

Financing in the Independent Sponsor and Search Fund World: SBA vs. Conventional Lending



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Financing is one of the most critical components of a successful search fund or independent sponsor acquisition, influencing not just deal structure and capital requirements but also long-term financial health and growth potential. Entrepreneurs and investors evaluating a business purchase must carefully weigh two primary financing options: Small Business Administration (SBA) loans and conventional bank loans.

While both have their merits, the choice between SBA and conventional lending impacts everything from cash flow management and debt servicing to operational flexibility and future capital raises. Selecting the right option requires a clear understanding of short-term liquidity needs, financial reporting obligations, investor expectations, and the intended growth trajectory of the acquired company.

SBA Loans: Flexible but Costly in Equity Terms

The SBA 7(a) loan program is a widely used financing tool, particularly for first-time entrepreneurs and acquisitions of lower middle-market businesses. The program is designed to make small business ownership more accessible by offering low down payments, extended repayment terms, and fewer financial covenants compared to conventional loans.

Key Advantages of SBA Loans:

- **Lower Equity Requirements** – SBA loans typically require only 10% equity, making them an attractive option for buyers with limited personal capital. In contrast, conventional loans often require 20-50% equity, significantly raising the cash burden.
- **Longer Repayment Terms** – The standard 10-year amortization schedule allows borrowers to maintain lower monthly payments, easing cash flow constraints.
- **Limited Financial Covenants** – Unlike conventional lenders, SBA-backed loans do not impose strict financial performance benchmarks, providing greater flexibility in early-stage business operations.
- **Easier Qualification Process** – Many first-time buyers may find it easier to secure an SBA loan compared to conventional financing due to the government-backed guarantee, reducing lender risk.

Challenges of SBA Loans

Despite their accessibility, SBA loans come with notable downsides, particularly for search funders and independent sponsors looking for long-term capital efficiency and equity retention:

- **Personal Guarantee Requirements** – SBA loans require personal liability from the borrower, meaning that if the business

fails, personal assets may be at risk.

- **Restrictions on Seller Notes & Subordinated Debt** – The SBA often limits the use of seller financing and additional subordinate debt, making capital structuring more rigid.
- **Prepayment Penalties & Financing Limitations** – Borrowers looking to refinance into more favorable debt structures down the road may face prepayment penalties, increasing overall financing costs.
- **Growth Limitations** – The lack of institutional-style covenants can prevent businesses from building the structured financial discipline needed for future capital raises or attracting private equity investment.

For sponsors and search fund entrepreneurs planning recapitalization, secondary financing rounds, or eventual exit strategies, the limitations associated with SBA loans should be carefully considered.

Conventional Bank Lending: More Rigid, but (Maybe) a Stronger Long-Term Fit

For experienced operators or businesses with strong existing cash flow, conventional loans can be a more sustainable long-term financing solution. These loans provide greater flexibility in structuring deals, but they also come with stricter requirements.

Key Advantages of Conventional Loans:

- **Higher Loan Amounts** – Unlike SBA loans, which cap at \$5 million, conventional banks can finance larger acquisitions, making them more suitable for companies with \$5M+ in EBITDA.
- **Stronger Banking Relationships** – Working with a commercial bank can create opportunities for long-term financial partnerships, including credit facilities, treasury services, and strategic capital allocation.
- **More Favorable Equity Retention Terms** – Conventional lenders often allow higher levels of seller financing and preferred equity arrangements, giving the buyer greater control over the capital stack.

Stricter Covenants: More Financial Controls and Reporting

Unlike SBA loans, conventional financing requires detailed financial oversight, which, while adding complexity, can ultimately benefit long-term financial planning and investor confidence:

- **Debt Service Coverage Ratios (DSCR)** – Lenders typically mandate a minimum DSCR threshold, ensuring the business maintains healthy cash flow relative to debt obligations.
- **Regular Financial Reporting** – Borrowers must provide quarterly and annual financial statements, reinforcing financial discipline and operational transparency.
- **Leverage & Liquidity Limits** – Many conventional loans include leverage constraints, preventing businesses from taking on excessive debt that could jeopardize financial stability.

While these restrictions may seem burdensome, they prepare companies for future institutional investment and create stronger exit opportunities by making businesses more attractive to private equity firms and strategic acquirers.

Choosing the Right Financing for Sponsors and Search Funds

The decision between SBA and conventional financing depends largely on the business model, investor profile, and long-term capital strategy of the acquirer.

SBA Loans Are Best For:

- First-time search funders acquiring sub-\$5 million EBITDA businesses

- Deals where seller financing is limited or unavailable
- Entrepreneurs seeking maximum leverage with minimal equity investment
- Buyers prioritizing cash flow flexibility over institutional financing constraints

Conventional Loans Are Best For:

- Larger acquisitions requiring more flexible financing structures
- Search funders looking to build long-term banking relationships
- Companies planning to secure future private capital or institutional investment
- Acquisitions where financial discipline and structured reporting will be critical for growth and scalability

Final Thoughts: Aligning Capital with Growth Strategy

For independent sponsors and search fund entrepreneurs, financing is about more than just getting the deal done—it's about positioning the business for long-term success. SBA loans can provide immediate access to capital, but conventional financing ensures long-term scalability and financial discipline.

Navigating the complexities of acquisition financing requires strategic planning and expert guidance. Working with an experienced attorney and financial advisor can help independent sponsors and search funders structure deals properly, negotiate loan agreements, and ensure compliance with lender requirements, ultimately protecting long-term equity value.