

News You Can Use



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Essential Capital
After 28 years
Moving business forward
is *still* what we do best.

March 2008
504 Interest
Rate
6.46%

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Corporation*

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How Does the Cost/Pricing Structure Operate?

Most bankers agreed that the SBA 504 loan is a better product for real estate acquisition than the SBA 7(a) loan, but for loans below the \$500,000 threshold, borrowers generally prefer the 7(a) loan. For real estate purchases of \$400,000 or less, most borrowers opt to use a 7(a) loan due to the higher fees and the prepayment penalty on 504 loans. For loans between \$500,000 and \$900,000, borrowers will use both, 504 and 7(a) loans, while for loans of \$900,000 and above, most will use 504 loans.

Comparison of SBA and 7(a) Loan Program

Issue	504 Loan Program	7(a) Loan Program
Purpose of loan	Fixed assets such as owner-occupied real estate and heavy equipment; no refinancing or working capital	Any business purpose
Goal of program	Job creation and retention; economic development	Capital access to capital for businesses that would not qualify elsewhere
Rates and Terms	Bank loan: Variable or fixed must be at least half as long as term of CDC loan CDC loan: Fixed rate, 10- or 20-year maturity	Variable or fixed; term of up to 25 years depending on use of proceeds
Maximum amounts	Bank loan size is unlimited; generally used for projects of \$3.75 million to \$5 million; \$10 million for manufacturing	\$2.0 million loan with a \$1.5 million guaranteed amount
Fees	Bank loan: Application fee and construction loan fee (if applicable) vary by bank; one-time SBA participation fee of 50 basis points paid by bank CDC loan: Upfront fees of approximately 2.75 percent which are financed	Up front guarantee fee of approximately 3% on guaranteed portion; ongoing fee of 54.5 basis points paid by lender
Bank lien position	Bank has exclusive first lien	Bank holds the first lien; with typical 75% guarantee, the lender receives 75% of any proceeds from a liquidation and SBA receives 25%
Loan- to-value	Bank loan: Typically 50% CDC loan: Maximum of 40%	Maximum of 90%
Qualification	Business net worth not to exceed \$7 million; average net profit for 2 consecutive years not to exceed \$2.5 million after taxes	Depending on the type of business, annual sales of less than \$5 million or manufacturing firm of less than 500 employees
Prepayment penalties	CDC loan: Penalty is 100% of one year's interest in the first year, declining to zero at the midpoint of the loan	Low; no penalty for up to 25% prepayment in first 3 years

The key factors that make the 504 loan attractive for borrowers are the potential for leverage and the long-term nature of the product. With a 504 loan, a business generally provides 10 to 15 percent down payment and receives 85 to 90 percent financing. The loan from the CDC (40 percent of eligible project costs) has a 10 or 20-year term, depending on the asset financed, and a fixed interest rate. The loan from the bank (50 percent of eligible project costs) may have a fixed or floating interest rate, but is often structured with a 20- or 25-year amortization, enabling long-term repayment. Conventional commercial loans, on the other hand, generally require a higher down payment, and typically have a shorter repricing term.

The loan by the CDC uses the 10-year Treasury note as a benchmark, and is amortized over 10 years for capital equipment loans and 20 years for real estate loans. If a project includes real estate and a significant portion of capital equipment, the weighted maturity is calculated and rounded to either a 10-year or 20-year maturity. The project can also be separated into two loans if it involves both types of collateral (real estate and equipment).

Banks vary in the benchmarks used to set the rates on their 504 loans and are not limited to which index they can use, although some secondary market purchasers may focus on loans tied to a particular benchmark. Many banks use Treasury rates or some other common index as a benchmark. Generally there are spreads attached to any benchmark rate, but the rates and fees are set by local market conditions and a bank's asset/liability management strategy. There are larger rate concessions in areas of the country where there is a more competitive market for 504 loans, such as California and western states, and fewer rate concessions in central and southeastern states. The spread is also affected by the creditworthiness of the borrower.

Most banks believe the 504 loan product performs well, with a small number of loans turning into problem assets and requiring liquidation, and when problems do occur the process coordinated by SBA is generally timely and effective. Most banks agree that there is not much burden imposed on banks by the SBA for offering this product.