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Exit Planning NAVIGATOR

Exit Planning Strategies for the Entrepreneur

Issue 44

Minimizing A Lender's Risk When Financing A Sale

Whether you plan to sell your company to a third party or transfer it to key employees, co-owners or children, your banker can provide the cash necessary for a smooth transition.

In all scenarios, banks strive to minimize their risk. One way to do so is for buyers to take advantage of the Small Business Administration's (SBA's) loan guaranty programs that can protect the lender bank against loss in case of default.

The SBA's 7A loan guaranty program is designed to facilitate the sale of a business interest by guaranteeing the loan repayment. While subject to restrictions on size and type of companies that qualify and on percentages and types of collateral allowed, as well as limits on the personal liquidity of the borrowers, the loan guarantee program does provide for a 75 percent loan guaranty to participating banks on loans of up to $1 million used by a new owner to acquire an entire business. The intended effect is to encourage banks to lend money (at a substantially reduced default exposure) to buyers of closely held businesses.

The challenge is: how do you design a transfer to your Key Employee Group (KEG) that satisfies a bank's (and the SBA's) 25 percent down payment requirement *and* does not require you to assume the position of a subordinate creditor?

One possible solution is to create an ownership-based management incentive program that transfers 25 percent to 40 percent of the ownership of company to the KEG. During this transfer, you retain control and ownership of the company. Because the KEG owns between 25 and 40 percent of the business, it meets the SBA's down payment requirement and can borrow the money needed to cash you out.

Combining this design with bank involvement can be an attractive and low-risk plan for many owners. To succeed, an owner must have in place:

1. A well-designed exit plan;
2. capable management acceptable to (even embraced by) your bank;
3. a financed debt to net worth ratio of less than 4 to 1;
4. an historical cash flow to annual debt payment ratio of at least 1.4 to 1; and
5. a good banking relationship.

Generally, banks want to continue good relationships with good businesses. They are realists. They know that every business will someday transfer ownership and they want their relationships to continue with new owners.

8820 Ladue Road
Suite 201
St. Louis, MO 63124

tel: (314) 725-9939
fax: (314) 725-9938

www.claytoncapitalpartners.com

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When asked what primary factor makes or breaks a loan, every banker we've met cites management. "We need to be *comfortable* with the new management as we assess the desirability of continuing the existing relationship and of loaning additional cash for the acquisition of ownership."

The best way to make your banker comfortable is to have motivated capable management remain after your departure. If your banker lacks confidence in the management team, the deal is dead on arrival.

As you can see, with the right planning, the right business, and the right banking relationship, you can leave your business right on time.

Subsequent issues of **The Exit Planning Navigator®** *discuss all aspects of Exit Planning.*

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