Commercial Lending School

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Introduction

The five C's of credit are the foundation for this two-day commercial lending school.

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Instructor

Beginning with an analysis of the commercial borrower's character, the program will emphasize measures of repayment, the impact of financial leverage, market and industry conditions to be monitored, the bank's collateral support, and the importance of timely and accurate risk ratings.

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Beginning Basics

A Company's External Environment

Business owners and companies do not exist in a vacuum.

Companies must compete successfully for market share and at the same time navigate the threats presented by what is called the external environment.

4

External Environment

Political / Legal
Social
Economic
Natural
Technological
Industry
Market
Owner **Firm** **Lender**

5

A Company's External Environment

Business owners and lenders must realize that none of the elements of the external environment can be controlled. They can only be anticipated and planned for.

Question: What elements of today's external environment present to greatest threats to your bank's business borrowers?

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Competitive Strategy

Companies compete differently.

Some will compete on price.

Some compete by differentiating their products or services from like competitors.

Others will identify a particular market segment and offer products and services to me unique customer needs.

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Competitive Strategy

Regardless of the competitive strategy, it must be sustainable.

Question: Why is it important to identify the competitive strategy used by your bank's business borrowers?

8

A Company's Life Cycle

Companies, products, markets and industries go through life cycles.

It is important for the lender to identify a company's position in its life cycle as well as the position of key products, markets and the industry itself.

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A Company's Life Cycle

As a company moves through its life cycle, company owners must cope with change.

See the Diagram on Page 3

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Sustainable Financial Leverage

Financial leverage is the relationship between a company's total debt and net worth.

All problem borrowers have too much debt on their balance sheet.

Excessive debt increases a company's operating leverage in two ways. Interest expense is high in relation to net profit.

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Sustainable Financial Leverage

Additionally, depreciation expense increases when debt has been used to acquire fixed assets.

A company's financial becomes "excessive" when the ratio of total liabilities/tangible net worth exceeds 3.00:1.00.

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The Five "C's of Credit

Character – Willingness to Repay

Capacity – Ability to Repay

Capital – Measures the ability to withstand adverse "conditions".

Conditions – The borrower's "external" environment.

Collateral – Strengthens the borrower's character by putting borrower assets at risk.

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Two Foundation Questions

Does the business owner's loan request "make sense"?

Does the request comply with all aspects of the bank's loan policy and credit administration procedures?

Can the loan be originated in compliance with all applicable regulatory and fair lending compliance requirements?

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Two Foundation Questions

Where can the bank "go" with the borrower's relationship?

Given a variety of factors, will the relationship be profitable through repayment?

Will the relationship remain in compliance with all applicable regulatory and fair lending compliance requirements?

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The Purpose of Business Lending

From the business owner's point of view, banks provide loans for the purpose of growing the business and creating an opportunity for the owner to accumulate personal wealth.

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The Purpose of Business Lending

From the banker's point of view, business loans, when properly managed create opportunities for long-term, profitable relationships that serve to increase bank earnings and capital.

Lenders to businesses become risk managers, financial consultants and trusted advisors.

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Types of Business Loans

Lines of Credit provide financing for current working assets of the business such as inventory and accounts receivable.

Annual operating lines of credit are also made to crop and livestock producers.

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Types of Business Loans

Terms Loans provide financing for the acquisition of fixed assets such as vehicles, equipment and even commercial real estate.

Term loans are repaid (amortized) over a specific repayment term.

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Types of Business Loans

Revolving Loans provide financing for a "permanent" investment in the current working assets of the business.

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Calculating the Business Owner's "Character Ratio"

The most subjective aspect in analyzing a small business owner's creditworthiness is the lender's character assessment of the small business owner.

Character is the first and most important of the five "C's" of credit.

While there is no "character ratio" to be calculated, the small business owner's consumer credit report gives important insight into the matter of character.

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Calculating the Business Owner's "Character Ratio"

Key Questions About Credit History

What does the credit report reveal about the borrower's:

Historical ability to manage debt?

Adverse information (late payments, judgments, past bankruptcy)?

Does the borrower have a "credit score" reflective of the bank's tolerance for risk of loss?

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Business Operating Cycles

The operating cycle of a business describes the manner in which current working assets are utilized in the business.

Working assets are typically inventory, accounts receivable and fixed assets.

23

Business Operating Cycles

All operating cycles begin with cash which is most often a combination of the owner's cash and an advance against the lender's operating line of credit.

See the Chart on Page 6

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Business Operating Cycles

At the start of the operating cycle, the owner begins to make a series of "cash investment" decisions.

A significant part of cash flow analysis will be for the bank to determine the quality of these decisions.

Current financial information is required to properly monitor the quality of cash investment decisions.

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Keys to Success for Manufacturers, Wholesalers, Retailers and Service Companies

26

Key Operating Cycle Questions

How does cash flow through the company's operating cycle?

When does cash flow?

When inventory is purchased, manufactured or sold.

When accounts receivable are collected.

When "bills" are paid.

27

Key Operating Cycle Questions

What is the quality of the owner's cash "investment" decisions?

What are the repayment consequences?

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Owner/Lender Goals for All Operating Cycles

Generate "sufficient" cash from operations to start the operating cycle over again.

Pay the Bank.

Pay the Owner.

29

Manufacturers

Start with Cash to purchase…

Raw Materials & Fund Labor Costs to produce…

Finished Goods for Sale to create…

Accounts Receivable for conversion back to…Cash…for Operations, Bank and Owner

30

Lending Risks for Manufacturers

What can go wrong?

An inefficient manufacturing process

Missed sales targets

Poorly managed inventory

Poorly managed accounts receivable

31

Retailers

Starts with Cash to purchase…

Inventory for sale to create…Cash…for Operations, Bank and Owner

Note: Some retailers may offer customers credit terms and create receivables

32

Lending Risks for Retailers

What can go wrong?

Missed sales targets

Poorly managed inventory

33

Wholesalers

Starts with Cash to purchase…

Inventory for sale to create…

Accounts receivable for conversion back to…Cash…for Operations, Bank and Owner

34

Lending Risks for Wholesalers

What can go wrong?

Missed sales targets
Poorly managed inventory
Poorly managed accounts receivable

35

Service Companies

Starts with Cash to support and provide…

Service delivery to create…

Accounts receivable for conversion back to…Cash…for Operations, Bank and Owner

36

Lending Risks for Service Companies

What can go wrong?

Missed sales targets

Poorly managed accounts receivable

37

Steps in Financial Analysis

The steps in financial analysis include:

Balance Sheet and Income Statement Review.

Comparative Analysis.

Ratio Analysis.

Cash Flow and Repayment Analysis.

38

Balance Sheet and Income Statement Review

This review permits the analyst to identify a company's "critical cash factors" which are discussed below.

Remember that these critical cash factors are sources and uses of cash.

39

Comparative Analysis

Comparative Analysis allows the credit analyst to quickly review a company's operating statements. Two types of comparisons can be made.

Internal comparisons where company performance is measured from one year to the next.

External comparisons where company performance is measured against third party data.

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Comparative Analysis

Internal comparisons are effective only if the analyst can establish meaningful trends.

"Common-sized" financial statements facilitate comparative analysis. Common-sizing reduces raw numbers to percentages.

Balance sheet accounts are divided by total assets.

Income statement accounts are divided by sales.

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Critical Cash Factors

These factors represent sources and uses of cash.

Successful business operations depend of how well the owner manages these variables.

They include:

See Page 12

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Critical Cash Factors

The factors are "critical because:

They are controllable by management.

They can be monitored by the bank using the borrower's current financial statements.

Question: Which factor is most important and why?

43

Narrowing the Focus of the Analysis

Question:

Assuming you begin a credit analysis with complete financial information, on average, how long will it take you to complete the analysis?

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Narrowing the Focus of the Analysis

The scope of the analysis can be narrowed identifying what's "most" important to analyze.

Every business has its own "critical cash factors".

A review of the company's balance sheet, income statement and operating cycle allows the lender or credit analyst to identify the important critical cash factors.

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Quick Analysis

A quick analysis focuses on the trends in the common-size percentages for the following:

Sales

Gross Margin

Operating Expenses

"Tangible" Net Worth

Short-Term Debt

This analysis involves three steps.

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Quick Analysis Exercises

See Pages 14 - 15

47

Knowing the Important Ratios

Comprehensive financial analysis of a business' balance sheet and income statement will include the calculation of certain ratios, depending of the purpose of the loan.

48

Knowing the Important Ratios

For example, if the bank is financing a company's current working assets (account receivable and inventory), the following ratios will be calculated:

Days Receivable Ratio

Days Inventory Ratio

Days Payable Ratio

There are five classes of ratio.

49

Cash Flow Available for Debt Service

Basic Cash Flow Questions

See the Diagram on Page 20

50

Underwriting Questions

Is the loan purpose specific? Does the purpose "make sense"?

Is the global debt service coverage ratio acceptable?

51

Underwriting Questions

Have the repayment sources been properly underwritten, including guarantors if applicable?

What is the most appropriate source of repayment for short-term debt, i.e., a line of credit?

What is the most appropriate source of repayment for a term loan?

Is the proposed loan term reasonable and within bank policy limits?

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Two Key Issues in Analyzing Cash Flow

When is a company's cash flow adequate?

What causes the company's cash flow to be volatile?

See the Diagrams on Page 21

53

Calculating Repayment Capacity

Discussion on Pages 22 - 23

54

Financing Current Working Assets and Calculating Working Capital Requirements

The lender faces two primary challenges when structuring a line of credit for the purpose funding a company's working capital requirements.

At initial underwriting, determining the amount of the line, or in the case of renewing an existing line, how much additional funding will be required.

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Financing Current Working Assets and Calculating Working Capital Requirements

Determining, based on a variety of factors, when to inform the borrower that the bank will no longer increase short-term debt and will now require the borrower to amortize some portion of the short-term debt currently extended.

To better understand these two challenges, a general understanding of working capital is required.

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Working Capital

"Net" Working Capital is defined as Current Assets – Current Liabilities.

Working capital bridges the "gap" between the sale of inventory, collection of accounts receivable and the payment of accounts payable to trade creditors.

See the Diagram on Page 24

57

What Creates A Need For Working Capital?

Growth in sales

Creation of a competitive advantage

Take advantage of trade discounts

Fund operating Losses

Overcome inefficiencies in the operating cycle

58

Calculating the Working Capital Financing Gap

The financing gap calculation is used to project a company's working capital requirements based on current and projected sales.

Consider the following financial information on Pages 25 – 26.

59

Calculating the Working Capital Financing Gap

Accounts receivable, inventory and accounts payable are the primary components of a company's working capital.

These components can be expressed as a percentage of sales.

Review the Calculation on Page 26

60

Financing Gap Calculation

A company's financing gap is the owner's cash investment in accounts receivable and inventory less the financing provided by accounts payable.

This assumes that the growth in working capital components will be proportionate with the growth in sales.

61

Financing Gap Calculation

For ABC Company, each $1.00 increase in sales will result in a funding gap of 37 cents.

This gap must be funded by internally generated profit, a capital contribution or an increase in the bank's line of credit.

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Determining When to Term Out Revolving Debt

The second challenge when structuring lines of credit is how to determine when to inform the borrower that the bank will no longer increase short-term debt and will now require the borrower to amortize some portion of the short-term debt currently extended.

The bank's decision is based on the answers to five questions:

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Determining When to Term Out Revolving Debt

Whenever the owner's projected sales growth will cause the above factors to exceed the control points, a portion of the current line of credit must be amortized.

Note: A loan agreement covenant requiring the borrower to maintain a minimum 1.30:1.00 current ratio limits the maximum short-term debt to a manageable amount.

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Determining When to Term Out Revolving Debt

The first step in determining the amount of revolving debt to amortize is to calculate the company's core cash flow.

Consider the following model:

See Page 28

65

Understanding the Relationship Between Balance Sheet Equity and Financial Leverage

Question:

How do business owner's measure "success"?

In other words, what is the business owner's priority for the use of cash?

66

Balance Sheet Equity

The "Balance Sheet Equation" is Assets = Liabilities and Equity (Net Worth).

The business' equity is the difference between total business assets (adjusted for overstatements) less total liabilities.

67

Balance Sheet Equity

Assets adjustments are typically made for overstated (uncollectible) accounts receivable and (unsalable) inventory.

Other asset adjustments include assets that add no tangible business value.

68

Financial Leverage

Financial leverage is the relationship between business equity and total business debt. The best measure of leverage is <u>Tangible (Adjusted) Net Worth divided by Total Liabilities.</u>

A debt/tangible net worth ratio of <u>less than</u> 3.00:1.00 is acceptable.

A ratio greater than 3.00:1.00 indicates excessive financial leverage.

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Financial Leverage

A company's debt/tangible net worth financial leverage ratio indicates to what extent the business can withstand long-term financial adversity (i.e., risks from the company's external environment.

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Loan Structure Issues

Cash Flow Adequacy Questions

See Page 30

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Loan Structure Issues

Cash Flow Stability or Volatility Questions

If the company's cash flow is not stable, what is causing the volatility?

Is repayment risk increasing due to unacceptable debt service coverage?

Is the borrower's total debt improperly structured?

Is the borrower's financial leverage increasing?

Has the bank exceeded its established collateral advance rates?

72

Loan Structure Issues

Loan Support Provided by Collateral

What are the bank's advance rates on various classes of collateral?

How will the bank monitor the quality of its collateral over the life of the loan?

73

Loan Structure Issues

Acceptable Repayment Terms

Are repayment terms in compliance with established loan policy requirements?

Is the bank financing the shorter of either the useful life of the asset or the depreciable life of the asset?

Is there an acceptable relationship between the company's core cash flow and its outstanding debt?

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Loan Structure Issues

Loan Monitoring Requirements

What will be the bank's financial statement requirements and what will be the frequency of presentation of this information?

What affirmative and negative covenants will be incorporated into the commercial loan agreement?

75

Loan Structure Issues

Questions Related to Loan Structure

See Page 31

76

Loan Structure Mistakes

Bank lenders can make the following "unforced errors":

See Page 32

77

The Owner's Personal Financial Statement

Basics to Consider

Before evaluation of the owner's personal financial statement, consider the following:

Is the statement addressed to your bank?

Have all sections been completed by the borrower?

Is the statement signed and dated by the borrower and spouse (if all or some of the assets are owned jointly?)

78

The Owner's Personal Financial Statement

Is the financial statement current (by date) in compliance with bank policy?

Is the statement dated prior to loan disbursement?

Has the statement been checked for math errors?

Does the statement summarize debt service payments?

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The Owner's Personal Financial Statement

Have all contingent liabilities been itemized?

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The Owner's Personal Financial Statement

The Mix of Assets and Liabilities

See Page 33

81

The Owner's Personal Financial Statement

Other Considerations

See Page 34

82

Adjusting Net Worth

The borrower's personal financial statement must be adjusted for the over (or under) stated value of the assets and liabilities listed.

This process is both objective and subjective.

For example, liabilities can be checked against the borrower's credit report.

83

Adjusting Net Worth

Cash balances can be verified. Some assets, such as marketable securities, can be checked against most recently quoted prices.

In the case of other assets, the process can be very subjective.

Adjustments can be made on the basis of the bank's experience in liquidating certain types of assets.

84

Adjusting Net Worth

In other cases, the lender can rely on general knowledge of the local market.

Typically, the following assets, if listed, are "adjusted" or deducted from net worth:

See Page 34

85

Impact of Contingent Liabilities

While a borrower's contingent liabilities can include litigation, the primary concern for lenders is to identify all of the personal guaranties given by the borrower.

Personal guaranties are required for several reasons:

See Page 35

86

Impact of Contingent Liabilities

There are two truths with regard to personal guaranties:

The only time a bank relies on the guaranty is when problems arise.

Problems arise for guarantors (and the bank) at the worst possible time!

87

Impact of Contingent Liabilities

A personal guaranty always represents a potential claim on the borrower's liquidity and net worth.

Reminder: A bank cannot require a spouse to guarantee company debt unless the spouse is a shareholder or company officer. (Regulation B)

88

Underwriting the Value of Personal Guarantees

What is the purpose of a personal guarantee?

What is a personal guarantee really worth?

89

Underwriting the Value of Personal Guarantees

The "cash" value of a personal guarantee must be supported by the guarantor's unassailable character (extreme willingness to repay) and personal (measurable) wealth (realistic ability to repay).

All personal guaranties must be underwritten using current financial information.

Personal Guaranties may be" unlimited" or "limited".

Personal Guaranties may be unsecured or secured.

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Sample Provisions of An Unlimited Personal Guaranty

Sample Provisions are listed on Page 36

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Evaluating the Bank's Collateral Position

Collateral – Strengthens the borrower's character by putting borrower assets at risk.

Question:

When is the only time the bank relies on the value of collateral?

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Evaluating the Bank's Collateral Position

Key Beginning Points

Cash (and only cash) repays a loan!

Not Collateral!

Just Cash! (Preferably the Borrower's Cash!)

93

Evaluating the Bank's Collateral Position

Collateral is only as good as the lender's ability to locate it, identify it, lay legal claim to it and sell it for enough to recover the outstanding principal balance plus interest and the cost of liquidation.

94

Evaluating the Bank's Collateral Position

Collateral Quality is a function of:

Collateral Liquidity

Marketability

Dependability of Value

Controllability

95

Evaluating the Bank's Collateral Position

Collateral Value

Collateral supports timely and orderly repayment.

The bank's valuation of current and proposed collateral is one of the most important parts of the loan underwriting process.

96

Evaluating the Bank's Collateral Position

Banks establish "advance rates" for various types of collateral in order to establish prudent loan-to-value relationships between the collateral and outstanding indebtedness.

For example:

See Page 37

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Assigning Timely and Accurate Risk Ratings

Credit risk is the primary financial risk in the banking system and exists in virtually all income-producing activities.

How a bank selects and manages its credit risk is critically important to the bank's performance over time.

98

Assigning Timely and Accurate Risk Ratings

Capital depletion through loan losses has been the primary cause of nearly all bank failures.

Identifying and rating credit risk is the essential first step in managing it effectively.

It is a regulatory expectation for banks to have loan quality risk management systems that produce accurate and timely risk ratings.

99

Assigning Timely and Accurate Risk Ratings

Accurate classification of borrower relationships is among the top supervisory priorities.

An effective loan quality rating system provides Management and the Board of Directors with a clear picture of the makeup and quality of the bank's loan portfolio.

100

Board and Management Expectations

No single credit risk rating system works for every bank.

The risk rating parameters described below should be incorporated into the bank's loan quality rating system.

The system should be integrated into the bank's overall portfolio risk management.

101

Board and Management Expectations

It should form the foundation for credit risk measurement, monitoring, and reporting, and it should support management's and the board's decision making.

The board of directors should approve the credit risk rating system and assign clear responsibility and accountability for the risk rating process.

102

Board and Management Expectations

The board should receive sufficient information to oversee management's implementation of the process.

The risk rating system should assign an adequate number (or range) of ratings.

103

Board and Management Expectations

To ensure that risks among pass credits (i.e., those that are not adversely rated) are adequately differentiated, most rating systems require several pass grades.

Risk ratings must be accurate and timely.

104

Assigning Ratings

The criteria for assigning each rating should be clear and precisely defined using objective (e.g., cash flow coverage, debt-to-worth, etc.) and subjective (e.g., the quality of manage-ment, willingness to repay, etc.) factors.

Ratings should reflect the risks posed by both the borrower's expected performance and inherent transaction risk.

105

Assigning Ratings

The risk rating system should be dynamic — ratings should change when the risk of loan loss changes.

The risk rating process should be independently validated (in addition to regulatory examinations).

106

Assigning Ratings

Banks should determine through back-testing whether the assumptions implicit in the rating definitions are valid that is, whether they accurately anticipate outcomes.

If assumptions are not valid, rating definitions should be modified.

The rating assigned to a borrowing relationship should be well supported and documented in the credit file.

107

Loan Quality Rating Controls

A number of interdependent controls are required to ensure the proper functioning of a bank's loan risk rating process.

The board and senior management must ensure that a suitable framework exists to identify, measure, monitor, and control credit quality and the risk of loan loss.

108

Loan Quality Rating Controls

Board-approved policies and procedures must guide the risk rating process.

These policies and procedures should establish the responsibilities of both management and individual lenders.

The board and management also must instill a credit culture that demands timely recognition of the risk of loss and a lending culture that has little tolerance for rating inaccuracy.

109

Staffing

The best and most important control over loan quality ratings is a well-trained and properly motivated staff.

Personnel who rate credits should be proficient in the bank's rating system and in credit analysis techniques.

110

Staffing

Most banks typically assign the responsibility for loan quality ratings to individual loan officers.

Loan officers maintain the closest contact with the borrower and have access to the most timely information about their borrowers.

111

Staffing

Keep in mind, however, that their objectivity can be compromised by those same factors and their incentives are frequently geared more toward producing loans than rating them accurately.

112

Subjective vs. Objective Risk Ratings

Subjective loan quality ratings provide narrative guidance to assess the risk of loan loss.

Examples: Narrative descriptions of risk levels such as "Substantially Risk Free", "Minimal Risk", "Modest Risk", etc.

113

Subjective vs. Objective Risk Ratings

Objective loan quality ratings provide defined guidance.

Examples include:

Current Ratio Requirements

Debt to Tangible Net Worth Requirements

Debt Service Coverage Requirements

114

Range of Ratings

The range (or individual number) of ratings depends on:

The scope of the bank's lending activities

The composition of the bank's loan portfolio

The size of the bank's loan portfolio

The bank's historical experience with loan loss

115

Risk Rating Exercise

On Pages 40 - 41

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Two Questions

Would you describe your bank's loan quality rating descriptions as more subjective or more objective in nature?

Do you believe that risk ratings are applied in a timely and accurate manner by lenders, credit analysts and loan review staff at all times?

117

Problem Loan Management

When is a borrower really a "problem"?

When the borrower cannot repay according to the note's repayment terms.

When the borrower cannot otherwise perform per a governing commercial loan agreement.

When the borrower's "loan support" (collateral, personal guaranty) no longer offsets the current repayment weaknesses.

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Problem Loan Management

Problem Loan Definition

Any loan with the potential for a breakdown in the repayment agreement which subjects the bank to the prospect of loss.

119

Problem Loan Management

The following should be documented in a problem borrower report.

See Page 42

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Trend Analysis Case Studies

On Pages 43 - 45

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Concluding Case Study

Acme Corporation

Pages 46 - 50

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Concluding Observations

See Page 51

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Your Questions?

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