BREAKING INTO BANKING

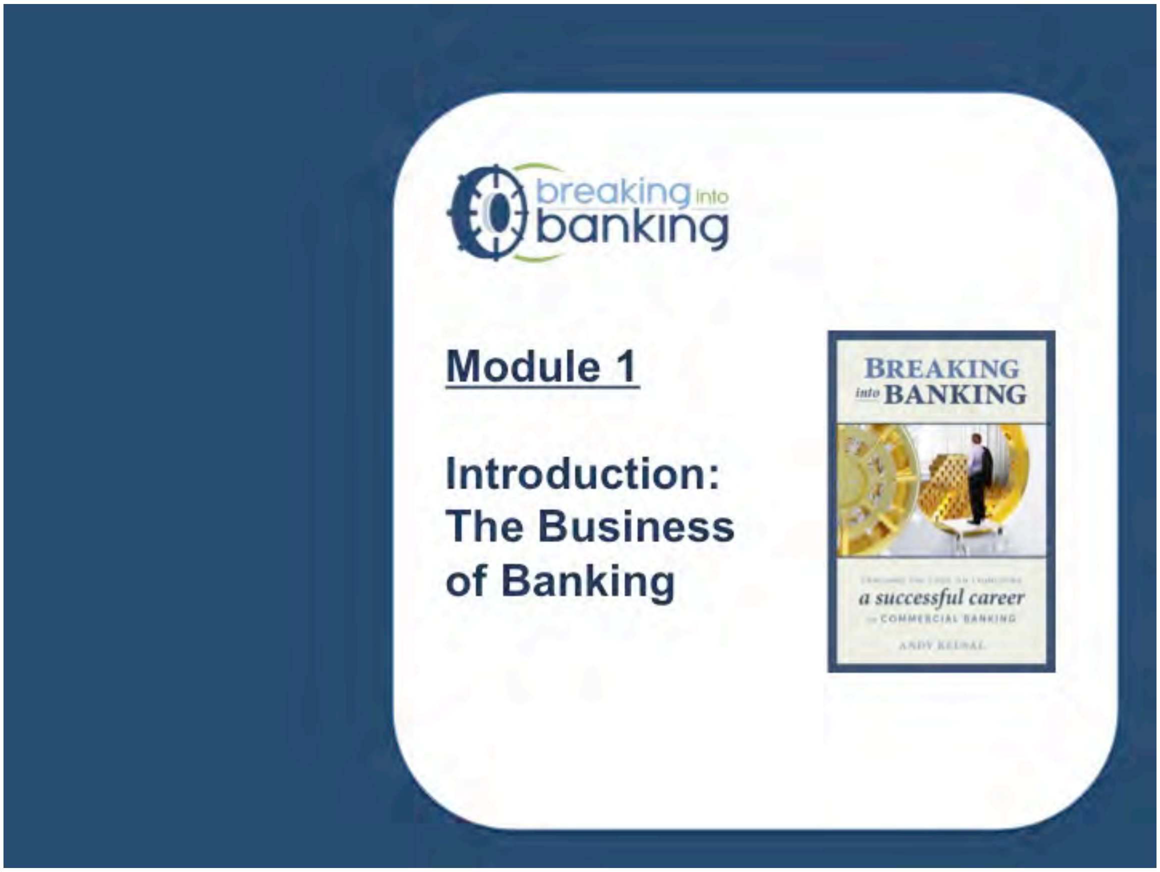
course workbook

KEUSAL LEARNING

BREAKING *into* BANKING

COURSE WORKBOOK

Important Notice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Module 1
Introduction:
The Business
of Banking
BREAKING
into BANKING
a successful career

About the Course

- Gives you a head start
- Start w/ basics and build on them
- Modules may be available to you online for review

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How Banks Make Money
Knowing Your Role
Borrowing Causes
Risk and Relationships
Internal Partners
Underwriting Loans
Monitoring
Approval Process
Loan Structuring
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Key Concepts in Module 1:

- Why and how banks take *risk*
- Why *relationships* matter
- The *business* of banking: how banks make money

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Definition:

RISK = The possibility of something bad or dangerous happening

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So Why Take Risk?

6

Because It Pays Well!

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Risk

- Conservative people doing risky things!
- Risk-taking – insurance, bonding, & banking
- Bankers go out seeking risk
- *Identify* and *manage* but not not *avoiding* risk
- Risks in banking:
  - Market
  - Credit

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Relationships

- Internal (other employees)
- External (customers)
- It's a people business
  - Character
  - Trust
  - Loyalty
  - Transparency

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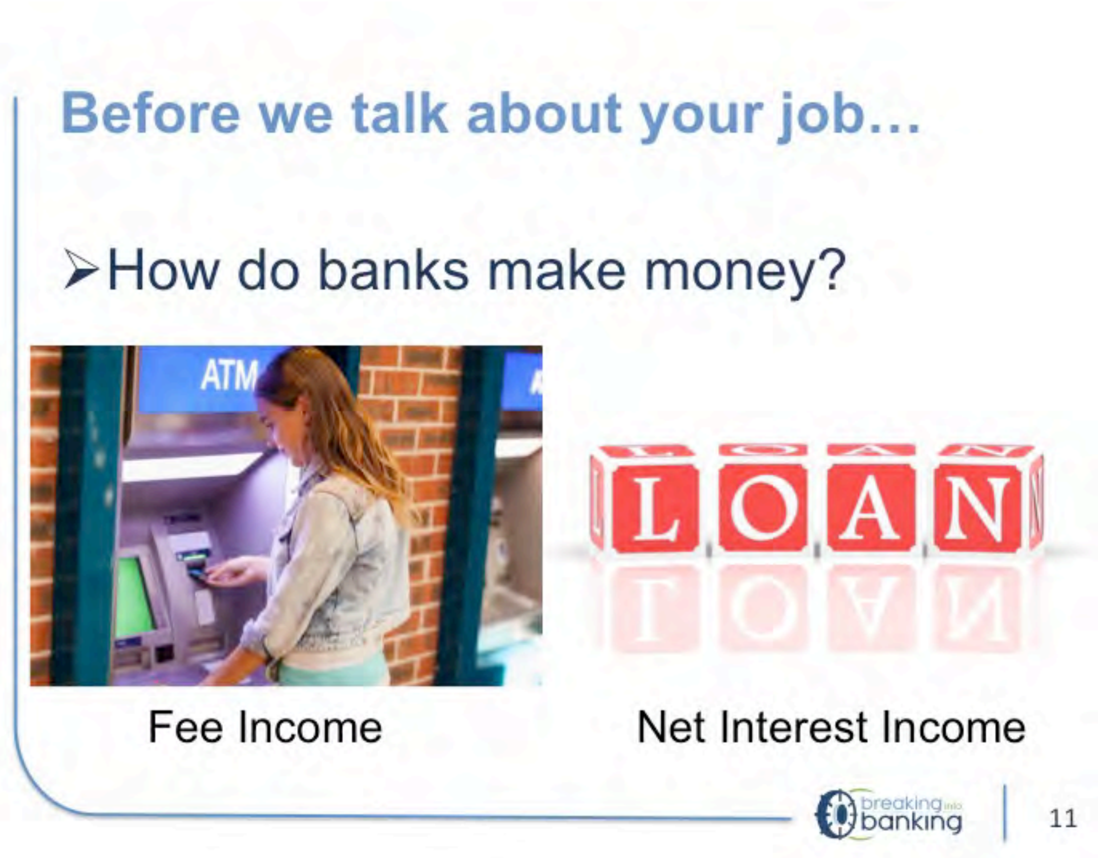
How Banks
Make Money


Before we talk about your job…
➢How do banks make money?
ATM
LOAN
Fee Income
Net Interest Income
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<u>Example Bank</u>

Income Statement

A bank's primary sources of revenue

Interest & Fee Income

(Interest Expense)

Net Interest Income

Interest paid by bank to depositors

(Provision for Credit Losses)

Net Interest Income after Provision

Money set aside based on the Expected Loss of all existing loans

Other Income

(Personnel Expense)

(Other Expenses)

Profit Before Taxes

(Income Tax Expense)

Net Income

Net Interest Income

- Buy low, sell high
- Banks collect deposits & pay low interest rates
- Then they lend that money at higher rates
- 1% = 100 bps

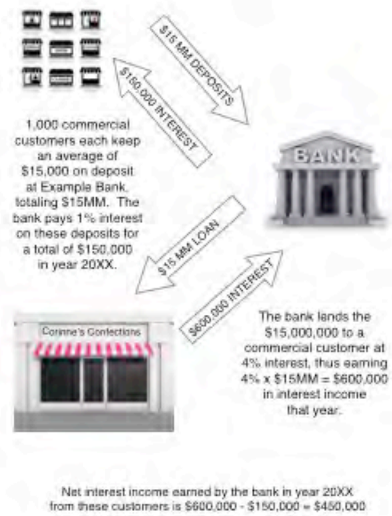

Figure 1.1

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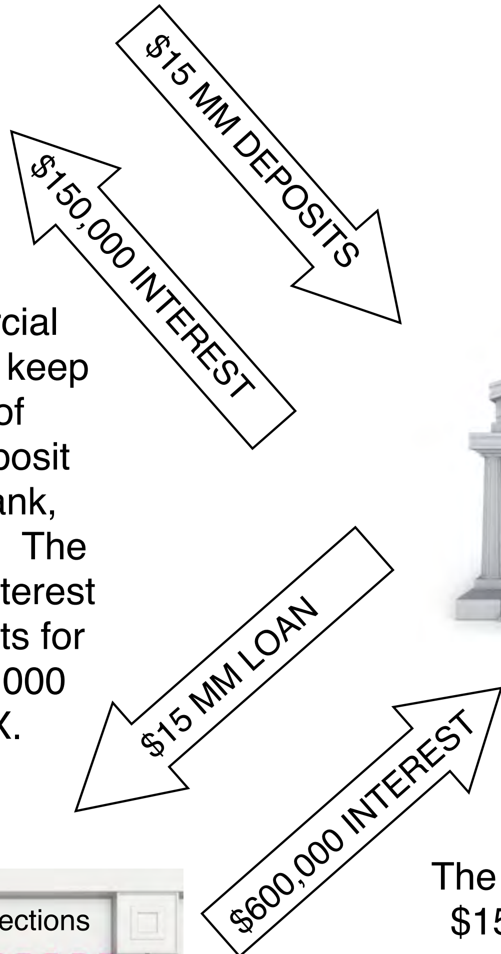
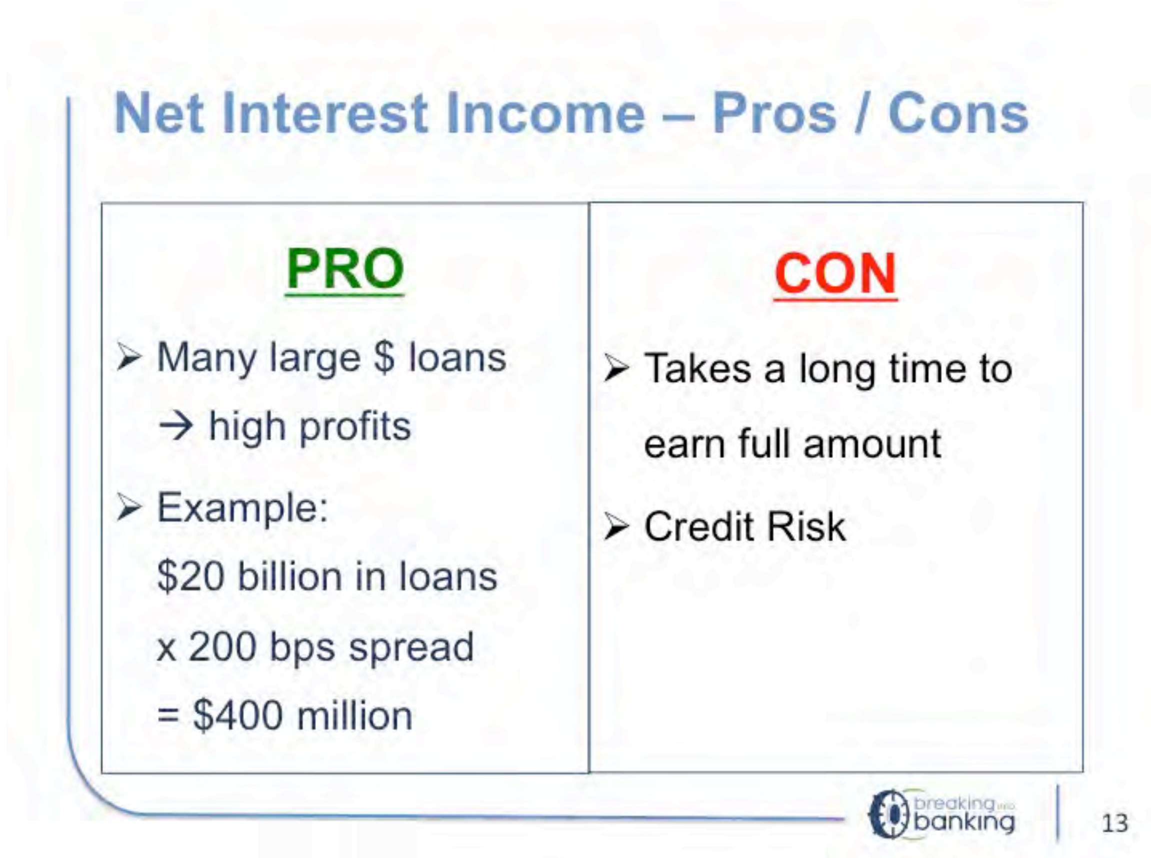
1,000 commercial customers each keep an average of $15,000 on deposit at Example Bank, totaling $15MM. The bank pays 1% interest on these deposits for a total of $150,000 in year 20XX.



The bank lends the $15,000,000 to a commercial customer at 4% interest, thus earning 4% x $15MM = $600,000 in interest income that year.

Net interest income earned by the bank in year 20XX from these customers is $600,000 - $150,000 = $450,000


Net Interest Income – Pros / Cons
PRO
➢ Many large $ loans
→ high profits
➢ Example:
$20 billion in loans
x 200 bps spread
= $400 million
CON
➢ Takes a long time to
earn full amount
➢ Credit Risk
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Fee (Non-Interest) Income

- DDA account fees (Retail)
- Loan Origination Fee
- Annual Renewal Fee
- Unused Portion (Commitment) Fee
- Covenant Waiver Fee
- Product Fees

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Fee Income – Pros / Cons

PRO	CON
➢ Paid up front ➢ No credit risk ➢ No market risk	➢ Some customers are fee-averse

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A Bank's Income Statement

Interest income

(Interest expense)

Net interest income

(Provision for credit losses)

Net interest income after provision

Non-interest (fee) income

(Non-interest expense)

Net Income

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A Bank's Balance Sheet

Assets

Cash

Investments

Loans

Liabilities

Noninterest-bearing deposits

Interest-bearing deposits

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Huntington Bancshares Incorporated
Consolidated Balance Sheets

(dollar amounts in thousands, except number of shares)	December 31, 2014	2013
Assets		
Cash and due from banks	$ 1,220,565	$ 1,001,132
Interest-bearing deposits in banks	64,559	57,043
Trading account securities	42,191	35,573
Loans held for sale	416,327	326,212
(includes $354,888 and $278,928 respectively, measured at fair value)(1)		
Available-for-sale and other securities	9,384,670	7,308,753
Held-to-maturity securities	3,379,905	3,836,667
Loans and leases (includes $50,617 and $52,286 respectively, measured at fair value)(1)		
Commercial and industrial loans and leases	19,033,146	17,594,276
Commercial real estate loans	5,197,403	4,850,094
Automobile loans	8,689,902	6,638,713
Home equity loans	8,490,915	8,336,318
Residential mortgage loans	5,830,609	5,321,088
Other consumer loans	413,751	380,011
Loans and leases	47,655,726	43,120,500
Allowance for loan and lease losses	(605,196)	(647,870)
Net loans and leases	47,050,530	42,472,630
Bank owned life insurance	1,718,436	1,647,170
Premises and equipment	616,407	634,657
Goodwill	522,541	444,268
Other intangible assets	74,671	93,193
Accrued income and other assets	1,807,208	1,609,876
Total assets	$ 66,298,010	$ 59,467,174
Liabilities and shareholders' equity		
Liabilities		
Deposits in domestic offices		
Demand deposits - noninterest-bearing	$ 15,393,226	$ 13,650,468
Interest-bearing	35,937,873	33,540,545
Deposits in foreign offices	401,052	315,705
Deposits	51,732,151	47,506,718
Short-term borrowings	2,397,101	2,352,143
Long-term debt	4,335,962	2,458,272
Accrued expenses and other liabilities	1,504,626	1,059,888
Total liabilities	59,969,840	53,377,021
Shareholders' equity		
Preferred stock - authorized 6,617,808 shares;		
Series A, 8.50% fixed rate, non-cumulative perpetual convertible preferred stock, par value of $0.01, and liquidation value per share of $1,000	362,507	362,507
Series B, floating rate, non-voting, non-cumulative perpetual preferred stock, par of $0.01, and liquidation value per share of $1,000	23,785	23,785
Common stock	8,131	8,322
Capital surplus	7,221,745	7,398,515
Less treasury shares, at cost	(13,382)	(9,643)
Accumulated other comprehensive loss	(222,292)	(214,009)
Retained (deficit) earnings	(1,052,324)	(1,479,324)
Total shareholders' equity	6,328,170	6,090,153
Total liabilities and shareholders' equity	$ 66,298,010	$ 59,467,174
Common shares authorized (par value of $0.01)	1,500,000,000	1,500,000,000
Common shares issued	813,136,321	832,217,098
Common shares outstanding	811,454,676	830,963,427
Treasury shares outstanding	1,681,645	1,253,671
Preferred shares issued	1,967,071	1,967,071
Preferred shares outstanding	398,007	398,007

(1) *Amounts represent loans for which Huntington has elected the fair value option. See Note 17.*
See Notes to Consolidated Financial Statements

Huntington Bancshares Incorporated
Consolidated Statements of Income

(dollar amounts in thousands, except per share amounts)	Year Ended December 31, 2014	2013	2012
Interest and fee income:			
Loans and leases	$ 1,674,563	$ 1,629,939	$ 1,675,295
Available-for-sale and other securities			
Taxable	171,080	148,557	184,340
Tax-exempt	28,965	12,678	8,999
Held-to-maturity securities	88,724	50,214	24,088
Other	13,130	19,249	37,541
Total interest income	1,976,462	1,860,637	1,930,263
Interest expense			
Deposits	86,453	116,241	162,167
Short-term borrowings	2,940	700	2,048
Federal Home Loan Bank advances	1,011	1,077	819
Subordinated notes and other long-term debt	48,917	38,011	54,705
Total interest expense	139,321	156,029	219,739
Net interest income	1,837,141	1,704,608	1,710,524
Provision for credit losses	80,989	90,045	147,388
Net interest income after provision for credit losses	1,756,152	1,614,563	1,563,136
Service charges on deposit accounts	273,741	271,802	262,179
Trust services	115,972	123,007	121,897
Electronic banking	105,401	92,591	82,290
Mortgage banking income	84,887	126,855	191,092
Brokerage income	68,277	69,624	72,684
Insurance income	65,473	69,264	71,319
Bank owned life insurance income	57,048	56,419	56,042
Capital markets fees	43,731	45,220	48,160
Gain on sale of loans	21,091	18,171	58,182
Net gains on sales of securities	17,554	2,220	6,388
Impairment losses recognized in earnings on available-for-sale securities (a)	---	(1,802)	(1,619)
Other income	126,004	138,825	137,707
Total noninterest income	979,179	1,012,196	1,106,321
Personnel costs	1,048,775	1,001,637	988,193
Outside data processing and other services	212,586	199,547	190,255
Net occupancy	128,076	125,344	111,160
Equipment	119,663	106,793	102,947
Professional services	59,555	40,587	65,758
Marketing	50,560	51,185	64,263
Deposit and other insurance expense	49,044	50,161	68,330
Amortization of intangibles	39,277	41,364	46,549
Gain on early extinguishment of debt	---	---	(798)
Other expense	174,810	141,385	199,219
Total noninterest expense	1,882,346	1,758,003	1,835,876
Income before income taxes	852,985	868,756	833,581
Provision for income taxes	220,593	227,474	202,291
Net income	632,392	641,282	631,290
Dividends on preferred shares	31,854	31,869	31,989
Net income applicable to common shares	$ 600,538	$ 609,413	$ 599,301
Average common shares - basic	819,917	834,205	857,962
Average common shares - diluted	833,081	843,974	863,402
Per common share:			
Net income - basic	$ 0.73	$ 0.73	$ 0.70
Net income - diluted	0.72	0.72	0.69
Cash dividends declared	0.21	0.19	0.16

(a) The following OTTI losses are included in securities losses for the periods presented:

Total OTTI losses	$ ---	$ (1,870)	$ (1,886)
Noncredit-related portion of loss recognized in OCI	---	68	267
Net impairment credit losses recognized in earnings	$ ---	$ (1,802)	$ (1,619)

See Notes to Consolidated Financial Statements

Key Takeaways: Module 1

- Banking is about *Risk* and *Relationships*
- Don't avoid risk – identify and manage it
- Fee income and net interest income
- Loans generate cash flow

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For Further Learning: Module 1

Find a bank's 10-K

- Income statement: Fee (non-interest) income versus net interest income
- Balance Sheet: Largest asset category?

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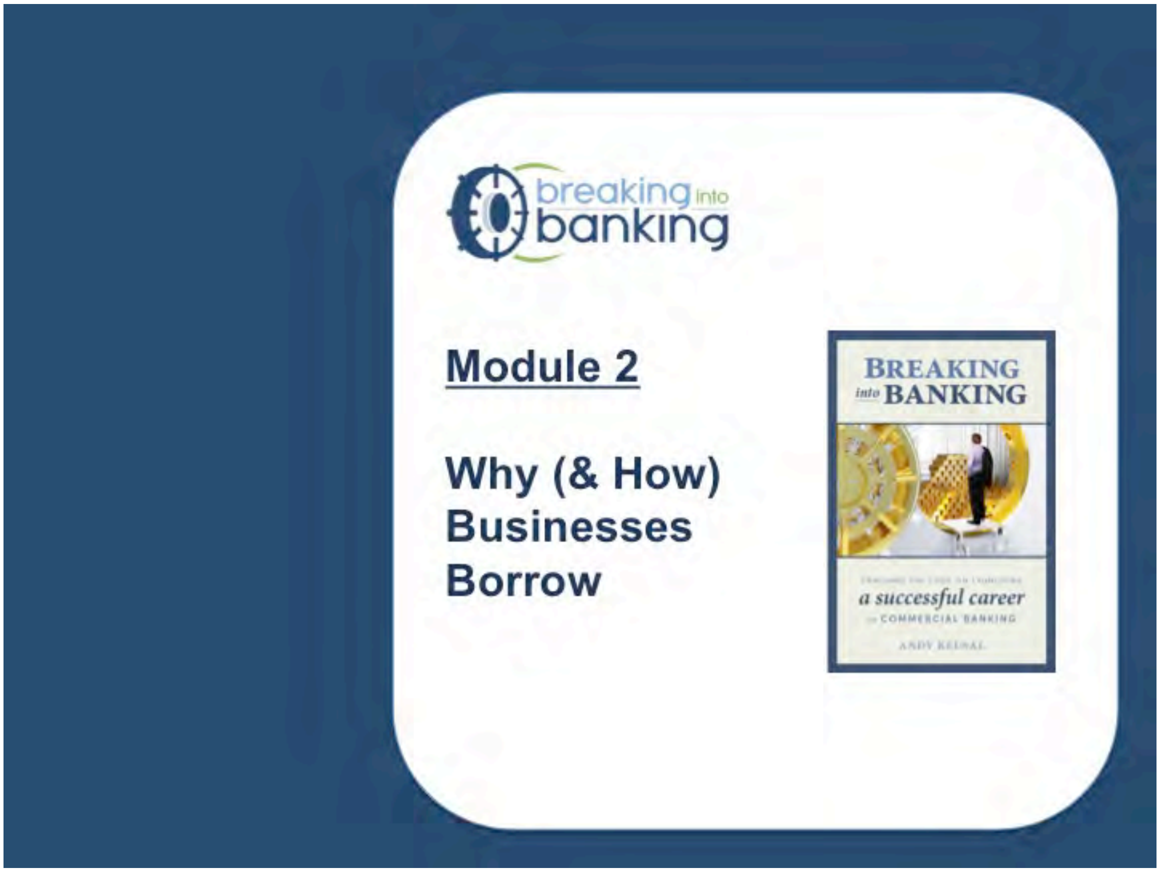
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Module 2
Why (& How) Businesses Borrow
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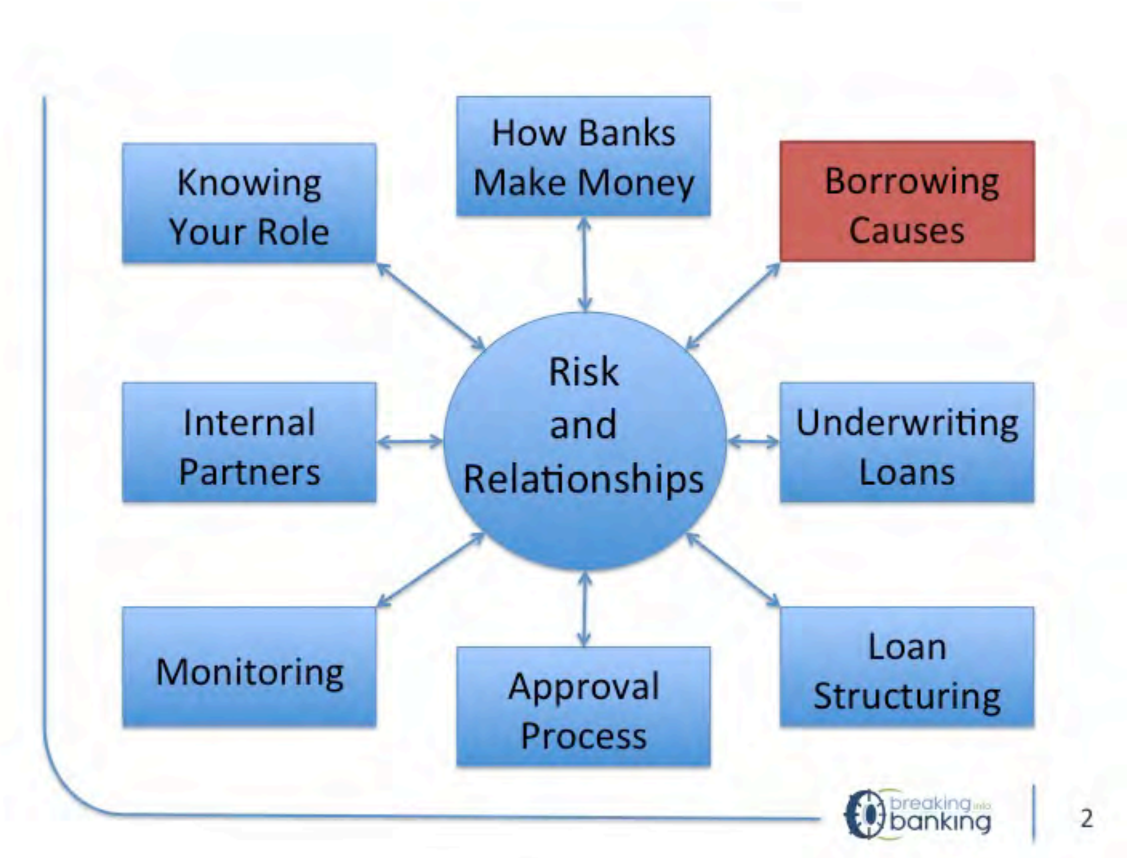
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Key Concepts in Module 2:

- Define / Explain Cash and Cash Flow
- Understand typical borrowing needs
  - ….and their respective facility types
- How loans are repaid (only CASH)

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Cash is King

- Why companies borrow – they need cash!
- People start businesses to generate cash flow

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But Cash Also Goes Out…

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Where Does the Cash Go?

- Normal operating (SG&A) expenses
- Income taxes
- Debt service
- Operating cycle eats it up
- Buying expensive stuff
- Distributions / dividends to owners
- Others not part of ordinary business….

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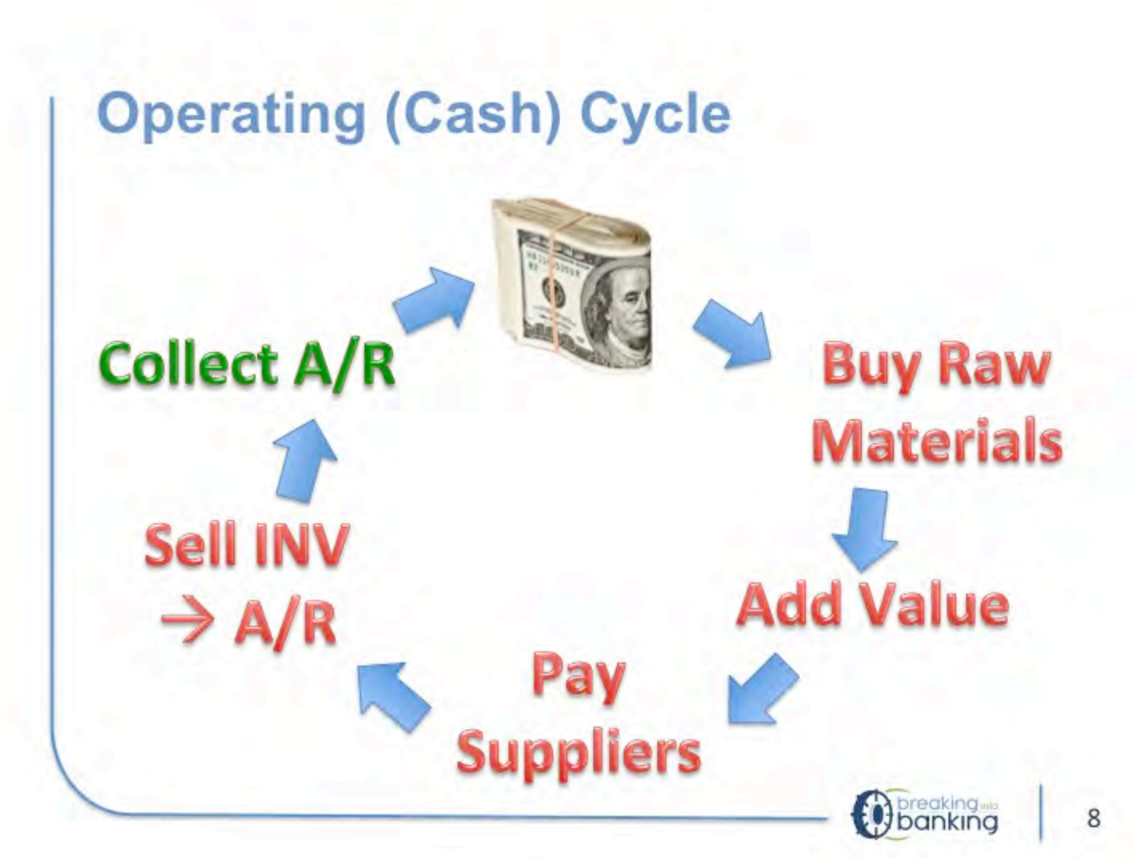
Working Capital
& Fixed Assets


Operating (Cash) Cycle
Collect A/R
Buy Raw Materials
Add Value
Pay Suppliers
Sell INV → A/R
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Working Capital Financing

- Increase Inventory and A/R
- Seasonality
- INV opportunities
- Financed with line of credit

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Capital Expenditures (Cap Ex)

- Increase equipment, vehicles, fixtures
- Financed with term debt (and equity)
- *Maintenance* vs. *Growth* Cap Ex

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Real Estate

- Existing Land / buildings; construction

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Real Estate

- Land & building or construction

Other Common Borrowing Needs

- Consider repayment sources for each:
- Refinancing debt at another bank
- Start-ups – risky!
- Acquisitions
- Owner buyouts / recaps
- Operating Losses

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Key Takeaways: Module 2

- Many *different* needs, facility types, and repayment sources
- Drill down to determine true need
- Banks don't want to finance all needs
- Borrowing is a source of cash, and only cash repays loans

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For Further Learning: Module 2

- Consider each borrowing need from an accounting viewpoint:
- What impact will borrowing the money have on the company's Balance Sheet?

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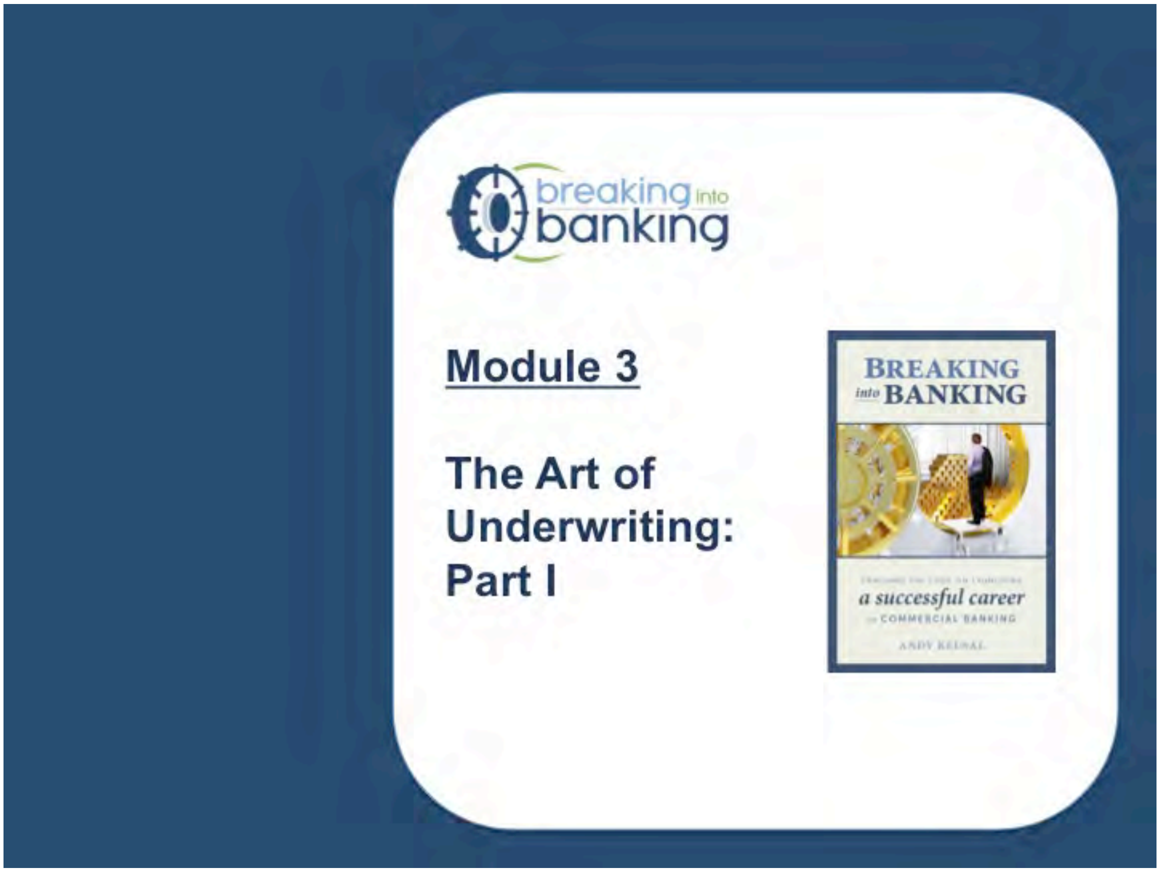
Borrowing Need	Change in Assets	Change in Liabilities & Equity
Buy Inventory		
Finance A/R		
Purchase Fixed Assets (Cap Ex)		
Refinance Debt		
Start-up Expenses		
Acquisition of another business		
Owner Buyout		
Finance Operating Losses		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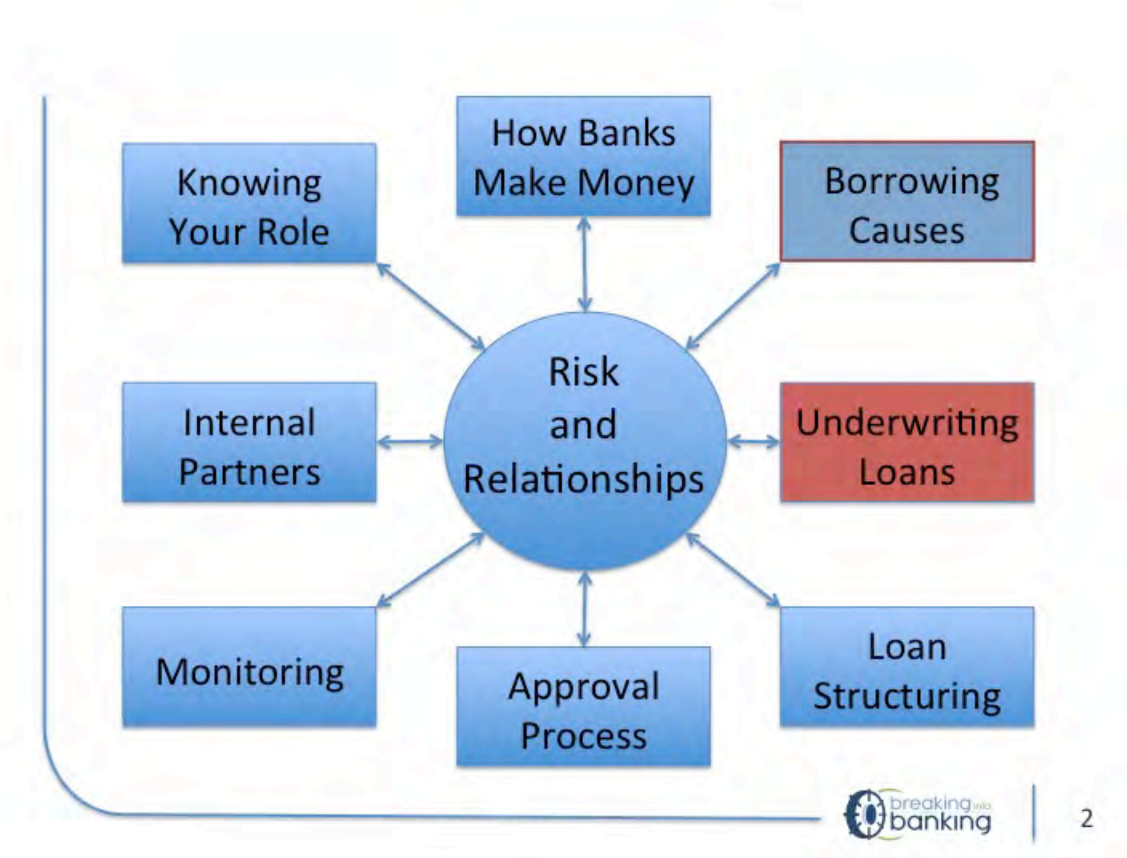
Module 3
The Art of Underwriting: Part I
BREAKING into BANKING
a successful career
COMMERCIAL BANKING


How Banks Make Money
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Key Concepts in Module 3:

- Define “Underwriting”
- Qualitative analysis and why we start there
- Understanding the industry
- Business life cycle considerations
- Quality of management

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Signing onto Risk

- Why "*underwriting*"?
- Ask questions
- $1,000 personal loan
- Be skeptical!

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The 5 C's of Credit

Conditions:	Qualitative factors impacting a borrower's financial performance Do the borrower's non-financial indicators predict success?
Character:	Borrower's intent and willingness to honor the loan agreement Do you trust your borrower?
Capital:	Borrower's equity or willingness to share in the risk Does the borrower have "skin in the game?"
Capacity:	Sufficiency of borrower's cash flow to service its obligations Are the borrower's coverage ratios acceptable?
Collateral:	Bank's backup plan if borrower cannot repay its loan Will the borrower pledge its assets to make the bank whole?

The Five C's of Credit

- Conditions
- Character
- Capacity
- Capital
- Collateral

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Qualitative Factors (Conditions & Character)

Industry Considerations

- Trajectory of overall industry
- Cyclicality (economic)
- Counter-cyclicality
- Seasonality (within calendar year)

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Industry Considerations

- Segments and sub-segments of each industry

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Industry Considerations

- Expertise / specialization needed: Filmmaking

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Industry Considerations

- Expertise / specialization needed: Race Horses

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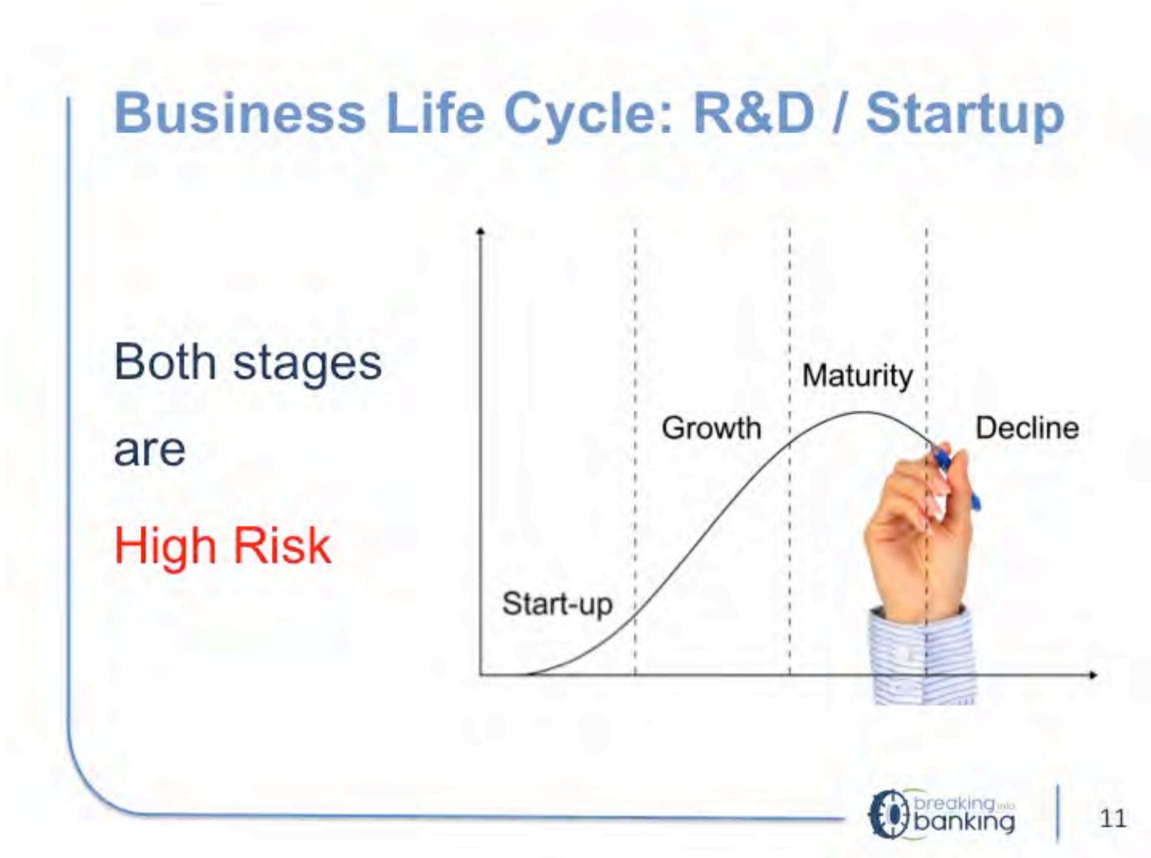
Business Life Cycle: R&D / Startup
Both stages
are
High Risk
Maturity
Growth
Decline
Start-up
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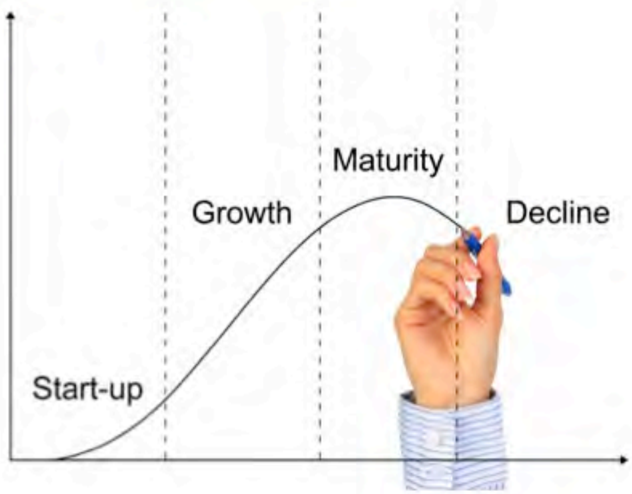
Business Life Cycle: Growth

- Business owners love growth
- But Growth uses cash (A/R & INV)



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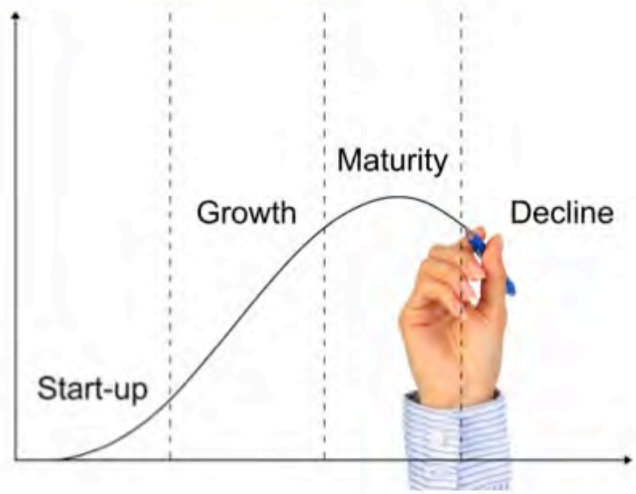
Business Life Cycle: Maturity

- Predictable revenues & cash flow
- Sweet spot for bankers



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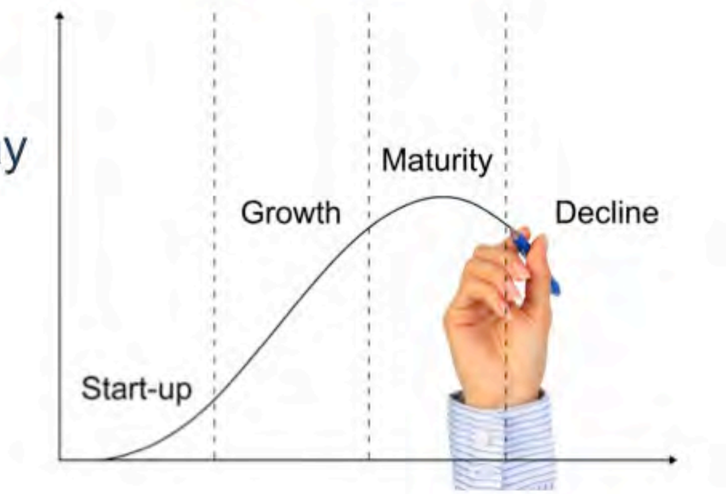
Business Life Cycle: Decline

- Riskier
- Lending may still make sense



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Quality of Management

- Bet on the jockey, not the horse
- What does it really mean?
  - Competence
  - Experience
  - Reputation
- Character matters

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Key Takeaways: Module 3

- Ask plenty of questions
- Character matters
- Understand the Industry
- Mature companies are most bankable
- Bet on the jockey, not on the horse

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For Further Learning: Module 3

- Test it out on your brother-in-law by asking to borrow $1,000 from him
  - Watch the underwriting process begin!
  - What questions does he ask you?
- Have you ever lent money? Been stiffed? Was it due to financial reasons or character issues?

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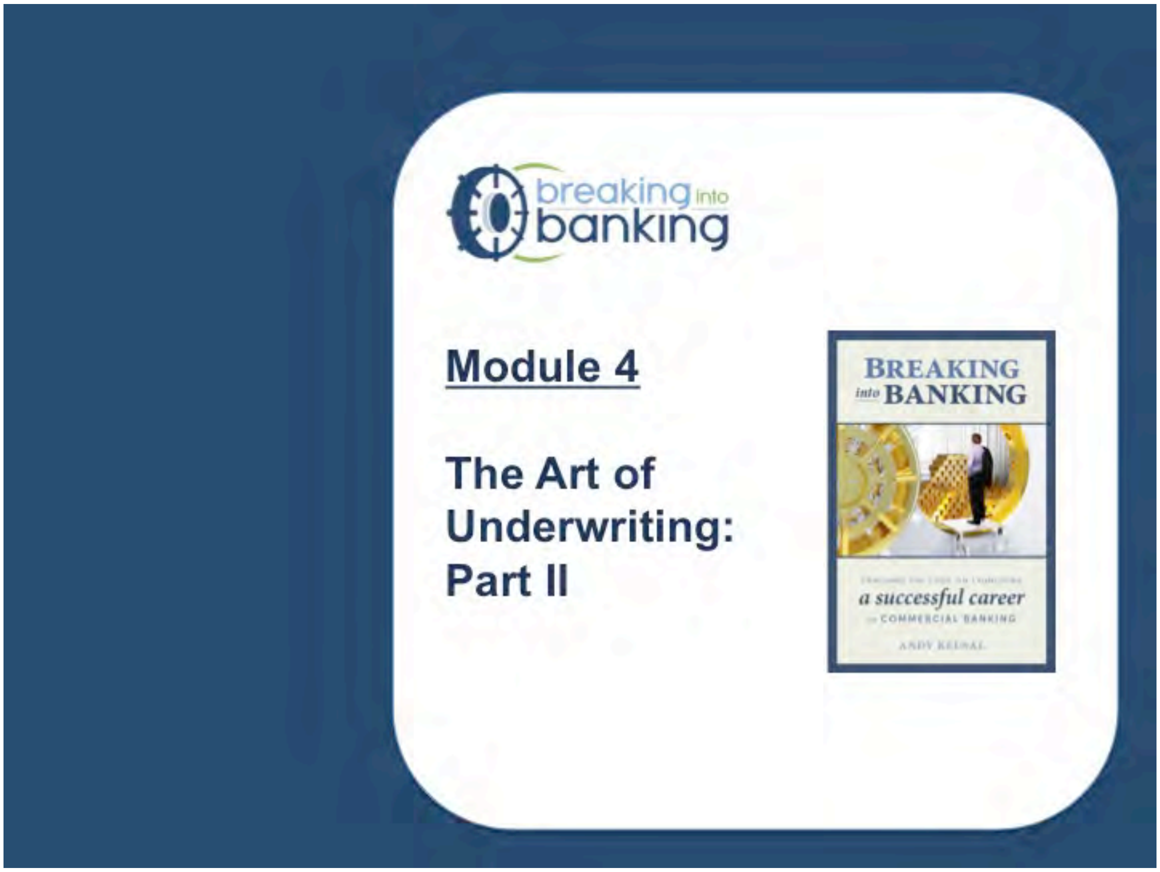
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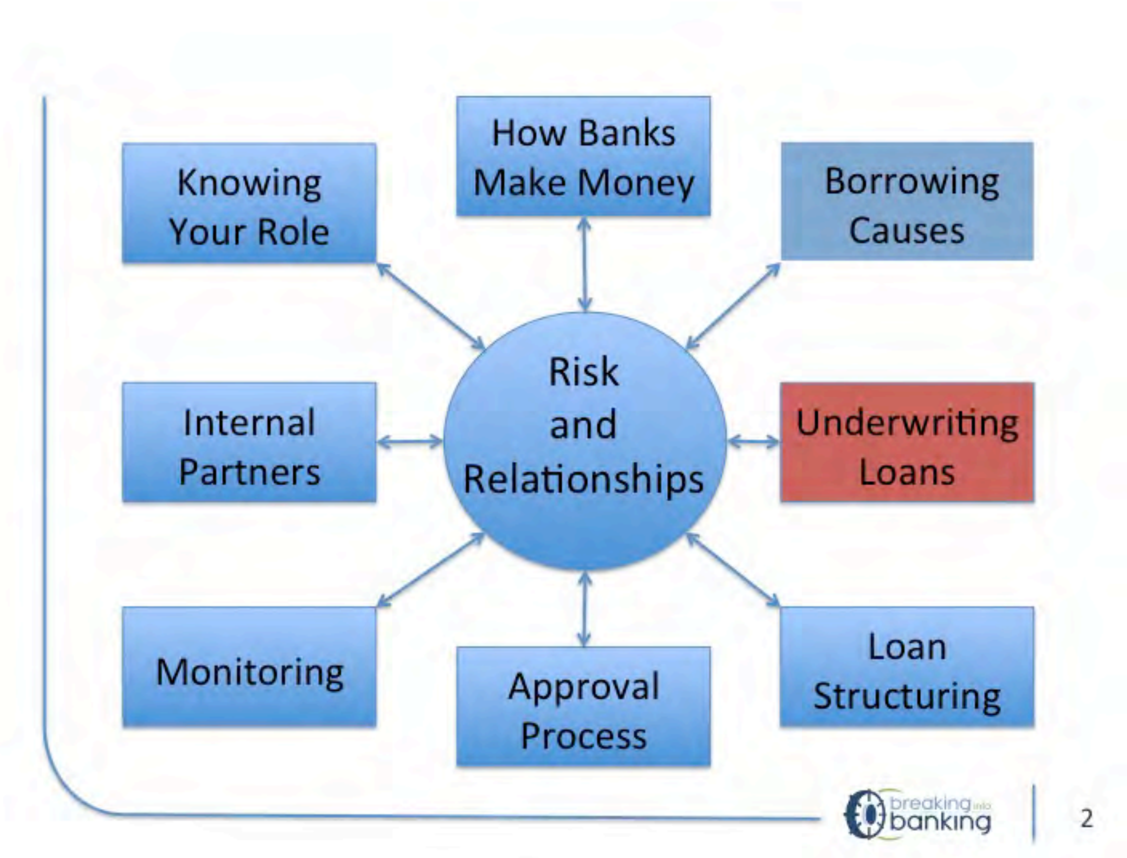
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Key Concepts in Module 4:

- Quantitative vs. qualitative analysis
- Why quantitative is key to underwriting
- Balance sheet analysis
- Income statement analysis
- The “art”: finding a way to make it work

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Keys to Quantitative Analysis:

- Quantitative vs. Qualitative
- How can we know if the company will repay?
  - Trust the borrower
  - Hope
  - Hire lawyers

4

Keys to Quantitative Analysis:

- Don't believe borrower's projections
- Best predictor of future: past (historical)
- Analyze historical financial statements

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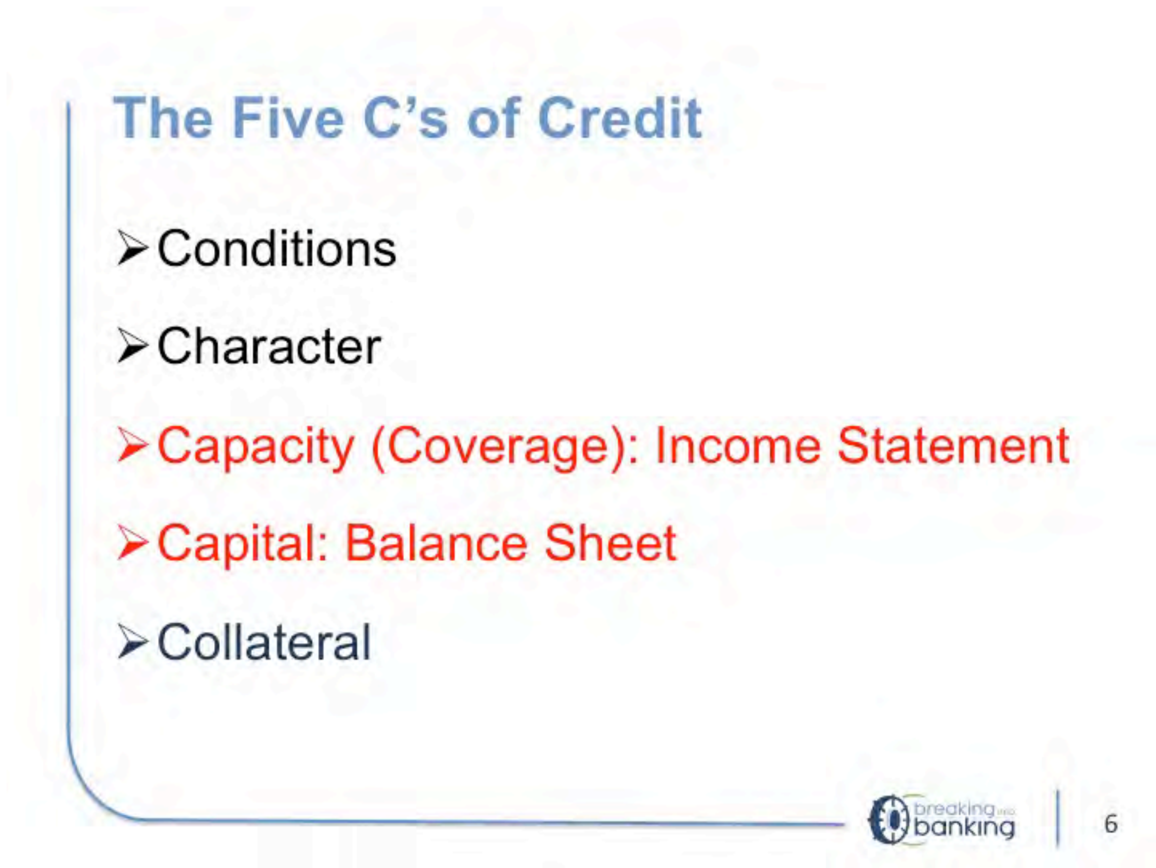
The Five C's of Credit
➢Conditions
➢Character
➢Capacity (Coverage): Income Statement
➢Capital: Balance Sheet
➢Collateral
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What Financial Statements Tell Us

- Can't analyze them independently

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What Financial Statements Tell Us

- Income Statement
  - aka Profit & Loss statement
  - "Financial *performance*"
  - Over a *period of time*
  - Summary of revenue and expenses
  - Profits (primary source of cash flow)

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What Financial Statements Tell Us

- Balance Sheet
  - "Financial *condition*"
  - At one *point* in time
  - aka statement of assets & claims
  - Shows how a company can access cash
  - Highlights who owns the most risk

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What Financial Statements Tell Us

- Cash Flow statement
  - Strips away effects of accrual accounting to show every dollar of actual cash in and out of company

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Number Crunching 101

- Most banks use "spreading" software for consistent presentation

Detailed Comprehensive Income Statement - Actual and %

GGH Company, Inc. Amounts Printed in Thousands
Industry Classification: NAICS Code: 123456

Statement Date	12/31/20X1		12/31/20X2		12/31/20X3	
Months Covered	12		12		12	
Audit Method	Reviewed		Reviewed		Reviewed	
Accountant	C. Brown, CPA		C. Brown, CPA		C. Brown, CPA	
Analyst	KTA		KTA		KTA	
Stmt Type	Annual		Annual		Annual	
SALES / REVENUE	$156,510	100.0	$170,920	100.0	$183,335	100.0
Cost of Goods Sold	87,319	55.8	99,014	57.9	111,996	61.1
GROSS PROFIT	69,191	44.2	71,906	42.1	71,339	38.9
SG&A Expense	11,040	7.1	12,558	7.3	12,993	7.1
Depreciation	2,381	1.5	3,875	2.3	5,041	2.7
TOTAL OPERATING EXP	13,421	8.6	16,433	9.6	18,034	9.8
NET OPERATING PROFIT	55,770	35.6	55,473	32.5	53,305	29.1
Interest Expense	2,016	1.3	1,993	1.2	1,802	1.0
Other Income	441	0.3	312	0.2	711	0.4
PROFIT BEFORE TAXES	54,195	34.6	53,792	31.5	52,214	28.5
Current Income Tax	15,175	9.7	15,062	8.8	14,620	8.0
NET PROFIT	$39,020	24.9	$38,730	22.7	$37,594	20.5

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Detailed Comprehensive Income Statement - Actual and %

GGH Company, Inc. Amounts Printed in Thousands
Industry Classification: NAICS Code: 123456

Statement Date	12/31/20X1		12/31/20X2		12/31/20X3	
Months Covered	12		12		12	
Audit Method	Reviewed		Reviewed		Reviewed	
Accountant	C. Brown, CPA		C. Brown, CPA		C. Brown, CPA	
Analyst	KTA		KTA		KTA	
Stmt Type	Annual		Annual		Annual	
SALES / REVENUE	$156,510	100.0	$170,920	100.0	$183,335	100.0
Cost of Goods Sold	87,319	55.8	99,014	57.9	111,996	61.1
GROSS PROFIT	69,191	44.2	71,906	42.1	71,339	38.9
SG&A Expense	11,040	7.1	12,558	7.3	12,993	7.1
Depreciation	2,381	1.5	3,875	2.3	5,041	2.7
TOTAL OPERATING EXP	13,421	8.6	16,433	9.6	18,034	9.8
NET OPERATING PROFIT	55,770	35.6	55,473	32.5	53,305	29.1
Interest Expense	2,016	1.3	1,993	1.2	1,802	1.0
Other Income	441	0.3	312	0.2	711	0.4
PROFIT BEFORE TAXES	54,195	34.6	53,792	31.5	52,214	28.5
Current Income Tax	15,175	9.7	15,062	8.8	14,620	8.0
NET PROFIT	$39,020	24.9	$38,730	22.7	$37,594	20.5

Number Crunching 101

- The numbers tell a story
- Four levels of analysis:
  - Raw numbers
  - Trends over time
  - Drivers – find out why
  - Impact on (company's) cash flow

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Number Crunching 101

Step 1: Look at the raw numbers

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Number Crunching 101

Step 2: Look for **trends** over time

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Number Crunching 101

Caution:
Avoid
"elevator
analysis"

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Number Crunching 101

<u>Step 3</u>: Find the **drivers** behind the numbers

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Number Crunching 101

Step 4: Explore the **impact** of the numbers on the borrower's **cash flow**

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Number Crunching 101

- Raw numbers
- Trends over time
- Drivers – Why?
- Cash flow impact

Detailed Comprehensive Income Statement - Actual and %

GGH Company, Inc. — Amounts Printed in Thousands
Industry Classification: NAICS Code: 123456

Statement Date	12/31/20X1		12/31/20X2		12/31/20X3	
Months Covered	12		12		12	
Audit Method	Reviewed		Reviewed		Reviewed	
Accountant	C. Brown, CPA		C. Brown, CPA		C. Brown, CPA	
Analyst	KTA		KTA		KTA	
Stmt Type	Annual		Annual		Annual	
SALES / REVENUE	$156,510	100.0	$170,920	100.0	$183,335	100.0
Cost of Goods Sold	87,319	55.8	99,014	57.9	111,996	61.1
GROSS PROFIT	69,191	44.2	71,906	42.1	71,339	38.9
SG&A Expense	11,040	7.1	12,558	7.3	12,993	7.1
Depreciation	2,381	1.5	3,875	2.3	5,041	2.7
TOTAL OPERATING EXP	13,421	8.6	16,433	9.6	18,034	9.8
NET OPERATING PROFIT	55,770	35.6	55,473	32.5	53,305	29.1
Interest Expense	2,016	1.3	1,993	1.2	1,802	1.0
Other Income	441	0.3	312	0.2	711	0.4
PROFIT BEFORE TAXES	54,195	34.6	53,792	31.5	52,214	28.5
Current Income Tax	15,175	9.7	15,062	8.8	14,620	8.0
NET PROFIT	$39,020	24.9	$38,730	22.7	$37,594	20.5

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Income Statement – Margins

- Percentages ("margins") matter more than raw numbers

Detailed Comprehensive Income Statement - Actual and %

GGH Company, Inc.
Industry Classification: NAICS Code: 123456

Amounts Printed in Thousands

Statement Date	12/31/20X1		12/31/20X2		12/31/20X3	
Months Covered	12		12		12	
Audit Method	Reviewed		Reviewed		Reviewed	
Accountant	C. Brown, CPA		C. Brown, CPA		C. Brown, CPA	
Analyst	KTA		KTA		KTA	
Stmt Type	Annual		Annual		Annual	
SALES / REVENUE	$156,510	100.0	$170,920	100.0	$183,335	100.0
Cost of Goods Sold	87,319	55.8	99,014	57.9	111,996	61.1
GROSS PROFIT	69,191	44.2	71,906	42.1	71,339	38.9
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NET PROFIT	$39,020	24.9	$38,730	22.7	$37,594	20.5

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Imagine that GGH Company is a clothing retailer with 100 store locations nationwide. Let's analyze the company's gross profit and gross profit margin.

Look at the raw dollar amount of gross profit for each of the three years. What do these numbers tell you?

Now look at the gross margins for each year and answer these questions:

Is there a trend in the gross margin figures? If so, what is it?

What are two possible reasons for the trend you observed in gross margin?

In general, what is the impact of this trend on the company's *cash flow*?

Bonus Question: Calculate what the company's gross profit would have been in year 3 if its gross margin had been the same as it was in year 1.

Income Statement - Capacity

Q. Is cash flow sufficient to cover all claims?

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Income Statement - Capacity

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Detailed Comprehensive Income Statement - Actual and %

GGH Company, Inc. Amounts Printed in Thousands
Industry Classification: NAICS Code: 123456

Statement Date	12/31/20X1		12/31/20X2		12/31/20X3	
Months Covered	12		12		12	
Audit Method	Reviewed		Reviewed		Reviewed	
Accountant	C. Brown, CPA		C. Brown, CPA		C. Brown, CPA	
Analyst	KTA		KTA		KTA	
Stmt Type	Annual		Annual		Annual	
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NET PROFIT	$39,020	24.9	$38,730	22.7	$37,594	20.5

EBITDA Calculation:

Net Profit
+ Income Tax Expense
+ Interest Expense
+ Depreciation Expense
= EBITDA

Income Statement - Capacity

- Q. Is the borrower generating enough cash flow to pay all of its claims?
- Cash flow = EBITDA
- Most important claim: bank debt!

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Income Statement - Capacity

Debt Service Coverage (DSC) Ratio:

$$\frac{\text{EBITDA}}{\text{Debt Service}} = \frac{\text{Pre-tax Profit + Interest exp + Depreciation exp}}{\text{Required Principal and Interest payments}}$$

Income Statement - Capacity

- What about all *other* claims?
- Can they cover all fixed charges?
- Taxes, Debt Service, Owners, Cap Ex
- Commonly used in loan covenants

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Income Statement - Capacity

Fixed Charge Coverage (FCC) Ratio:

$$\frac{\text{EBITDA}}{\text{Fixed Charges}} = \frac{\text{Pre-tax Profit + Interest exp + Depreciation exp}}{\text{Taxes + Debt Service + Owner Dist. + CapEx}}$$

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Balance Sheet - Liquidity

- Q. How can company obtain cash?
  - Convert current assets (A/R & INV)
  - Measure w/ Current / Quick Ratios
  - Consider quality & liquidity of assets
  - Drawing up line of credit

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Balance Sheet - Leverage

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Balance Sheet - Leverage

- Questions:
  - Who owns the most risk in the agreement?
  - Do earnings support the level of debt?

Personal Balance Sheet

Assets		**Liabilities**		
Home	$100,000	Mortgage Loan	$80,000	
		Equity	$20,000	
Totals	$100,000		$100,000	

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Balance Sheet - Leverage

- Most common ratios:
  - Debt / Equity (Balance Sheet leverage)
  - Debt / EBITDA (Cash Flow leverage)
- Too much leverage → high risk for bank

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Decision Time: Yes or No?

- Consider both qualitative & quantitative
- Numbers rarely look perfect
- Be cautious, but look for a way to do it

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Key Takeaways: Module 4

- The numbers must work
- Best predictor of future performance is past performance
- Be wary of borrower's projections

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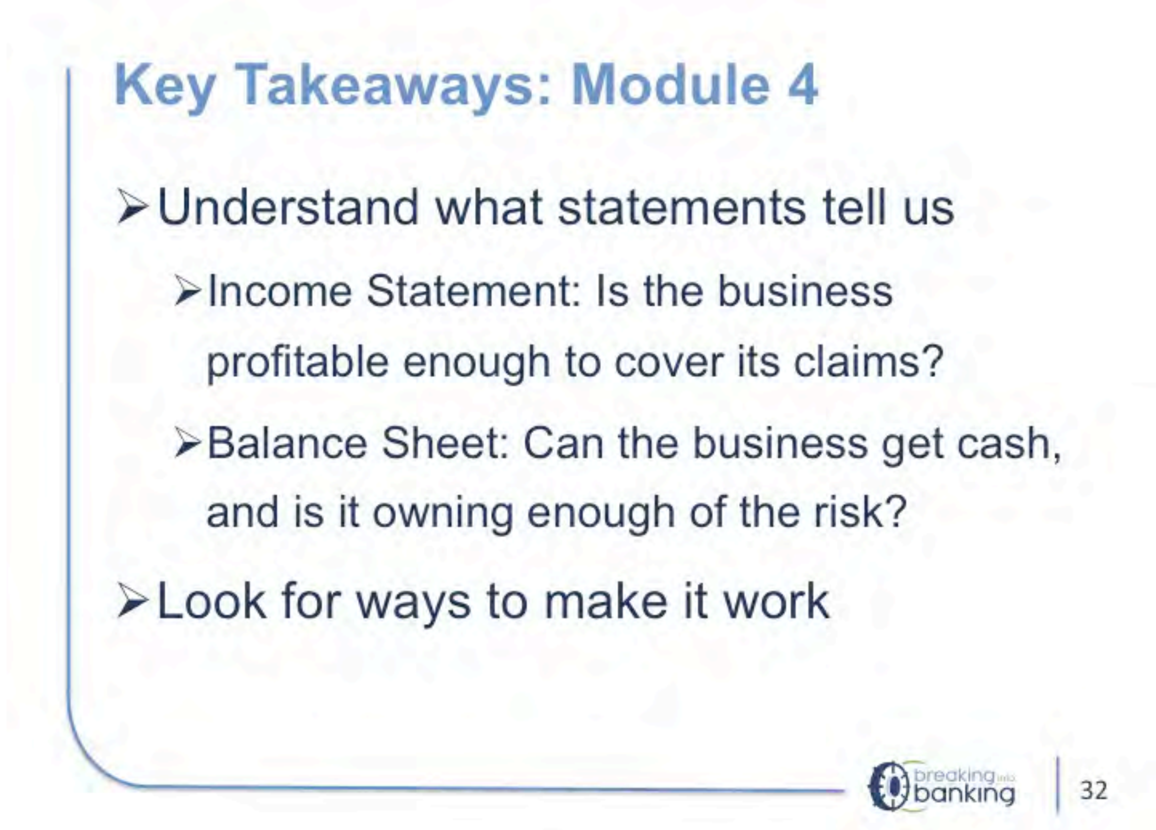
Key Takeaways: Module 4
➢Understand what statements tell us
➢Income Statement: Is the business profitable enough to cover its claims?
➢Balance Sheet: Can the business get cash, and is it owning enough of the risk?
➢Look for ways to make it work
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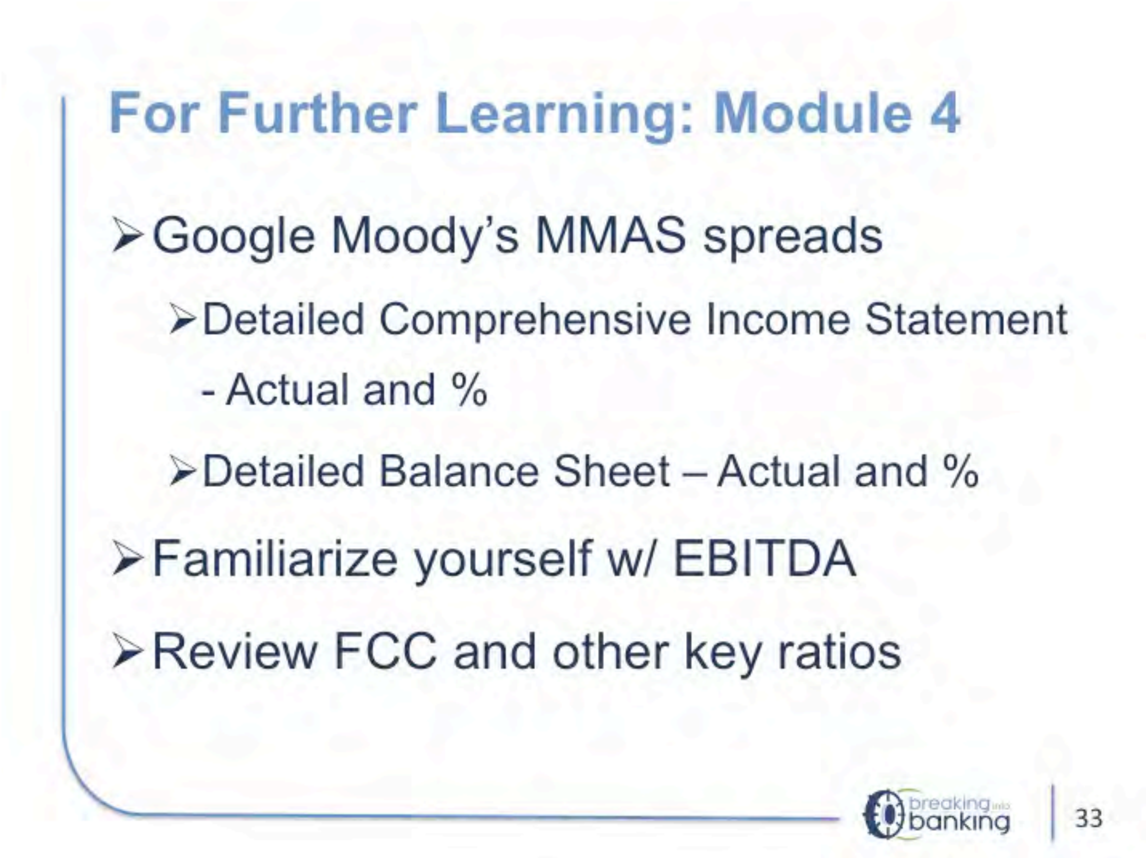
For Further Learning: Module 4
➢Google Moody's MMAS spreads
➢Detailed Comprehensive Income Statement - Actual and %
➢Detailed Balance Sheet – Actual and %
➢Familiarize yourself w/ EBITDA
➢Review FCC and other key ratios
breaking into banking
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Detailed Balance Sheet – Actual and %

MMAS Sample Customer (MMASSample) Prepared: 17:58, 9/22/2005
Detailed Balance Sheet - Actual and % Amounts Printed in: Thousands
Industry Classification: NAICS Code: 315228 MMAS (3.1.6.0)

Statement Date	6/30/2001		6/30/2002		6/30/2003		6/30/2004		6/30/2005	
Months Covered	12		12		12		12		12	
Audit Mthd	Unqualif'd		Unqualif'd		Unqualif'd		Unqualif'd		Unqualif'd	
Accountant	KPMG		KPMG		KPMG		KPMG		KPMG	
Analyst	GJH		GJH		GJH		GJH		GJH	
Stmt Type	Annual		Annual		Annual		Annual		Annual	

Source Currency: USD United States Dollars Target Currency: USD United States Dollars

CURRENT ASSETS										
Cash	71	1.7	121	2.4	144	3.1	90	1.8	75	1.2
Accts/Notes Rec-Trade	1,424	34.0	1,744	34.9	1,669	36.0	1,842	35.9	1,698	27.2
Bad Debt Reserve (-)	54	1.3	54	1.1	64	1.4	86	1.7	90	1.4
Total Accts/Rec-Net	1,370	32.7	1,690	33.9	1,605	34.6	1,756	34.2	1,608	25.8
Inventory	1,936	46.3	2,211	44.3	2,141	46.2	2,610	50.8	3,056	49.0
Prepaid Expenses	88	2.1	77	1.5	59	1.3	119	2.3	131	2.1
TOTAL CURRENT ASSETS	3,465	82.8	4,099	82.1	3,949	85.2	4,575	89.1	4,870	78.1
NON-CURRENT ASSETS										
Property Plant & Equipment	1,644	39.3	1,885	37.8	1,922	41.5	2,011	39.2	2,957	47.4
Furniture, Fixtures & Vehicles	182	4.3	282	5.7	356	7.7	421	8.2	568	9.1
Gross Fixed Assets	1,826	43.6	2,167	43.4	2,278	49.1	2,432	47.4	3,525	56.5
Accumulated Deprec (-)	1,161	27.7	1,412	28.3	1,675	36.1	1,912	37.2	2,205	35.4
Total Fixed Assets - Net	665	15.9	755	15.1	603	13.0	520	10.1	1,320	21.2
Cash Value Life Insurance	12	0.3	14	0.3	18	0.4	20	0.4	22	0.4
Other Assets	42	1.0	122	2.4	66	1.4	20	0.4	22	0.4
TOTAL NON-CURRENT ASSETS	719	17.2	891	17.9	687	14.8	560	10.9	1,364	21.9
TOTAL ASSETS	4,184	100.0	4,990	100.0	4,636	100.0	5,135	100.0	6,234	100.0
CURRENT LIABILITIES										
Note Payable - Bank	433	10.3	1,200	24.0	1,148	24.8	1,134	22.1	1,475	23.7
CPLTD-Bank	199	4.8	226	4.5	142	3.1	115	2.2	169	2.7
Accounts Payable-Trade	651	15.6	832	16.7	583	12.6	980	19.1	1,139	18.3
Accrued Expenses	277	6.6	236	4.7	214	4.6	222	4.3	281	4.5
Income Taxes Payable	-	-	-	-	30	0.6	-	-	-	-
TOTAL CURRENT LIABILITIES	1,560	37.3	2,494	50.0	2,117	45.7	2,451	47.7	3,064	49.1
NON-CURRENT LIABILITIES										
Long Term Debt	907	21.7	860	17.2	630	13.6	492	9.6	1,347	21.6
TOTAL NON-CURRENT LIABILITIES	907	21.7	860	17.2	630	13.6	492	9.6	1,347	21.6
TOTAL LIABILITIES	2,467	59.0	3,354	67.2	2,747	59.3	2,943	57.3	4,411	70.8
NET WORTH										
Common Stock	17	0.4	17	0.3	17	0.4	17	0.3	17	0.3
Retained Earnings	1,700	40.6	1,619	32.4	1,872	40.4	2,175	42.4	1,806	29.0
TOTAL NET WORTH	1,717	41.0	1,636	32.8	1,889	40.7	2,192	42.7	1,823	29.2
TOTAL LIABILITIES & NET WORTH	4,184	100.0	4,990	100.0	4,636	100.0	5,135	100.0	6,234	100.0
Working Capital	1,905	45.5	1,605	32.2	1,832	39.5	2,124	41.4	1,806	29.0
Tang Net Worth-Actual	1,717	41.0	1,636	32.8	1,889	40.7	2,192	42.7	1,823	29.2

Detailed Comprehensive Income Statement – Actual and %

MMAS Sample Customer (MMASSample) Prepared: 17:58, 9/22/2005
Detailed Comprehensive Income Statement - Actual and % Amounts Printed in: Thousands
Industry Classification: NAICS Code: 315228 MMAS (3.1.6.0)

Statement Date	6/30/2001		6/30/2002		6/30/2003		6/30/2004		6/30/2005	
Months Covered	12		12		12		12		12	
Audit Mthd	Unqualif'd		Unqualif'd		Unqualif'd		Unqualif'd		Unqualif'd	
Accountant	KPMG		KPMG		KPMG		KPMG		KPMG	
Analyst	GJH		GJH		GJH		GJH		GJH	
Stmt Type	Annual		Annual		Annual		Annual		Annual	

Source Currency: USD United States Dollars Target Currency: USD United States Dollars

Net Sales - Manufacturing Division	9,785	98.7	9,523	95.5	9,477	90.0	9,564	80.7	9,317	75.0
Net Sales - Catalog Division	126	1.3	445	4.5	1,058	10.0	2,284	19.3	3,102	25.0
NET SALES/REVENUE	9,911	100.0	9,968	100.0	10,535	100.0	11,848	100.0	12,419	100.0
Cost of Goods Sold	7,311	73.8	7,477	75.0	7,739	73.5	8,552	72.2	9,468	76.2
Cost of Goods Sold - Depreciation	155	1.6	209	2.1	239	2.3	224	1.9	273	2.2
TOTAL COST OF SALES/REV	7,466	75.3	7,686	77.1	7,978	75.7	8,776	74.1	9,741	78.4
GROSS PROFIT	2,445	24.7	2,282	22.9	2,557	24.3	3,072	25.9	2,678	21.6
SG & A Expense	1,843	18.6	2,032	20.4	2,114	20.1	2,454	20.7	2,755	22.2
Depreciation	19	0.2	15	0.2	13	0.1	17	0.1	21	0.2
TOTAL OPERATING EXPENSE	1,862	18.8	2,047	20.5	2,127	20.2	2,471	20.9	2,776	22.4
NET OPERATING PROFIT	583	5.9	235	2.4	430	4.1	601	5.1	(98)	(0.8)
Interest Expense (-)	68	0.7	126	1.3	147	1.4	153	1.3	306	2.5
Other Income	14	0.1	46	0.5	47	0.4	32	0.3	35	0.3
Gain(Loss) on Asset Sale	42	0.4	2	-	-	-	13	0.1	-	-
TOTAL OTHER INCOME(EXP)	(12)	(0.1)	(78)	(0.8)	(100)	(0.9)	(108)	(0.9)	(271)	(2.2)
PROFIT BEFORE TAXES	571	5.8	157	1.6	330	3.1	493	4.2	(369)	(3.0)
Current Income Tax	122	1.2	31	0.3	77	0.7	144	1.2	-	-
NET PROFIT	449	4.5	126	1.3	253	2.4	349	2.9	(369)	(3.0)
EBIT	639	6.4	283	2.8	477	4.5	646	5.5	(63)	(0.5)
EBITDA	813	8.2	507	5.1	729	6.9	887	7.5	231	1.9
EBIDA	691	7.0	476	4.8	652	6.2	743	6.3	231	1.9
COMPREHENSIVE INCOME	449	4.5	126	1.3	253	2.4	349	2.9	(369)	(3.0)
Dividends - Common	(27)		(207)		-		(46)		-	
Adj to Retained Earnings	(40)		-		-		-		-	

Detailed Reconciliations

MMAS Sample Customer (MMASSample)
Detailed Reconciliations
Industry Classification: NAICS Code: 315228

Prepared: 17:58, 9/22/2005
Amounts Printed in: Thousands
MMAS (3.1.6.0)

Statement Date	6/30/2001	6/30/2002	6/30/2003	6/30/2004	6/30/2005
Months Covered	12	12	12	12	12
Analyst	GJH	GJH	GJH	GJH	GJH
Stmt Type	Annual	Annual	Annual	Annual	Annual
Reconciliation of Retained Earnings					
BEGINNING RETAINED EARNINGS, AS PREVIOUSLY REPORTED		1,700	1,619	1,872	2,175
BEG RET. EARNINGS, RESTATED		1,700	1,619	1,872	2,175
Net Profit		126	253	349	(369)
Dividends - Common		(207)	-	(46)	-
ENDING RETAINED EARNINGS		1,619	1,872	2,175	1,806
Reconciliation of Net Worth					
BEGINNING NET WORTH		1,717	1,636	1,889	2,192
Net Profit		126	253	349	(369)
Div & Withdrawals-Cash		(207)	-	(46)	-
ACTUAL ENDING NET WORTH		1,636	1,889	2,192	1,823
INCR(DECR) IN NET WORTH		(81)	253	303	(369)
Reconciliation of Working Capital					
BEGINNING WORKING CAPITAL		1,905	1,605	1,832	2,124
Decrease(Increase) in Non-Current Assets:					
Total Fixed Assets-Net		(90)	152	83	(800)
Cash Value Life Insurance		(2)	(4)	(2)	(2)
Other Assets		(80)	56	46	(2)
Increase(Decrease) in Non-Current Liabilities:					
Long Term Debt		(47)	(230)	(138)	855
Increase(Decrease) in Net Worth		(81)	253	303	(369)
ENDING WORKING CAPITAL		1,605	1,832	2,124	1,806

Detailed Ratios

MMAS Sample Customer (MMASSample) Prepared: 17:58, 9/22/2005
Detailed Ratios Amounts Printed in: Thousands
Industry Classification: NAICS Code: 315228 MMAS (3.1.6.0)

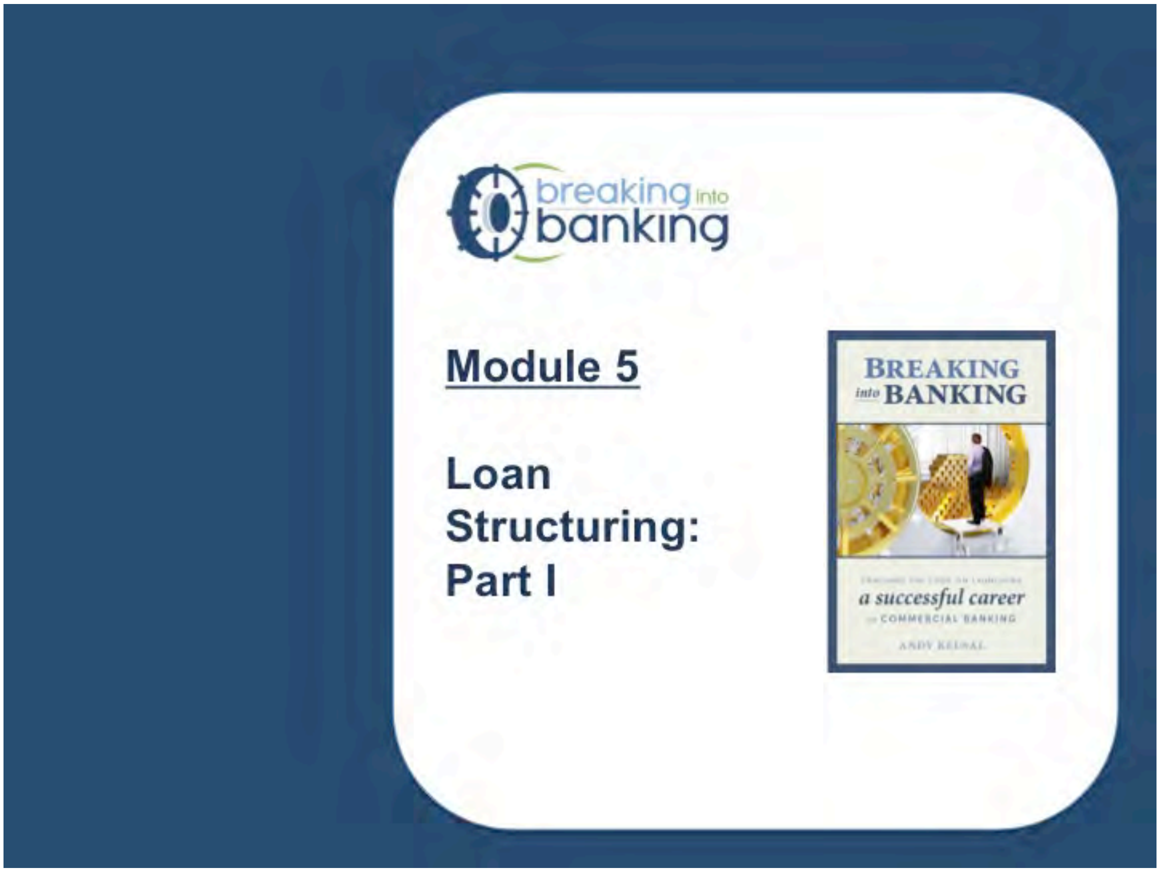
Statement Date	6/30/2001	6/30/2002	6/30/2003	6/30/2004	6/30/2005
Months Covered	12	12	12	12	12
Analyst	GJH	GJH	GJH	GJH	GJH
Stmt Type	Annual	Annual	Annual	Annual	Annual
LIQUIDITY					
Working Capital	1,905	1,605	1,832	2,124	1,806
Quick Ratio	0.92	0.73	0.83	0.75	0.55
Current Ratio	2.22	1.64	1.87	1.87	1.59
Net Sales/Working Capital	5.20	6.21	5.75	5.58	6.88
LEVERAGE					
Net Worth-Actual	1,717	1,636	1,889	2,192	1,823
Tang Net Worth-Actual	1,717	1,636	1,889	2,192	1,823
Eff Tang Net Worth-Actual	1,717	1,636	1,889	2,192	1,823
Debt/Worth	1.44	2.05	1.45	1.34	2.42
Debt/Tang Worth	1.44	2.05	1.45	1.34	2.42
Debt Less Sub Debt-Liability/Eff Tg Wth	1.44	2.05	1.45	1.34	2.42
Borrowed Funds/Eff Tg Worth	0.90	1.40	1.02	0.79	1.64
LT Debt/Net Fixed Assets	1.66	1.44	1.28	1.17	1.15
Total Liabilities/Total Assets	0.59	0.67	0.59	0.57	0.71
COVERAGE					
Interest Coverage	9.40	2.25	3.24	4.22	(0.21)
Net Income+Depr+Amort-Divs/CPLTD	2.99	0.63	3.56	4.73	(0.44)
Net Income+Depr+Amort-Divs/CPLTD pp		0.72	2.23	3.83	(0.65)
UCA Cash Flow Coverage		0.05	2.02	1.35	0.29
UCA Cash Flow/CPLTD pp		0.06	1.57	1.25	0.33
EBITDA/Interest Exp+CPLTD	3.04	1.44	2.52	3.31	0.49
EBITDA/Interest Exp+CPLTD pp		1.56	1.95	3.01	0.55
EBITDA	813	507	729	887	231
EBIDA	691	476	652	743	231
Fixed Charge Coverage	3.04	1.44	2.52	3.31	0.49
PROFITABILITY (%)					
Return on Assets	10.73	2.53	5.46	6.80	(5.92)
Return on Equity	26.15	7.70	13.39	15.92	(20.24)
Gross Margin	24.67	22.89	24.27	25.93	21.56
Gross Margin (plus Depr) %	26.23	24.99	26.54	27.82	23.76
Operating Expense %	18.79	20.54	20.19	20.86	22.35
Operating Expense (excl Depr) %	18.60	20.39	20.07	20.71	22.18
Operating Profit Margin	5.88	2.36	4.08	5.07	(0.79)
Operating Profit Margin (plus Depr) %	7.64	4.60	6.47	7.11	1.58
Net Margin	4.53	1.26	2.40	2.95	(2.97)
Dividend Payout Rate	6.01	164.29	-	13.18	-
Effective Tax Rate	21.37	19.75	23.33	29.21	-
ACTIVITY					
Gross Accounts Receivable Days	52.44	63.86	57.82	56.75	49.90
Net Accounts Receivable Days	50.45	61.88	55.61	54.10	47.26
Inventory Days on Hand	94.65	105.00	97.95	108.55	114.51
Inventory Days on Hand (excl Depr)	96.65	107.93	100.98	111.39	117.81
Accounts Payable Days	31.83	39.51	26.67	40.76	42.68
Accounts Payable Days (excl Depr)	32.50	40.62	27.50	41.83	43.91
Net Sales/Total Assets	2.37	2.00	2.27	2.31	1.99
Net Sales/Net Worth	5.77	6.09	5.58	5.41	6.81
Net Sales/Net Fixed Assets	14.90	13.20	17.47	22.78	9.41
Profit Before Taxes/Total Assets (%)	13.65	3.15	7.12	9.60	(5.92)
GROWTH (%)					
Total Assets Growth		19.26	(7.09)	10.76	21.40
Total Liabilities Growth		35.95	(18.10)	7.14	49.88
Net Worth Growth		(4.72)	15.46	16.04	(16.83)
Net Sales Growth		0.58	5.69	12.46	4.82
Operating Profit Growth		(59.69)	82.98	39.77	N/A
Net Profit Growth		(71.94)	100.79	37.94	N/A
Sustainable Growth	32.59	(4.72)	15.46	16.04	(16.83)

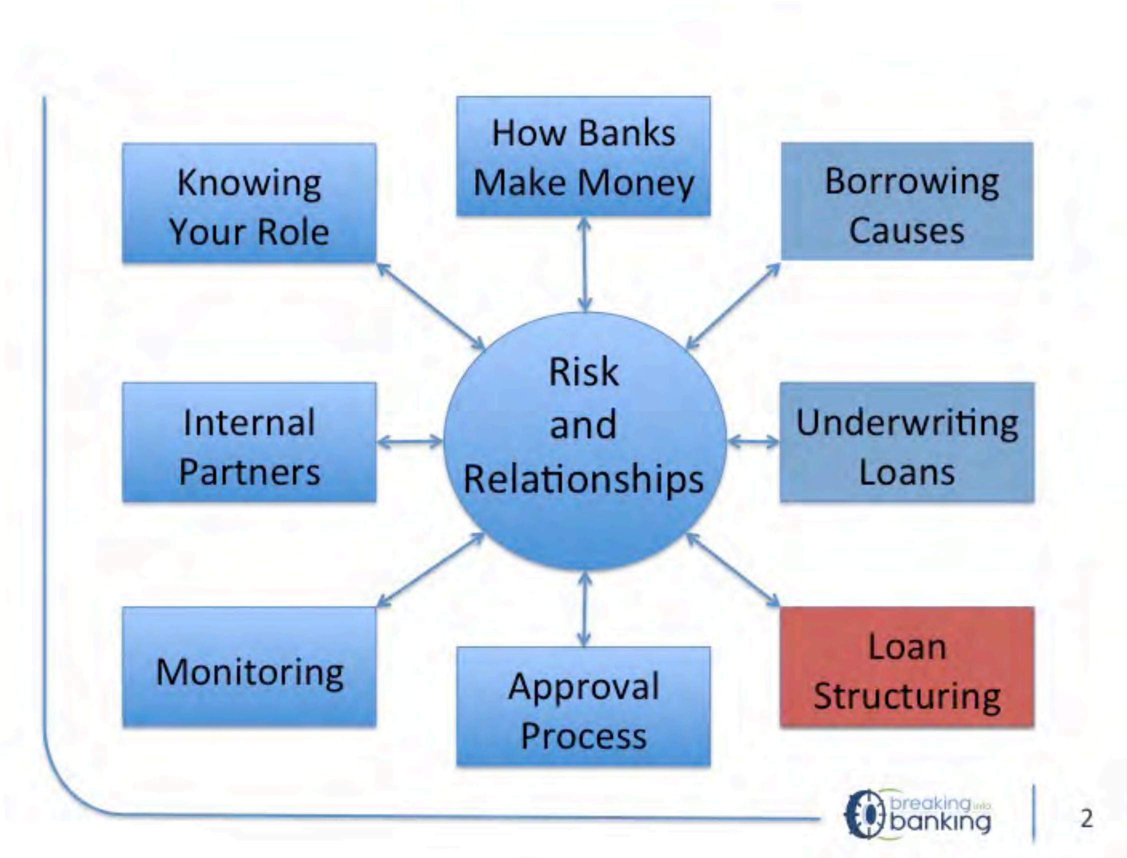
Summary UCA Cash Flow

MMAS Sample Customer (MMASSample)
Summary UCA Cash Flow
Industry Classification: NAICS Code: 315228

Prepared: 17:58, 9/22/2005
Amounts Printed in: Thousands
MMAS (3.1.6.0)

Statement Date	6/30/2001	6/30/2002	6/30/2003	6/30/2004	6/30/2005
Months Covered	12	12	12	12	12
Analyst	GJH	GJH	GJH	GJH	GJH
Stmt Type	Annual	Annual	Annual	Annual	Annual
Net Sales		9,968	10,535	11,848	12,419
Chg in Accts/Notes Rec-Trade(Net)		(320)	85	(151)	148
Cash Collected From Sales		9,648	10,620	11,697	12,567
Cost of Sales/Revenues		(7,477)	(7,739)	(8,552)	(9,468)
Chg in Inventories		(275)	70	(469)	(446)
Chg in Accts Payable-Trade		181	(249)	397	159
Cash Paid To Suppliers		(7,571)	(7,918)	(8,624)	(9,755)
CASH FROM TRADING ACTIVITIES		2,077	2,702	3,073	2,812
S,G&A Expense(Less Non-Cash Exp)		(2,032)	(2,114)	(2,454)	(2,755)
Chg in Prepaids/Deferreds		11	18	(60)	(12)
Chg in Accruals & Other Pay		(41)	(22)	8	59
Cash Paid for Operating Costs		(2,062)	(2,118)	(2,506)	(2,708)
CASH AFTER OPERATIONS		15	584	567	104
Other Income (Expense)		46	47	32	35
Taxes - Paid in Cash		(31)	(47)	(174)	-
Other Income (Expense) & Taxes Paid		15	-	(142)	35
NET CASH AFTER OPERATIONS		30	584	425	139
Interest Expense		(126)	(147)	(153)	(306)
Dividends - Paid in Cash		(207)	-	(46)	-
Cash Paid for Dividends & Interest		(333)	(147)	(199)	(306)
NET CASH INCOME		(303)	437	226	(167)
Current Portion Long Term Debt		(199)	(226)	(142)	(115)
CASH AFTER DEBT AMORTIZATION		(502)	211	84	(282)
Chg in Net Fixed Assets		(312)	(100)	(145)	(1,094)
Chg in Investments		(82)	52	44	(4)
Cash Paid for Plant and Investments		(394)	(48)	(101)	(1,098)
FINANCING SURPLUS (REQMNTS)		(896)	163	(17)	(1,380)
Chg in ST Loans/Other Payables		767	(52)	(14)	341
Chg in LT & Sub Debt		179	(88)	(23)	1,024
Total External Financing		946	(140)	(37)	1,365
CASH AFTER FINANCING		50	23	(54)	(15)
Add:Beginning Cash & Equivalents		71	121	144	90
ENDING CASH & EQUIVALENTS		121	144	90	75


breaking into banking
Module 5
Loan Structuring: Part I
BREAKING into BANKING
a successful career
COMMERCIAL BANKING


How Banks Make Money
Knowing Your Role
Borrowing Causes
Risk and Relationships
Internal Partners
Underwriting Loans
Monitoring
Approval Process
Loan Structuring
breaking into banking
2

Key Concepts in Module 5:

- Underwriting flows into loan structure
- Tenor and amortization
- Types of loan facilities
- How loan pricing really works

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Tenor and Amortization

- Maturity: date by which all principal must be repaid
- Tenor: amount of time left before loan must be repaid (until its maturity date)
- Amortization: repayment of principal
- Tenor & amortization *can be* the same

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Types of Loan Facilities

- Lines of credit
- Term and mortgage loans
- Multi-draw notes
- Bridge loans
- Letters of Credit

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Revolving Lines of Credit

- Draw and repayment feature
- Only borrow amount needed today
- Interest only, principal at maturity
- Demand (non-contractual) vs. committed
- Some feature a borrowing base formula

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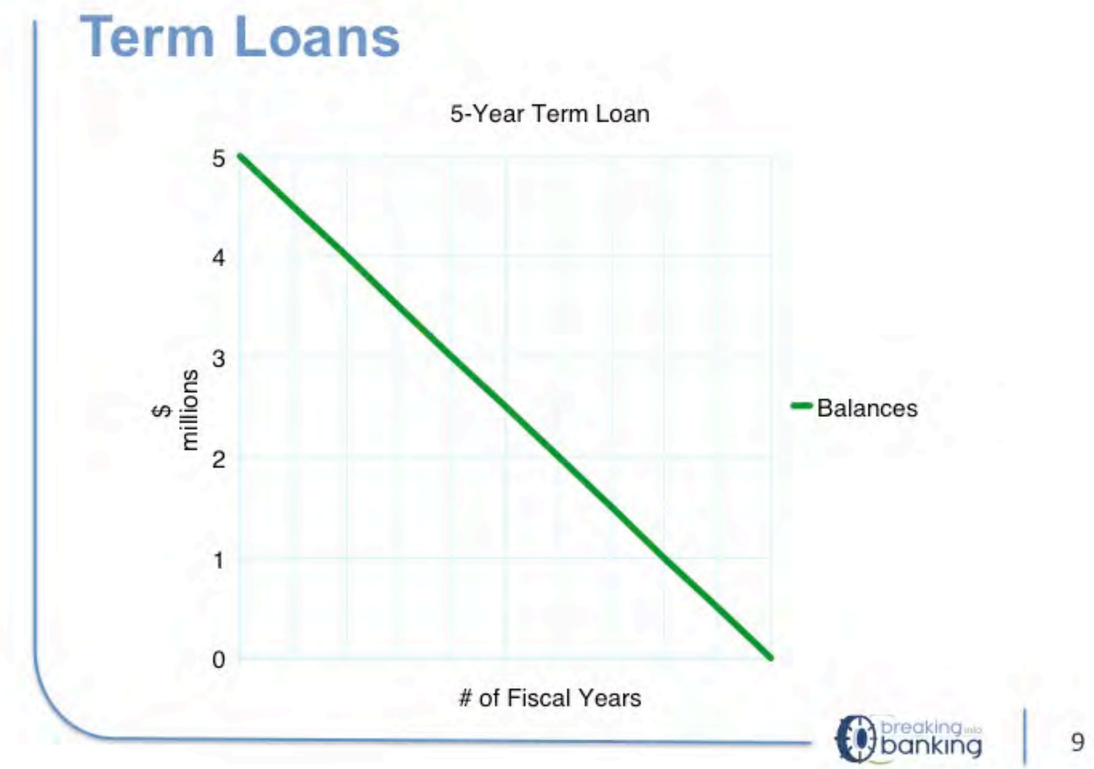
Revolving Lines of Credit

7

Term Loans

- Similar to car / home mortgage loan
- 100% of funds disbursed at closing
- Periodic payments of principal & interest
  - Mortgage-style (P&I)
  - Level principal (P+I)
- Borrower cannot draw more funds

8


Term Loans
5-Year Term Loan
5
4
3
2
1
0
$ millions
Balances
# of Fiscal Years
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9

Multi-Draw Facilities

- Funds disbursed in chunks over a finite period of time
- Amount needed may be uncertain
- Construction or pieces of equipment
- Frequently converted to term loan

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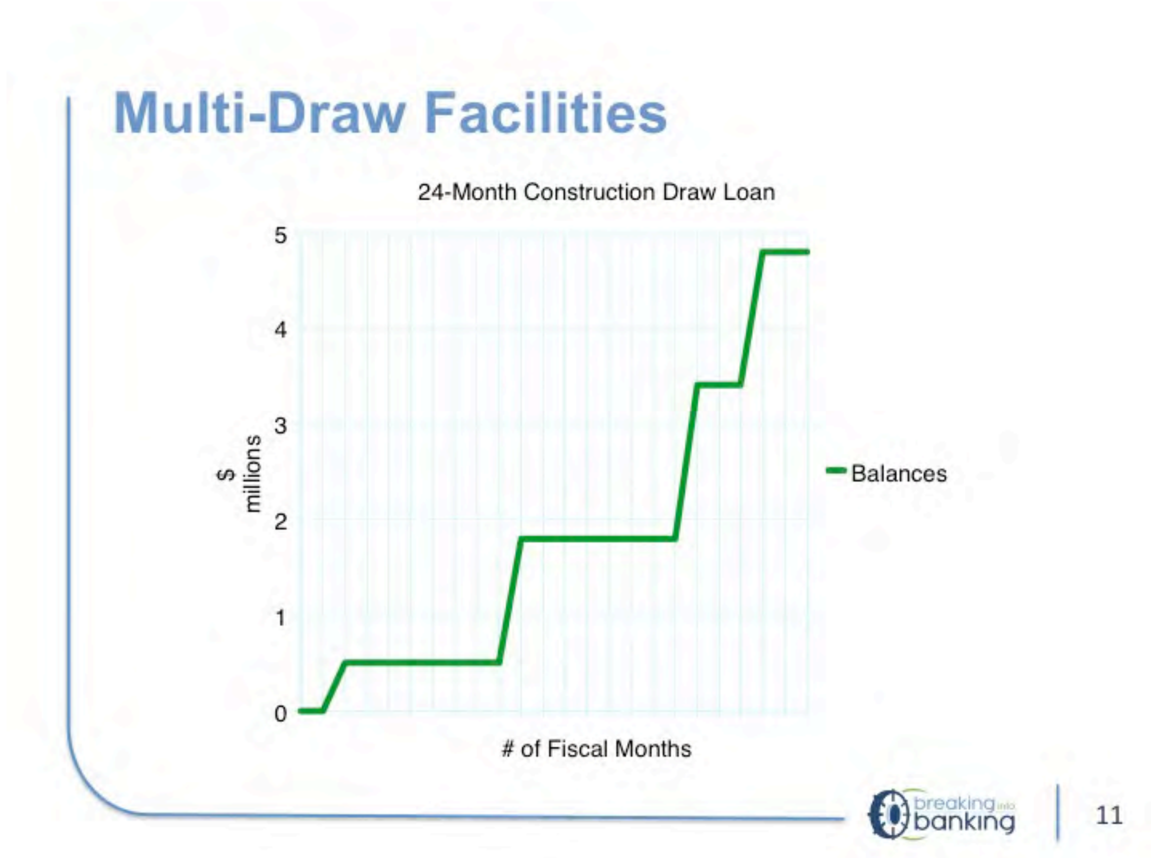
Multi-Draw Facilities
24-Month Construction Draw Loan
5
4
3
2
1
0
$ millions
Balances
# of Fiscal Months
breaking into banking
11

Bridge Loans

- Temporary need of funds until…
- 100% of funds disbursed at closing
- Interest only then all principal at maturity
- Typically paid off by a "liquidity event"
  - Sometimes higher pricing & fees

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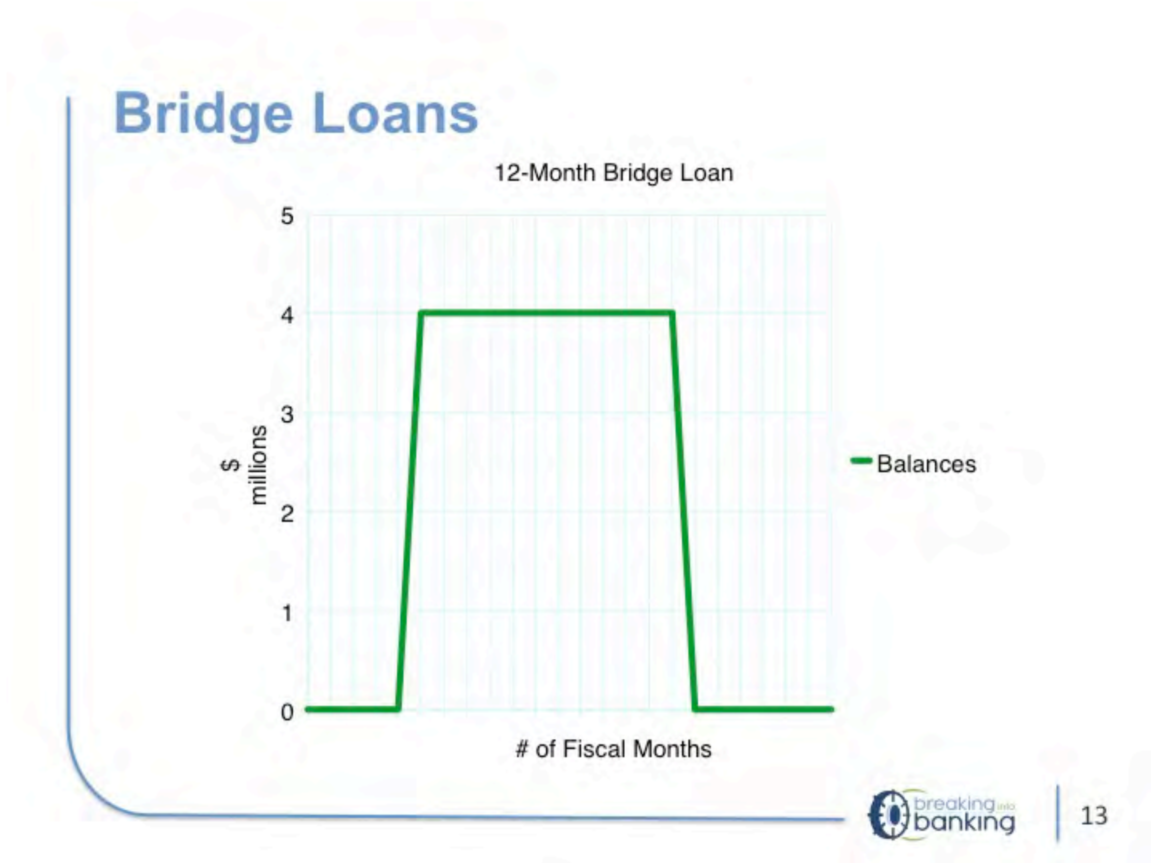
Bridge Loans
12-Month Bridge Loan
5
4
3
2
1
0
$ millions
# of Fiscal Months
Balances
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13

Facility Types Impacts Risk

- Bridge loan to buy equipment?
- Term loan for working capital?

Letters of Credit

- Provide assurance to seller that it will get paid if buyer defaults
- Standby L/C – not typically drawn
- Import (Trade) L/C – designed to be drawn on

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Loan Pricing

- Banks make $ from interest rate spread
- Rate = (Index) + (Spread)
  - Index for floating: Prime or LIBOR
  - Index for fixed: Bank's COF
- Every basis point matters
  - 5 bps x $100 billion = $50 million incremental profit

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Loan Pricing
Risks
Rewards
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17

Loan Pricing

- Based on risk of borrower
- Competitive (market) pressure
- Fee income can compensate for lower spread
- Some risks are simply too high to price

Paperwork, Paperwork

- Promissory Note:
  - Legal Names of Lender and Borrower
  - Amount
  - Pricing (Index and spread)
  - Tenor and Amortization
  - Signatures

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Key Takeaways: Module 5

- Know the difference between tenor and amortization and how they impact risk
- Understand how the choice of facility type affects the bank's risk
- Pricing is negotiable and must meet bank's <u>and</u> market's hurdles

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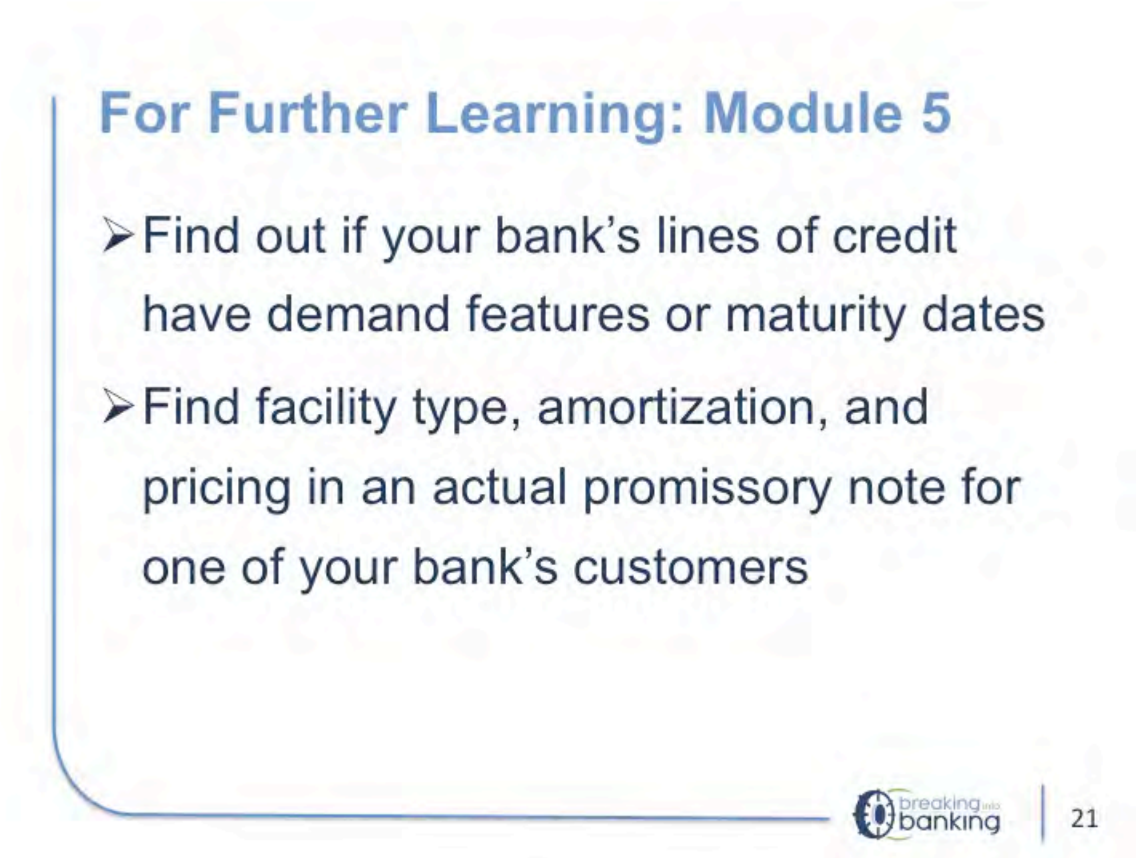
For Further Learning: Module 5
➢Find out if your bank's lines of credit have demand features or maturity dates
➢Find facility type, amortization, and pricing in an actual promissory note for one of your bank's customers
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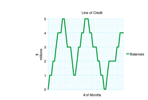
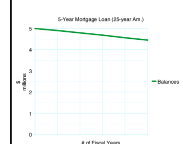
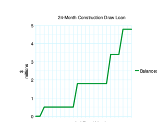
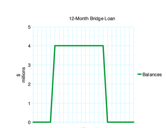
Facility Types

Facility Type	Typical Borrowing Need	When Funds Disbursed	Amortization	Repayment Source	Able to Re-draw?	Graph of Loan Balances
Line of Credit	Working Capital	Multiple times as needed by borrower	Interest monthly, principal on demand / maturity	Conversion of INV and A/R to cash	Yes - unlimited # of times	
Term	Piece of Equipment	100% up front (at closing)	Monthly payments of P&I or P+I	Cash flow from operations over many years	No	
Mortgage	Real Estate purchase	100% up front (at closing)	Monthly payments of P&I or P+I	Cash flow from operations over many years OR tenant's rent payments	No	
Mulit-Draw	Construction or multiple pieces of equipment	In large chunks during limited time period	Interest only during draw period, then monthly payments of P&I or P+I	N/A during draw period, then cash flow from operations or rent payments	Yes - only during draw period	
Bridge	Purchase distressed real estate to rehab or sell	100% up front (at closing)	Interest only during bridging period, then full principal at maturity	Liquidity event (sale of large asset) or long-term financing	No	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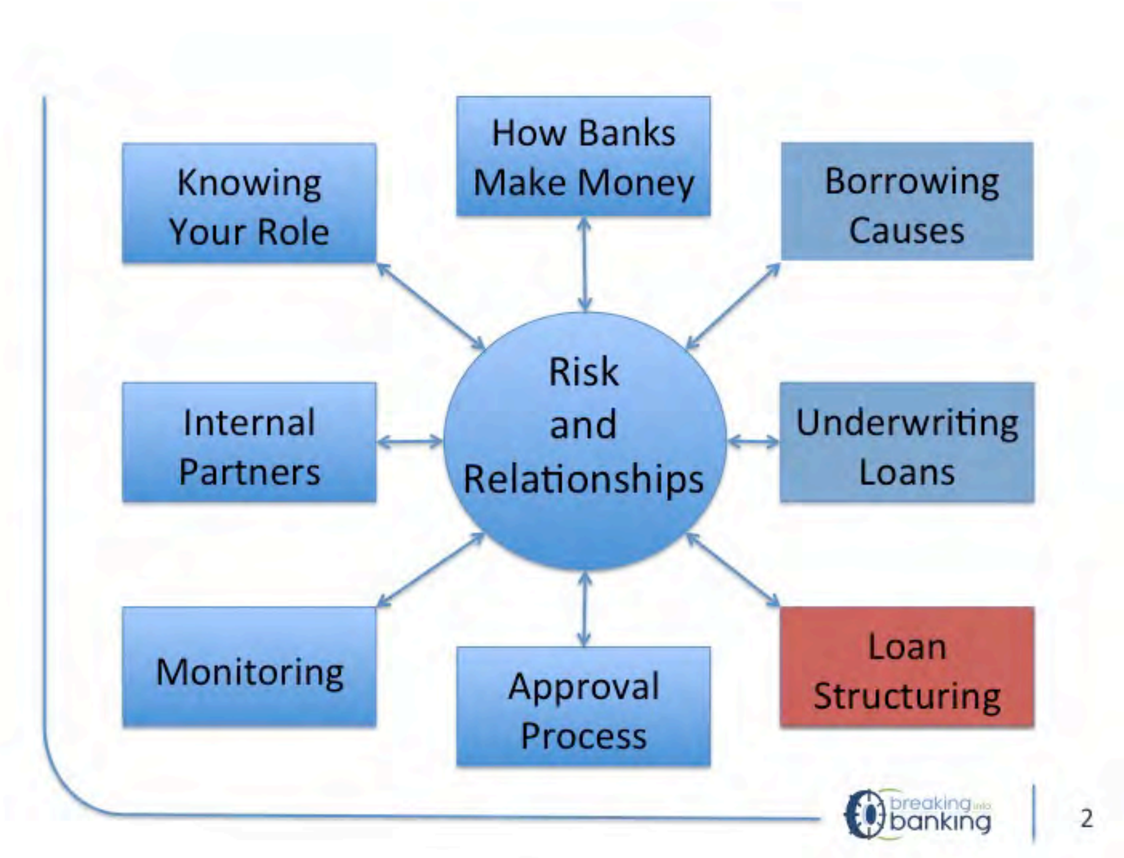
Module 6
Loan Structuring: Part II
BREAKING into BANKING
a successful career
COMMERCIAL BANKING


Knowing Your Role
How Banks Make Money
Borrowing Causes
Internal Partners
Risk and Relationships
Underwriting Loans
Monitoring
Approval Process
Loan Structuring
breaking into banking
2

Key Concepts in Module 6:

- Sources of Repayment
- Tools to mitigate risk
  - Collateral
  - Guarantees
  - Covenants

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Sources of Repayment

- Varies based on need and facility type
  - Amortizing loans: cash flow from operations
  - Line of credit: conversion of trading assets
  - Bridge / Bullet loans: liquidity event
- Mitigation tools are typically not primary sources

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Collateral

- Backup plan in case primary source fails
- "Liquidation of collateral" is a common secondary source of repayment (SSOR)
- Only CASH repays loans
- Often secured by the asset financed

5

Collateral – Where is it?

- Do you know its location?
- Centralized or scattered?
- Cost to find and collect it?

6

Collateral – Where is it?

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Collateral – Where is it?
8

Collateral – How liquid is it?

- How quickly / simply converted to cash?
- Self-liquidating or not?
- Proceeds if sold at auction?
  - *Less than* Fair Market Value (FMV)
  - Orderly Liquidation Value (OLV)
  - Forced Liquidation Value (FLV)

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Collateral – How marketable is it?

- If borrower couldn't sell it, can the bank do any better?
- Is the bank *legally allowed* to sell it?
- Reputational risk of foreclosure

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Collateral

- Secured is still preferred
- Unsecured (uncommon)
- Under-secured

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Guarantees

- Can right-size the borrower's risk
- "Skin in the game"
- If money leaves the room, at least keep it in the house
- Highlights importance of relationship

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Guarantees
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Guarantees

Guarantees

- Very common in middle market deals
- Personal or parent
- "Joint & several"
- Unlimited (full) vs. limited ($ or %)
- Releases
- Springing

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Loan Covenants

- An agreement between two parties
- "Quid pro quo" = something for something
- Breach is an event of default
  - Red flags – early warning sign
  - Fee income for waiver
- NOT a source of repayment

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Loan Covenants

- What matters most to bank?
  - Coverage, liquidity, leverage
- So we covenant on those things
  - FCC ratio $\geq$ 1.2x
  - Borrowing base (formula)
  - Debt / TNW or Debt / EBITDA $\leq$ 3x

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Negotiation and Paperwork

- Who decides the structure?
  - Both parties
  - The market
  - Relationship!
- Loan agreement

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The 6 C's of Credit

Conditions:	Qualitative factors impacting a borrower's financial performance Do the borrower's non-financial indicators predict success?
Character:	Borrower's intent and willingness to honor the loan agreement Do you trust your borrower?
Capital:	Borrower's equity or willingness to share in the risk Does the borrower have "skin in the game?"
Capacity:	Sufficiency of borrower's cash flow to service its obligations Are the borrower's coverage ratios acceptable?
Collateral:	Bank's backup plan if borrower cannot repay its loan Will the borrower pledge its assets to make the bank whole?
Competition:	Banks must be disciplined and guard against overaggressive structure What are other banks in the market offering to customers?

Key Takeaways: Module 6

- Structure around sources of repayment
- Think of the funds lent as your own
- Get dibs – secure with collateral
- Require "skin in the game" via guarantee
- Covenants help but don't repay loans

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For Further Learning: Module 6

- On a limited guarantee, would the bank prefer *$ amount* or *percentage*? Why?
- Ask at your bank about the *enforceability* of loan covenants
  - Lender, attorney, workout specialist
- Find risk mitigants in a Loan Agreement

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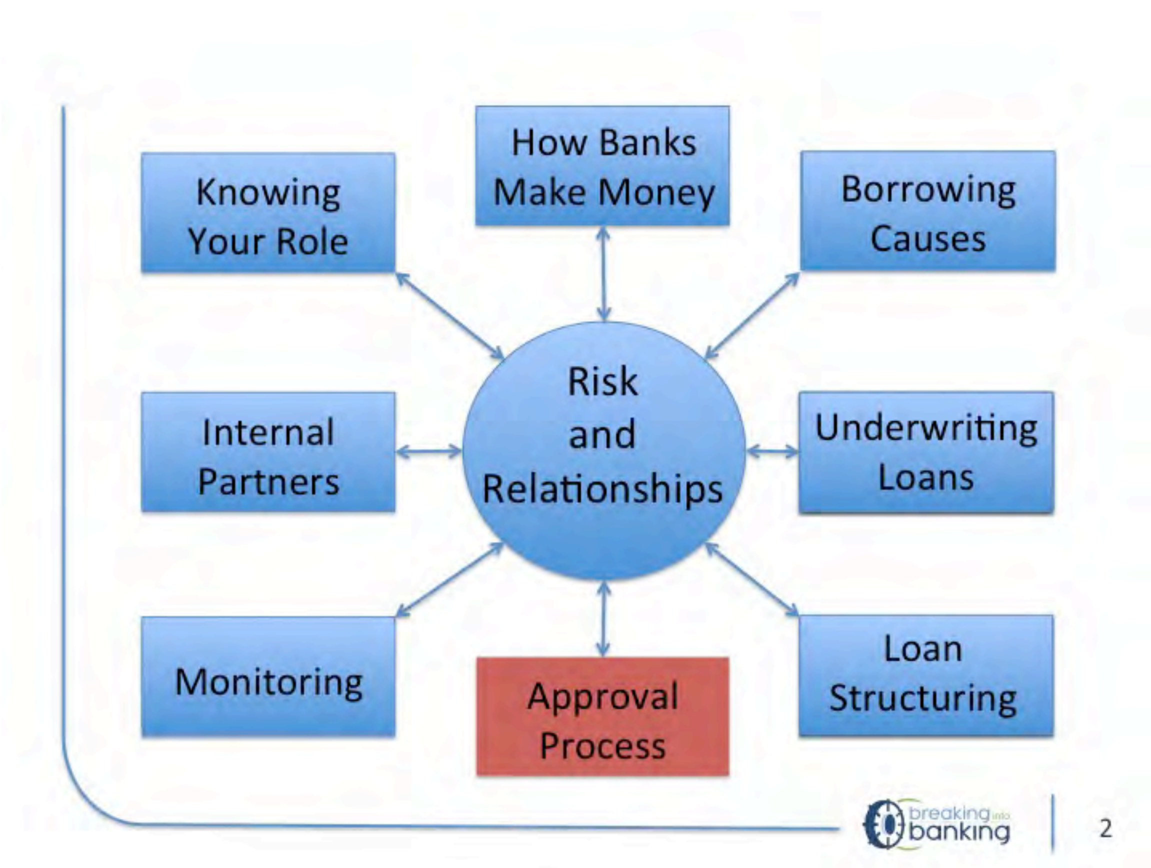
breaking into banking
Module 7
The Credit Approval Process
BREAKING into BANKING
a successful career


How Banks Make Money
Knowing Your Role
Borrowing Causes
Risk and Relationships
Internal Partners
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Monitoring
Approval Process
Loan Structuring
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Key Concepts in Module 7:

- Approval is culmination of negotiations and everything we've learned so far
- Credit approval is part of a multiple-step process that can take a long time
- Life of a loan (using flow chart)

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Credit Approval Process Flow Chart

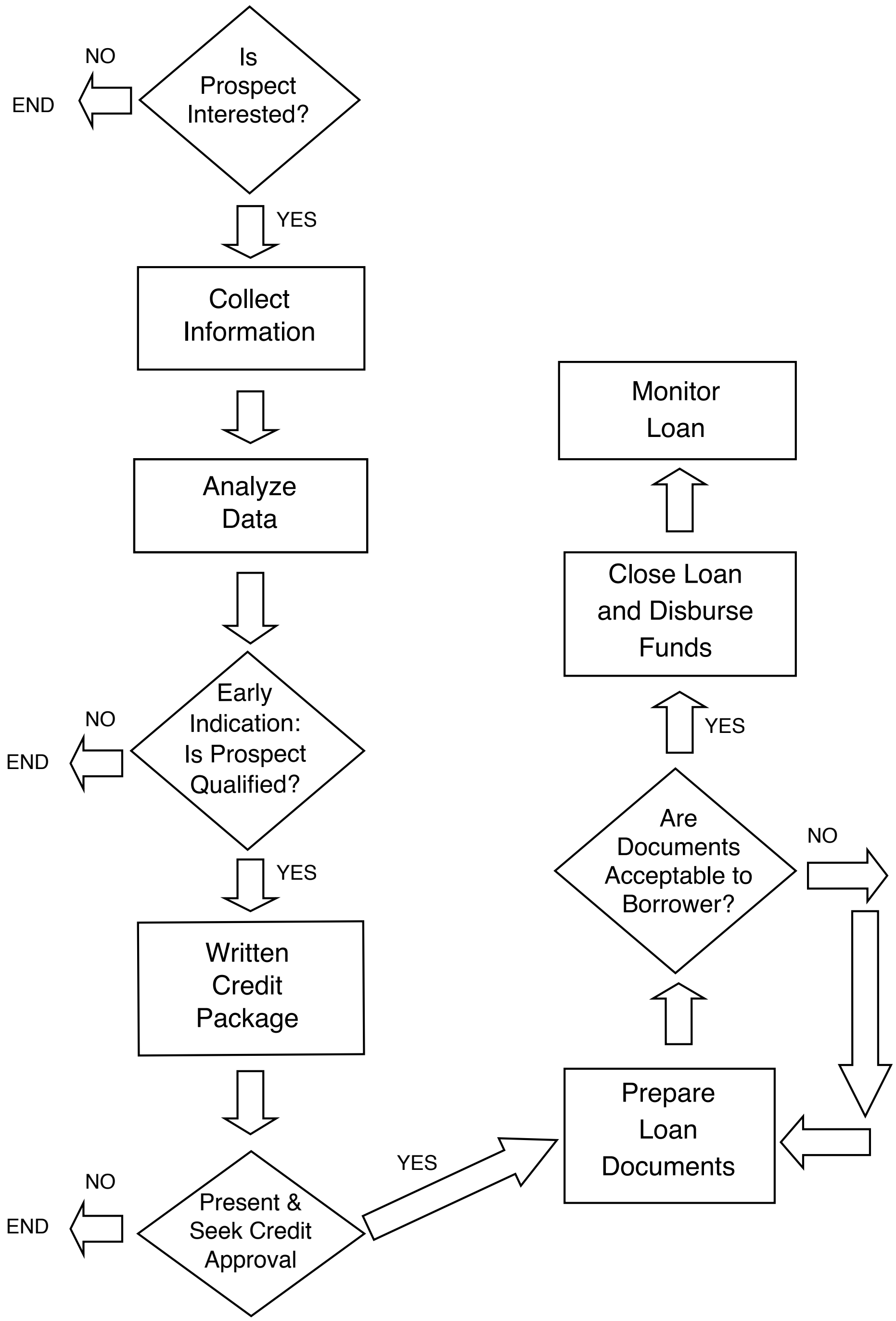
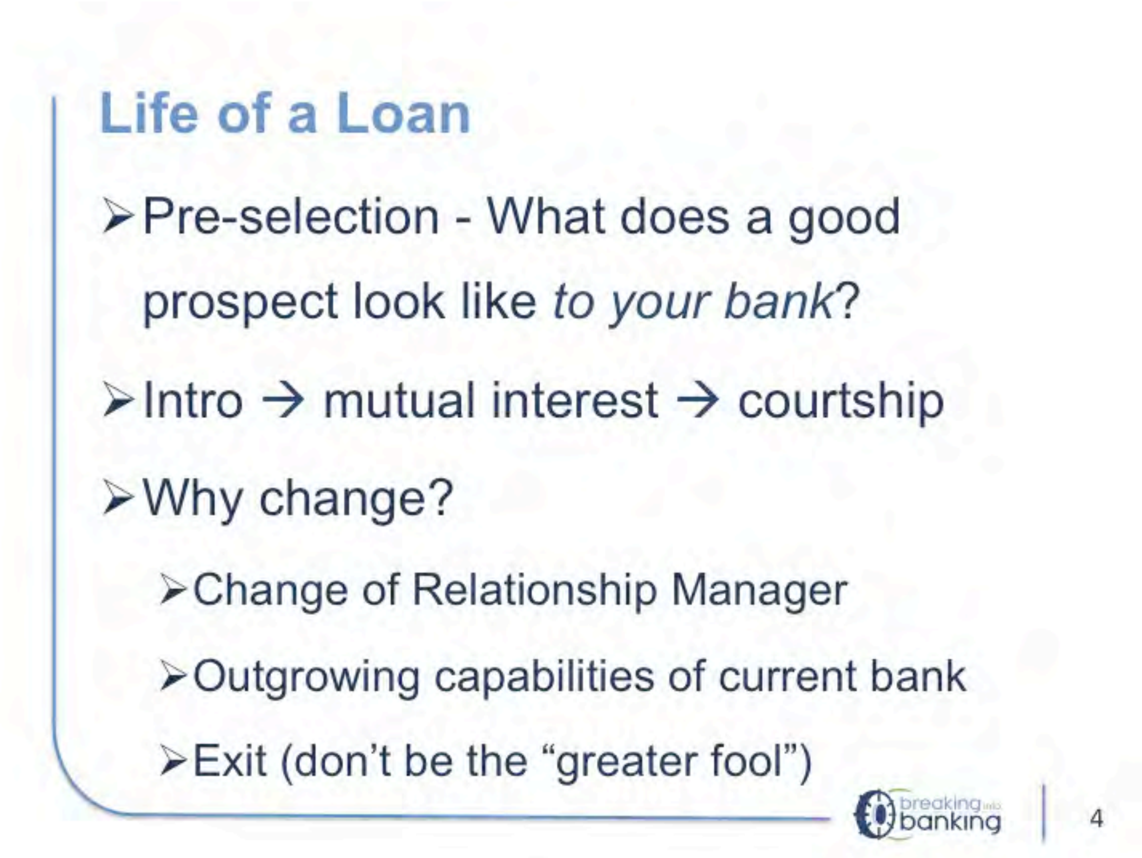


Figure 7.1


Life of a Loan
➢Pre-selection - What does a good prospect look like *to your bank*?
➢Intro → mutual interest → courtship
➢Why change?
➢Change of Relationship Manager
➢Outgrowing capabilities of current bank
➢Exit (don't be the "greater fool")
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Gathering Financial Information
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Collect and Analyze Data

- Collect data
- Early assessment of interest and risks
- Qualitative & Quantitative analysis
- If "yes," then begin to document:
  - Risks & mitigants
  - Narrative about borrower & industry

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Business Writing
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7

Paperwork, Paperwork

- Seek approval w/ written credit package:
  - Borrower's company background
  - Request(s)
  - Pro forma total credit exposure
  - Details of facilities
  - Risks and mitigants

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Paperwork, Paperwork

- Who are the document's end-users?
  - Signer (Approver)
  - Document Preparation team
  - Loan Review
  - Regulators
  - Subsequent analysts

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Loan Committee Presentations

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10

Seeking Approval

- Presenting the request
  - Written and oral
  - Know your audience
  - Simply looking for “yes” (stop talking)
- RM must “sell” the structure twice

11

Signing Off

12

Loan Documents

- Promissory Note & Loan Agreement
- Internal or external (law firm)
- Must be accepted by both parties
  - One final chance for negotiation

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The Art of Negotiating
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14

Left at the Altar

15

Left at the Altar

- Not all prospective deals come to fruition
- Bank's underwriters may decide "No"
  - Borrower not creditworthy
  - Exposure or concentration too high
- Prospect may choose another (or stay at incumbent) bank

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Closing (Commencement) Box 9

- The long (?) process finally concludes with loan closing (wedding day)
- Funds are disbursed (if applicable)
- But your work is far from over….
  - Monitoring (the marriage!) → Module 8….box 10

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Key Takeaways: Module 7

- Approval process is typically long
- Oral & written presentation skills
- Not all loan requests are approved

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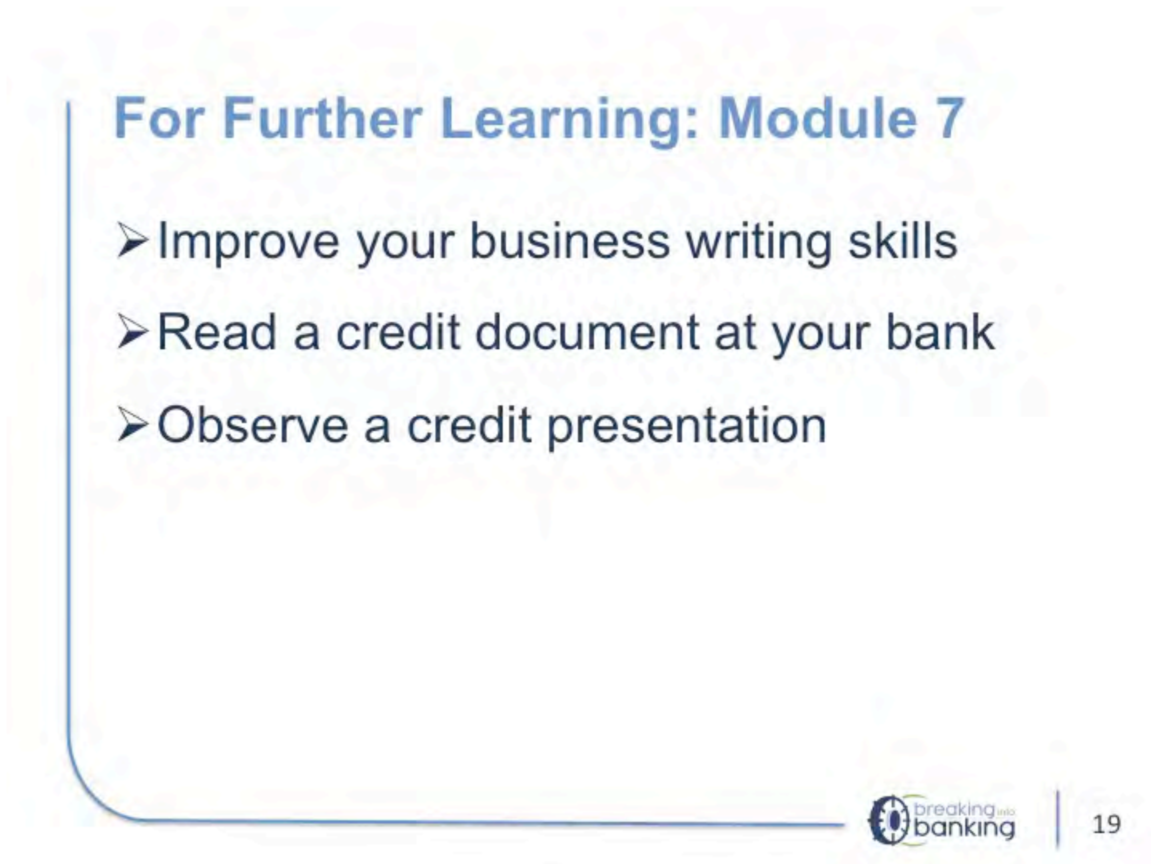
For Further Learning: Module 7
➢Improve your business writing skills
➢Read a credit document at your bank
➢Observe a credit presentation
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Module 8
Checking In:
Loan and
Portfolio
Monitoring
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Key Concepts in Module 8:

- How & why banks monitor existing loans
- "Expected Loss" and why it matters
- How loans are graded
- Non-performing assets
- Stepping back to examine the entire loan portfolio

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Why Monitor Existing Loans?
➢Banking is about risk and relationships
RISK = The possibility of something bad or dangerous happening
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Why Monitor Existing Loans?

- Banking is about risk and relationships

4

Why Monitor Existing Loans?

- What is the quality of your collection?

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Q. What Do Businesses Collect?

A. Assets (to generate cash flow)

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Q. What Are a Bank's Assets?

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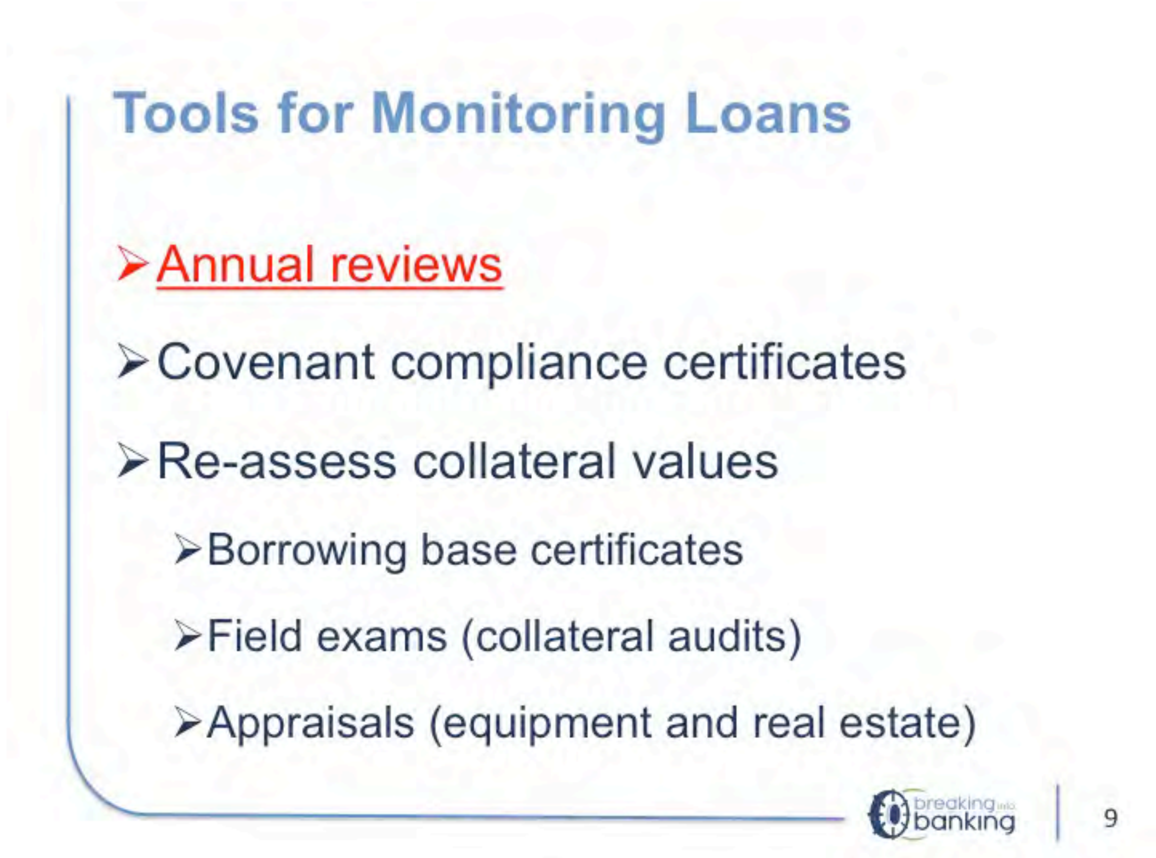
Q. What Are a Bank's Assets?

A. Loans

(Because loans generate interest income for the bank)

8


Tools for Monitoring Loans
➢Annual reviews
➢Covenant compliance certificates
➢Re-assess collateral values
➢Borrowing base certificates
➢Field exams (collateral audits)
➢Appraisals (equipment and real estate)
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9

Covenant Compliance Certificates

Corinne's Confections, Inc.

Loan Covenant Compliance
As of 12/31/20XX

Ratio of *Total Liabilities to Tangible Net Worth* must not exceed 3.0x at the end of any fiscal year
(tested annually beginning 12/31/XX)

Total Liabilities = $2,340,655
Tangible Net Worth = $1,400,722
Ratio = 2,340,655 / 1,400,722 = 1.67x

Result: In Compliance

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Borrowing Base Certificates

Borrowing Base Certificate

		Accounts Receivable	Inventory	Total
Collateral as of:	12/31/20XX	$8,000,000	$12,000,000	$20,000,000
Less Ineligible Accounts as of:	12/31/20XX	$1,500,000	$3,500,000	$5,000,000
Eligible Collateral		$6,500,000	$8,500,000	$15,000,000
Rate of Advance:		80%	50%	
Net Collateral		$5,200,000	$4,250,000	$9,450,000
Line of Credit Limit:				11,000,000
Less Line Balance as of:	12/31/20XX			$6,250,000
Net Availability as of:	12/31/20XX			$3,200,000

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Borrowing Base Certificate

		Accounts Receivable	Inventory	Total
Collateral as of:	12/31/20XX	$8,000,000	$12,000,000	$20,000,000
Less Ineligible Accounts as of:	12/31/20XX	$1,500,000	$3,500,000	$5,000,000
Eligible Collateral		$6,500,000	$8,500,000	$15,000,000
Rate of Advance:		80%	50%	
Net Collateral		$5,200,000	$4,250,000	$9,450,000
Line of Credit Limit:				11,000,000
Less Line Balance as of:	12/31/20XX			$6,250,000
Net Availability as of:	12/31/20XX			$3,200,000

Tools for Monitoring Loans

- Annual Reviews
- Covenant compliance certificates
- Re-assess collateral values
  - Borrowing base certificates
  - Field exams (collateral audits)
  - Appraisals (equipment and real estate)

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Expected Loss

- Probability of Default
- Loss Given Default (LGD)
- What does "expected loss" tell us?

Grading Loans

- Asset quality – based on expected performance
- Regulatory grades
  - Pass / Watch
  - Special Mention – “potential weaknesses”
  - Substandard – “well-defined weakness”
  - Doubtful – full collection is “highly questionable”
  - Loss – considered “uncollectible”
- Non-performing assets

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Grading Loans

- Asset quality – based on expected performance
- Regulatory grades
  - Pass / Watch
  - Special Mention – “potential weaknesses”
  - Substandard – “well-defined weakness”
  - Doubtful – full collection is “highly questionable”
  - Loss – considered “uncollectible”
- Non-performing assets

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Special mention (SM)

"A special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification."

Substandard

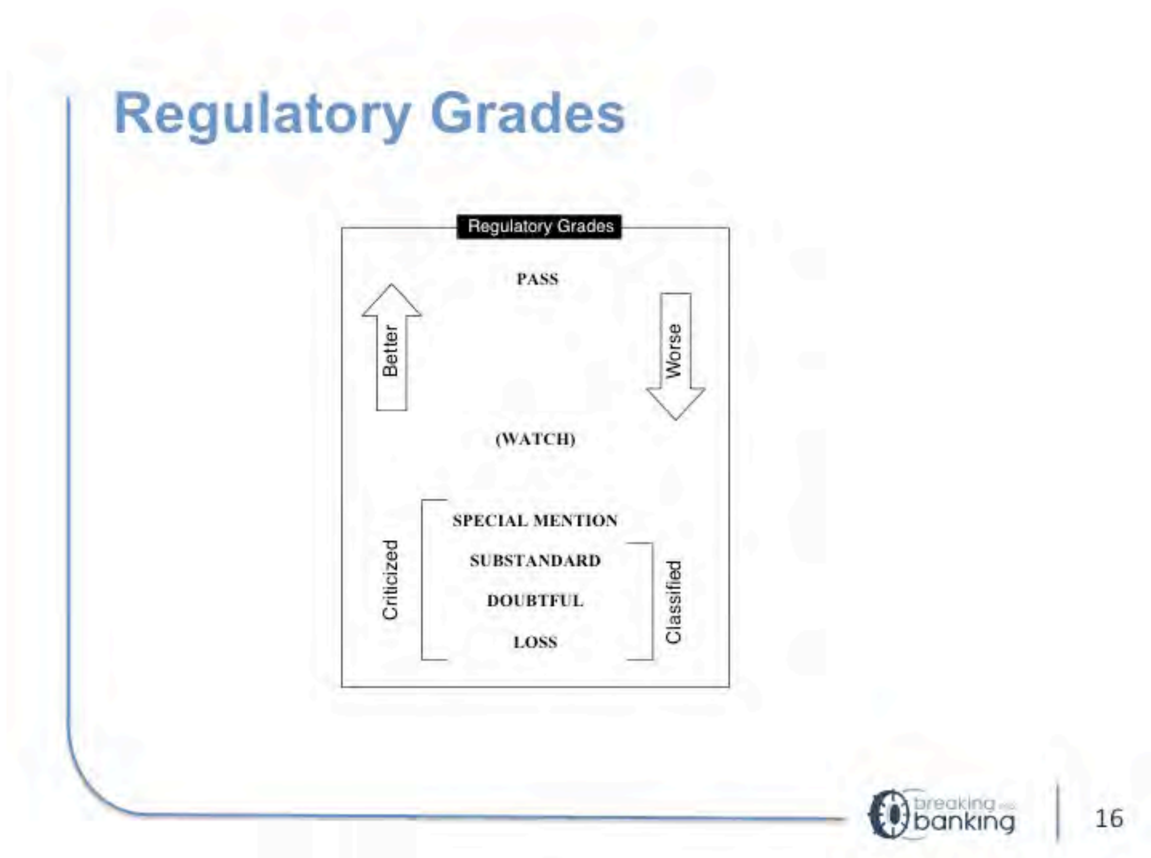
"A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected."

Doubtful

"An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable."

Loss

"Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future."


Regulatory Grades
Regulatory Grades
PASS
Better
Worse
(WATCH)
SPECIAL MENTION
SUBSTANDARD
DOUBTFUL
LOSS
Criticized
Classified
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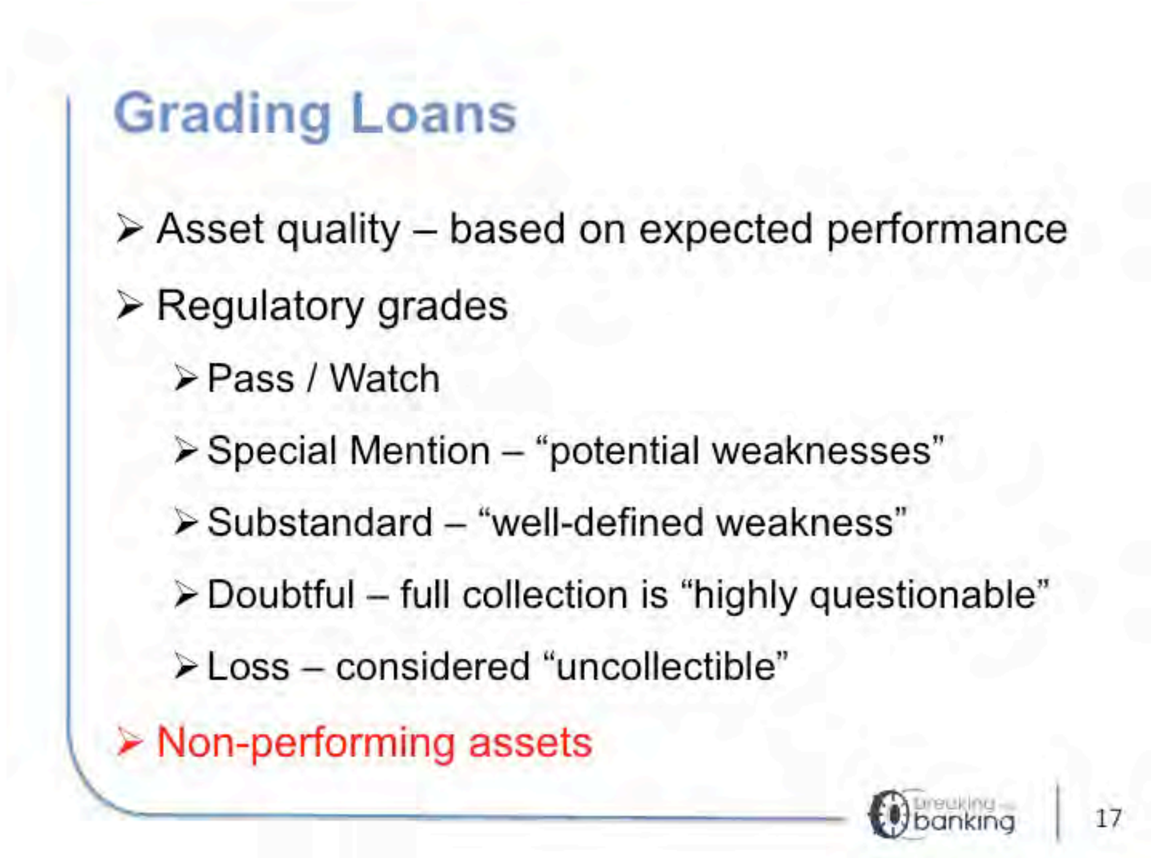
Grading Loans
➢ Asset quality – based on expected performance
➢ Regulatory grades
➢ Pass / Watch
➢ Special Mention – "potential weaknesses"
➢ Substandard – "well-defined weakness"
➢ Doubtful – full collection is "highly questionable"
➢ Loss – considered "uncollectible"
➢ Non-performing assets
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Monitoring at the Portfolio Level

- Metrics and trends
  - Criticized, Classified, NPA as a % of total portfolio
  - Examine trends over time
- Provision for loan losses

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Provision for Credit Losses

Income Statement Data ($000)

	2009	2010	2011	2012	2013
Interest Income	$2,238,142	$2,145,392	$1,970,226	$1,930,263	$1,860,637
Interest Expense	$813,855	$526,587	$341,056	$219,739	$156,029
Net Interest Income	$1,424,287	$1,618,805	$1,629,170	$1,710,524	$1,704,608
Provision for Credit Losses	$2,074,671	$634,547	$174,059	$147,388	$90,045
Net Interest Income after Provision	$650,384	$984,258	$1,455,111	$1,563,136	$1,614,563
Net Income (loss)	$3,097,179	$312,347	$542,613	$641,022	$638,741

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Key Takeaways: Module 8

- Relationships require staying in touch
- Tools to help you "trust, but verify"
- Expected Loss and loan loss provisions
- Regulatory grades
  - Pass, Watch, Special Mention, Substandard, Doubtful, Loss
  - Criticized / Classified
- Non-performing assets

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For Further Learning: Module 8

- Find 10-K from a bank and read the discussion about its credit quality (credit risk and Provision for Credit Losses)
  - Look for specific reference to the bank's level of NPAs
- Read definitions of regulatory grades
  - Comptroller's Handbook at www.occ.gov/publications
  - Definitions are under "Rating Credit Risk"

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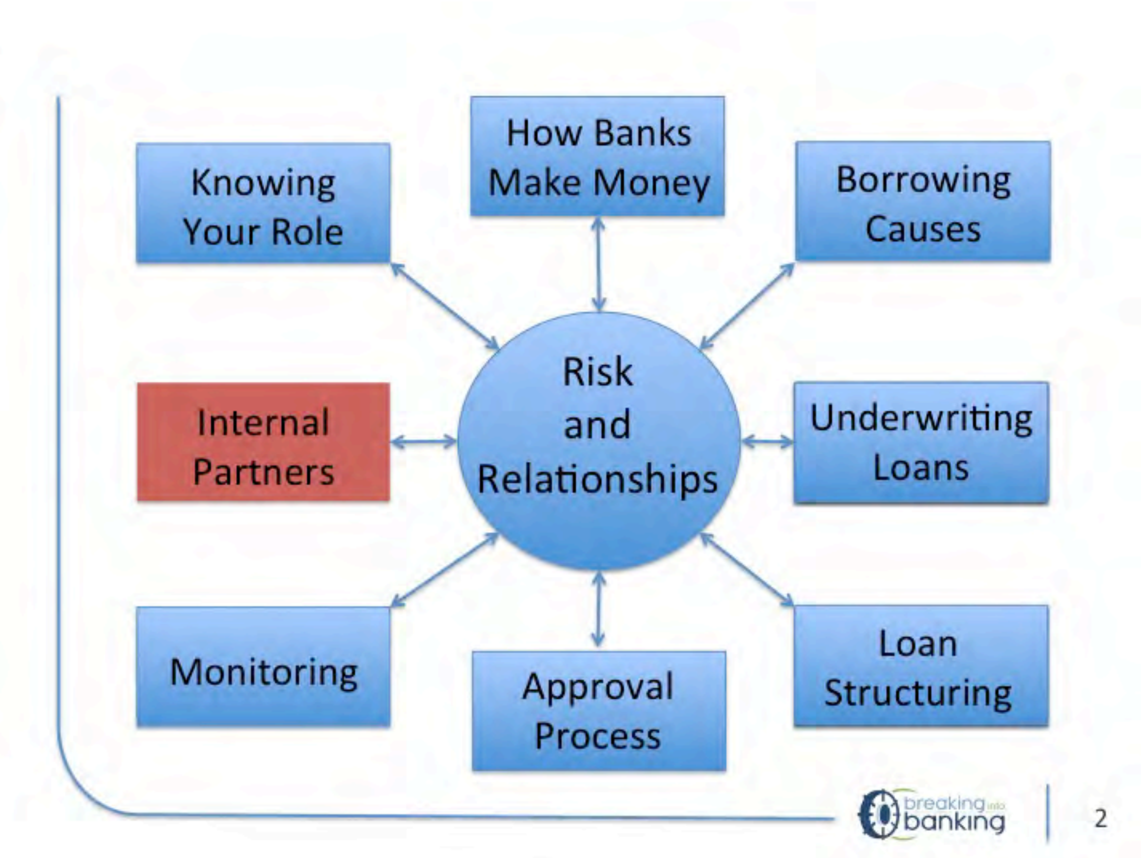
Module 9
The Complex Lending Machine
BREAKING into BANKING
a successful career


How Banks Make Money
Knowing Your Role
Borrowing Causes
Internal Partners
Risk and Relationships
Underwriting Loans
Monitoring
Approval Process
Loan Structuring
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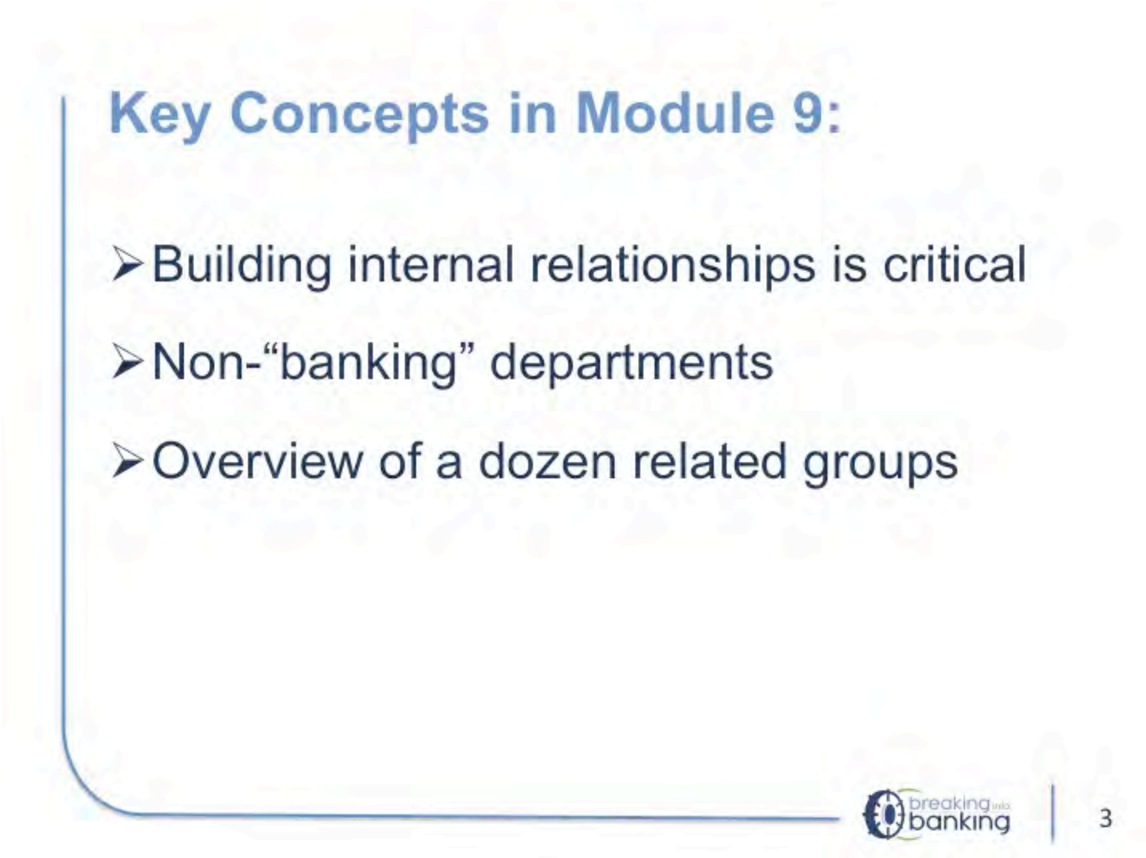
2


Key Concepts in Module 9:
➢Building internal relationships is critical
➢Non-"banking" departments
➢Overview of a dozen related groups
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3

They Work at a Bank, but…

- Human Resources (people)
- Information Technology (computers)
- Accounting (bookkeeping)
- Marketing (advertising / promotion)
- Communications (public relations)
- Facilities (buildings and space)

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Retail

- The face of the bank
- Branch network & ATMs
- Personal Bankers
- Consumer mortgages
- Home equity lines of credit

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Retail – Branches and ATMs

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Credit Administration

- Approvers of credit requests
- Senior credit officers – power of the pen
- Underwriters
- Portfolio Managers
- Credit Analysts

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Credit Administration

Commercial Lending

- Relationship Managers (quarterback)
- aka “lenders,” “bankers,” “the line,” or “business development officers” (BDOs)
- Generalists (“C&I”) vs. specialists
- Large Corporate, Middle Market, Business Banking, start-up (SBA)

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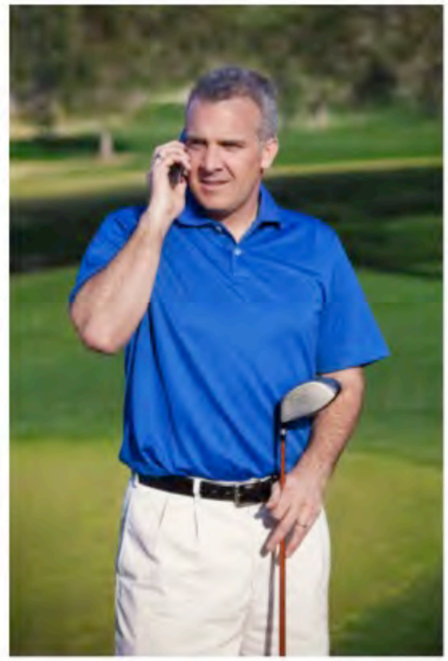
Commercial Lending

- Focused on networking and prospecting



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Commercial Real Estate

- Requires expertise due to complexity
- Office / Retail / Multi-family / Health Care
- Appraisal / valuation
- Construction risk
- Environmental issues

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Commercial Real Estate - Office

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Commercial Real Estate - Apartment

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Commercial Real Estate - Construction

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Equipment Leasing

- Financing Capital Expenditures
- Renting vs. buying
- Tax advantages for borrowing customer
- Frequently offer 100% financing

Collateral Services

- aka "Field Exam" or "Secured Credit"
- Verifying value of A/R and Inventory
- Accounting background helpful
- Early detection of problem loans
- Specialty – auto dealer "floorplan"

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Collateral Services
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Special Loans

- aka "Workout" or "Problem Assets"
- Rehab specialists – criticized assets
- No crying over spilled milk
- Exit or liquidation when necessary

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Special Loans

Loan Review

- aka “Credit Review”
- Independent internal audit function
- Conduct periodic exams related to:
  - Adherence to credit policies
  - Appropriate and timely risk grading
  - Approval process / credit authority
- Findings go to Board, CPAs, regulators

Private Banking

- aka "Wealth" or "Private Client Group"
- Servicing "*certified rich people*"
- Credit needs
- Investment advice
- Asset management
- Trusts

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Treasury Management

- aka "Cash Management"
- Offer fee-generating products
  - Automated Clearing House (ACH)
  - "Auto-sweep" on lines of credit
  - Wholesale Lockbox
  - Remote Deposit Capture (RDC)

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Legal

- Banks sue and get sued by customers
- Assistance w/ loan documentation
  - Internal document preparation
  - Coordinating w/ other law firms (external)

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Government Regulators

- Increased presence since 2008
- Office of Comptroller of Currency (OCC)
- Federal Reserve System (Fed)
- Federal Deposit Insurance Corp. (FDIC)

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Federal Reserve Bank in D.C.

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Key Takeaways: Module 9

- Complexity of commercial banking requires you to know a little about a lot
- It's what you know *and* who you know
- Credit / Lending relationship is critical

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For Further Learning: Module 9

- Learn the names for each of these groups at your bank
- Make a friend in each department who can be a resource for answering your questions

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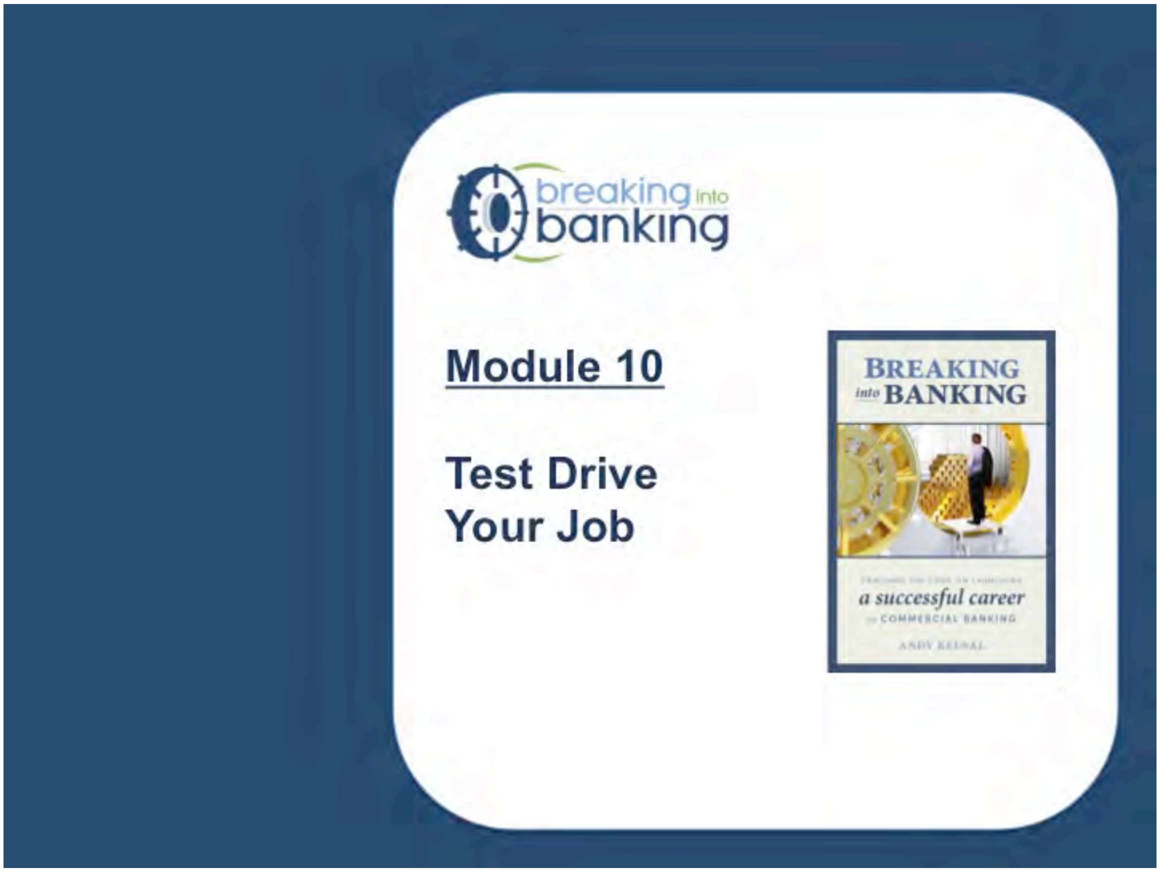
Who They Are and What They Do

Credit Administration	*Approving the risks*
Lending	*Winning new customers*
Commercial Real Estate	*Financing bricks and sticks*
Leasing	*Financing heavy equipment*
Collateral Services	*Trusting but verifying*
Private Banking	*Wooing the wealthy*
Special Loans	*Rehabilitating the wounded*
Loan Review	*Checking and reporting*
Treasury Management	*Generating fee income*
Legal	*Defending and protecting*
Regulators	*Looking over your shoulder*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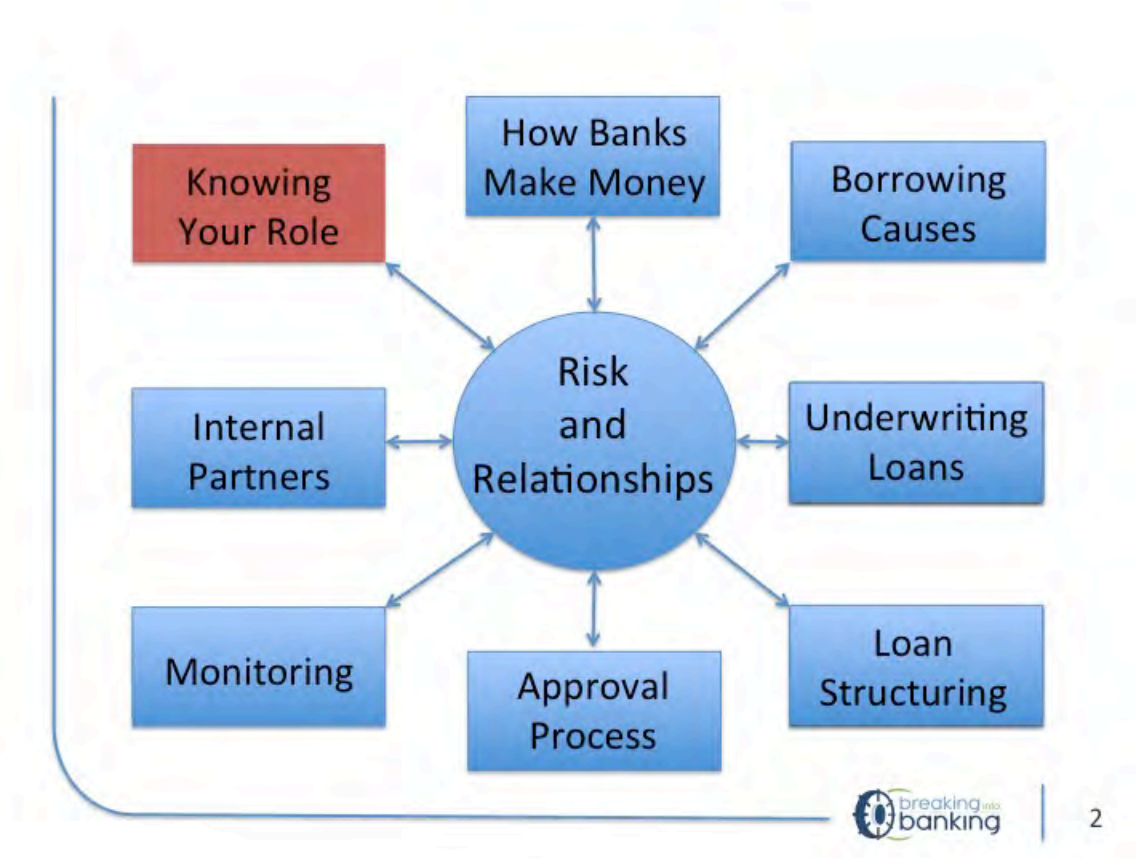
Module 10
Test Drive
Your Job
BREAKING into BANKING
a successful career
COMMERCIAL BANKING



Knowing Your Role
How Banks Make Money
Borrowing Causes
Internal Partners
Risk and Relationships
Underwriting Loans
Monitoring
Approval Process
Loan Structuring
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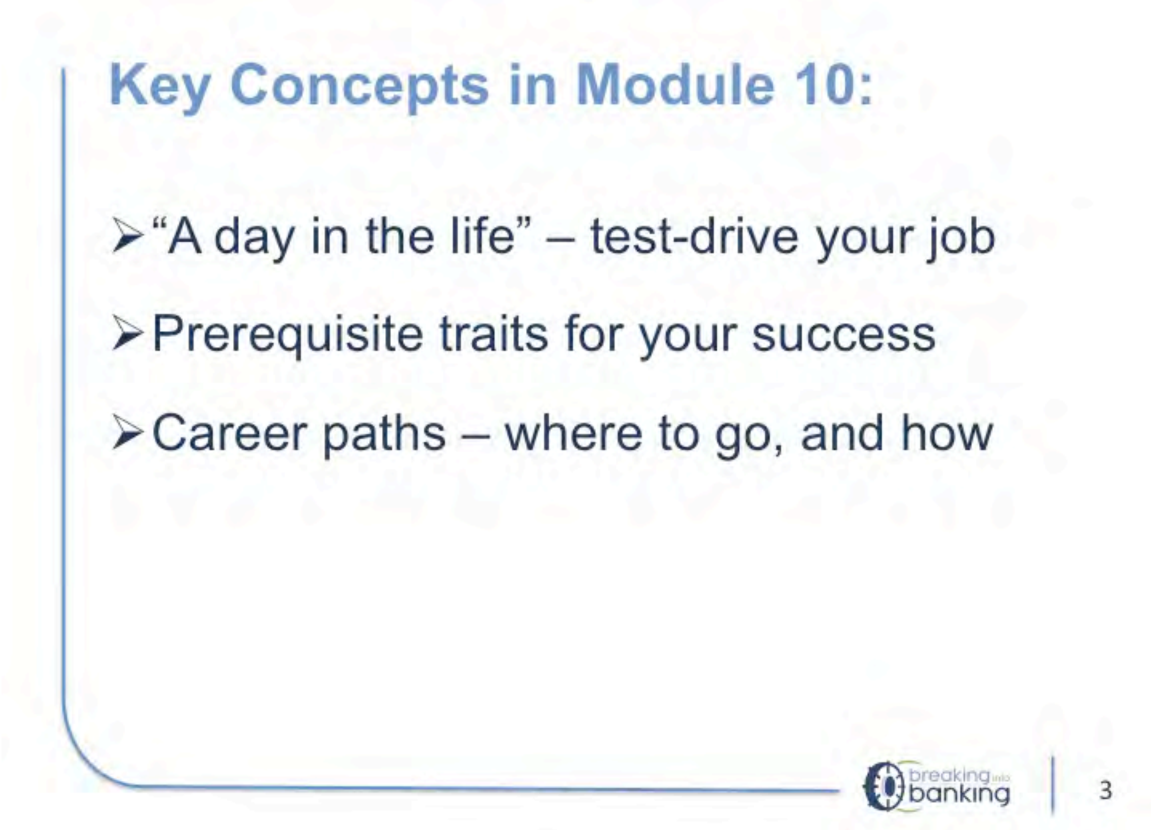
Key Concepts in Module 10:
➢ "A day in the life" – test-drive your job
➢ Prerequisite traits for your success
➢ Career paths – where to go, and how
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A Word About Interviewing:

- Now that you can speak the language and understand the concepts…
- Convince them that you will be prepared to hit the ground running
- Mention this course to them
- YOU tell THEM about your typical day

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Test-Drive Your New Job

A Day in Your Life

- Production / time management
  - Spreads and writing credit packages
  - Multiple deals "at once"
  - Quantity *and* quality

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Time Management

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A Day in Your Life

- Meetings, Meetings
  - Early assessment ("pipeline") discussions
  - Training classes
  - Loan committee meetings
  - Staff meetings

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A Day in Your Life

- Researching and Learning
  - Industry research
  - Mock loan committee presentations
  - Interrupt often and ask questions

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Ask Questions

A Day in Your Life

- Attend Customer Calls
  - Get out of the office!
  - Ask to go with RMs & PMs, Workout team
  - Prepare
  - Look around and ask questions

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Prerequisites for Success

- Curiosity & desire / ability to learn
- Time management skills
- Interpersonal communication skills
- Humility & teamwork
- Financial accounting & business writing
- Patience w/ career development

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Career Paths – How & Where?

- Credit Analyst (Sr.) for 1-2 years
- Most move into Jr. PM / RM role
- Rotational programs
- Which deals most interested you?
- SAD, Field Exam, Loan Review, CRE

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Career Paths – How & Where?

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Career Advice

- Dream big, but focus short-term
- Ask for special assignments
- Go the extra mile
- Don't burn bridges – you'll need them

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Key Takeaways: Module 10

- Get paid to learn – enjoy it!
- Never stop asking questions
- Start well, then enjoy lasting benefits
- Get connected as early as possible
- Every interaction is a job interview

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For Further Learning: Module 10

- Prepare by interviewing other bankers
- Identify your strengths / weaknesses
- Keep in touch!

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For more information, contact us:

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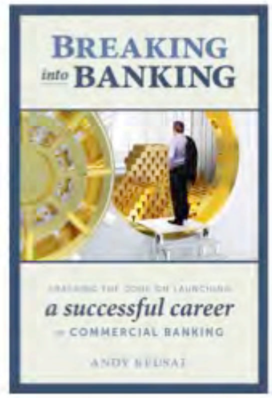
andy@keusallearning.com



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