New SBA Lending Rules Impede Deals

As everyone knows, the domestic financial markets are in a state of disarray. One day they are up, the next day they are way down. Gas prices went through the ceiling; then they came down. So what is the financial institutions' current disposition when it comes to buying and selling petroleum properties? As with everything else, it's all about change.

I knew things had changed earlier in 2008 when the deals I was working on started taking longer and longer to close. Banks were becoming more particular, asking for increasing amounts of documentation, and always at the last minute. I thought it was just typical of bankers trying to cover themselves (and they were). But in late summer the Small Business Administration (SBA) made an announcement confirming my suspicions that securing loans for the purchase of petroleum properties was going to get even tougher.

On Aug. 1, 2008, the SBA decided to expand the indemnification of environmental issues when making loans on petroleum-related properties. This expansion includes keeping the previous owner liable for environmental issues for an extended period of time past the closing date. This was an unprecedented and unheard of requirement. To put this in perspective, let me explain briefly how environmental issues work when selling a petroleum-related property.

Normally, when an owner sells a petroleum-related property, the site is checked for any outstanding issues or incidents by an environmental engineer. This is known as a Phase I study. Sometimes, the buyer may request a Phase II study, which involves drilling a few holes on the property and testing for the presence of petroleum hydrocarbons to see if any contamination is present. If contamination is found, the owner is required to present a plan of remediation to the state in which the property is located. The plan is executed until the contamination has been remedied. When the state is satisfied that the problem has been fixed, they will then issue the owner of the property a "No Further Remediation" letter or NFR letter.

Until such a letter is issued, the owner of the property at the time when the contamination was found is responsible for any and all remediation efforts. In the industry we call it "our watch, your watch," meaning that if an environmental issue is identified prior to the closing date, the seller is responsible for the cleanup and indemnifies the buyer from any work or costs associated with the cleanup. Once the business is sold, however, the new buyer is responsible for any issues found after the closing date.

A buyer therefore can get property that is clean, with the exception of the one known issue that the past owner is going to take care of. Once the issue has been cleaned up and the seller receives the NFR letter, the seller is off the hook for any future environmental issues. Traditionally, banks and lenders have accepted this procedure.

But the SBA has changed that, and now wants the seller to remain on the hook, whether the property is clean or dirty, for the duration of the buyer's loan period and maybe even past the term of the loan, depending on how the document is interpreted. This essentially extends the liability period of the seller of the property. There is no way a seller will be willing to stay on the hook for environmental issues after he sells the business, especially unknown issues.

Why would the SBA make such a requirement for petroleum-related properties? If a bank does not want to make a loan, it will structure the requirements so that obtaining the loan is much more difficult. This creates the appearance that the bank is willing to make the loan when the reality is the bank doesn't want to lend the money. However, if someone is willing to go to such extremes to meet its requirements, then the bank will go ahead and issue the loan. In essence the bank is telling the borrower "no" in the end by saying "yes" up front. Meanwhile, the bank saves face by looking like it is willing to make loans.

I don't know if this is what the SBA is doing by extending the environmental indemnification, but the sellers that would be willing to stay on the hook for possible environmental issues after they don't own the property anymore are going to be few and far between.

While it is getting harder and harder to get a loan on petroleum-related properties, it is still possible. To begin with, a lot of local banks are not in trouble and want to make good loans, especially loans that include real estate. A local banker called me recently to ask about the quality of the assets of a chain of 10 convenience stores he was considering lending on. At the end of the conversation, he said he needs to continue making good loans because that was his business. This tells me two things, first, he has the money, and second, he needs to make loans. The point of this story is that local banks are making loans.

Another solution to getting deals done is owner financing. This can be done in one of two ways: total owner financing or partial owner financing. With total owner financing the buyer will typically pay 20 percent of the purchase price plus the cost of the inventory to the seller at closing. The seller basically sells the business and property on contract. The seller agrees to finance the buyer on a loan with a 20-year amortization schedule and an interest rate that may be slightly above the market rate. The note would typically have a balloon payment due and be payable in three to five years. It is a solution that is used often and is very effective.

Next, there is partial owner financing. I think we will be seeing a lot more of this in the future. With partial owner financing, the buyer has secured a lender for the business and property, but the requirements of the lender are too stiff to meet on his own accord. Instead of wanting the normal 20 percent down payment on the loan, the lender is now requiring 30 percent down. Plus the buyer still has to come up with the money for the inventory. This is often difficult for some buyers, so in this situation it may be time for the seller to step up and agree to take a second mortgage on the 10 percent difference in down payment. Is it the perfect solution? Maybe not, but this way the seller gets the property sold, the buyer gets to buy the business, and the seller at least gets 90 percent of his money at closing. In addition, the seller gets a note with a good interest rate for a three- to five-year period.

With tougher lending practices, buyers and sellers must learn to be more creative in their thinking. If you are a buyer, be aware that the lending requirements are getting stiffer and you may need to find creative solutions to your borrowing needs. If you are a seller, be prepared to take an active role in the lending process. While it is getting tougher to borrow money on gas stations and convenience stores, take solace in the fact that businesses are getting sold and transferred every day. You just need to remain flexible with your deal structuring and keep focused on the outcome, which is getting the store sold.

Terry Monroe is president and COO of American Business Brokers, a national brokerage company based in St. Louis. Over his 25 year career, Monroe has owned more than 30 businesses and 10 franchises. He can be reached at tmonroe@abbunitedstates.com.

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