

TIME TO BUY

Your business is growing and you're tired of renting space. Here are the financing options you can consider for purchasing commercial property.

TABLE OF CONTENTS

Benefits of Ownership.	2
Conventional Loans	2
SBA 504 Loans	4
Understand the Loan Process and Timing.	6
Conclusion.	7

EXECUTIVE SUMMARY

Small businesses that have ridden out the economic storm may be well positioned to take advantage of a buyer's market for commercial real estate. For many owners, now is the perfect time to buy. But which financing is right for you? Potential buyers will want to evaluate two main types of loans for owner-occupied commercial real estate (OOCRE). Conventional loans, underwritten by a bank, can be used to purchase, refinance, improve, or build a property. SBA 504 loans, a coordinated effort between the U.S. Small Business Administration (SBA), a Certified Development Company (CDC), and a private lender, offer long-term, fixed-rate financing for a range of fixed-asset projects. This paper examines the features and benefits of each.

BENEFITS OF OWNERSHIP

You've survived the startup phase of your business, having built up a strong customer base and stable cash flow. So why are you still renting your commercial space? Property ownership can provide valuable financial benefits for an established business and may actually contribute to your company's continuity and growth.

The benefits of owning your business property are magnified by the current real estate environment, in which lower property values, high vacancies, and low interest rates have combined to create a sustained buyer's market in many regions. But business owners shouldn't wait too much longer to buy; a drop in construction during the recession means that once the economy starts growing and demand for commercial real estate picks up, vacancy rates will begin trending down quickly. The National Association of Realtors reports that vacancy rates are expected to fall over the next year in the office market (down 1 point to 15.3 percent), industrial market (down nearly a point to 13 percent) and the retail market (down half a percentage point to 12.6 percent).¹

"Rarely has there been a better time to look at purchasing and owning your own commercial building," says Rick Benito, Credit Solutions Executive at Bank of America Merrill Lynch. "Today's economy has driven down the cost of commercial real estate, and interest rates are at historical lows."

Aside from finding the right property to suit your needs, you also need to find the proper financing. There are two main types of financing for owner occupied commercial real estate (OOCRE): conventional loans and SBA 504 loans. Which one is right for you? This paper looks at the benefits of each to help you decide. We can only offer a broad overview on these pages; you should discuss your options in more detail with a trusted financial advisor, who can help you find the solution that most closely aligns with your business goals.

CONVENTIONAL LOANS

In a conventional OOCRE financing, a bank underwrites a loan to your business according to its specific underwriting requirements. The loan may be used to purchase, refinance, improve, or build a property. To qualify as an OOCRE, your business must occupy at least 51% of the building.

Loan amounts and terms will vary by financial institution. Banks may offer conventional commercial real estate loans ranging from \$500,000 to \$20

¹Commercial Real Estate Outlook, Q2 2011 outlook, National Association of Realtors, referenced at <http://www.realtor.org/research/research/commercialhome>

million. “In most cases, you can get a conventional loan with a 20% down payment and an amortization schedule of up to 25 years (20 years on average),” says John DeFranza, Credit Solutions Executive at Bank of America Merrill Lynch. “Most loans mature within 10 years, giving you the option to renew or refinance, or you may decide to sell the property to acquire a larger one.”

Interest rates and fees

Lending fees for a conventional loan are negotiable, but typically are set at 1% of the loan amount. Most fixed-rate loans come with prepayment fees, while variable-rate financing has a different payment structure. A strong banking relationship with a long-term focus can help you to negotiate down the cost of loan fees, and also ensure you get the right loan solution.

Loan Program Comparison

	Conventional Loan	SBA 504 Loan
Loan size	\$500,000–\$20 million	\$500,000–\$13 million total project costs
Purpose	Refinance, purchase and improvement of OOCRE	Build, purchase or improve OOCRE; refinance existing SBA 504 first deed of trust; purchase equipment with usable life over 10 years
Down payment	20–30%	10–15% depending on property
Amortization (OOCRE)	15, 20 or 25 years	20–25 years (equipment – 10 years)
Fees	Negotiable	Fees may be financed in most cases
Rates	Contact your bank	Contact your bank
Prepayment fees	May be applicable	May be applicable

Note: Credit is subject to approval. Normal credit standards apply. Interest rates and terms are subject to change without notice.

Loan structure

Depending on the location of the property, with a typical conventional loan the bank will provide 70% to 80% of the purchase price, with the remaining funds coming from the buyer. Special-purpose properties such as a restaurant or a cold storage facility, which are more customized and have a smaller resale market, may require a higher down payment to achieve a lower loan-to-value ratio. The buyer’s capital injection may include funds from a 1031 exchange, in which you sell one property and inject that equity into another one. Be sure to consult a certified public accountant or tax specialist to closely examine your 1031 exchange options.

Sample loan structure

Conventional Loan	SBA 504 Loan
Total project: \$1.5 million	Total project: \$1.5 million
Bank: \$1.2 million first trust deed (80%)	Bank: \$750,000 first trust deed (50%) CDC/SBA: \$600,000 second trust deed (40%)
Borrower: \$300,000 down payment (20%)	Borrower: \$150,000 down payment (10%)

Interest rate protection

Several options are available to business owners who want to mitigate the potential negative impact of fluctuating rates during the course of a conventional loan. You may decide to fix all of the interest rate on the note, for example, or keep part of it variable. The latter option can be useful for making adjustments to cash flow needs during the life of the loan.

Borrower benefits

A conventional loan offers the advantage of a direct transaction with the bank, which should make the loan process efficient and timely. Obtaining a loan with a bank where you already do business should also enable you to negotiate fees and terms based on a holistic, long-range view of your financial relationship. In addition, you may be able to get cash out of a conventional commercial real estate loan, which can be used for remodeling, equipment purchases, and other business reinvestment. As mentioned previously, interest-rate protection options are available on conventional loans.

SBA 504 LOANS

A 504 loan is a coordinated effort between the U.S. Small Business Administration (SBA), a Certified Development Company (CDC), and a private lender, which work together to provide long-term, fixed-rate financing for a range of fixed-asset projects.

Designed to promote business development and job creation, 504 loans enable businesses to put less money down than a conventional loan, so you can keep more cash on hand for expansion or operating expenses. Qualifying small businesses are defined as having up to \$5 million in net profit after taxes (averaged over the last two years) with up to \$15 million in tangible net worth.

Interest rates and fees

504 loans feature interest rates that are pegged to an increment above the current market rate for 5- and 10-year U.S. Treasury issues. In most 504 loans, fees for the first trust deed are typically 1.5% collected for SBA. Second trust deed fees total approximately 2.15% of the debenture – but most of these fees can be financed with the loan.

Loan structure

504 loans typically have a 50/40/10 structure in which the bank holds a first trust deed loan of 50% on the property. A second trust deed loan of 40% is secured from a CDC (backed by a 100% SBA-guaranteed debenture), while the borrower contributes as little as 10% equity. Special-purpose properties such as restaurants, hotels and skating rinks, which have a more limited resell market, may require an additional capital injection by the borrower. Depending on your banking relationship, your bank may increase its loan position to more than 50% for larger loans in order to offset the SBA's 40% limit.

Eligibility requirements

The SBA maintains six primary eligibility requirements for 504 financing:

- The business owner must be a U.S. citizen
- The business must be for-profit
- The business's tangible net worth cannot exceed \$15 million
- The business must show a two-year average net income after taxes that does not exceed \$5 million
- The owner must plan to occupy at least 51% of the building for a purchase or at least 60% for new construction.
- The maximum debenture is \$5 million, up to \$5.5 million for manufacturing businesses

Borrower benefits

The ability to keep more money in your business, longer amortization schedules, lower loan-to-value ratios due to government backing, and below-market rates on the SBA debenture make 504 loans highly attractive for many businesses. 504 loans provide access to capital that is generally afforded to larger corporations and give banks greater flexibility to offer favorable terms.

Unlike conventional loans, the use of proceeds from 504 loans is limited to the eligible costs of acquiring, renovating, or constructing improvements on real estate and associated equipment, if applicable. All costs must be documented and the borrower is not eligible to take cash out if the appraised value exceeds the cost.

"A lower down payment can help you preserve cash for your business," says Benito. "And historically low interest rates – including blended rates of the first and second trust deeds that are typically less than market rates – will reduce your monthly payments."

Construction Financing: Assess the Complexities of Building Your Own Facility

Conventional and 504 loan programs both offer options for construction financing. A construction loan is a fixed-price contract in which the scope of work, including plans and specifications, must be fully disclosed. Whether it's adding onto existing property or building from the ground up, construction financing requires a formal contract and an approved contractor who has submitted a qualification package that meets the required standards as defined by your lender. Change orders must be in writing and signed by both you and your contractor.

In the case of SBA construction financing, items needed to ensure certification and final payment include the following:

- Final certificate of occupancy
- Final inspection card
- Unconditional lien releases from all prior draws
- Conditional release for the retention draw
- Final lien-free endorsement from the title company
- Third-party disbursement control and inspection agreement (your lender should engage an independent construction control company to assist with draws and inspection requirements)

An experienced construction lender can help you navigate these and other complex issues involved in planning and executing the construction of your building. Consulting your lender in the pre-planning stages of your project—and maintaining ongoing open dialogue throughout the process—benefits both your business and your banking relationship.

UNDERSTAND THE LOAN PROCESS AND TIMING

With either type of commercial loan, the loan process begins once your lender has received your completed application. In a conventional loan, your application package goes directly to the banker, who will see your application through the underwriting process. With a 504 loan application, the bank and CDC will underwrite, with the CDC coordinating approval from the SBA. Credit approval is normally received within one to two weeks. The average timeframe for closing and funding for either type of loan is 60 days.

Here's how the commercial loan process works:

1. The borrower submits a completed application. All information must be received before the underwriting process can begin.
2. The bank orders title and appraisal. A title report is usually received within a day, but appraisals often take 15 to 20 business days. Allow time for the bank to review and address any concerns.
3. The bank reviews environmental due diligence. If there are environmental concerns, as in the case of underground storage tanks or oil well, for example, the lender will review professional environmental inspections, depending on the property type and use. If a 504 loan, the SBA requires a specific environmental reliance letter. Underwriting, appraisal and environmental review may be done simultaneously or the borrower may choose to wait for credit approval prior to pay for the appraisal and environmental reports.

4. The loan is completed and funded. Conventional loans are typically closed and funds are provided to the borrower upon completion of due diligence and receipt of closing items. The CDC funding mechanism is a monthly debenture sale, so the bank will typically provide a bridge loan for the CDC portion in the interim between loan closing and the receipt of funds by the CDC. Bank and CDC closing documents are normally signed together in escrow for purchase transactions, minimizing borrower paperwork, funding time and bank risk.

To learn more about conventional and 504 loan programs, the impact of changing rates and legislation, or other financial topics and solutions relevant to your business, please contact your Bank of America Merrill Lynch representative.

Determining Your Financing Needs:

Key Questions

Before purchasing commercial real estate, it's a good idea to assess your current financial situation to determine the right financing needs. The U.S. Small Business Administration recommends that business owners ask themselves the following questions:

- Do you need more capital or can you manage the existing cash flow?
- What is the nature of your need?
- How urgent is your need?
- How great are your risks?
- In what state of development is your business?
- For what purposes will the capital be used?
- What is the state of your industry?
- Is your business seasonal or cyclical?
- How strong is your management team?
- How does your need for financing mesh with your business plan?

Source: SBA.gov

CONCLUSION

To determine the type of commercial real estate financing that's the best fit, business owners should ask themselves a few important questions: How much of a down payment can I provide? How long am I planning to keep the property? Am I eligible for SBA financing? What's my preferable term or maturity timeline? By working with your lender to answer these questions and get the right financing in place, you can begin to reap the benefits of property ownership – and turn your focus back to serving customers and growing your business.

