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Financing a business acquisition in today's market

Katrina Loftin-Winkel, 2/6/2012

Buying a business can be challenging in today's market, yet there are still several financing options for business acquisitions. If you're considering buying or selling a business in the near future, it's a good idea to understand the different financing options that exist.

SBA: SBA recently raised its limits for business acquisitions to $5 million, so this opens SBA financing to a wide range of businesses. Despite news that banks are not lending, there are a lot of SBA deals coming together right now. The key factors are a profitable business, a buyer with strong experience and 10-20 percent cash as a down payment. Most lenders are requiring the sellers to offer seller financing for a portion of the purchase price, usually 10-20 percent. In addition, buyers are required to personally guarantee the loan and they may have to provide additional security in the form of other assets they may own. Experience and down payment are the key components of an SBA deal. The upside is it is cheap money for the buyer, and the seller will usually get 80 percent of the purchase price up front in cash. The bad news for sellers is they usually won't see payments on the seller note for a year or two and they are only secured by the business assets in second position to the bank. For buyers, the downside is they may have to pledge everything they own in addition to a personal guarantee. Rates vary by bank but generally range from prime-plus-2 to prime-plus-2.75 percent floating or 5.25 percent to 6 percent. It is always a good idea talk to more than one lender for an SBA loan. Some banks like certain types of businesses better than others.

401(k)/retirement plan rollover: This is a great way to fund all or part of the purchase price. In essence, the buyer becomes the bank. There are a lot of rules associated with this type of funding, so it is imperative to contact a professional for this type of transaction. In simple terms, you transfer your retirement account to a service company (much like a 1031 exchange intermediary). They will act as your trustee and purchase shares of the new company. By doing this you can access your retirement account without having to take a taxable distribution. You can also mix this capital with other sources of funds. This is an interesting option particularity in light of the volatility of the stock market. The buyer is in control of his own financial success and this allows the buyer to come into the acquisition with decreased or no debt. The downside of this type of financing is that in the event the business fails, the buyer may lose his retirement funds. Traditional bank financing: Basically very similar to SBA financing as far as requirements. Banks like to see a strong buyer with an adequate down payment, usually 10-20 percent of the purchase price. Having real estate in the deal is helpful a traditional commercial loans. A/R funding: This can be helpful in bridging the gap between the seller's expectations and the buyer's available cash as well as provide the buyer operating capital they may need to operate the business once they take over. This is not A/R factoring. A company will purchase some of the receivables (usually 60 percent or less) and charge a daily fee until they are paid. The cost of this type of financing is high, however these are usually very short term loans so depending on the cash needs of the parties, A/R funding is a good way to obtain cash in as little as four to five days. Seller financing: Over the past few years, seller financing has been a key element in getting businesses sold. There is a lot of upside to this type of financing. 1. The seller is the bank, the seller makes the decision on who they will finance, how much down they will accept, the interest rate, and the term. 2. They are in first position. If the buyer defaults they can take business back quickly without delay from other lender and get it back on track if necessary. 3. This option may offer a tax benefit to the seller. The seller can defer some of the tax due on the sale of the business until full payment is received, which could be several years down the road. 4. This will usually result in a faster sale; a typical SBA loan could take 45 days or longer. Seller financing sends a strong message to the buyer that the seller is confidant in the business. Of course, there are downsides. If

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the seller has debt that needs to be paid off, this option may not work and in the event the buyer defaults the business could be damaged. The only downside for buyers is seller financing usually comes at a higher rate than SBA or traditional financing and may require a larger down payment. Earn-outs: Earn-out financing involves a certain dollar amount agreed on by the buyer and seller to be paid to the seller based on the performance of the company after the transaction is completed. Earn-outs can be structured in a variety of ways and can be based on different financial benchmarks such as a company's revenues, gross profits or net income. Earn-out financing is often used for companies that are in a turnaround situation or when buyers are purchasing on potential, rather than on historical cash flow. Earn-outs are tricky and can carry risk for both parties. It is essential to have earn-outs written properly by a qualified professional and make sure they are thoroughly understood by all parties.

Buying a business is more than likely one of the most expensive and important purchase you will ever make, it is imperative to have qualified professionals guide you through the process. A knowledgeable business broker can guide you through the options and help you chose the method of financing that is right for your particular situation.

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