

## **AN ECONOMIC WORKOUT**

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*Sue Donath always wanted to work in fitness. In college she built a business plan from her time working for a small business gym owner. After graduation, she purchased that small business gym. Once it began growing under Sue's ownership, she needed a larger space. However, a variety of factors have halted progress on obtaining financing for the expanded facility.*

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### **NARRATIVE**

"The Workout Lady."

This moniker belongs to the one and only Sue Donath. She's from Aiken, SC through and through, and a former student of the Entrepreneurship class at UofSC Aiken. As the nickname "Workout Lady" suggests, fitness is the definition of her being. Naturally, she gravitated to said profession. While working on her college degree, she became a temporary employee of Ledbetter Training, a local gym in the Central Savannah River Area. As one might imagine, Sue wanted nothing more than to eventually purchase and run her own establishment. While taking the entrepreneurship class at UofSC Aiken, her professor required her to write a business plan. As one might expect, she used this opportunity to begin research for her desired gym. Rachelle, the owner of Ledbetter Training, agrees to help her with producing realistic forecasts and costs for the project. Sue's passion and dedication on this topic translate into an easy "A" and impresses her professor.

Let's move the clock forward three years, shall we? Sue has now graduated but stuck in a full-time, non-fitness job that does not allow her to pursue her passion. Luck would have it that Rachelle Ledbetter, the prior owner of Ledbetter Training and Sue's former boss during college, is looking to sell her establishment.

Sue knows this may be her only opportunity to fulfill her dream. She immediately contacts her prior mentor and expresses interest in buying Ledbetter Training. Rachelle is happy to hear of Sue's interest, but there are some concerns with financing. Sue is not able to buy the business outright in cash. Rachelle needs \$60k

for the sale. Therefore, Sue begins researching assistance options. When she contacts the Small Business Administration (SBA), they direct her to a no-cost option for small business guidance: The Small Business Development Center (SBDC).

Following the advice of the SBA, she registers as a client of her local SBDC office. She decides to use her prior business plan work as a starting point for the prospective sale. The SBDC consultant is happy to use this as the foundation for her loan package. Rachelle's mentorship is instrumental regarding cash flow information; the numbers in the pro forma are conservative estimates derived from Ledbetter's actual financial performance. Once Sue's pro forma cash flow analysis is created, she applies for a business loan via Bank of Aiken, requesting \$60,000. Sue had been an avid saver for most of her teen years. Therefore, she supplied \$1,000 of her own cash with the deal. Bank of Aiken accepts and approves the loan application, and Sue takes over the reins of Ledbetter Training. Naturally, Sue rebrands in the first year to reflect new ownership (e.g., name change to Donath Training). Also, Sue decides to include a mobile café component to the gym.

Once again, we move the clock forward two years. Donath Training is operational and well-respected in the community, but there's a slight problem. The dilemma facing Sue is this: she needs a bigger space. Rachelle, the prior owner, enjoyed the small space and operated Ledbetter Training as a form of supplemental income. Thanks to improved marketing and Sue operating the gym full-time, demand has grown substantially. Sue has to turn people away. The extra income has allowed for Sue to completely pay back the initial \$60k loan for the business purchase, but Sue knows her market reach and potential profits could be far grander.

Therefore, she wants to expand to a new and larger location. Sue schedules an appointment with a Bank of Aiken loan officer and asks for financing of a new location. Additionally, the thought of also including a mobile unit with additional work-out equipment, which has intrigued her for the past year.

Not everything is perfect for Sue, though. Thanks to COVID-19 shutting down the business temporarily, Sue racks up credit card debt totaling \$29,000. She settles with 7 different card companies, but before seeking the advice of her SBDC consultant, she doesn't understand that these credit card settlements will appear on her credit report when Bank of Aiken conducts their due diligence of both Sue and the business. Before this debt issue, her blended FICO credit score was perfect. However, it is now barely hovering around the 700 mark. Due to the extra risk to

the lender, the bank would like the SBA involved to guarantee the loan. Therefore, Bank of Aiken is weighing options between the 7a and 504 programs (*see page # 4 of the case for the fully defined 7a and 504 options*). The bank explains the pros and cons of each option to Sue. While they participate with SBA loans, the bank is not part of the Preferred Lending Program, or PLP (*for more information, please see the following link: <https://sbacomplete.com/knowledge-center/resource/why-plp-status-matters-for-lenders/>*).

Also, given the desired new Donath Training location and its “café/restaurant” component, Bank of Aiken informs Sue that the SBA might request an economic feasibility study as part of her loan package. Unfortunately, this particular area is outside the scope of services for Sue’s SBDC consultant.

Luck would have it that Sue’s recently departed grandmother left her a vacant property within five minutes of driving distances to most of Aiken and Sue’s clients. The property is already set up for water, utilities, mail, etc. The zoning on the land permits both residential and commercial use, an ideal location for the expanded Donath Training. The building’s footprint is 5,000 square footage. Probate Court executed her grandmother’s will, and Sue now has the title to said property through a deed of distribution. Also, this land is deemed rural by USDA standards.

As a default, 7a and 504 loans require 10% down payment from the borrower. Even though Sue’s venture has operated in a small-scale production and is financially solvent, the bank is still considering the venture a start-up business; in Bank of Aiken’s eyes, it’s a new location, thus an extra 5% down payment required (down payment now equals 15% total).

The process of obtaining the 15% down payment will not be clear cut for Sue. She has to resolve her cash and credit issues before the expansionary loan can be completed.

Should she use the 7a or 504 programs? How can she resolve the debt issue? Does she relinquish her dreams of expansion, or does she turn to another lender? What should Sue do to achieve her vision?

### **STUDENT REFERENCE FOR UNDERWRITING**

When evaluating a business loan proposal, Bank of Aiken involves underwriters in compliance with industry standards. The bank’s loan officers evaluate on a

merit basis whether the loan is feasible for the lending institution. The following factors are primarily used:

1. Blended Credit Score (FICO)
2. Credit Report History
3. Debt Service Coverage Ratio (DSCR)
4. Proposed Business Property Location Analysis
5. Personal Financial Statement
6. Business Plan
7. Financial Performance (Company Actuals)
8. 3 Years of Past Taxes (Personal and Business)

### **STUDENT REFERENCE FOR RATIOS**

Regarding the subject of ratios, banks use the Debt Service Coverage Ratio (DSCR) to determine if a business's cash flow can support the debt repayment to the bank. The ratio is calculated as follows:

$$\begin{aligned} & \text{Debt Service Coverage Ratio (DSCR)} \\ &= \frac{\text{Monthly Net Profit Before Debt Repayment}}{\text{Monthly Debt Repayment}} \end{aligned}$$

For reference, a minimum DSCR is typically around 1.2, or 1.25. While calculated monthly, banks evaluate this ratio on a total annual basis.

While not required for her underwriting evaluation, Sue and her SBDC consultant are going to assess the Owner's Coverage Ratio (OCR) for Sue's business. This ratio follows the same pattern and benchmarks as the DSCR above. This isn't required by a bank. However, Sue is considering how well she can handle her own salary. In her mind, if she cannot pay herself, why is she in business? The OCR is calculated as follows:

$$\begin{aligned} & \text{Owner's Coverage Ratio (OCR)} \\ &= \frac{\text{Monthly Net Profit}}{\text{Monthly Payment to Owner of Business}} \end{aligned}$$

An ideal OCR is 2.0 or greater. This represents a 1:1 match; with a 2.0 OCR, Sue's personal bank account grows by the same amount as her company's checking account.

### **SBA LOAN HISTORY**

For reference, 7a and 504 are popular options that the SBA offers. The SBA is not the lender here. Rather, it simply guarantees the loan offerings. Banks on their own assume greater liability when it is a non-SBA loan. If the borrower cannot pay back the loan, the bank has to seize the collateral securing the loan and then subsequently liquidate the collateral. This is no different than a home foreclosed when the home owner defaults on the mortgage. Unless that collateral is cash, it costs time and effort for the bank to liquidate. In essence, banks run a significant risk of losing money if a loan cannot be paid back.

If a loan is guaranteed by the SBA, this minimizes the risk to the lender. Accordingly, it can be an attractive option. However, with most aspects of life, there are trade-offs. SBA loans usually incur guarantee fees, origination fees, loan packaging fees, etc. These aforementioned fees are the responsibility of the borrower, but they are usually bundled into the overall loan amount. While it seems like a good deal not having to pay them out of pocket, a borrower ends up paying compounding monthly interest on those costs for the duration of the loan because they become part of the principal.

The following chart compares and contrasts the two primary SBA loan types:

**TABLE 1:**

	<b>7a</b>	<b>504</b>
<b>Down Payment</b>	10% (can increase based on borrower and/or industry); typically, 10-15%	10, 15 or 20% (15% depending if business is new or specialty industry, 20% if both)
<b>Cap</b>	\$5 million (standard)	Can increase to \$15 million
<b>Rate</b>	Prime plus fixed percentage (e.g., 2% +Prime since this is real estate)	Two rates: one negotiated by lender & CDC rate is fixed
<b>Term (In Years)</b>	Varies (e.g., 25 for construction of real estate)	20 or 25 years (can be 10 if only used for equipment)
<b>Funds Usage</b>	Working capital (operational cash), land, equipment, etc.	Fixed assets (land, building, etc.)

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<sup>1</sup> 504 vs. 7a Loan Comparison. (n.d.). Retrieved from <https://cdcloans.com/504-vs-7a/>

The 504 program is unique; it requires the borrower to have a Certified Development Corporation (CDC) to fund between 30-40% of the project request. This CDC is a nonprofit corporation that mitigates some of the risk to the primary lender. A typical 504 deal involves a 50%/40%/10% split between the primary lender, the CDC, and the borrower (the 10% would be the down payment or other equity injection). For more information on CDC goals and stipulations, please read the following resource: <https://sba504.loans/sba-504-blog/sba-504-job-creation-requirements>

Prime rate, or Wall Street Journal Prime Rate, is an adjusted benchmark for most loan interest percentages across the USA. At the time of this case writing in November 2021, it is at 3.25%. With SBA loans, each quarter, the loan rate for 7a can fluctuate depending on what happens with Prime.

If needed, the debt on an initial 7a loan can be refinanced into a 504 deal. The following calculation can be used to determine monthly payment for these amortized loans to determine monthly payment amounts:

$$\text{Periodic Debt Repayment} = \text{Principal} \frac{r(1+r)^t}{(1+r)^t - 1}$$

\* $r$  represents the interest rate while  $t$  represents the number of payments. In Excel, the formula for determining a monthly payment to the bank is  
=PMT (Rate/12, Years\*12, Loan Amount)

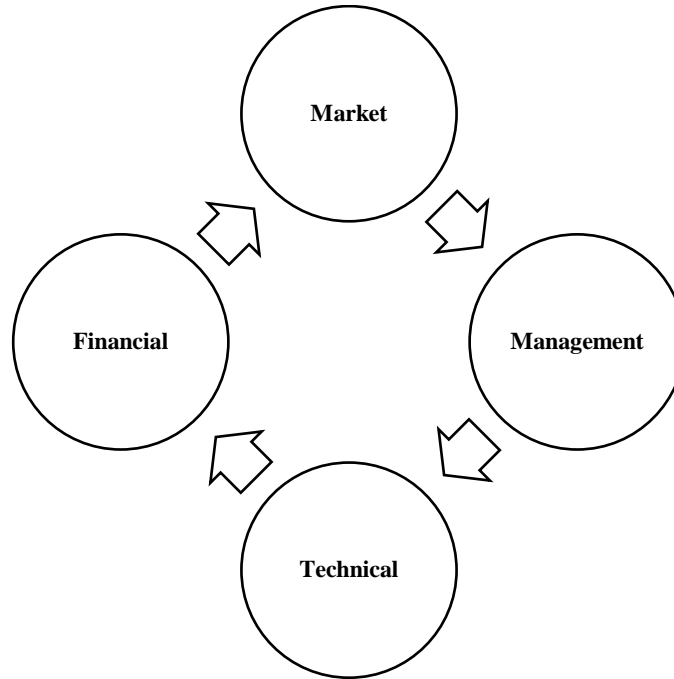
*\*The reasoning for the “/12” and “\*12” is due to compounding monthly interest. Most amortization schedules for these loans are based on months.*

#### **MISCELLANEOUS RECOMMENDATIONS**

- <https://www.sba.gov/federal-contracting/contracting-assistance-programs/women-owned-small-business-federal-contracting-program>
- <https://www.sba.gov/funding-programs/loans/7a-loans>
- <https://www.sba.gov/brand/assets/sba/sba-lenders/504-Loan-Fact-Sheet-Borrower-Version.pdf>

### **ECONOMIC FEASIBILITY STUDY**

Within the economic feasibility study, additional components might need to be addressed as follows:



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This feasibility study could be conducted by a third-party company or by utilizing local universities. On average, these studies can easily exceed more than 100 pages. This can be required for either 504 or 7a loans. One could consider this type of feasibility study as an expanded business plan. For Sue's case, it would focus on the impacts of a new location. The market rate for obtaining this type of plan could easily cost more than \$10,000.

As a substitute, a business could craft a demand schedule for a business. If backed by contingent letters of commitment, these letters from prospective buyers or clients can serve as a quasi-Accounts Receivable (AR) and are very favorable to a positive review of the borrower.

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<sup>2</sup> SBA (Small Business Administration) Loan - Feasibility Study Company - Wert-Berater, LLC. (2020). Retrieved from <https://www.unitedethanol.com/markets/stocks.php?article=einpresswire-2020-10-11-sba-small-business-administration-loan-feasibility-study-company-wert-berater-llc>