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Stress Test for Business

The other day while in the middle of a discussion about increased interest rates with a colleague / SBA Loan specialist our conversation shifted to an interesting subject –

Business Stress Testing.

A lender that provides acquisition financing with variable rate loans has a formula whereby interest rates and payments change as interest costs change. The stress test that the lender looks at is loan payments / debt service coverage at an interest rate of 2% to 2.5% above the current rate. As an example, a loan with a current rate of 6% would be tested with a rate of perhaps 8.5%. Examples of “stress” caused by higher rates is interesting, to say the least.

Here’s the difference between a 6% rate and “stress rate” of 8.5%.

A ten year loan of \$500,000 at 6% has a payment of \$5,551 per month or \$66,612 per year. The same loan at 8.5% has a payment of \$6,200 per month or \$74,400 per year. The difference is \$7,788 higher annual payment. If the initial rate is 8% compared to 10.5%, the dollar change goes up as the rate increases. A ten year loan of \$500,000 at 8% has a payment of \$6,066 per month or \$72,792 per year. At 10.5% the loan has a monthly payment of \$6,747 per month or \$80,964 per year – \$8,172 higher. Something to keep in mind.

Other stress issues include a new competitor entering the market or a competitor that cuts prices to get business. Losing a major customer can cause stress. Cost increases other than

Difficulties Transferring the Facility Lease

Whereas a great majority of the obstacles in selling their business are somewhat within sellers' control, that is not necessarily the case with transferring a facility lease. Landlords can be unpredictable and typically have a lot of leverage in lease negotiations with prospective buyers.

It is imperative that you become thoroughly familiar with the terms of your facility lease

Before ever putting your business on the market, you need to be familiar with the legal language in your lease. Your intermediary might help you preliminarily interpret the lease but should also strongly suggest you ask your attorney to review and interpret the lease provisions.

Most facility leases will address the issue of assignability of the lease. Many will allow the lease to be assigned, but usually "only with written permission from the landlord." You also hope to see the phrase that the landlord's permission "shall not be unreasonably withheld."

In addition, there may be provisions explaining what the landlord needs to approve a new tenant. There also may be notification time frames stated, as well as the landlord's required response time. It's also possible there will be transfer fees associated with obtaining the landlord's approval.

About lease assignments

Typically, if a lease is assigned to a new tenant, the original tenant remains liable in the event of a default by the assignee. The implications are if the buyer struggles after acquiring your business and stops making payments on the lease, the landlord can look to collect lease payments from you for the remainder of the lease commitment. In the final definitive documents of the business sale, you will likely have indemnity clauses in your favor from the buyer. But, although you have the legal right to do so, there is no assurance funds will exist to reimburse you if the buyer defaults on an assigned lease.

SBA financing requires the lease term (with options) to match the loan term.

There's another complicating factor. If the buyers' financing is based on an SBA loan, the SBA will require the lease term, including tenant options to match the loan term - usually either 7 or 10 years. That can be favorable for landlords because they can use that fact to achieve a longer-term lease commitment, but the option has to be the tenant's, so that creates an offsetting factor. The real difficulty arises if the landlord has other plans for the leased space and is not willing to negotiate a lease term to match the loan term. Or, some landlords will use that prerequisite as leverage to try to negotiate unreasonable lease terms.

Novation agreements are desirable

As the tenant on a lease, your ideal solution is to negotiate a novation agreement, which means the landlord and prospective buyer enter into a new lease agreement at the same time you are released from obligations under the original lease agreement. In theory, it's great. In reality, it's extremely difficult to negotiate because in most circumstances the landlord has all the leverage in lease negotiations. Unless, of course, the

Interest rates can cause added stress. The costs of material, labor, and freight in and out come to mind as things that contribute to added business stress. Knowing the issues and adjusting timely is necessary.

The value of every business is influenced by many factors. Buyers of businesses want to retain what they are buying. They also have a plan to take it forward. Possible stress factors impact the future and are a consideration that impacts business value / price and whether a buyer will make the acquisition.

We have seen and advised the owners and buyers of almost every type of business. We don't have all the answers, but our experience is invaluable in assessing business value. We invite you to contact us for a no obligation discussion about business stress and anything else. It very well could be one of the more meaningful discussions you will have.

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NEXT ISSUE
Real Estate Transfer Issues

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business can be relocated, but even that leaves you on the hook for the remaining lease term.

When to talk to the landlord

The other difficult decision is when to approach the landlord. On the one hand, if you discuss a lease assignment early in the sale process, you have to be very concerned about the landlord honoring your request for confidentiality of your intentions to sell. That is a very legitimate concern that requires significant consideration. On the other hand, if you approach the landlord two weeks before closing, that's not enough time to avoid an angry response.

One approach is to informally ask about transferring the lease far in advance of the sale. For instance, "I'm thinking I might sell my business in the next few years. What's the process of transferring my lease?" Then, once you have a serious buyer with whom you've reached a preliminary agreement subject to due diligence, consider contacting the landlord at that time. The longer the notice you can provide, the happier the landlord will be. Then again, it would be best if you still were concerned with confidentiality.

Preparation is the key to a successful lease transfer

Because a lot is not within your control, lease transfers can be an extremely difficult obstacle to overcome. But you need to do what you can to prepare. Having a good working relationship with your landlord, as opposed to an antagonistic relationship, is a good first start. Know the terms of your lease and ask your attorney to interpret the language. It's important to prepare yourself mentally for a lease assignment that requires you to remain liable for the lease if the buyer defaults. The possibility of negotiating away that provision is slim.

And, finally, select an intermediary who has significant business sales skills, AND also has experience in dealing with lease transfer issues. Keep in mind that in selecting an intermediary, business sales experience is far more important than handling lease issues. Also, a real estate agent with minimal business brokerage experience is not a good choice for an intermediary to help sell your business.



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