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Forgotten SBA loan program gets new life

By John Reosti | Published July 18, 2019

The Small Business Administration's 504 program has operated in the shadow of the larger, more popular 7(a) loan guarantee program throughout its 60-year-history. This year is proving to be an exception.

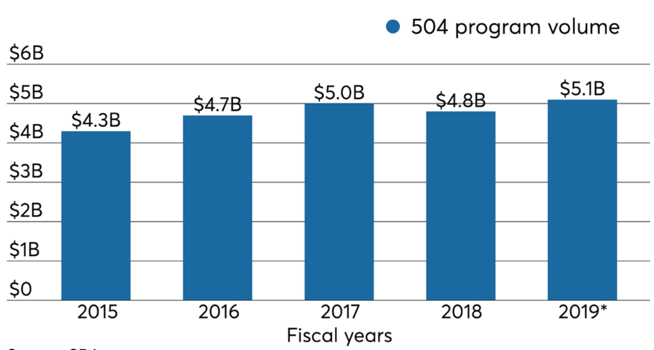
SBA officials, as well as lenders at the certified development companies that participate in every 504 loan, ascribe much of the program's recent growth to a 25-year lending product introduced in April 2018. Prior to that, 20 years was the longest term for a 504 loan.

At the same time, the 7(a) program — which is tied is caught in the middle of a budget battle between Congress and the Trump administration — has languished.

In a little more than nine months ending July 12, 504 lending totaled $3.8 billion, up 7% from the same period in the agency's 2018 fiscal year. Lending under 7(a) totaled $17.8 billion, an 8% year-over-year decrease. The federal government's fiscal year begins Oct. 1.

The ability to extend payments over an additional 60 months — especially at today's current low interest

On track for a five-year high



Source: SBA
* Projection based on data through June 30

rates — has proven to be hugely popular, according to Dianna Seaborn, director of SBA's Office of Financial Assistance.

The new product "actually has performed better than we expected," Seaborn said. "Because we've had such a flat yield curve, there's really no difference in rates" between the 20- and 25-year terms."

Currently, "the [rates for] the 25-year term [504 loan] is in the low fours, less than prime," said William Manger, assistant administrator for capital access. In contrast, 7(a) loans are tied to the prime rate, which is currently around 5.5%.

Cash flow is a critical factor for entrepreneurs, so low rates and longer repayment terms associated with the 25-year loan can shift money that would otherwise be consumed by debt service back into their pockets.

"It's huge," said Pat MacKrell, president and CEO of The 504 Company in Albany, N.Y. MacKrell added that, given the current interest rate environment plus the fact prepayment penalties for the 25- and 20-year loan are identical, he is not sure why any borrower would opt for the shorter note.

Those doubts notwithstanding, the 504's 20-year loan still has a constituency. Yet there is no disguising the rapid shift to the 25-year product. In the 15 months since SBA rolled it out, lenders have closed 4,349 25-year loans for just over $4 billion, Manger said. Over the same span, they've closed 3,309 20-year loans for about $2.25 billion.

At Oakland, Calif.-based TMC Financing, one of the most active CDC's on the West Coast, 73% of 327 loans closed since April 2018 have been 25-year deals, CEO Barbara Morrison said.

"If I looked at just the last six months, I suspect the proportion might be even higher," Morrison added. "Businesses are loath to spend cash on fixed assets. They want to use their money to grow."

Unlike 7(a), where SBA guarantees loans up to $5 million for a variety of uses, including working capital or purchase of real estate and equipment, 504 loans can only be used to finance capital equipment or commercial real estate.

And where 7(a) loans are relatively straightforward transactions with loans made directly by a bank or other lender and guaranteed by SBA, 504 deals are more complex. Borrowers provide a down payment of at least 10%, a CDC kicks in 40% and a third-party lender, typically a bank, provides the remaining 50% and has a first lien on financed assets.

There's also a job-creation requirement tied to 504 lending. Current rules call for creation of one job for every $75,000 provided by SBA.

Investors finance the CDC portion of the loan through debentures sold periodically by SBA. With 504, the agency guarantees payment on the debentures, rather than the underlying loans.

Now, with the 25-year loan well established, SBA, along with a bipartisan group of lawmakers, is seeking to tap the revitalized 504 program and the 25-year loan option to spur manufacturing.

The maximum loan size for manufacturing-related loans is currently $5.5 million, but the Trump administration is seeking to increase it by $1 million as part of its proposed fiscal 2020 budget.

"We think having a 25-year term is obviously better for someone taking on debt of $6.5 million," Manger said. SBA also recently relaxed the job-creation requirement for manufacturing projects to $120,000 per job, Manger added.

A bipartisan group of lawmakers upped the ante Tuesday, introducing legislation in the House and Senate that would increase the maximum size for 504 manufacturing loans to $10 million.

According to Seaborn, SBA officials had been considering a 25-year 504 option for several years before former Administrator Linda McMahon gave it the go-ahead.

Said Manger: One of the first things [McMahon] signed was authorization for the 25-year debenture, allowing for a 25-year term for the 504 program.

"We have discussed it off and on for a period of years," Seaborn added. "It was being nurtured in some ways, but it wasn't put as a priority until the current administration came."

SBA officials expect solid 504 production to continue through the remainder of the current 2019 fiscal year and into 2020, especially if the impasse over the 7(a) program's status continues. The agency says it will need a $99 million credit subsidy to fund 7(a) in fiscal 2020unless Congress allows it to increase user fees — a step lawmakers have balked at taking.

"Because we're having discussions about the funding of the 7(a) loans in the next fiscal year … and understanding we have no [similar] issues with the 504 program, you'll find many of the 7(a) lenders go ahead and push [deals] into a 504 transaction when there's long-term real estate or capital equipment involved," Seaborn said. "We expect to see [growth] solidly through the end of this fiscal year, and I think the beginning of fiscal year 2020 in October."

Expectations are similar at TMC. "Barring some unforeseen economic catastrophe, I would assume into the next fiscal year we should be seeing [gains]," Morrison said.