FinancialPlanning

Don't Make this Practice Acquisition Loan Mistake

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Some banks, once wary of lending money to financial professionals because they lacked guaranteed income streams, have changed positions. Since Live Oak Bank's path to dominance seven years ago, when it pioneered financing for advisor succession through Small Business Administration loans, conventional loans have joined the fray.

Those changes are key amid a red hot buyer/seller market. Whether you want to buy or sell a practice, choosing the right loan structure can cut costs and boost profits, and financial advisors should look closely at the expanding conventional loan market to access capital. There are more options today than those SBA loans.

Banks are even loaning money for smaller-scale wealth management acquisitions. For example, advisors Steve Serati and Lee Neumann of Millenia Investments have built up most of their St. Louis-area practice, which has $350 million in client assets, by leveraging conventional loans to buy books of business.

“One thing is certain: we've never seen a better time than today for sellers to receive top-dollar for their practices,” Serati said. “If you are a seller, the stars seem perfectly aligned. High demand, combined with increasing lending opportunities, has created an amazing opportunity for motivated sellers.”

SBA lenders have provided as much as 80% of the capital in purchases of advisory practices in recent years, compared to only 10% from conventional lenders, according to the Succession Resource Group, a consulting firm.

SBA loans serve specific purposes, but you shouldn't use an SBA loan unless you have to. Buyers with strong credit should expect to secure better rates through conventional loans than they can get through the SBA.

Besides higher rates, SBA loans can come with significant origination or servicing fees — another significant drawback for borrowers. The size of these loans comes from projected cash flow (and could potentially help a less-tenured buyer), versus the look-back approach for conventional loans.

An SBA loan with a 3.25% interest rate and 2.5% SBA lender fee comes to a total of 5.75%. A comparable conventional loan might run 5%, or 75 basis points less, because of its lower administrative costs.
SBA obligations are typically structured as floating-rate loans, whereas fixed-rate options are readily available from conventional lenders. Regardless of your view on future interest rate moves, the conventional structure does provide certainty that your monthly payment will not change over the entire life of the loan.

Banks set their own rates for their portion of the loan, which may be fixed or variable, but cannot exceed an SBA interest rate cap, 6% over the prime rate, or 9.25% as of Jan. 22, 2021.

Fees

In addition to the fixed or floating rate garnered in each loan obligation, there are additional fees that the applicant must take into consideration including guarantee fee, origination fee and prepayment penalties. For government-guaranteed loans, the SBA charges a guarantee fee prior to close. The amount of the guarantee fee can range from 3% to 3.75%, depending on the loan amount, and is often paid out of pocket by the borrower.

Conventional loans do not have a government guarantee nor the requisite fee. Commonly, conventional lenders charge an origination fee of around 2% to 3% of the loan amount. An origination fee can be paid from loan proceeds; as a result, the borrower does not have to pay out of pocket.

Borrowers need to show caution with entities charging an application fee. Application fees can vary between $3,000 and $5,500 and do not guarantee funding, whereas origination fees are only paid when the transaction closes.

Getting expert help

That all means that conventional loans could replace SBA loans in the foreseeable future as the dominant form of succession lending. In fact, conventional loans have created a cottage industry attracting entrepreneurs who function as loan consulting and procurement specialists to advisors.

That's because, as Succession Resource Group also notes, external financing made up 55 cents of every dollar of loan value in the deals, versus a nickel just seven years ago. The procurement specialists are filling the void of conventional loan accessibility. Practice buyers want readily attainable loan options that protect their best interests, and working with trusted specialists is an effective strategy.

The startups have culled hundreds of commercial banks to find partners to fuel their growth. Some engage with as many as 15 lenders who share their vision and goals.

They provide value by bridging the gap between advisors and loans. Advisors may tackle the formidable steps of securing conventional loans directly through banks, but it's probably not worth the time spent on it for a single purchase.

Engaging procurement specialists as resources for education, service and competitive pricing should serve you well throughout the buy/sell process. They enlighten through road shows and webinars, as well as personal and digital contact.

If you're within six months of your first transaction, you should discuss financing options with reputable loan procurement specialist as early as possible. They'll determine if a conventional loan is realistic based on your financial status and history. Take advantage of their established bank relationships for both cost and time savings. Their expert advice will manifest itself through your communications/interactions with the seller. Your knowledge and confidence should help comfort the seller during this emotional event.