

## SBA 7(A) OR SBA 504 LOAN FOR MY BUSINESS?

Businesses may be eligible for a lower interest rate through the SBA 504 loan program compared to the SBA 7(a) loan program. This pertains to a portion of the financing. Why do more small business owners choose the SBA 7(a) loan, and when does the SBA 504 loan program work better for your small business?

### 7(a) and 504 loan structures

- The SBA 7(a) loan program allows banks to offer financing using their own funds, with a partial government guarantee that mitigates the risk in case of borrower default.
- The SBA 504 loan consists of a conventional bank loan in the first lien position that finances 50% of the project cost. An SBA-backed debenture covers up to 30–40% of project costs as a second lien.

### 7(a) and 504 loan interest rates

The 7(a) loan and the 504 first lien bank loan typically have variable interest rates based on a premium added to the Wall Street Journal Prime Rate. The SBA debenture linked to a 504 loan offers a competitive, below-market interest rate throughout the entire loan term. Debenture interest rates are usually set at least one point below the Wall Street Journal Prime Rate and remain fixed for the duration of the loan. A lower debenture rate is particularly helpful for small business borrowers during periods of increasing or volatile interest rates. The 504 loan blended rate between the first lien bank loan and the second lien SBA debenture may be attractive to the small business borrower.

### 7(a) and 504 loan prepayment penalties

The primary distinction between these two loan programs concerns the structure of their prepayment penalties. All 7(a) loans from the SBA are subject to identical prepayment penalties. This feature appeals to small business borrowers seeking flexibility to sell their business and repay the loan. It may also be attractive if the borrower wants to refinance the SBA loan after they have sufficient time to demonstrate stable earnings and timely payments to a lender who may offer better refinancing terms based upon these factors.

#### SBA 7(a) loan prepayment penalty

SBA 7(a) loans with a term of 15 years or more have prepayment penalties that apply within the first three years. The penalties are structured as follows:

- **First year:** 5% of the prepayment amount
- **Second year:** 3% of the prepayment amount
- **Third year:** 1% of the prepayment amount

These penalties are triggered when a borrower voluntarily pays off 25% or more of the loan's outstanding balance within the specified time frame.

## SBA 504 loan prepayment penalties

SBA does not regulate prepayment penalties on the bank's conventional first lien loan in a 504 transaction. Most SBA 504 lenders include significant prepayment penalties as part of this loan. Following is an example of the typical prepayment penalties for the first lien bank loan:

- 10-year prepayment penalty
  - 5% in years 1-5, 4% in year 6, 3% in year 7, 2% in year 8, 1% in years 9/10

## Calculation of 504 Debenture Prepayment Penalties

- **Debenture Rate:** The penalty is calculated based on the debenture rate assigned to your loan, not the effective interest rate. For instance, if your debenture rate is **5.82%**, the penalty for paying off the loan in the first year would be **5.82%** of the remaining balance, decreasing over time.
- **Example Calculation:** If you have a \$2 million loan and decide to pay it off in the third year, you might incur a penalty of around **\$48,000**. However, if you wait until the 10th year, the penalty could drop to just **\$6,000**.

## Strategies to Manage Prepayment Penalties

- **Timing Your Payoff:** To minimize penalties, consider waiting until after the 10-year mark when the penalty is eliminated. This can lead to significant savings if you plan to refinance or sell the property.

## OTHER FACTORS TO CONSIDER

- SBA 7(a) loans cover any legitimate business purpose, while SBA 504 loans are restricted to financing fixed assets such as real estate or equipment. An SBA 504 lender will sometimes originate a small 7a loan in addition to the 504 loan to cover costs not eligible for 504 financing (the goodwill portion of the purchase price in a business acquisition and/or working capital required to operate a new business or a business in transition).
- An SBA-designated Preferred Lender (PLP) can originate an SBA 7(a) loan. The SBA PLP lender has the authority to approve and close the loan internally, without the need for added SBA approvals. SBA 504 loans require approval from the bank, SBA, and the SBA CDC issuing the debenture. This can sometimes double the processing time it takes to reach a loan closing compared to a 7(a) loan.

## CONCLUSION

The SBA 504 loan program fits small businesses planning to keep both the conventional loan and SBA debenture for at least 10 years. Because the prepayment penalties for first lien bank loans vary by the participating bank, it is important to review the costs associated with paying off the loan and debenture early with the 504 lender before choosing this loan program. For borrowers who plan to keep the loan longer than 5 years, and for borrowers who are concerned about future interest rate increases, the SBA 504 loan may be a practical choice.