LIVE OAK BANK®

RESTORATION, REMEDIATION & CLEANING CONTRACTOR'S GUIDE TO FINANCE

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INTRODUCTION

Every single business, whether small or large, is funded by a mixture of debt and equity to allow the business' assets to generate the revenue needed to sustain and grow operations. Understanding the options available to you as a business owner to fund your business is vital in both good and bad times. Knowing what the financing options are and how to use them can be the key to unlocking the growth potential of your company and increasing its value.

Traditional, large industrial companies have both liquid capital – their cash and financial assets – and capital goods such as buildings, equipment and inventory that could be sold off to raise funds. In addition to accumulating profits, these companies raise capital in order to expand or endure hard times by taking loans or inviting direct investment. The larger the business, and the more capital it already has, the more likely it is to be able to obtain more.

Access to capital is difficult for small businesses, especially new businesses or service businesses such as restoration, remediation and cleaning contractors, whose assets are primarily intangible, like the brand of the business and the customer lists. A service-based business must leverage its ability to generate consistent or increasing cash flow to gain access to capital, whether that is debt or equity.

Knowing the options available to you as a business owner is not only important if you are an existing owner looking to expand your business, but for those approaching retirement as well. The owners of contracting businesses in the restoration, remediation, and cleaning trade industries have an average age above 50. Most owners in the industry are edging towards retirement, and the time to strategically plan an exit, if an owner has not already done so, is now. In addition, it's time to understand the financing options that are available for your identified buyer to help smooth the sale and transition.

This paper outlines various forms of capital available to contractors for expanding their businesses, acquiring a business, modernizing their business, recruiting, buying or building real estate for their business and other needs. The below options will be presented in the order of most frequently to least frequently used today.

In any transaction taking place, it is important for the buyers and sellers to work closely with appraisers, tax professionals and attorneys to ensure that they formulate a structure that works for their needs.

SELLER FINANCING

Business owners often find that in order to close a business sale, they must finance it themselves with a note. This could be for a multitude of reasons such as the buyer not having the personal assets to secure conventional bank financing, or the seller would like to receive interest payments over the course of several years versus an upfront lump sum.

Seller financing can take multiple forms, whether that is a seller note that finances the entire sale and will be paid back over time, with interest, an earn-out agreement, or even a slow timely transition of ownership to the buyer. The seller financing can be a combination of a note and an earn-out agreement as the buyer may protect their investment by requiring the seller to help with the transition, so that certain benchmarks are met, and employees and customers are retained for an extended period, in which case the seller would be paid based upon the benchmarks associated with the earn-out agreement.

For buyers, the advantage of seller financing is that it incentivizes the seller to do his or her utmost to help the new owner succeed, as ultimately the seller is only paid for the sale if the business continues to succeed.

The disadvantage of an extended transition is that the seller may overstay his or her welcome, preventing the buyer from modernizing or making changes in the firm that they desire or causing unrest amongst employees and customers. Seller financing is also risky for the seller who is essentially acting as a bank in the transaction and is reliant upon the buyer for repayment of the sale after the seller's years of hard work put into growing their business. If the business were to fail during the pay-back period of the seller note, the seller would have to step out of retirement to run the business again and will most likely not receive the full value for what he/she originally sold the business for.

FRIENDS AND FAMILY

Many businesses begin with funds put up by family and friends. Some of these funds are merely gifts given to the business owners, but oftentimes they are not, and the investor is given an ownership stake in the business. Some of these investments will make the family members rich, but many will find that their potential rewards are much lower.

Raising money within one's inner circle is the first route that many business owners go as it is the most accessible. The money can either be debt or equity, and the family and friends must be comfortable in the business before they invest. A poor investment can lead to tension at Thanksgiving and other holiday gatherings. It can be an easy-going process or an extremely emotional one.

Nevertheless, loans and investment by family and friends are still business transactions. For legal and financial reasons, it is essential to have written loan or equity agreements regardless if they are family and friends and to have these agreements reviewed by attorneys. If the money is being lent, the lender must charge interest, or the IRS may view the loan as a gift to the business owner, which can be taxable. If the venture is not successful, the paperwork will protect the borrower, who will want to repay the loans and share the profits as agreed – and not necessarily beyond.

SBA LOANS

An SBA loan is a loan administered by the Small Business Administration that enables banks to lend to small businesses up to $5,000,000 or multiple loans until a business has reached its SBA limit. A contractor that applies for an SBA loan is not borrowing directly from the government. Instead, the SBA guarantees (insures) bank loans to small businesses that meet the SBA's size criteria for that industry. As the business owner, you are only speaking with the bank who is enabled by the SBA to make this type of loan. Although categorized as a small business, many restoration, remediation, and cleaning contractor businesses that use this program are worth millions of dollars. These are not small businesses and are quite valuable providing many employment opportunities for the local community. The size criteria for a restoration, remediation, or cleaning contractor business may vary between $5.5 million to $20 million based on the services provided doing $5-20 million or less in sales, but even if your company is doing more than that, there is an alternative size standard under which you can qualify for an SBA loan. Unlike a conventional bank loan, which we will describe later, an SBA loan has more lenient terms which fit with the SBA's mission to expand business ownership and create jobs. Terms are generous, up to 10 years on a business loan for a business acquisition or working capital and up to 25 years for loans involving real estate. There are no covenants that will restrict your business' growth as long as the loan is paid back as agreed.

SBA loans can be used to acquire a business, whether you are an existing restoration/remediation business looking to acquire a crosstown competitor or a general manager who has been the identified successor to the current owner, if the business is in the United States. The loans can also be used to refinance existing business debt, purchase equipment, and working capital. SBA loans can be used to acquire real estate for your new headquarters, if you want to buy or build your satellite location or add on to your existing property.

Applicants must be able to demonstrate that the loan will be used for a sound business purpose. Many banks offer SBA loans, but may not be adept at handling the paperwork, or truly understanding the variables involved in SBA financing or what the loans can be used for.

Although a bank with the ability to lend conventionally, Live Oak Bank specializes in SBA loans and has developed an expertise in using them. Live Oak Bank was named the top SBA lender by volume for Fiscal Year 2018.

The key difference between a conventional loan and an SBA loan is an SBA loan does not require the tangible business assets of the subject entity or the personal tangible assets of the owner to fully secure the SBA loan. The reliance is upon the character and resume of the owner/guarantor and of the ability of the business to operate successfully and for historic financial statements to demonstrate the ability of the business cash flow to meet all proposed and existing debt payments, as well as continue to pay the owner a comfortable salary. This is important for contracting businesses in the restoration and remediation industries because in most instances there are not enough tangible assets like real estate or equipment to fully secure the loan, which eliminates access to conventional bank financing for many great businesses. An SBA loan provides the opportunity for businesses that have the cash flow, but not necessarily the collateral, to secure financing to grow. This also means that a son or daughter who has worked his or her way up the business can now possibly purchase the business without necessarily having the personal assets to fully secure the loan. The ability for a buyer to potentially receive an SBA loan even without having the personal assets to secure it or having to put 20 percent down means that seller financing is no longer the only option around. Sellers now have an option to sell and receive all or most of the proceeds from the sale up front rather than having to wait 10 years and cross their fingers that the buyer pays them back.

For contractors looking to acquire a local competitor, expand to a new business line or service area, an SBA loan is akin to having an arrow in your quiver -- a great tool to use to acquire a business. Seller financing has been the main source of financing in the industry for years as access to bank financing has been limited for buyers, so a seller had to resort to holding the risk of the transaction versus a bank holding the risk. Knowing the uses of an SBA loan and the fact that a seller could receive all or most of the proceeds of the sale of their business up front could lead to a reduced purchase price and help with negotiations of the sale.

CONVENTIONAL BANK LOANS

Banks are the primary source of credit for businesses, and the first lending institution that comes to mind for most borrowers. Here, however, a business that lacks tangible assets and relies on intangible assets like client lists or goodwill may have trouble qualifying for a loan. Banks want their business loans to be fully secured by real property, and the customer list of a business being acquired cannot be used to secure the loan to a conventional lender's policy or satisfaction.

A remediation, restoration, or cleaning contractor who does qualify for a conventional bank loan will enjoy several advantages. Firstly, interest rates will most likely be lower due to a higher credit quality as the loan will be secured by tangible assets meaning the bank's chance of getting repaid is higher than an unsecured loan. Secondly, borrowers will have to show a plan for how they intend to use the funds but may have more flexibility in how they structure the loan. Conventional bank loans will also oftentimes put in place covenants that a business must maintain, so as not to default on the loan, which can restrict the ability of the business to grow or operate autonomously depending upon the covenant.

PREPARING FOR A STRATEGIC MOVE

It takes time to prepare for a transaction to determine the option that best fits your business needs. Contracting business owners should do their due diligence before they are even looking at a specific transaction to get to know the lending market and better understand the best options for funding. This will make for an easier and more efficient process. Understanding the financials of your business and what your banker is looking for, whether you are seeking a conventional loan or an SBA loan, is important to the success of the transaction and the bank approving your loan request. Your banker will be happy to talk about potential transactions and explain the terms of a potential transaction and what the bank looks for to approve the loan request.

Both buyers and sellers need to get their firms appraised by an objective third party. Not one business is the same and will be valued on its own merits.

Using an appropriate combination of debt and equity to finance your business or acquisition is the key to healthy and responsible growth for a firm and wealth for the business owner. Have certainty in your financing partner, take time to work through your options, and consult with experts to ensure that the structure in place works for those involved.

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