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Exploring and Understanding the U.S. Small Business Administration 7(a) Loan Program

Search fund entrepreneurs can access highly advantageous terms and conditions in a 7(a) loan

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When search fund entrepreneurs finally have a signed letter of intent (LOI) in hand for an acquisition they are pursuing, they often breathe a well-earned sigh of relief. They are on the road to potentially closing a deal and then shifting into the CEO role. Unfortunately, the signed LOI is just the beginning of many more action steps and crucial decisions that must be made. Diligence is a large mountain to climb, herding equity investors along is concurrently exciting and time-consuming, and selecting the right debt partner is essential.

In our note On the Nature of Debt, we examined the role debt plays in entrepreneurship through acquisition (ETA) journeys. That note decomposes loan terms and unpacks the mathematical nuances in various debt arrangements with an eye toward maximizing equity value for investors and entrepreneurs. Although it is not prerequisite reading for this document, it will be helpful in understanding some of the concepts we will touch upon here.

In this note, we will explore a specific financing arrangement that can be a particularly compelling debt answer for search fund entrepreneurs, especially *self-funded searchers*—the U.S. Small Business Administration 7(a) funding program. This government-sponsored product is worth deep consideration for all aspiring ETA CEOs. It is packed with highly desirable features that can be quite appealing to the ETA crowd. While no solution is universally perfect, and the 7(a) certainly has shortcomings, it is still worth examining, understanding, and considering.

The 7(a) product is explicitly designed to assist small businesses with multiple activities requiring capital in a firm's evolution. These include working capital needs, refinancing existing debt, purchasing equipment and owner-occupied commercial real estate, and *change of ownership transactions (acquisitions)*. While the federal government sponsors the 7(a) loan initiative, the Small Business Administration (SBA) does not take any primary credit risk or provide frontline underwriting. Instead, the SBA guarantees a portion of the loan that a 7(a) participating bank makes to an entrepreneur. It serves as a backstop and secondary resource for the lending bank. The government sets the stage, but commercial banks and entrepreneurs are the show's leading actors.

When considering the 7(a) solution, search funders must comprehend all of the features and requirements of the loan because, while intriguing, it is not a panacea—but it is nearly tailor-made for some situations. Entrepreneurs need to assess how their individual deals and goals uniquely fit within the 7(a) structure. We will break down all things 7(a) in this note, which will serve as a primer. Namely, we will tackle the seven pertinent topics highlighted in **Figure 1**.

Figure 1: Themes related to the 7(a) loan program we will discuss in this note

01 The origin of the 7(a) loan program and why it exists
02 Breaking down the key players in a 7(a) loan
03 Key features of a 7(a) loan
04 Assessing the 7(a) loan's pros and cons
05 Comparing the 7(a) loan to a conventional bank loan
06 Why the 7(a) loan is so compelling for self-funded searchers
07 How to select a 7(a) loan creditor partner

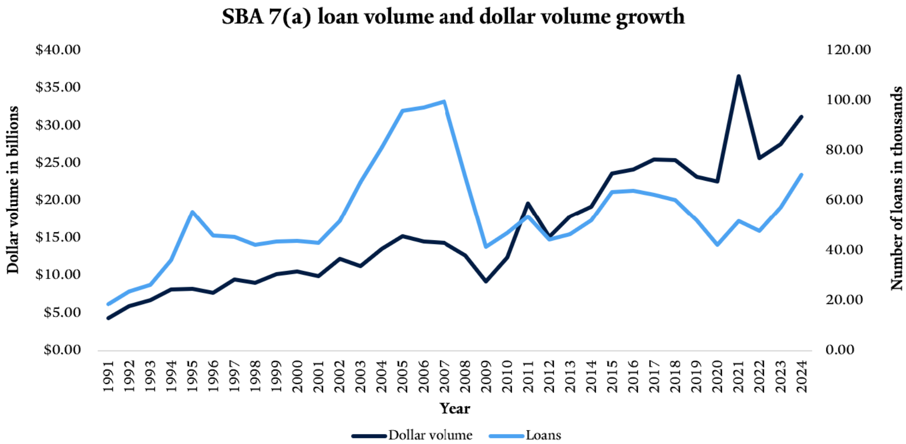
The origin of the 7(a) loan program and why it exists

In the aftermath of the Great Depression and World War II, Congress passed the Small Business Act of 1953, which established the Small Business Administration (SBA). The Act aimed to "aid, counsel, assist, and protect insofar as is possible the interests of small business concerns."[4] To accomplish that goal, the legislation empowered the SBA to provide loans to small businesses to support their growth and success, and in particular, Section 7(a) of the Act outlined the terms under which the SBA could offer those loans. Though the distinct provision governing the SBA's loan program is no longer codified under Section 7(a) in the U.S. Code, the SBA's primary loan program is still colloquially referred to as the "7(a) loan program."[5]

The 7(a) loan program exists to incentivize regulated lenders (commercial banks) to lend to small businesses that may not otherwise qualify for loans on commercially reasonable terms. Initially, the SBA made direct loans to borrowers. However, in the late 1990s, the SBA completed a shift to a loan-guarantee model, where banks issued loans and the SBA guaranteed a portion of the loan. By offering a government-backed guarantee on a portion of the loan, the 7(a) program reduces the risk for lenders, making them more willing to loan to small businesses with limited financial history, weaker credit, or insufficient collateral. This access to otherwise unavailable credit helps small businesses secure the capital to start, acquire, or grow their enterprise—furthering the SBA's mission to "assist . . . small business concerns."[6] While their approved purposes are not exhaustive, 7(a) loans can be used to fund working capital, equipment purchases, real estate, new building constructions, renovation and expansion, starting a new business, and *purchasing an existing business*. However, 7(a) loans cannot be used to pay off an existing business loan, buy out a partner, or fund SBA-designated "ineligible businesses."[7]

The SBA 7(a) loan program has proven to be quite popular in the small business universe. The SBA conveniently provides volume data for the program from 1991 to 2024 by the number of loans underwritten and total dollars in the program by calendar year from all participating banks. In **Figure 2,** we see that in 1991, the program facilitated approximately 18,000 loans with a dollar value of $4.3 billion. Fast forward to 2024, and 70,000 loans worth $31.1 billion were created.[8] For the raw data behind **Figure 2**, see **Exhibit 1**.

Figure 2: Growth of SBA 7(a) loans from 1991 to 2024

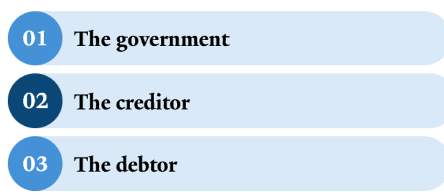


Source: Created by the case writers based on data at [7(a) & 504 Activity Reports: Current Month - MonthlyYearlyActivity_7a_504_-202412-1991-to-Present.xlsx - U.S. Small Business Administration (SBA) | Open Data]

Breaking down the key players in a 7(a) loan

The SBA 7(a) loan ecosystem is comprised of three key players: the government, the creditor, and the debtor (**Figure 3**). This section examines the role each of these parties plays, offering a practical overview of the incentives and constraints driving the government's regulations, the creditor's decisions, and the debtor's outcomes.

Figure 3: The trio of players in the 7(a) ecosystem



01 The government

The 7(a) loan program would not exist without government involvement, making the government an integral player in the program's operation. The government oversees the operation of the program, allocates resources, assesses fees to sustain the program, and approves (to varying extents) each loan guarantee.

The SBA oversees the 7(a) program's operation by promulgating rules to govern its administration. Most of this guidance is published through federal regulations, codified in the Federal Register. However, for ease of reference, the SBA compiles the rules governing the program in SOP* 50 10, which directs lenders and borrowers on the administrative and compliance requirements for 7(a) loans.

In addition to establishing the program's rules and regulations, the SBA allocates resources for its administration. Similar to other government credit programs, the 7(a) program is nominally "zero

* Standard operating procedure.

subsidy," which requires the SBA to estimate the costs of the program and collect fees to cover them.[9] These fees cover the SBA's operating expenses for the loan program and are designed to encompass or absorb the default risk the SBA might incur, which is less than 1.75%, as we will detail below. Participants pay via fees for the program's risk, and the SBA creates rules around the program, forcing a degree of homogeneity that facilitates the secondary market and is largely absent in conventional commercial credit markets.

The SBA assesses fees on creditors when they issue 7(a) loans.[10] This is done primarily in two forms. First, lenders pay the SBA Guaranty Fee (also known as the Upfront Fee) on a one-time basis when the loan is issued. This fee is calculated as a percentage of the guaranteed portion of the loan and is typically passed along to the borrower, most often by financing it in the loan proceeds. Second, lenders pay an annual 7(a) Lender's Service Fee. This fee is computed as a percentage of the lender's gross outstanding 7(a) loan approval amount, including guaranteed and unguaranteed portions, and it may not be shifted onto the borrower. Banks are willing to pay these fees because the SBA is guaranteeing 75% of the loan, thus shifting the credit risk. Banks are also able to sell the SBA-guaranteed portion of the loan in the secondary market, often at a premium. This allows banks with smaller balance sheets to leverage their capital and deposits while also accelerating the earnings of their SBA portfolio with the market purchase premiums. However, regardless of the benefits of offering SBA 7(a) loans, banks do not underwrite imprudent and uncreditworthy businesses because banks will always be on the hook for the unguaranteed portion of the loan.

As previously mentioned, the SBA does not issue loans itself; it only guarantees a portion of each 7(a) loan, providing lenders with some backstop against the small business's default. Nevertheless, the SBA does play a crucial role in the loan approval process.

If the creditor is not enrolled in the SBA's Preferred Lender Program (PLP), the creditor must submit the loan application materials to the SBA's Loan Guaranty Processing Center (LGPC) for review and approval. The LGPC conducts its own independent analysis of the lender's credit decision before issuing final approval on the 7(a) loan guarantee. This process can take 2–3 weeks; to avoid this delay, 7(a) loan-seekers tend to prefer creditors enrolled in the PLP.

Fortunately, most 7(a) loan creditors are enrolled in SBA's PLP; in 2024, over 600 lenders were actively enrolled. As a PLP member, creditors have delegated authority to underwrite and service most 7(a) loans without prior SBA review. When PLP lenders extend 7(a) loans, they submit a checklist to the SBA, and the SBA approves the loan guarantee with minimal additional oversight. SBA PLP creditors can typically obtain SBA guarantee approval within 24 hours. However, in some complex situations, PLP lenders still elect to submit loans through the LGPC process to provide the SBA an opportunity to opine on something that might otherwise put the lender at risk for a guaranty denial if they made the decision on their own; this type of voluntary submission typically occurs only when the lender believes that the loan could be in a "gray area" rule scenario in accordance with the SBA's SOP 50 10.

02 *The creditor (the bank)*

While the government manages the 7(a) program, individual creditors implement the program. In this respect, the creditor—not the government—is the most important party to the entrepreneur (i.e., the debtor). The creditor processes the borrower's loan application, secures SBA guaranty approval, services the loan, and interfaces with the 7(a) secondary market.

Once all debtor application materials are received, the bank evaluates the borrower's creditworthiness and determines loan terms. The creditor consolidates the loan terms and presents the borrower with a non-binding term sheet. The creditor also seeks SBA approval for the loan's SBA guaranty, either through LGPC review or the expedited PLP process discussed above. With all terms finalized and SBA approval in hand, the bank is ready to enter a formal credit agreement with the borrower.

Once a lender issues a 7(a) loan, they are responsible for ongoing loan servicing (regardless of whether the loan is sold in the secondary market, which we will discuss below). This includes processing principal and interest payments, monitoring the loan's performance, and submitting monthly updates on their 7(a) portfolio to the SBA using Form 1502. Additionally, lenders must also ensure compliance with applicable regulations to keep their 7(a) program in good standing with the SBA. Finally, and unfortunately, creditors sometimes need to work with borrowers who default on their loan obligations. From 2019 to 2023, the annual default rate for 7(a) loans was relatively low— 1.22% for business acquisition loans and 1.64% for non-business acquisition loans.[11]

After the loan is issued, creditors can sell the guaranteed portion of the loan to investors in the secondary market. The sales often occur at a premium, with investors paying more than the loan's par value due to the low-risk, government-backed nature of the guaranteed portion. For example, a creditor might sell a $100,000 guaranteed portion of an SBA 7(a) loan for $108,000, realizing an immediate $8,000 gain in accordance with Generally Accepted Accounting Principles as defined in ASC 860[†].

The premium exists because originating banks write loans based on a spread over the Prime rate, yet they sell loans into the secondary market based on a comparable treasury. Prime-based paper typically is more expensive than a comparable treasury. This creates an arbitrage opportunity for the originating bank and the ability to bring forward future earnings into the current period. Secondary market investors are willing to accept lower rates than the originating bank because the loans are underwritten and processed, they do not have to service the loans, and multiple SBA-guaranteed loans are bundled together, allowing the investor to deploy more capital. However, secondary market investors accept both the risk of prepayment and the risk of default (which is not the loss of capital due to the SBA guarantee but the loss of future interest earnings). This is referred to as a constant prepayment rate (CPR) and distinguishes SBA-guaranteed paper from treasury paper.

For creditors, selling the guaranteed portion of the loan provides liquidity, applies an accounting treatment to accelerate the recognition of earnings on those loans, and reduces exposure to prepayment risk. From the investor's perspective, holding the guaranteed portion of an SBA 7(a) loan offers a low-risk investment backed by the U.S. government with a higher yield than similarly low-risk bonds. The secondary market creates strong financial and risk-management incentives for lenders to offer 7(a) loans, helping to maintain liquidity and competition in the 7(a) loan market.

03 *The debtor (the entrepreneur)*

Many readers of this note are likely entrepreneurs (or aspiring entrepreneurs) who may consider using a 7(a) loan to fund a business acquisition. As mentioned earlier, the SBA loan application process can be detailed and time-consuming, requiring extensive data and supporting documentation. We suggest that

[†] Accounting Standards Codification.

curious entrepreneurs reach out to potential lenders early in the journey to build a professional relationship with loan officers and familiarize themselves with the bank's unique application and underwriting requirements. Investing in these relationships early can save time and effort when entrepreneurs are ready to submit their application materials.

When a borrower approaches a creditor for a 7(a) loan, the creditor will require the potential debtor to submit a significant amount of information before they will consider underwriting the loan. Application requirements include SBA Form 1919 (Borrower Information Form), SBA Form 912 (Statement of Personal History), and SBA Form 413 (Personal Financial Statement). Additional supporting documentation requirements include business and personal tax returns for the past three years, business financial statements (balance sheet, profit and loss statement, and income projections), long-term contracts and lease agreements, schedule of assets, incorporation documents, license documents, and business plans. Of note, the SBA SOP requires lenders to underwrite the target business's IRS-verified business tax returns, not historical financial statements; accordingly, in SBA lending, most lenders place a heavy emphasis on whatever the business tax returns show, even though in commercial lending, underwriting to accrual financial statements may be more desirable.

Furthermore, to help navigate the 7(a) loan process more effectively, we recommend working with an SBA 7(a) loan broker. These brokers are familiar with the SBA 7(a) market, and they can steer applicants toward lenders who are best suited to meet their precise needs. Loan brokers' fees are paid by the banks, so as a debtor, there is little downside to engaging a loan broker early in the process. Banks are willing to pay brokers' fees because they are avoiding variable customer acquisition costs, and the banks do not need to invest as much in proprietary customer development functions.

Key features of a 7(a) loan

As we highlight in On the Nature of Debt, loan terms and conditions can vary widely, and borrowers must pay attention to several components of the term sheet beyond just the cost of debt (i.e., interest rate). This section will break down the features of 7(a) loans to help debtors better understand the vehicle's common terms and conditions (**Figure 4**).

Figure 4: Key toggles in a 7(a) loan for examination

01 **Amount**

02 **Covenants**

03 **Amortization and term**

04 **Pricing and fees**

05 **Guarantees**

01 *Amount*

Entrepreneurs can access up to $5 million in debt with a 7(a) loan in a single North American Industry Classification System (NAICS) code family (i.e., NAICS codes with the same first three digits). Though the SBA does not set a minimum threshold for 7(a) loans, individual lenders may establish a minimum loan size requirement to make 7(a) lending economically feasible.

Borrowers can hold more than one 7(a) loan at a time, but the cumulative value of their 7(a) loans per NAICS code family cannot exceed the $5 million cap. In other words, if the first three digits of the business's NAICS code are the same, a borrower cannot take an additional 7(a) loan if they already have $5 million in SBA loans outstanding at the time. However, if the first three digits of the business's NAICS code are different, a borrower may be able to take an additional $5 million 7(a) loan. Borrowers typically operate with a single NAICS code in one business unless they have multiple distinct operating entities in unique enterprises that would have different NAICS codes. Any additional loans for novel NAICS codes would require another personal guarantee from owners with a 20% equity interest.

02 *Covenants*

There are no financial covenants for 7(a) loans. However, these loans may include standard non-financial covenants, such as quarterly financial reporting obligations and insurance requirements. This is one of the most attractive components of selecting a 7(a) solution. By not requiring financial covenants, the SBA 7(a) loan program strikes a balance between risk management and the accessibility needed to fulfill its mission of supporting small businesses that may otherwise not be able to obtain access to capital. Furthermore, these loans are covenant-free because the SBA will not allow banks to take action on technical defaults, only on payment defaults. Therefore, with no teeth in covenants, most lenders have done away with them altogether in SBA loans.

03 *Amortization and term*

The amortization schedules for 7(a) loans must be appropriate for the type of loan. For fixed interest rate loans, the payments must be calculated to ensure full amortization by the maturity date. For variable interest rate loans, the loan must re-amortize every time the interest rate changes to ensure that the loan will fully amortize by the maturity date. Balloon payments cannot be used for 7(a) loans.

Additionally, 7(a) loan terms must be the shortest appropriate term based on the use of proceeds and the entrepreneur's ability to repay. The maximum loan maturity for 7(a) loans used for purchasing a business is generally 10 years. However, when the purchase price includes the business's commercial real estate (i.e., the property from which the company operates), and when the value of that real estate is 51% or more of the purchase price, the maximum loan maturity may be 25 years.

04 *Pricing and fees*

The SBA imposes interest rate caps for 7(a) lenders, which vary based on the size of the loan. For loans greater than $350,000, the interest rate cannot exceed Prime or SBA Optional Peg Rate (which the SBA establishes each quarter) plus 3%.

As previously mentioned, 7(a) loans are subject to a variety of fees. Borrowers can expect to incur the SBA Guaranty Fee (Upfront Fee) and lender-specific service and packaging fees. As of this note's publication, the SBA Guaranty Fee for loans greater than $1 million with a maturity that exceeds 12 months is 3.5% of the guaranteed portion of the loan up to $1 million, plus 3.75% of the guaranteed portion of the loan over $1 million.[12] Lender-specific service and packaging fees can come in numerous forms, subject to a variety of SBA restrictions. When engaging with lenders, borrowers should understand each lender's unique fee arrangement. Debtors must calculate their effective interest rate after taking into account the originating fee, also known as the guaranty fee. The nominal rate might be substantially lower than the effective rate.

Bank pricing models will consider many things depending on how sophisticated they are (which varies widely across banks). Some of the pricing model factors will be the same whether the loan is an SBA 7(a) loan or not, such as the bank's cost of funds for the term being contemplated, borrower relationship, level of profitability from other products and services, and probability of default. However, when determining default exposure, the SBA loan will have an obvious advantage due to the SBA's 75% guarantee of any potential collateral shortfall in the event of a default—and most search fund business acquisition loans have a significant collateral shortfall.

Another consideration that some banks will factor in is the liquidity of the loan. The fact that SBA-guaranteed paper can readily be sold on a highly liquid and established secondary market means there is a very low liquidity premium applied in the pricing model to the SBA loan versus a similar conventional loan with the same tenor that lacks this source of liquidity for the bank. Liquidity has become more valuable to smaller banks in the aftermath of the Silicon Valley Bank collapse and the subsequent increase in deposit flow volatility for smaller banks in particular.

05 *Guarantees*

Owners of 20% or more of the debtor business must provide an unlimited full personal guarantee (PG) for the 7(a) loan. If no one individual owns 20% or more of the debtor business, at least one of the owners must provide the guarantee.

Prospective 7(a) loan debtors should thoughtfully consider the impact that a personal guarantee may have on their individual assets. For young search fund entrepreneurs who have not yet accumulated substantial personal wealth, the required personal guarantee is likely not a significant deterrent to pursuing a 7(a) loan. However, for more financially established entrepreneurs, personal guarantees may pose a significant barrier. Regardless of someone's financial situation, we recommend consulting with a lawyer to better understand the potential personal liability.

The PG requirement is an important factor to consider when selecting investors if the entrepreneur is also planning to obtain a 7(a) loan. Individual investors who participate in the self-funded 7(a) market rarely want more than 20% of the firm due to the PG requirement. Traditional institutional search fund investors typically do not participate at all in self-funded 7(a) financed transactions for several reasons: they are not in the PG business, they seek more equity and superior terms than these deals frequently offer, and they prefer larger transactions where they can get more dollars to work.

Assessing the 7(a) loan's pros and cons

As we have mentioned, the 7(a) is not a cure-all, and while it offers several compelling features, there are some unequivocal drawbacks, too. This section builds on the previous section and calls attention to the instrument's pros and cons.

01 *The pros*

As the previous section highlights, 7(a) loans have several benefits for acquisition entrepreneurs. We will now discuss those points (**Figure 5**).

Figure 5: SBA 7(a) positive elements

- **01** **No covenants**
- **02** **Attractive term and amortization**
- **03** **Relatively low cost of capital**
- **04** **Minimal equity requirements**

No covenants

There is a complete absence of covenant compliance with 7(a) loans, making them very forgiving—and an entrepreneurial fantasy come true. Early in an ETA CEO journey, entrepreneurs will undoubtedly make mistakes from which they can likely recover. With a 7(a) loan, young CEOs will have the breathing room to make these missteps without defaulting on loan covenants. This dramatically de-escalates the CEO's stress levels in the search fund trek.

Attractive term and amortization

The 10-year term and amortization period provide the CEO with a very generous amount of time to repay the loan without refinancing risk. In contrast to a conventional business loan—which is likely to have a 5-year term with a 10-year amortization schedule—the 7(a) loan's 10-year term and amortization period is an opportunity that cannot be found elsewhere.

Additionally, despite the fact that 7(a) loans do not carry financial covenants, 7(a) lenders underwrite to debt coverage ratio rather than a multiple of EBITDA[‡] (as is often the case with conventional commercial lending). Combined with a more extended amortization period, this method of underwriting allows room for more leverage (and, consequently, requires less equity). Accordingly, if the searcher is relying on equity from outside investors, the reduced equity requirement in a 7(a) scenario means that the searcher can retain a more significant ownership percentage of their business.

Relatively low cost of capital

Interest rate caps on 7(a) loans tend to keep the cost of borrowing relatively low, given the credit's underlying company size, the loan's perceived default risk profile, and substitute choices. Since the SBA guarantees a large portion of each 7(a) loan, lenders assume less risk, which allows them to offer lower

[‡] Earnings before interest, taxes, depreciation, and amortization.

interest rates to borrowers (that would not otherwise be offered in an efficient debt market). Note that the SBA does not take on any explicit default risk because it assesses fees to banks (which are passed on to the debtor) to cover defaults fully.

Furthermore, anecdotally, there is not a robust conventional credit market for small business acquisition loans for companies with less than $3 million of EBITDA. Those loans are almost exclusively the domain of SBA programs. Therefore, while it is difficult to make an apples-to-apples comparison between a market that exists and a market that does not exist, SBA pricing is attractive for the smallest loans that might otherwise be challenged to attract debt capital.

Minimal equity requirements

SBA 7(a) loans offer access to debt capital with minimal equity requirements. Acquisition entrepreneurs can often secure 7(a) financing with just a 10% equity injection—leveraging up to 90% of the acquisition cost because there are no covenant tests. A typical 7(a) acquisition structure usually includes a 10% equity profile, a seller note covering 10%–15% of the purchase price on a 5-year amortization schedule, and a 7(a) loan financing the remaining 75%–80%**.**

02 *The cons*

Despite the many benefits, 7(a) loans do have some notable shortcomings (**Figure 6**). While these encumbrances are real and worth considering, they need to be considered in the context of the many compelling elements of the 7(a). We will now discuss the 7(a) cons.

Figure 6: 7(a) drawbacks to contemplate and understand

01 **Loan size**
02 **Deal structure limitations**
03 **Personal guarantees**

Loan size

Since 7(a) loans are limited to $5 million, acquisition entrepreneurs may not be able to use them for larger deals. Many search fund entrepreneurs aim to acquire businesses with $2 million in EBITDA, and it may not be possible to use a 7(a) loan to entirely finance the debt on these higher-value targets. For example, if a target has $2 million in EBITDA, the enterprise value might be $12 to $14 million, reflecting a 6x to 7x multiple. With a 7(a) debt cap of $5 million, equity would need to be $7 to $9 million, which might be an over-equitized cap stack building a hurdle for attractive returns.

Deal structure limitations

The requirements for a 7(a) loan can materially constrain the deal structure. For example, these loans prohibit earn-out arrangements (which allow the seller to participate in the upside potential of the business's future performance), which are often used to bridge equity gaps. Since the earn-out mechanism is not allowed, entrepreneurs must bridge the equity gap through other means (e.g., increasing bank debt, obtaining a seller note, or seeking additional equity investors). Additionally, 7(a) loans are typically not compatible with supplemental debt instruments, like mezzanine debt (though some lenders *may* be willing to provide an additional pari passu conventional loan alongside the $5 million 7(a) loan). These constraints might block some deal structures that appeal to the traditional ETA set.

Personal guarantees

As we previously mentioned, one of the defining features of the 7(a) loan is the unlimited PG for all equity holders with at least 20% equity. While the PG has implications for the entrepreneur-debtor, it could also have implications for outside equity investors if they own more than 20% of the equity. Entrepreneurs pursuing 7(a) financing must consider the composition of their cap table to shield their investors from this PG requirement. This is a stark difference from most conventional loans in ETA land, which do not require a PG. Without the presence of a PG, the entrepreneur has a pure option—upside with no financial downside. With a PG, the CEO is no longer an optionee; they can lose money and go negative in the trade.

Comparing the 7(a) loan to a conventional bank loan

Depending on the size of the target acquisition, searchers *might* also be able to finance their acquisition using a conventional bank loan. To highlight the differences between a 7(a) loan and a conventional loan, this section examines the key components of a term sheet (previously mentioned in **Figure 4**) from the perspective of a conventional loan. **Figure 7** provides a simple summary of the major differences between a 7(a) and a conventional loan.

Figure 7: Summary of differences between 7(a) and conventional loans

	SBA 7(a) loan	Conventional loan
Amount	• Limited to $5 million • Minimal equity required	• No statutory limit • Higher equity requirements
Covenants	• None	• Many
Amortization and term	• 10-year amortization and term	• Likely 10-year amortization and 5-year term
Pricing and fees	• Based on SBA formula • Typically, no prepayment penalties	• Market-driven • Prepayment penalties
Guarantees	• Mandated PG for owners with greater than a 20% position	• Likely no PG

01 *Amount*

Conventional loans are not subject to the 7(a)'s $5 million maximum limit. Instead, the loan amount for a conventional loan typically reflects the bank's assessment of the acquisition's risk and the entrepreneur's financial position. This evaluation will be primarily based on the acquisition's projected cash flows and the value of the available collateral. For businesses with significant projected cash flows and valuable collateral, banks will be more comfortable to lend; for companies with only moderate cash flows and less valuable collateral, they will be hesitant to lend.

Additionally, acquisitions with a conventional bank loan typically require a greater equity contribution. While entrepreneurs can acquire a business with 7(a) financing with as little as 10% equity injection, searchers seeking a conventional bank loan should expect to contribute at least 30% equity (and likely more) for their acquisition.

02 *Covenants*

Unlike 7(a) loans, conventional loans will contain covenants. These covenants can take many forms, including negative covenants (limitations on what the debtor can do) and affirmative covenants (promises that the debtor agrees to keep). Different lenders will require different covenants; there is no "one size fits all" set. For further familiarity with the types of covenants that conventional borrowers can expect to encounter, we recommend reading our note On the Nature of Debt. Typical financial covenants the debtor will see include debt service coverage tests, capital expenditures limitations, liquidity tests, debt to earnings tests, and distribution limitations.

03 *Amortization and term*

While a 7(a) loan's amortization and term are statutorily fixed, those of a conventional bank loan are not. Conventional loans are typically set up with a 5-year term and a longer amortization period. As a result, at the end of the initial 5-year term, the entrepreneur will be required to pay off the principal balance or refinance the loan (with the same—or a different—creditor). While this structure provides lenders with the flexibility to adjust the loan's terms after 5 years, it creates an element of uncertainty (financial and otherwise) for the entrepreneur, which can negatively impact long-term business planning. Some conventional loans also have interest-only periods with no amortization at the beginning of the loan.

04 *Pricing and fees*

While 7(a) loans are subject to statutory interest rate caps, conventional loans are not. Lenders typically determine conventional loan interest rates based on the business's creditworthiness, the loan's collateral, and general market conditions.

In addition to common conventional lending fees (e.g., origination fees, application fees, underwriting fees), conventional bank loans almost certainly include a prepayment fee (i.e., penalty). In contrast, 7(a) loans are only subject to a prepayment penalty in rare circumstances. The prepayment penalty for conventional loans is contractually called out in loan documents and is usually calculated as a specified percentage of the outstanding principal or the present value of the future interest that the lender would have collected if the loan were not prepaid. SBA 7(a) loans include a 3-year prepayment fee only when the inclusion of commercial real estate results in a loan term that exceeds 15 years. The penalty fee is paid directly to the SBA, not the bank, and was instituted to slow secondary market prepayment speeds during periods of rapidly falling interest rates.

05 *Guarantees*

Conventional bank loans may or may not require a personal guarantee, depending on the loan's risk and the lender's preference. Entrepreneurs hoping to avoid the 7(a) program's personal guarantee requirement may (or may not) be able to do so with a conventional bank loan. However, when an entrepreneur has a distributed ownership group, the entrepreneur tends not to be on the hook for a PG.

Why the 7(a) loan is so compelling for self-funded searchers

The 7(a) program can be particularly compelling for self-funded searchers. While we do not suggest that every aspiring entrepreneur should opt for a self-funded search, the 7(a) program does enable self-funded searchers to maintain a significant degree of control and autonomy. To explore the potential economic upside of a 7(a)-funded acquisition, we developed a simple model to illustrate one possible outcome for a self-funded deal (**Exhibit 2**). The 7(a) loan program is certainly not a golden ticket for all self-funded searchers, but when employed in the right circumstances, it can be a significant wealth-generating vehicle for an aspiring entrepreneur.

To set the stage for our model, we make several assumptions that align with a prototypical self-funded deal.[13] First, we assume that the self-funded acquisition will be slightly smaller than a traditional search fund acquisition; in this scenario, we assume an acquisition EBITDA of $1 million at a 4.0x acquisition multiple for a total acquisition enterprise value of $4 million. Second, we assume that the acquisition is 80% leveraged (the 7(a) loan funds 80% of the purchase price), with the remaining 20% equity funded by outside investors. Our model supposes that the equity investors will be entitled to a 10% preferred return in addition to 25% of the common stock (a 1.25x step-up on the 20% equity contribution); the entrepreneur will receive the remaining 75% of the common stock. Third, our scenario holds that the 7(a) loan is subject to a 12% interest rate and is amortized over 10 years. Fourth, the model assumes that the entrepreneur will experience a slight J-curve effect in their first year of operation, with a 10% EBITDA growth rate in year 2 and beyond. Finally, the scenario assumes slight exit multiple expansion, with a 5.5x exit multiple in year 5.

As **Exhibit 2** illustrates, in a prototypical self-funded scenario, the entrepreneur stands to walk away in year 5 with $4.6 million! As for the equity investors, they can achieve a 35% IRR[§], 3.1x MOIC[**], and $2.5 million in proceeds—comparable metrics to a traditional search fund investment. We are not stating that the self-funded ETA approach with a 7(a) is superior to the traditionally funded model. Each aspiring entrepreneur should ascertain what works for them based on a risk-adjusted, lifestyle-adjusted, and financial outcome basis. It is not a pure apples-to-apples comparison since the structure and features are so different. Both approaches can result in life-changing windfalls for the protagonist, and both frameworks can result in a complete loss of capital.

[§] Internal rate of return.

[**] Multiple of invested capital.

How to select a 7(a) loan creditor partner

Selecting the right SBA 7(a) lender is critical to ensuring a smooth financing process and setting the stage for a successful long-term lending partnership. We consider a creditor's expertise, reliability, and support for future growth to be the most important considerations for a first-time 7(a) borrower. We believe that searchers should consider individual term sheets only after these lender qualifications are met. As previously mentioned, an SBA loan broker will be able to help searchers navigate selecting the right creditor partner to meet specific needs.

One of the most important considerations is the volume of business acquisition loans funded by the lender, particularly in the last 24 months. This information is readily available on the SBA's website. While many banks may claim to have expertise in SBA lending, it is essential to verify their experience with *business acquisitions* (rather than experience with other 7(a) financing uses, like purchasing equipment or funding working capital), as these transactions often have unique nuances. A lender with a proven track record in this area will be better equipped to navigate complexities and deliver on their initial term sheet without unexpected delays or unfavorable changes to terms.

Another key factor is the lender's overall reliability—a factor that can be assessed by considering the bank's ranking among the top 100 SBA lenders. Banks that rank highly typically have more robust teams capable of handling all aspects of the loan process, from underwriting and closing to post-close servicing. These lenders often demonstrate better follow-through on commitments, providing borrowers with greater confidence that the loan will close as planned. Additionally, their infrastructure is more likely to support the ongoing servicing needs of the SBA loan, including any associated lines of credit.

Borrowers should also consider the lender's willingness and capacity to support future growth. After the initial acquisition loan is funded, businesses often require additional financing for add-on acquisitions, equipment purchases, or line of credit increases. Prospective borrowers should inquire about the bank's process and credit philosophy for handling subsequent credit requests. A lender with an accommodating approach and a strong commitment to their clients' growth can be an invaluable long-term partner in scaling the business.

Finally, while repayment terms and structure are relatively consistent across SBA lenders due to program regulations, there are some differences across lenders. The primary structural variance lies in the interest rate, which can be fixed or variable, with a range often spanning up to three percentage points between the lowest and highest rates. However, we believe that, while certainly important, interest rate considerations might not be the overriding selection metric since factors such as lender expertise, reliability, and support for future growth are far more impactful to the overall success of the transaction.

Mini-profile: A 7(a) loan creditor

Bruce Marks has been involved with SBA lending since 1986. He currently serves as a Senior Vice President and M&A Sales Manager at First Bank of the Lake, one of the nation's most active SBA lenders. Throughout his career, he has helped finance over one thousand three hundred SBA transactions. Marks maintains an active voice in the SBA ecosystem (@SBABMarks), and he is a Certified Merger & Acquisition Advisor.

The 7(a) program is an incredible option for self-funded searchers. For most searchers, a conventional loan is not going to work in a change-of-ownership scenario. Lenders under those programs do not know the borrower well enough to justify the risk, and most searchers don't have a significant track record of assets or credit history to fall back on. So, without the SBA, many searchers would not be able to obtain access to capital, unless they are working with an SBIC[††] or a very different kind of funding source. The 7(a) program perfectly fills that gap to facilitate these lower market transactions.

I encourage searchers to reach out to me whenever they are ready. As a lender, I see my role as being supportive and accessible at all stages of the process. That said, it's always helpful to get involved early. I like to understand the deal dynamics, share insights, and offer guidance that might help searchers structure their transaction better or avoid potential pitfalls.

When evaluating a deal, I think of it in three buckets: the 3 Gs of a good deal—lending on a **Good Business**, to a **Good Buyer**, with **Good Strong Cash Flow**.

- The business. Is it sustainable? Will it be around for 10+ years? Is the industry mature or growing?
- The searcher. Whom am I backing? What is their experience and commitment? Am I betting on the right jockey?
- The deal itself. Does the structure make sense? Are the debt dynamics manageable? Is there plenty of cash flow to withstand any hiccups (just in case they experience the J-curve effect)?

One common concern I hear from searchers is about the SBA's required personal guarantee. I remind entrepreneurs that their concern is often more psychological than financial. The personal guarantee can feel daunting, but in practical terms, if a searcher doesn't own a home or have substantial assets, it's not as significant as it seems. And then I also like to remind them, if they don't believe in the business enough to guarantee it, then why should they expect the SBA or the lender to trust the business enough to finance it?

Lastly, SBA brokers also play a valuable role in this ecosystem. I have a lot of respect for them because they can easily cut through the noise and match borrowers to banks that fit their specific needs. If a deal is atypical or challenging, brokers often know exactly which lender is best suited for it. They're an integral part of the system.

[††] Small Business Investment Companies

Mini-profile: A 7(a) loan debtor

Jeremy Vernetti (Kellogg School of Management at Northwestern University 2012) launched a self-funded search in 2023. In 2024, he acquired T&M Environmental Services, an environmental remediation company based in Louisiana. Before his entrepreneurial venture, Vernetti held several roles in the petrochemical and oil industries and worked as a consultant at McKinsey. He holds a Bachelor of Science in chemical engineering from Texas Tech University.

When I first launched my search, I carefully evaluated various financing options before deciding that the SBA 7(a) loan program was the best fit for my acquisition strategy. I had raised some outside investor capital, but I knew that a significant amount of my acquisition would be debt financed. I knew that the 7(a) program's specific features would be advantageous as I embarked on my entrepreneurial journey.

The 7(a)'s 10-year term and amortization is critical. The SBA program is unique in that it offers such a long repayment horizon, and to buy a small business, you really do need the flexibility that the longer term provides. Additionally, even though the SBA application can be paperwork intensive, I actually view that as one of its most valuable features. The rigorous underwriting process served as an additional layer of due diligence—a way to validate my financial models and assumptions. After the bank completed its independent quality-of-earnings analysis and proof-of-funds verification, I felt even more comfortable with my deal.

The personal guarantee was initially hard to swallow. I talked to my loan broker and lender about the implications of the personal guarantee, and I weighed the risks against my personal finances and the specifics of my deal. Ultimately, I became comfortable with the guarantee, seeing it as a powerful signal to my investors. It demonstrated my commitment to and confidence in the business and reinforced my alignment with their interests.

Partnering with an experienced SBA loan broker was one of the best decisions I made. My deal—like all deals—carried some risk. In particular, some lenders were concerned with my company's customer concentration. I needed a lending partner with a strong reputation for certainty of closing—one who wouldn't introduce unnecessary challenges late in the process. My broker connected me with the perfect lender, whose expertise and reliability ensured a smooth path to closing without any last-minute surprises.

Conclusion

The SBA 7(a) loan program can be an incredible debt option for acquisition entrepreneurs. As this note highlights, the 7(a) program exists to help facilitate lower market transactions, and its key features are highly favorable to the borrower. When used in the right circumstances, the 7(a) loan program can be a significant wealth-generating vehicle for an aspiring entrepreneur. However, entrepreneurs should evaluate all of the pros and cons of the loan product and make sure it works for their specific needs and situation. Despite our unabashed enthusiasm for this credit solution, it is not a catholicon.

Furthermore, despite being a compelling debt strategy, a 7(a) will never overcome purchasing an inferior business or poor leadership. It can be a turbocharging ingredient to what is already a foundationally excellent business with a dynamic manager.

We hope that this note has been helpful for prospective 7(a) borrowers. Whether you choose to pursue 7(a) financing or not, we wish you fun, fulfillment, and unbounded success on your entrepreneurial expedition!

Exhibit 1: Historical SBA 7(a) loan data

Year	Loans (nominal count)	Dollar volume (in billions)
1991	18.44	$4.33
1992	23.66	$5.88
1993	26.29	$6.69
1994	36.05	$8.14
1995	55.55	$8.25
1996	45.85	$7.69
1997	45.29	$9.46
1998	42.27	$9.02
1999	43.63	$10.15
2000	43.75	$10.52
2001	42.96	$9.89
2002	51.67	$12.21
2003	67.31	$11.27
2004	81.13	$13.57
2005	95.90	$15.22
2006	97.29	$14.53
2007	99.61	$14.29
2008	69.44	$12.67
2009	41.29	$9.19
2010	47.00	$12.41
2011	53.71	$19.64
2012	44.38	$15.15
2013	46.40	$17.87
2014	52.04	$19.19
2015	63.46	$23.58
2016	64.07	$24.13
2017	62.43	$25.45
2018	60.35	$25.37
2019	51.91	$23.18
2020	42.30	$22.55
2021	51.86	$36.54
2022	47.68	$25.69
2023	57.36	$27.52
2024	70.24	$31.12

Source: Created by the case writers based on data at 7(a) & 504 Activity Reports: Current Month - MonthlyYearlyActivity_7a_504_-202412-1991-to-Present.xlsx - U.S. Small Business Administration (SBA) | Open Data

Exhibit 2: Illustrative model for a self-funded searcher using an SBA 7(a) loan

					0	1	2	3	4	5
Acquisition EBITDA	$1,000	Acquisition Debt (%)	80%	EBITDA	$1,000	$975	$1,073	$1,180	$1,298	$1,427
Acquisition Multiple	4.00	Acquisition Equity (%)	20%	Depreciation & Amortization	$400	($400)	($400)	($400)	($400)	($400)
Acquisition EV	$4,000	Acquisition Debt ($)	$3,200	Operating Income (EBIT)	$600	$575	$673	$780	$898	$1,027
EBITDA Growth	10%	Acquisition Equity ($)	$800	Interest Expense		($384)	($362)	($338)	($310)	($279)
Tax Rate	40%	Interest Rate	12%	Earnings Before Taxes (EBT)		$191	$310	$442	$588	$748
Exit Multiple	5.50	Amortization (years)	10	Taxes		($76)	($124)	($177)	($235)	($299)
Preferred Return	10%			Net Income		$115	$186	$265	$353	$449
Investor Common	25%	(1.25x step-up on 20% equity contribution)								
Entrepreneur Common	75%			Plus: Depreciation & Amortization		$400	$400	$400	$400	$400
				Less: Capital Expenditures (10% of EBITDA)		($98)	($107)	($118)	($130)	($143)
				Less: Δ in WC (5% of EBITDA)		($49)	($54)	($59)	($65)	($71)
Total Available for Distribution (Equity Cash Flows + Exit Proceeds)	$7,126			Free Cash Flow Before Debt Extinguishment		$368	$425	$488	$558	$635
Overall IRR on Invested Capital	65%			Less: Debt Extinguishment		($182)	($204)	($229)	($256)	($287)
Overall MOIC on Invested	8.9			Free Cash Flow to Equity		**$186**	**$221**	**$260**	**$302**	**$348**
Equity Invested	$800									
Total Equity Invested	$800			Total Debt Service		$566	$566	$566	$566	$566
				DSCR		1.72x	1.89x	2.08x	2.29x	2.52x
Preferred Return (10%)	$488									
Investors Get First (Total Equity Invested + Preferred Return)	$1,288			Exit:						
				Exit EBITDA						$1,427
Total Distributed to Equity Investors	$2,494			Exit Multiple						5.50x
IRR	35%			Exit EV						$7,851
MOIC	3.1			Less: Debt at Exit						($2,042)
Equity Invested	$800			Equity Value at Exit (Proceeds)						$5,810
Total Equity Invested	$800									
				Equity Cash Flows		$186	$221	$260	$302	$348
Entrepreneur Gets ($) in millions	**$4.6**			Plus: Exit Proceeds						$5,810
				Total Equity Cash Flows	($800)	$186	$221	$260	$302	$6,157
				Preferred Balance	$800	$880	$763	$542	$283	$0
		Cash Flow Waterfall	-->	Investor Preferred (10% compounded + initial capital)	($800)	$186	$221	$260	$283	$0
				Investor Common (25%)	$0	$0	$0	$0	$5	$1,539
				Investor Total (for IRR calc)	($800)	$186	$221	$260	$287	$1,539
				Entrepreneur Common (75%) in millions					$0.0	**$4.6**

Exhibit 3: Additional resources

- "What Is an SBA 7(A) Loan?" *YouTube*, 28 May 2020, www.youtube.com/watch?v=NcJNrkG48fY.
- "7(A) Fees Effective October 1, 2024, for Fiscal Year 2025 | U.S. Small Business Administration." *Sba.gov*, 2024, www.sba.gov/document/information-notice-5000-858936-7a-fees-effective-october-1-2024-fiscal-year-2025.
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- Wylie, Melissa. "SBA 7(A) Loan: How to Get the Popular SBA Loan." LendingTree, 11 Nov. 2024, www.lendingtree.com/business/sba/sba-7a-loan/.

Endnotes

[1] Jacob Wirz is a 2025 candidate for a JD degree at Yale Law School.

[2] Heather Endresen is the owner and founder of Viso Business Capital, a California-based loan sourcing intermediary for acquisition entrepreneurs.

[3] A. J. Wasserstein is the Eugene F. Williams, Jr., Senior Lecturer in the Practice of Management at the Yale School of Management.

[4] *Small Business Act of 1953*. 30 July 1953.

[5] "Bankers' Guide to the SBA 7(A) Loan Guaranty Program." Office of the Comptroller of the Currency, Dec. 2014.

[6] *Small Business Act of 1953*. 30 July 1953.

[7] 13 CFR 120.110.

[8] U.S. Small Business Administration website: 7(a) & 504 Activity Reports: Current Month - MonthlyYearlyActivity_7a_504_-202412-1991-to-Present.xlsx - U.S. Small Business Administration (SBA) | Open Data

[9] 15 U.S.C. § 636(a)(23)(A).

[10] "7(A) Fees Effective October 1, 2024, for Fiscal Year 2025." 23 July 2024.

[11] "Lumos Launch Pad." *LUMOS*, 11 Oct. 2023, lumosdata.com/launch-pad. Accessed 24 Oct. 2024.

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[13] Search Investment Group. "2023 Self-Funded Search Study." 10 Jan. 2023.