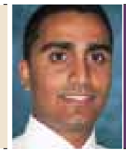

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The Value of Valuation Rules

In the latest SBA standard operating procedure, knowing how to determine business value is key

The U.S. Small Business Administration's (SBA's) 7(a) lending program processed more than 16,000 loans this past first quarter, which was more than double the number it backed in the first quarter of 2009. This increase in SBA loan volume was partially spurred by the American Recovery and Reinvestment Act, which contained temporary provisions that removed the guarantee fee and increased the government-guaranteed percentage of SBA 7(a) loans from 75 percent to 90 percent.

Many of these loans are for business acquisitions that include considerable amounts of "goodwill." The SBA defines goodwill as "an intangible asset of a business that relates to a favorable relationship with customers, and excess earning power."

As small-business lending continues to grow, commercial mortgage brokers should familiarize themselves with the new guidelines for goodwill financing and for business valuations.

Know the SBA's SOP

Early in 2009, the SBA instituted a goodwill cap of $250,000, but revoked it later that year. In September 2009, the SBA released standard operating procedure (SOP) 50-10 5(B), which states: "If the purchase price of the business includes intangible assets (including, but not limited to, goodwill, client/customer lists, patents, copyrights, trademarks and agreements not to compete) in excess of $500,000, the borrower and/or seller must provide an equity injection of at least 25 [percent] of the purchase price of the business."

The seller equity (i.e., take-back financing) must be on full standby for at least two years. If the combined equity is less than 25 percent, then SBA lenders cannot process the loan application internally. Instead, the loan must be submitted to the SBA's 7(a) loan-processing center in California, which could cause a delay in approval and require additional documentation.

This past September, the SBA released an updated SOP — 50 10 5(C) — which took effect on Oct. 1. The real estate appraisal requirements remained unchanged: "SBA requires a real estate appraisal if the SBA-guaranteed loan is greater than $250,000 [and] is collateralized by commercial real property."

Many of the business-valuation requirements also remained the same, mainly: "If the amount being financed minus the appraised value of real estate and/or equipment is greater than $250,000 or if there is a close relationship between the buyer and seller (for example, transactions between family members or business partners), the lender must obtain an independent business valuation from a qualified source."

The definition of a qualified source is important for brokers and lenders to understand. Additionally, brokers and lenders must follow business-valuation guidelines closely.

Find a qualified source

Many lenders have never previously ordered a business valuation, as most were simply conducting in-house valuations as part of their underwriting. The recent third-party business-valuation requirement, however, combined with the increase in government stimulus programs, brought about an immediate need for business valuations for many loan applications.

When lenders cannot find qualified valuation companies that understand SBA loans, closing delays may occur. To avoid such delays, brokers can assist lenders when it comes to hiring a qualified business-valuation company, as well as help lenders gather the required documents for the business valuation.

Before engaging a business-valuation company, the qualifications of the person actually compiling the report should be reviewed. The SOP states: "A 'qualified source' is an individual who regularly receives compensation for business valuations" and is either a certified business appraiser, accredited senior appraiser, certified valuation analyst, accredited valuation analyst, accredited in business valuation or a certified public accountant (CPA).

If engaging a CPA, it is recommended that this person also is accredited in business valuation or a certified valuation analyst. This ensures that the CPA has business-valuation training.

Additionally, the SOP reads: "The business valuation must include the individual's opinion of value, the qualifications of the individual performing the valuation and their signature certifying to the information contained in the valuation."

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Simply stated, the valuation cannot be compiled by an unqualified appraiser and then simply signed off by a "qualified source." To ensure this requirement is met, brokers and lenders should review the qualifications of the person compiling and signing the report before engaging the company.

Remember that the business valuation must be requested by and prepared for the lender. The lender is considered the appraiser's client; brokers may suggest what valuation company to use, but they cannot engage the company themselves. Providing the lender with a few qualified companies to choose from, however, will save the borrower time and money, and the lender will likely appreciate the recommendations.

Don't wait until a lender issues a commitment letter to search for a business-valuation company. Experienced lenders and brokers are now contacting valuation companies as soon as they issue a letter of intent.

Prepare for the valuation

Although most lenders will wait until the borrower signs the commitment letter to engage the valuation company, requesting and completing the business-valuation questionnaire ahead of time will save days, even weeks.

Essentially the same information required to complete the loan application is required for the business valuation, so preparing these two items in parallel will increase efficiency. Brokers are allowed to assist borrowers and sellers with the business-valuation questionnaire, so they should familiarize themselves with the form.

In addition to the business questionnaire, all valuations require three years of tax returns, interim profit-and-loss statements within 90 days of closing, and a copy of the purchase agreement. Having these documents ready will streamline the valuation process.

The new SOP also now requires that the "lender must obtain a copy of the financial information relied upon by the individual who performed the business valuation and verify that information against the seller's [Internal Revenue Service] transcripts to ensure the accuracy of the information."

To make sure they conform to this rule, the broker and borrower can send all documents directly to the lender, and after reviewing, the lender can forward the documents to the appraiser. The lender should be copied on all correspondence in the event that you send a document directly to the appraiser. This will ensure that the lender knows about all documents that the appraiser is using to compile the valuation report.

Valuation reports

The type of report lenders choose is important, as it will determine the price and the quality of the report. Many companies have several different options, and some might not disclose that the "limited" appraisals or "calculation of value" reports are not suitable for SBA-related valuations.

The report has to provide a conclusion of value and should conform to the Uniform Standards of Professional Appraisal Practice. Additionally, the report should include economic reports and industry reports and should specify how these two factors affect the business being appraised.

Experienced appraisers also will include financial-ratio analysis and describe the business and the terms of the contract thoroughly. More important, the report will include all three valuation methods: the income approach, the market approach and the asset-based approach. The report should be called a "complete" or "summary" report.

Complete appraisal reports compiled for SBA lenders typically cost between $2,300 and $3,500 and should be 70 to 90 pages long. The cost of the report can be passed down to the borrower, as per SOP guidelines.

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Brokers should take time to understand the basic requirements of the SBA's updated SOP. With a thorough understanding, you likely will find you can screen and structure SBA deals more efficiently. ●