

# A Lowdown on Lending

*Why the choice of bank controls the means of financing.*

Dear Dan,

*It was time to sell my business. I was approached by a nice person who actually lives in my town and works for a nearby business. We quickly reached an agreement on price and terms for my funeral home business and the real estate. It was simple. That is, until the bank got involved. The bank said that I had to take more money as a carryback and defer the amount for two years! Who are they to tell me what the terms of the sale are going to be?*

*Mad at the Bankers in Bennington*

Dear Mad,

Life is simple: If you have the money, you make the rules. Please remember to get that as a tattoo following your closing.

Bankers are easy targets for sarcastic funeral columnists. A banker will loan you an umbrella only on sunny days. Bankers will loan you \$1,000 so long as you post a \$1,500 CD as collateral. They are risk-averse people. They assume that everyone who borrows from them is going to default, and it is their lot in life to anticipate this and protect against it. I owned a lending institution for about five years and saw the evolution of the word *risk*.

Let me give you a history lesson. Banks and lenders have existed throughout history. People with the cash try to use the management of that cash as their business. Banks have always made loans and are subject to the risk they perceive they are taking, and they are going to dictate their terms and the terms of others standing behind them in a deal.

You, as a soon-to-be-former owner, will invariably be holding a note as part of the financing. This note will be in the form of a second mortgage, consulting agreement, covenant not to compete (CNC) or something else. A default on the first lender's note will cause the second posi-

tion – your position – to default as well.

During my tenure in funeral service, I negotiated with companies that were true lenders. They would dictate some terms, but it was on a deal-by-deal basis. Some portion of a funeral home purchase is always allocated to a CNC. That is because a funeral home is a personal service business and bears the alter ego of the owner. A CNC prevents the seller of a funeral home from competing with the new owner. CNCs are a part of the financing and collateral for that personal goodwill.

*Banks like using the Small Business Administration because they can make loans with less risk and lower reserves. The SBA does not make a 100 percent loan to purchase price; typically, they are at 75 percent. The other 25 percent is required to come from the buyer's own money or the seller's carryback. You may not like this, but it is the rule.*

The amount of the seller note is not necessarily driven by the bank but more so by the borrower. If the borrower hits the lottery and chooses to buy a funeral home with some of his or her winnings, the bank would not care about the deferral. The issue underlying this mandate by the bank is probably driven by the borrower's lack of equity in the purchase.

In today's world, the Small Business Administration funds most business loans. However, the SBA does not make

loans directly to borrowers; it funds the banks that are making the loans to qualifying small businesses via several loan platforms. Thus, the SBA funds the banks that are funding most funeral home transactions. This is due to two functions. First, the SBA is well funded, and second, it lessens the risk for the lender. Banks are still making real estate loans, but when the real estate is for a special use, the lender gets nervous and uses the SBA.

The relationship between a lender and the SBA is simple. An approved bank has a few preset loan types the SBA will underwrite. Some loans have a large amount of goodwill while others have a large amount of tangible assets. When the SBA underwrites a loan, the bank puts up less money and shares in the interest collected.

In addition, the bank gets a servicing fee; i.e., it receives compensation for originating these loans. The most important factor for the bank is that it does not need to use much of its reserves to put this loan out. Typically, a bank may need to use from 5 percent to 12 percent of its reserves every time it makes a loan, but with SBA underwriting, the bank reserve is on a lesser amount and is fully protected.

Banks like using the SBA because they can make more loans with less risk and lower reserves. The SBA does not make a 100 percent loan to purchase price. Typically, they are at 75 percent. The other 25 percent is required to come from a buyer's own money or the seller's carryback. In most cases, this carryback deferral is for the first two years. You may not like this, but it is the rule.

If you don't like the deferral, you have a few options. First, you can elect not to sell to this buyer. Second, you can carry the entire note yourself. Or you could call the SBA and get it to change its rules. If you elect the third option and are successful,

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*The name of the Lord is a strong tower;  
the righteous run to it and are safe.  
Prov. 18:10*



*Love your family<sup>SM</sup>*

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can you please get gravity to stop affecting my chins as your next trick?

A deferred note is usual. What we tend to do is rebuild the deferral note. For example, with a \$100,000 note that bears a 5 percent interest rate, we would reconstruct to accrue the interest for two years. The note would grow to about \$110,250 at the end of the second year of deferral. At that point, we would structure the note to be paid off over the next 10 years.

The loan approval process is complex. This is where we see lenders that are marketing to funeral homes as having an advantage over those that are generalists. The funeral-savvy SBA lender has the ability to produce the documents needed much quicker. It is able to underwrite a loan quicker. If a borrower encounters a tough business spell, the SBA funeral lender understands more workout solutions than the generalist. This last point is a big reason I have my clients use a funeral specialist.

Most banks that use the SBA have to submit the loan to the SBA for its approval. A limited few are "direct submission,"

which means if the lender's underwriters approve the loan, the SBA must approve it. This is a huge benefit and greatly speeds up the closing of the loan and therefore the business transaction.

The SBA charges a fee to give its guarantee of the loan approved. This fee is a few percentage points of the loan. Therefore, in some cases, you would want a conventional loan. For example, if the real estate value alone is more than the total borrowed, it is possible you do not need to go through the SBA. A conventional loan, similar to getting a mortgage on the property, is more suitable.

Like it or not, the SBA is rebuilding the banks. It is the world in which we live. Usually, the bank is not the problem. The problem is finding a buyer who is willing to pay the price you want.

Say, did I tell you about the banker who died but still made loans to ghosts? If you defaulted, the spirit got repossessed!

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