Rising Interest Rates Are Creating Refinancing Headaches for Small Businesses

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The recent rise in interest rates is resulting in large drops in property valuations, making it harder for small businesses to refinance their commercial real estate loans.

This looming cloud is gathering even with a robust U.S. economy and regardless of whether the businesses' underlying performance is strong. It is undeniable that as interest rates go up, affordability goes down, and commercial real estate appraisals reflect this with lower values. As values drop, existing owners may find themselves underwater with their conventional mortgages when it comes time to renew or refinance.

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It is a trend that is likely to accelerate, particularly for businesses that are closely linked to real estate, such as manufacturing firms, wholesalers, hotels and restaurants.

While some business owners may find the current situation desperate, one solution is often ignored or little understood: a Small Business Administration-backed commercial loan can often work around the downward pressure on appraisals.

How we got here

The U.S. prime interest rate has risen by 2 percent since 2013 to 5.25 percent now. As a result, we are seeing appraisals on owner-occupied real estate come in as much as 20 percent to 25 percent lower than five years ago in certain markets.

Many businesses took out commercial property loans when interest rates were at rock bottom around 2013. These conventional loans were commonly structured with large "balloon" payments due at the end of a five- or 10-year term — a way for banks to mitigate their risks from declining property values and ensure they remain in compliance with regulators.

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As those very large payments become due, businesses often need to refinance. The problem is that with appraisals so much lower, commercial banks are demanding large additional principal payments to satisfy their loan-to-value requirements.

Take the following example. In 2013, a small business takes out an $800,000 conventional commercial mortgage loan to buy a property valued at $1 million. After five years, the business has paid down that loan to $714,995. But, as it looks to refinance in 2018, the appraisal on the property has dropped 20 percent and now is valued at $800,000. The maximum loan a bank can typically offer is 80 percent of its value, meaning the bank can give a maximum loan of $640,000. Even if the business is booming, the bank requires it to come up with the $75,000 needed to fill the gap between the outstanding loan and its new maximum loan-to-value.

Options seem dire but not all are.

Faced with this prospect, one option for companies is to come up with some other collateral that could make up the gap. This may be some free and clear equipment or equity in another property that is pledged.

Another option is to take out an additional loan to cover the $75,000 difference, although this would mean additional payments would have to be made on top of the mortgage loan — and these types of loans are typically written on much shorter terms unless they are secured by other real estate.

But, many are unaware that a much better option may be to seek out a loan guaranteed by the U.S. Small Business Administration. The big advantage of an SBA-backed loan is that it can refinance the whole conventional mortgage and will never require a balloon payment, leading to lower monthly payments and no more balloons to worry about.

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A lack of collateral is not an obstacle for SBA lending, making it a potential lifeline for businesses that are struggling to qualify for conventional financing.

To illustrate, let’s again take the example of the $800,000 loan taken out in 2013 on a $1 million property. With an original interest rate of 5.5 percent, the monthly payment of principal and interest would have been about $4,913.

Under a conventional bank refinance today (assuming the owner can offer adequate additional collateral), and based on a rate of 7.5 percent (2 percent higher than in 2013. and 240 months left on the loan term, that payment would jump to $5,805 on the remaining $714,995.

Alternatively, if the business only refinances $640,000 with

the bank and takes out an additional unsecured note over five years for $75,000 (both at 7.5 percent), the combined payments jump to $6,703 per month. Under an SBA refinancing, the term could go back to 300 months, so even at the same 7.5 percent interest rate the monthly payment would be significantly lower than the conventional refinance options, with a payment of $5,204, despite the higher interest rate.

SBA requirements are more flexible.

The requirements for SBA-backed refinancing – which has a limit of $5 million per business – are relatively straight-forward. The business must be principally owner-occupied (over 51 percent) and owned by a U.S. citizen or legal resident with good character and credit.

In addition, the loan it is seeking to refinance must have terms that the SBA considers "unreasonable," which includes balloon payments and loans taken out at very high interest rates. The SBA also needs to be sure that business owners do not have alternative ways to refinance the loan under similar terms, and that they really need the SBA loan.

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The SBA does have some additional requirements in these cases. It will require additional collateral on loans over $350,000 if the loan will not be fully secured and additional collateral is available. That could take the form of a lien on equipment owned free and clear by the business or a junior lien on equity that the owner may have built up in their personal residence. Failing that, an SBA refinancing is still possible if the owner takes out a term life insurance policy to cover the gap in collateral in the event of their death.

It goes without saying that the business must demonstrate the ability to repay the loan. But, that is generally not the biggest problem these days since many businesses are enjoying

healthy growth and can show a track record of making their monthly loan payments.

So don’t panic if you find yourself in a jam when it comes time to refinance. Consider all of your options and an SBA loan may just be the best solution.

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