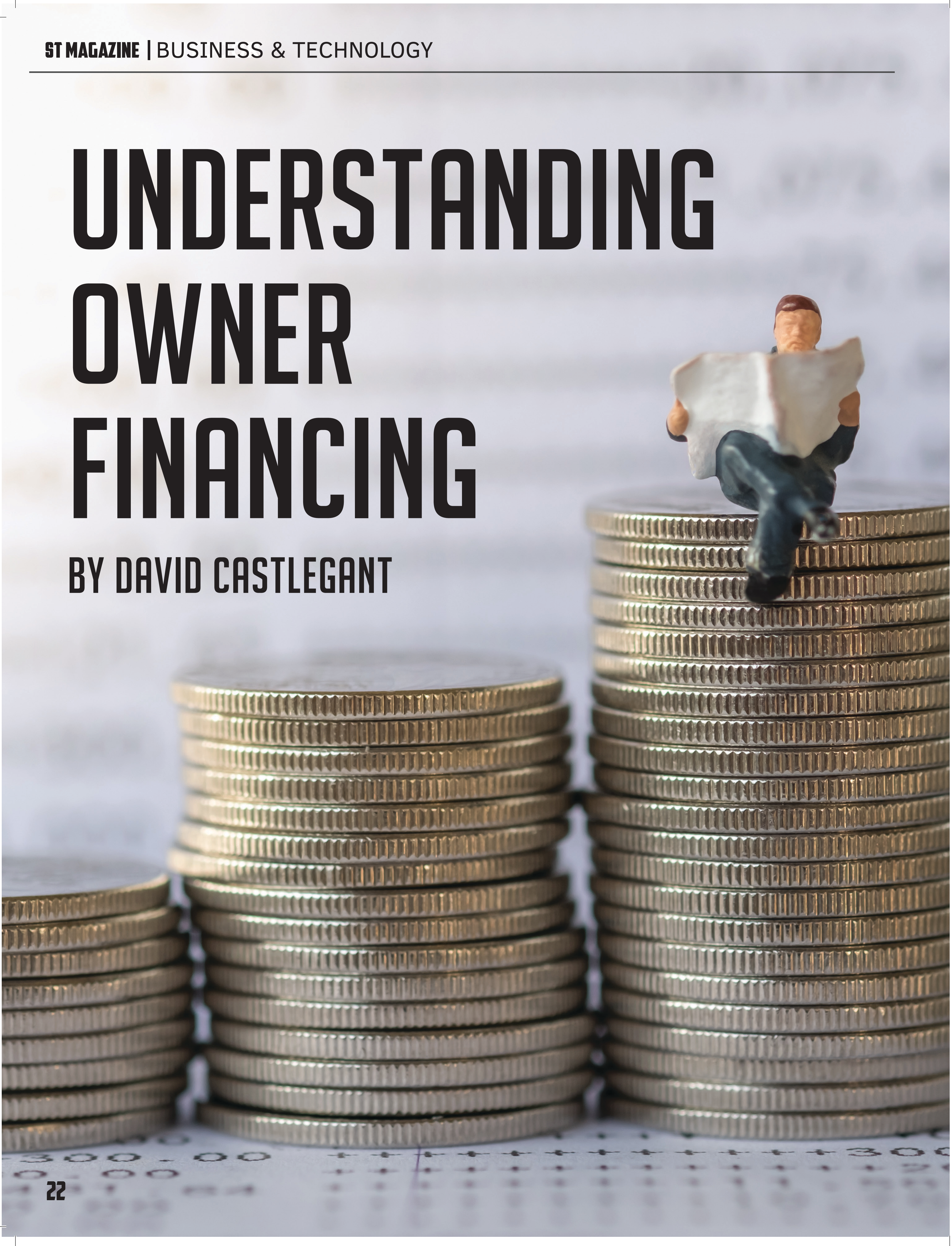
UNDERSTANDING OWNER FINANCING

BY DAVID CASTLEGANT



Over the past thirty-two years of advising owners who want to sell their small businesses, I have always brought to these discussions information regarding owner financing. Typically, this raises unwarranted red flags, with the owner negating further discussion. Owner financing does not have to be a scary thought. It just needs to be better understood.

Owner financing happens when the business' owner acts as a bank. The owner offers to loan the buyer needed funds to cover a percentage, or all, of the total purchase price of their business. Conversely, buyers repay the owner in installments with interest. This method of financing is beneficial for both buyers and owners. It can bridge business ownership for buyers who do not have sufficient cash to buy the business outright. For the owner, it can open up the pool of potential buyers.

What can owner financing do?

Owner financing removes the middlemen (bankers) and works directly with the buyer to close the deal. Buyers must still come up with the funding to cover the entire purchase price, but the owner agrees to carry all or part of the note, and the buyer makes regular payments to the owner with interest.

Owners can offer any percentage of the total asking price, so most buyers combine owner financing with additional funding to meet their total capital needs. The additional funding includes cash, loans from family or friends, business loans (SBA), or 401(k) and business financing.

The willingness of owners to offer financing is usually a sign that the owner is confident the business will generate enough income to repay the loan. Conversely, some entrepreneurs believe that if an owner does not offer to finance the loan, the company may be in trouble.

How does owner financing work?

Owner financing involves many of the same characteristics as a traditional business loan. The owner typically asks the potential buyer to provide personal financial documents, a resume and other focused information related to finances and business experience. The owner may also want to ensure the buyer has a successful strategy to grow the business by requiring a business plan.

The owner can pull a potential buyer's credit history and has the right to deny financing if any information received does not meet their criteria. Buyers with a lower credit score can be expected to pay higher interest rates and may be required to make a large down payment or use collateral.

After the owner approves the buyer for financing, a contract is drawn to specify the terms and conditions

of the loan and outline any collateral needed to guarantee the loan. This contract will likely include a clause outlining that the buyer will forfeit business ownership if complete payment is not made within a specified period stated in the contract to purchase. Once the buyer and owner sign closing documentation, the buyer takes ownership of the business.

Typical terms of owner financing arrangements

Traditional business loans often have set terms, whereas owner financing terms can be negotiated — by both the buyer and the owner. Here are some standards that are seen in owner financing:

- **Loan amount:** Between 5 and 90 percent of the selling price. In rare cases, the owner may offer financing for the total asking price.
- **Term length:** 5 to 7 years
- **Interest rates:** Comparable to SBA 7(A) Express Loan interest rates which range from prime* plus 4.5% to prime plus 6.5%, depending on the amount borrowed.
  *As of February 2023, the current prime rate is 7.75%.
- **Down payment:** 10 to 25 percent of the purchase price.

Benefits of owner financing for buyers

- *Better access to financing.* Owners are usually more willing than banks to offer to finance individuals who may not meet the strict financial requirements banks require.
- *Better financing terms.* Interest rates and down payments tend to be lower with owner financing. In addition, owners are often highly motivated to close the deal and can make loan terms more appealing to buyers. In contrast, banks have strict terms based on eligibility criteria.
- *Faster close times.* Traditional business loans have multiple approval requirements and can take up to six months to close. Conversely, owners are generally motivated to close the deal quickly.

Combining financing methods to fill in gaps

Since owner financing usually does not offer 100 percent of the total asking price, buyers must fill the funding gap and deliver a down payment. As a result, many will apply for a traditional SBA loan. Their approval odds may also improve since they only ask for a portion of the total price.

Benefits of owner financing for owners

- *Attract more buyers*. Because Owners can be more lenient regarding financing requirements, more buyers can afford to buy the business.
- *Faster closing times*. Financing can move quickly, as the owner receives a potential buyer's information and approves them for financing.
- *Higher selling price*. With the owner controlling the finance amount, they may be able to ask for a higher price for the business without affecting the timeline or approval. Moreover, owners will receive interest on the loan amount they otherwise would receive.

- *Tax benefits*. Owners receive monthly payments drawn out over time. Reporting such incremental gains instead of lump sums may have favorable tax ramifications. Always consult with your CPA, however.

Owner financing can be an attractive option for buyers who may not be able to obtain traditional financing due to credit issues, lack of down payment or other reasons. It can also be a good option for sellers who want to sell their business quickly or who want to earn interest on the sale.

Owner financing does come with its risks and considerations. Buyers should be aware that the terms of owner financing agreements can vary widely and should be carefully negotiated and reviewed with the help of an attorney. Likewise, sellers should be aware of the potential risks of acting as a lender, such as the risk of default by the buyer. Therefore, they should obtain legal and financial advice before entering an owner financing agreement.

DAVID CASTLEGRANT received his undergraduate degree from William Paterson University of New Jersey and his graduate degree from Central Michigan University. David has extensive experience as an executive manager, educator and business consultant. In 1992, he founded David Castlegrant & Associates, a management and marketing consulting firm specializing in family-owned businesses.