recent update added that loan deferments and/or modifications are now eligible for refinancing as long as borrowers have not been past due on these newly-modified terms. It's not possible to use the 504 to refinance loans with existing federal guaranties (includes 7(a), 504, and USDA loans), however.

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2012: The Year of SBA Lending

Commercial real estate brokers who are familiar with the SBA 504 loan program can help their small business clients make smart decisions when it comes to commercial property financing, which will continue to be a hurdle until our economy gets a bit healthier. I have a strong feeling that SBA lending will continue to increase through 2012, and smart business owners (and commercial real estate brokers) will take full advantage of it.

Additional information about SBA 504 refinancing is available at SBA504LoanRefi.com or 504Experts.com.