



Commercial Insights



Risk Management Insights

Savvy Bankers Select the SBA 504 Loan for Commercial Real Estate Projects

Merril A. Levesque, Director of Communications & Outreach, National Association of Development Companies

In the current economic climate of increased reserve requirements and regulatory concerns regarding CRE, the SBA 504 loan program deserves serious consideration when small business owners are seeking financing for the purchase and/or renovation of commercial real estate or the acquisition of machinery and equipment.

This government-guaranteed loan program is designed to make job creation and economic development possible by providing long-term, fixed rate financing to small businesses that are investing in their companies and adding staff. Indeed, any assistance that can be afforded to business owners who are creating or retaining jobs should be given priority in today's economy.

SBA 504 loans are unique in that they combine government-guaranteed funding from Certified Development Companies (CDCs) and private funding from traditional lending institutions to create a public-private financing partnership. When structuring SBA 504 loans, CDCs partner with traditional commercial lenders who provide 50 percent of project funds. The CDC provides up to 40 percent of the project funds — which are guaranteed by the SBA — and the borrower supplies as little as 10 percent as a down payment.

Considering the fact that SBA 504 loans are designed to finance growth companies, a small business that is investing in a permanent facility is often entering into its largest business-related loan. In many cases an SBA 504 loan becomes the basis of an entire banking relationship that can provide fee income from various sources. More specifically, by participating in SBA 504 loans, banks can also mitigate credit risk, manage overall lending limits, manage liquidity and strengthen core earnings.

Bankers who have used the 504 loan become advocates of the product since it can work well for a variety of unique financing scenarios. For example, late in 2009, Stephen Leist of People Bank of Texas was approached by a man and wife about a 504 loan to build a new daycare facility. The couple had utilized the 504 program several times before and wanted to take advantage of the long-term fixed rate financing. Since the majority of their net worth was wrapped up in the equity of their daycare facilities it was decided to refinance all of their daycare facilities into a new single 504 loan. The interim loan was roughly \$5.3 million with roughly \$2.6 million earmarked for the interim loan on the new facility. Once the new facility was built, People Bank closed on the 504 portion amounting to \$1.5 million.

Leist felt that the 504 loan program was the right choice for two major reasons: "The first is the bank is secured with a first lien on all the properties at a better loan-to-value with the SBA taking on a second lien position. The second is that the customer gets to have fixed rate financing for 20 years which in this case improved their overall cash flow."

Richard Frank, senior vice president at Virginia Partners Bank in Fredericksburg, Va., has been in banking for over 30 years and serves on the Lender Advisory Council of the National Association of Development Companies (NADCO). Frank relates that his experience with the 504 program both as a lender and manager of lenders has been very positive. He maintains that "the key for a lender in making the 504 workable for the bank and the borrower is to become familiar with the program, developing a working knowledge of the requirements to assist the process." He also recommends developing a good relationship with a CDC loan officer.

In one of Virginia Partners Bank's recent 504 loans, the principals of Dafore, LLC, Jeffrey Davis and Dennis Forrest, had leased space to house their drywall services company for several years. Purchasing two flex-space office/warehouse units utilizing the SBA 504 program last year allowed them to become commercial real estate owners rather than tenants, with loan payments lower than their previous rent payments. Virginia Partners Bank's initial funding was \$592,332, which eventually resulted in a commercial mortgage of \$329,073 and an SBA 504 loan of \$272,000.

Frank maintains, "In all cases in my experience, the resulting loan structure for the borrower has been beneficial, from the below-market long-term fixed rate on the 504 loan to the relaxed equity injection (versus conventional financing). The resulting exposure for the bank is desirable." When asked how he would compare the 504 program to conventional financing he remarked, "There are some different documentation and process requirements because of the necessary involvement of a CDC. The benefits of the program for the bank and borrower far outweigh any additional steps in the process of making the loan."

In conclusion he stated, "My advice for bankers considering the 504 program would be to allow a CDC to make a presentation to them, delineating the benefits of the program, and to contact bankers who use the program to give real examples and testimony to its usefulness."

Mark J. Wills, who is senior vice president of Georgia Bank & Trust in Augusta, Ga., is also a member of NADCO's Lender Advisory Council. Wills points out, "It comes down to knowing your customer. My most recent 504 was with a fast food franchise owner that needed to expand to keep his territory. However, the concerns for a bank for this type of deal are tight cash flow and cash for equity in the deal. With the 504 product, the customer can do 90 percent financing with long-term fixed rates. At the end of the day, the customer is able to build several stores using the cash flow from the new stores as he grows. The benefit for the bank is that it limits its exposure and allows the bank to grow with the customer over time as the company's cash flow builds." Wills went on to say, "Bankers need to know the product and how it can benefit the customer. In the long run, it benefits the bank also."

Most small businesses are eligible for 504 loans. The business owner must be operating a for-profit business that has a tangible net worth of less than \$15 million and average annual net profit after taxes of less than \$5 million. There is no limit to the total project cost; however, the SBA-guaranteed portion is limited to 40 percent of the project with a dollar cap of \$5 million depending on the type of project. 504 loans can go as high as \$5.5 million per project for eligible manufacturing projects and for certain "green" projects that incorporate energy saving technologies for sustainable design.

Some banks have expressed concern about financing the SBA 504 portion during a construction or renovation period putting the bank in the position of being out of compliance on a temporary basis. Based on feedback from bankers who participate in the 504 program, their experience with being paid down by the CDC on a timely basis has been very good.

With the 504 loan, smaller banks can handle larger projects and larger banks can limit their exposure to certain industries and/or to a particular borrower. The reduction of commercial real estate loan concentration on the balance sheet also reduces regulatory concerns. Ninety percent financing also means that more of the customer's funds remain on deposit. The bank is able to earn fees and interest on the interim loan, and generate fee income from sale premiums and loan fees if it chooses to sell the first mortgage loan in the secondary market. Banks that participate in SBA 504 loans are also eligible for Community Reinvestment Act credit on certain projects.

Since an SBA 504 loan is long-term, fully amortized financing, it enables a small business owner to fix business occupancy costs and avoid risky loan call provisions while enjoying lower monthly loan payments. In fact, current effective interest rates are coming in at around 5 percent, which is an extremely attractive rate for long-term commercial money.

Your bank does not have to carry the personnel cost for expertise in SBA 504 lending. Let a Certified Development Company be the SBA lending division for your bank and contact a CDC as soon as you believe you have a potential 504 project. The CDC would be pleased to review the project and advise on eligibility and timelines. Or if you are new to the SBA 504 loan program, contact a CDC for information on 504 lending. CDCs are always available to answer all technical and programmatic questions, and they also handle all the paperwork with the SBA. Your bank creates its own companion loan for 50 percent of the project and the CDC closes and services the 504 loan.

Selecting an SBA 504 loan is a winning strategy for your bank, your small business clients and your community.

For additional information, visit nadco.org or contact the National Association of Development Companies at 703-748-2575.