

SOP Policy Changes Impacting Business Valuations & Equipment Appraisals

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U.S. Small Business Administration



We would like to thank Neal for his time and providing information regarding his experience on SBA lending programs from his perspective.

All opinions, conclusions, and/or recommendations expressed herein are those of the presenter and do not necessarily reflect the views of the SBA.



SOP 50 10 5(J) Policy Changes Impacting Business Valuations & Equipment Appraisals



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- Neal Patel, CBA, CVA is the Principal of Reliant Business Valuation, a business valuation and equipment appraisal firm specialized in SBA related valuations nationwide.
- Recipient of Coleman Report's '2017 Emerging Leader Award'
- Our firm currently works with over 150 SBA lenders around the nation.
- Certified Business Appraiser through the Institute of Business Appraisers (IBA) (ex-Chair of the Board of Governors)
- Certified Valuation Analyst through the National Association of Certified Valuators and Analysts (NACVA).



Topics Covered

Special vs. Non-Special Purpose
Properties

Intangible Assets / Deal Structure

Equity Injection / Partner Buyouts

Equipment Appraisals



SBA SOP 50 10 5(J)

Effective January 1, 2018

The term “Business Appraisal” is now reverted to “Business Valuation”

All SOP versions can be downloaded here:

www.sba.gov/document/sop-50-10-5-lender-development-company-loan-programs



Who is a "qualified source" as per the SBA?

(Minor typo in previous version fixed, all else unchanged)

- (a) Accredited Senior Appraiser (ASA)
- (b) Certified Business Appraiser (CBA)
- (c) Accredited in Business Valuation (ABV)
- (d) Certified Valuation Analyst (CVA)
- (f) Business Certified Appraiser (BCA)

- (e) Accredited Valuation Analyst (AVA)*

**(the AVA designation was merged with CVA and dropped)*

NOTE: CPA is not considered a "qualified source" - he/she also has an ABV credential.



When is a Third Party Appraisal Required? (**Non Special Purpose Property**)

If the amount being financed (including any 7(a), 504, seller or other financing) minus the appraised value of real estate and/or equipment is greater than \$250,000, **or..**

Note: no mention of goodwill!

If there is a close relationship between the buyer and seller (for example, transactions between family members or business partners), **or..**

Note: employee / employer also included!

If the lender's internal policies and procedures require an independent business appraisal from a qualified source

Note: every change of ownership loan requires a business appraisal !



Special Purpose Property

SOP 50 10 5(J) – pg. 197

- A **Special Purpose Property** is defined in the SOP as *"a limited-market property with a unique physical design, special construction materials, or a layout that restricts its utility to the specific use for which it was built."*



Special Purpose Properties from 5(I)

Examples of Special Purpose Properties (pg. 239 SOP 50 10 5(I))

Amusement parks	
Bowling alleys	Mines
Car wash properties	Museums
Cemeteries	Nursing homes, inc. assisted living facilities
Clubhouses	Oil wells
Cold storage facilities...	Quarries, including gravel pits
Dormitories	Railroads
Farms, including dairy facilities	Sanitary landfills
Hospitals, surgery centers, urgent care centers and other health or medical Facilities	Service centers (e.g., oil and lube, brake or transmission centers) with pits and in ground lifts
Funeral homes with crematoriums	Sports arenas
Gas stations	Swimming pools
Golf courses	Tennis club
Hotels, motels, and other lodging facilities	Theaters
Marinas	Wineries



Alert: SOP 50 10 5(J) pg. 259-260
(effective Jan 1, 2018)

A revised list of examples of Special Purpose Properties - **this list is not intended to be all-inclusive**. Only six examples are listed in the new version:

- i. Car wash business;*
- ii. Gas stations;*
- iii. Hotels, motels and other lodging facilities;*
- iv. Hospitals, nursing homes and assisted living centers;*
- v. Marinas; and*
- vi. Farms, including livestock and dairy facilities.*



When is a Third Party Appraisal Required? (Special Purpose Property)

If the amount being financed (including any 7(a), 504, seller, or other financing) minus the appraised value of real estate and/or equipment being financed is **\$250,000 or less**, the Lender may perform its own valuation of the business being sold, unless the Lender's internal policies and procedures require an independent business valuation from a qualified source.

If the amount being financed (including any 7(a), 504, seller, or other financing) minus the appraised value of real estate and/or equipment being financed is **over \$250,000** or **if there is a close relationship between the buyer and seller** (for example, transactions between existing owners or family members) **and the business operates from a Special Purpose Property**, the Lender must obtain an independent appraisal performed by a Certified General Real Property Appraiser.



Special Purpose Properties

- *“...the lender must obtain an independent appraisal performed by a Certified General Real Property Appraiser.” Additionally,*
 - *The appraisal must allocate separate values to the individual components of the transaction including land, building, equipment and intangible assets.*
 - *The Certified General Real Property Appraiser must have completed no less than four going concern appraisals of equivalent special use property as the property being appraised, within the last 36 months, as identified in the qualifications portion of the Appraisal Report.*
 - *Each appraisal assignment under this section must be... in compliance with current USPAP guidelines.*



Alert: SOP 50 10 5(J) pg. 174
(effective Jan 1, 2018)

Minimum equity injection requirements for certain Applicants or loans:

- (i) *Resulting in a new owner (complete change of ownership): SBA considers an equity injection of at least 10 percent of the total project costs to be necessary for such change of ownership transactions.*
- (ii) *Seller debt may not be considered as part of the equity injection unless it is on full standby for the life of the SBA loan **and** it does not exceed half of the required equity injection.*



I am awaiting clarification from SBA on exact definition of “project costs”.

Alert: SOP 50 10 5(J) pg. 134
(effective Jan 1, 2018)

NEW: *If any of the loan proceeds will be used to finance intangible assets, the amount must be specifically identified in the Use of Proceeds section of the application and the Authorization.*



Intangible Assets: SOP Definition

SOP 50 10 5(J) pg. 134

The value of the intangible assets is determined by...the value of the business as identified in the business appraisal minus the sum of the working capital assets and the fixed assets being purchased.

In other words:

intangible assets =
business value – (working capital* + fixed assets)

*Working Capital = Current Assets – Current Liabilities



Intangible Assets: SOP Definition

Final Value	\$700,000
Cash or Cash Equivalent	\$0
Accounts Receivable	\$0
Inventory	\$50,000
Other Current Assets	\$0
Fixed Assets (net book value)	\$100,000
Other Assets	\$0
Total Tangible Assets Included in Value	\$150,000
Current Liabilities	\$0
Long Term Liabilities	\$0
Total Liabilities Included in Value	\$0
Assets less Liabilities (rounded)	\$150,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	\$550,000



Intangible Assets: SOP Definition

Final Value	\$700,000
Cash or Cash Equivalent	\$0
Accounts Receivable	\$0
Inventory	\$50,000
Other Current Assets	\$0
Fixed Assets (appraised value)	\$250,000
Other Assets	\$0
Total Tangible Assets Included in Value	\$300,000
Current Liabilities	\$0
Long Term Liabilities	\$0
Total Liabilities Included in Value	\$0
Assets less Liabilities (rounded)	\$300,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	\$400,000



Intangible Assets: SOP Definition

Final Value	\$600,000
Cash or Cash Equivalent	\$0
Accounts Receivable	\$0
Inventory	\$50,000
Other Current Assets	\$0
Fixed Assets (appraised value)	\$250,000
Other Assets	\$0
Total Tangible Assets Included in Value	\$300,000
Current Liabilities	\$100,000
Long Term Liabilities	\$0
Total Liabilities Included in Value	\$100,000
Assets less Liabilities (rounded)	\$200,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	\$400,000



Initial Use of Proceeds Table

Final Value	\$700,000
Cash or Cash Equivalent	\$0
Accounts Receivable	\$0
Inventory	\$50,000
Other Current Assets	\$0
Fixed Assets (net book value)	\$100,000
Other Assets	\$0
Total Tangible Assets Included in Value	\$150,000
Current Liabilities	\$0
Long Term Liabilities	\$0
Total Liabilities Included in Value	\$0
Assets less Liabilities (rounded)	\$150,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	\$550,000

Even before the appraisal is ordered, you can setup the use of proceeds...



..using the net book value of tangible assets, to give you the most accurate intangible asset value.

Assume that Final Value is equal to Purchase Price – adjust post appraisal if required.



Purchase Price	\$700,000
- Tangible Assets (book value as per B/S)	\$150,000
= Intangible Assets (estimated)	\$550,000

Important Reminder: Transaction Type

The following paragraph was moved up to the top of the Business Valuation Requirements section, most likely due to the importance of its contents.

SOP 50 10 5(J) States: *"The scope of work should identify whether the transaction is an asset purchase or stock purchase and be specific enough for the individual performing the business valuation to know what is included in the sale (including any assumed debt)."*

- All assets and liabilities that are included in the final transaction must be included in the business appraisal. This is similar to the basic concept of "comparing apples to apples".



The value of a business includes:

Cash Flow x Multiple = Asset Value

$$\$215,000 \times 3.0 = \$650,000$$

- The value above includes:
 - all operating assets (FF&E)
 - all intangible assets (goodwill)



Important Reminder: Transaction Type

Example 2

Enterprise Value	\$650,000
If transaction includes \$200M in Target NWC	
+ Current Assets	\$250,000
- Current Liabilities	-\$50,000
= Net Working Capital	\$200,000
Value includes Net Working Capital	
+ Value incl. NWC	\$850,000
<i>At closing, NWC balance should be confirmed.</i>	



Alert: SOP 50 10 5(J) pg. 174
(effective Jan 1, 2018)

Minimum equity injection requirements for certain Applicants or loans:

*Change of ownership between existing owners (“partner buyout”): The pro-forma equity position after the change of ownership must be at least **10 percent of the total assets**. Otherwise, the remaining owner(s) must provide an additional equity injection that will result in at least a **10 percent net worth** (maximum pro forma **debt-to-worth ratio of 9:1**).*



Partnership Buyout

Can the owner's existing equity in the business be used to satisfy the 10% "equity requirement"?

- Example: 10% partner is buying out a 90% partner's ownership interest, resulting in 100% ownership vesting in the purchaser.
- The business appraisal reflects a pre-sale stock value equaling \$1,000,000
 - value includes all assets and liabilities (pre-sale)



Partnership Buyout

Table 1: 90% Partner Buyout

[Appraised] Pre-Sale Stock (Equity) Value	<u><u>\$1,000,000</u></u>
Loan for Partner Buyout	900,000
Loan for Working Capital	25,000
Loan for Closing Costs	<u>25,000</u>
Total Loan Amount:	<u><u>\$950,000</u></u>

[Appraised] Pre-Sale Stock (Equity) Value	\$1,000,000
Add: Working Capital	<u>25,000</u>
Gross Pro Forma Stock (Equity) Value	<u>1,025,000</u>
Less: Total SBA Loan	<u>(950,000)</u>
Net Pro Forma Stock (Equity) Value	<u>75,000</u>

The purchasing partner does not retain 10% equity in the business.

Pro Forma Stock (Equity) Percentage = $\frac{\$75,000}{\$1,025,000} = 7\%$



Partnership Buyout

$$\text{Pro Forma Stock (Equity) Percentage} = \frac{\$75,000}{\$1,025,000} = 7\%$$

Multiply Pro Forma Stock Value by 10% to calculate the difference that buyer is required to inject...

Gross Pro Forma Stock (Equity) Value	1,025,000
Times 10%	10%
<hr/>	
Buyer's Required Pro-Forma Equity	<u>102,500</u>

Buyer needs to inject \$27,500 to have 10% equity.



Partnership Buyout

Table 2: 90% Partner Buyout

[Appraised] Pre-Sale Stock (Equity) Value	<u>\$1,000,000</u>	Loan for Partner Buyout	872,500
		Buyer's Additional Equity Injection	27,500
		<u>Total Partner Buyout</u>	<u>900,000</u>
Loan for Partner Buyout (reduced by \$27,500)	872,500		
Loan for Working Capital	25,000		
Loan for Closing Costs	<u>25,000</u>		
Total Loan Amount:	<u><u>\$922,500</u></u>		
[Appraised] Pre-Sale Stock (Equity) Value	\$1,000,000		
Add: Working Capital	<u>25,000</u>		
Gross Pro Forma Stock (Equity) Value	<u>1,025,000</u>		
Less: Total SBA Loan	<u>(922,500)</u>		
Net Pro Forma Stock (Equity) Value	<u>102,500</u>		

As reflected in Table 2, the borrower must inject additional equity of \$27,500, thereby reducing the Partner Buyout portion of the loan, to meet the 10% equity requirement.

$$\text{Pro Forma Stock (Equity) Percentage} = \frac{\$102,500}{\$1,025,000} = 10\%$$



Equipment Appraisals

- When ordering an equipment appraisal, always request both standards of value:
 - Fair Market Value
 - No time restriction to sell assets
 - FMV of equipment can be used in Business Valuation in lieu of Net Book Value
 - Orderly Liquidation Value
 - Approx. 90-120 Days and typically 65% of Fair Market Value
 - Also ask the equipment appraiser to separately allocate aggregate values of machinery/equipment and furniture/fixtures



Collateral requirements updated (next slide)

Equipment Appraisals

7(a) Loan Program – Equipment Appraisals (pg. 186-187)

Collateral Requirements (loans over \$350,000):

- For collateral purposes, the SBA has intentionally separated **machinery and equipment** from **furniture and fixtures**, as highlighted in bold below.
 - *New **machinery and equipment** (excluding furniture and fixtures) may be valued at 75% of price minus any prior liens for the calculation of “fully-secured”;*
 - *Used or existing **machinery and equipment** (excluding furniture and fixtures) may be valued at 50% of Net Book Value or 80% with [sic] an Orderly Liquidation Appraisal minus any prior liens for the calculation of “fully-secured.”*
 - ***Furniture and Fixtures** may be valued at 10% of Net Book Value or appraised value. (SBA has confirmed “appraised value” is also Orderly Liquidation)*

Equipment appraisers should now **separately allocate aggregate values** of machinery/equipment and furniture/fixtures when providing the lender with Fair Market and Orderly Liquidation Values.



Equipment Appraisals

504 Loan Program – Collateral Requirements (pg. 312)

New language for equipment appraisal requirements utilized in conjunction with the 504 loan program:

- *SBA requires that an equipment appraisal be obtained when used equipment is part of the Project and is either being purchased from someone other than an equipment dealer, or being refinanced. The equipment appraisal needs to be a written document from a **(1) person that is qualified to provide a valuation, (2) is independent of the transaction, and (3) has performed an onsite inspection of the equipment.** The appraisal must be dated **no more than twelve months prior to the date of the application.***
- 'Project' as noted above is defined in the SOP as: *the purchase or lease, and/or improvement or renovation of long-term fixed assets by a small business, with 504 financing, for use in its business operations.*



Equipment Appraisals

Although the term 'qualified' is not defined, it's highly recommended that the lender select an equipment appraiser that provides a USPAP compliant report which defines the lender as the client and intended user, and includes the different standard of values (namely, fair market and orderly liquidation values).

The appraiser should also possess a reputable equipment appraisal designation, such as one of the following:

- Certified Machinery and Equipment Appraiser (CMEA)
 - www.nebbinstitute.org/cmea-search.html
 - *Reliant has an in-house CMEA for our equipment appraisals*
- Accredited Senior Appraiser (Machinery) by the ASA
 - www.appraisers.org/Disciplines/Machinery-Technical-Specialties
- Certified Equipment Appraiser (CEA) by the AMEA
 - www.amea.org/find-an-appraiser

Auctioneers, equipment dealers may not be independent of the transaction and therefore should be relied upon. Individuals are not certified or trained in providing USPAP compliant appraisal reports.





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Upcoming SBA Webinar (contact richard.haney@sba.gov):
Introduction to Business Valuations - March 27, 2018 at 11:00AM

Visit our blog www.sbavalue.com for a recent article about:

Policy Changes in the SBA SOP 50-10 5(J) that Impact Business Valuations and Equipment Appraisals

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