Loan Underwriting & Processing

EPA Region 1 RLF Grantee Workshop

Southbridge Hotel – Crystal Ballroom

Southbridge, MA

April 6, 2017

Preliminary Information

- Who is the Borrower?
- What is the proposed project?
- What are the project costs?
- How much do they need to borrow?
- Does the Financing fit?

Preliminary Information

- Basic financial/company information required for first meeting :
  - 3 years financials;
    - Historical Sales/profitability/net worth; and,
    - Projections: Start-up – Full Occupancy.
  - Ownership structure/involvement/management experience.

Goal of Credit Analysis

- Make sound investments with long-term returns:
  - Healthy projects create permanent jobs.
- Answer the question:
  - Will the borrower have sufficient cash in the future to repay the loan?
- Requires assessment of likelihood that borrower will achieve future goals in context of:
  - Market;
  - Management capacity; and
  - Financial plan.

What is Credit Analysis?

- Trend Analysis:
  - comparing a project to itself (3 yrs financials)
- Raises issues or questions:
  - doesn’t supply answers;
  - points in which direction to look.
- Numbers don’t lie, but they can hide the truth!

What is Credit Analysis?

- Credit Analysis cannot be done in vacuum!
  - Process of:
    - field visits and interviews;
    - analysis of financials, market and economy; and
    - requests for additional information.
- Game of Interpretation and Opinions:
  - No two analysts will review deal the same way.
  - Any lender with a track record has lost money.
  - Not science - but ART!

What is Credit Analysis?

- By determining the strengths and weaknesses of:
  - Marketplace;
  - Management capacity and organizational structure; and,
  - Financial performance and plan,
- You identify risks to future cash flow and financial position.

Credit Analysis Process

- Is Cash Flow > Debt Service?
  - Analyze 3 years financials:
    - B/S - Management of company’s resources;
    - P/L - Company’s ability to buy & sell/make profits.
  - Analyze financial projections:
    - Do projections pass the “Straight Face Test”;
    - Are the assumptions reasonable based on:
      - Economy;
      - Marketplace;
      - Vacancy Rates.

Credit Analysis Process

- Collateral:
  - Fixed assets vs. current assets/intangible;
  - Valuation and Security vs. liquidation; and
  - Guarantees.
- Character:
  - Management experience;
    - Historical performance/clues from Balance Sheet.
  - Gut feeling from meetings.

The Business Plan

- Basic Business Plan should include the following information:
  - Project history and description;
  - Market information;
  - Management experience;
    - Resumes of key staff, board members, and owners
  - Historical, interim, and annual financial statements; and,
  - Projected financial statements.

The Business Plan

- A communication tool:
  - Represents the borrower/project;
  - Educates lenders, investors, advisors, and partners;
  - Demonstrates management's understanding, capacity and commitment;
  - Serves as a basis to secure financing; and,
  - Demonstrates the likelihood of reasonable return on investment/profitability.

Evaluating the Business Plan

- General questions to consider:
  - Is there a compelling need?
  - Is there proof that the target market is interested?
  - What are the benefits to the project?
  - Is there a sustainable competitive advantage?
  - Can the risks be mitigated?
  - Can a profit be made?
  - How much investment is required?

Balance Sheet vs. Profit & Loss

Balance Sheet	Profit & Loss Statement
How well the company manages its financial resources.	How well the company buys and sells services to make a profit.
Snapshot of financial condition at an instant in time: i.e. Dec. 31, 2001.	Reports financial results over a period of time: i.e. Jan. 1 – Dec. 31, 2001.
Matches sources and uses of funds.	Matches revenue and expenses.

Analyzing the Balance Sheet

- Current Assets:
  - Assets that mature into cash within 12 months:
    - Cash
    - Accounts Receivable
    - Inventory
    - Notes Receivable
    - Prepaid Expenses
    - Other Current Assets
- Long-term Assets:
  - Assets that mature into cash in more than 12 months:
    - Net Fixed Assets
    - Investment in Subsidiaries
    - Intangibles

Analyzing the Balance Sheet

- Current Liabilities:
  - Liabilities that must be paid with cash within 12 months:
    - Note Payable
    - Accounts Payable - Trades
    - Accruals
    - Taxes Payable - Income
    - Current portion of Long-term Debt
- Long-term Liabilities:
  - Sources of funds that must be paid with cash in more than 12 months:
    - Long-term Debt
    - Subordinated Officer Debt

Analyzing the Balance Sheet

- Net Worth (also known as Stockholder Equity):
  - Sources of funds that never are due: can be earned or purchased:
    - Stock
    - Capital Surplus
    - Paid-in-Capital
    - Retained Earnings

- Do I want to do this deal?
  - Practical Answer:
    - Is the borrower collecting receivables on time?
    - Are creditors happy and are bills paid on time?

Analyzing the Profit and Loss Statement

- Cost of Goods Sold (COGS):
  - Variable expenses related directly to the product or service sold.
- Selling & General Admin. (SG&A):
  - Fixed expenses or basic overhead costs to operate business.
- Discretionary:
  - Expenses entrepreneur can control in order to limit reported profit.
- Determines cash flow available to repay debt.

Analyzing the Profit and Loss Statement

- Goal: separate variable, period and discretionary expenses for analysis,

	Sales	
-	Cost of Goods Sold	(variable expenses)
=	Gross Profit	
-	Selling & General Admin.	(fixed expenses)
=	Operating Profit	
-	Officer Salaries	(discretionary expense)
-	Interest	(discretionary expense)
-	Depreciation	(non-cash expense)
-	Rent	(discretionary expense)
+	Other Income (Expenses)	
=	Earnings Before Taxes	
-	Taxes	
=	Profit After Tax	

Cash Flow Analysis

CASH FLOW:	**2009**	**2010**	**Year 1**	**Year 5**
Net Operating Income #1	($62,000)	$13,000	($3,000)	$200,000
+Depreciation Expense	$3,000	$1,000	$75,000	$75,000
+Interest Expense	$13,000	$16,000	$84,000	$80,000
+Rent/Other Non Reccuring Exp	$22,000	$24,000	$0	$0
=Total Cash Flow	($24,000)	$54,000	$156,000	$355,000
Annual Debt Service (P&I)	2009	2010	Year 1	Year 5
Existing Senior CREM	$77,000	$77,000	$77,000	$77,000
Proposed SMPDC CREM	$0	$0	$124,000	$124,000
Total Debt Service	$77,000	$77,000	$201,000	$201,000
Cash Surplus/(Deficit)*	2009	2010	Year 1	Year 5
*Cash Flow - Debt Service	($101,000)	($23,000)	($45,000)	$154,000
Debt Service Coverage Ratio*	2009	2010	Year 1	Year 5
*Cash Flow/Debt Service	(0.3)	0.7	0.8	1.8

Overview of Financial Ratios and Quality Indicators

- Financial Ratios and Quality Indicators provide clues to the management of company's financial resources.
- Provides qualitative, not quantitative, information:
  - Strengths and weaknesses.
- Illustrates Trends:
  - Getting better is more important than being good.

Overview of Financial Ratios

- Working Capital:

  Current Assets - Current Liabilities

  - Measure of liquidity:
    - excess of current assets over current liabilities.
  - Look for a positive and growing amount of working capital as a sign that the company can handle its obligations.

Overview of Financial Ratios

- Current Ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

  - A variation on the working capital measure of liquidity.
  - Look for a 2 : 1 ratio, which indicates that there are twice as many current assets to satisfy current obligations.

Overview of Financial Ratios

- Quick Ratio:

$$\frac{\text{Cash + Accounts Receivable}}{\text{Current Liabilities}}$$

  - Another variation on the working capital measure of liquidity:
    - Measures assets closest to cash to pay current obligations.
  - Look for a 1 : 1 ratio.

Overview of Financial Ratios

- Debt to Equity Ratio:

$$\frac{\text{Total Liab. - Sub. Officer Debt}}{\text{Net Worth + Sub. Officer Debt - Intangibles}}$$

  - Measures the % of the company financed by lenders relative to owner financing.
  - Strictly used as a credit test:
    - Higher the ratio lower the owner investment.
  - Weakness is the measure doesn't account for quality or timing of debt.

Overview of Quality Indicators

- Five Balance Sheet questions:
  - Does the company collect its bills?
    - How large and old are Accounts Receivable?
  - Does the company pay its bills?
    - Days large and old are Accounts Payable?
  - Does the company control its inventory?
    - What is the Vacancy Rate?
  - Are the officers committed to the company?
    - Notes Receivable/Subordinated debt/Debt to Equity
  - Does the company have a successful history?
    - Positive Retained Earnings

Overview of Quality Indicators

- Five Profit & Loss Statement questions:
  - Is the company growing?
    - Are Sales/Gross Revenue increasing?
  - Does the company control its Margins?
    - COGS stable or falling?
  - Does the company control its Overhead?
    - SG&A stable or falling?
  - Is the company Profitable?
    - EBT stable or increasing?
  - Is there hidden cash flow?
    - Officers Comp./Saved Rent/Depreciation/Interest

Secondary Sources of Repayment

- Provide fallback position for lender in the event that projected profitability is not achieved.
- Balance Sheet analysis is only a starting place for determining the collateral value of assets, whose convertibility to cash under adverse conditions requires professional assessment.

Collateral

- Collateral Requirements:
  - Security Agreement/lien on all business assets, real and personal;
  - Mortgages, commercial and personal;
  - Personal Guaranties; and,
  - Assignments of: Life Insurance, Stock and Leases.
- Fixed assets vs. current assets/intangible:
  - Real Estate and Machinery & Equipment; vs.
  - A/R, Inventory and Good Will.

Collateral

- Valuation and Security vs. liquidation:
  - Appraisals can represent Fair Market or Liquidation Values;
    - Sellers
    - Auctioneers
    - Trade bulletins and publications

Real Estate	Stabilized MV	Discount	Discounted Value	Mortgage Balance	Available Equity
#1 Mill, LLC "As Is"	$500,000	20%	$400,000	$900,000	($500,000)
#1 Mill, LLC "As Completed"	$2,400,000	20%	$1,920,000	$900,000	$1,020,000

- Guarantees establish:
  - Nature of guarantor's commitment; and
  - Independent creditworthiness.

Loan to Value/Debt Coverage Ratio

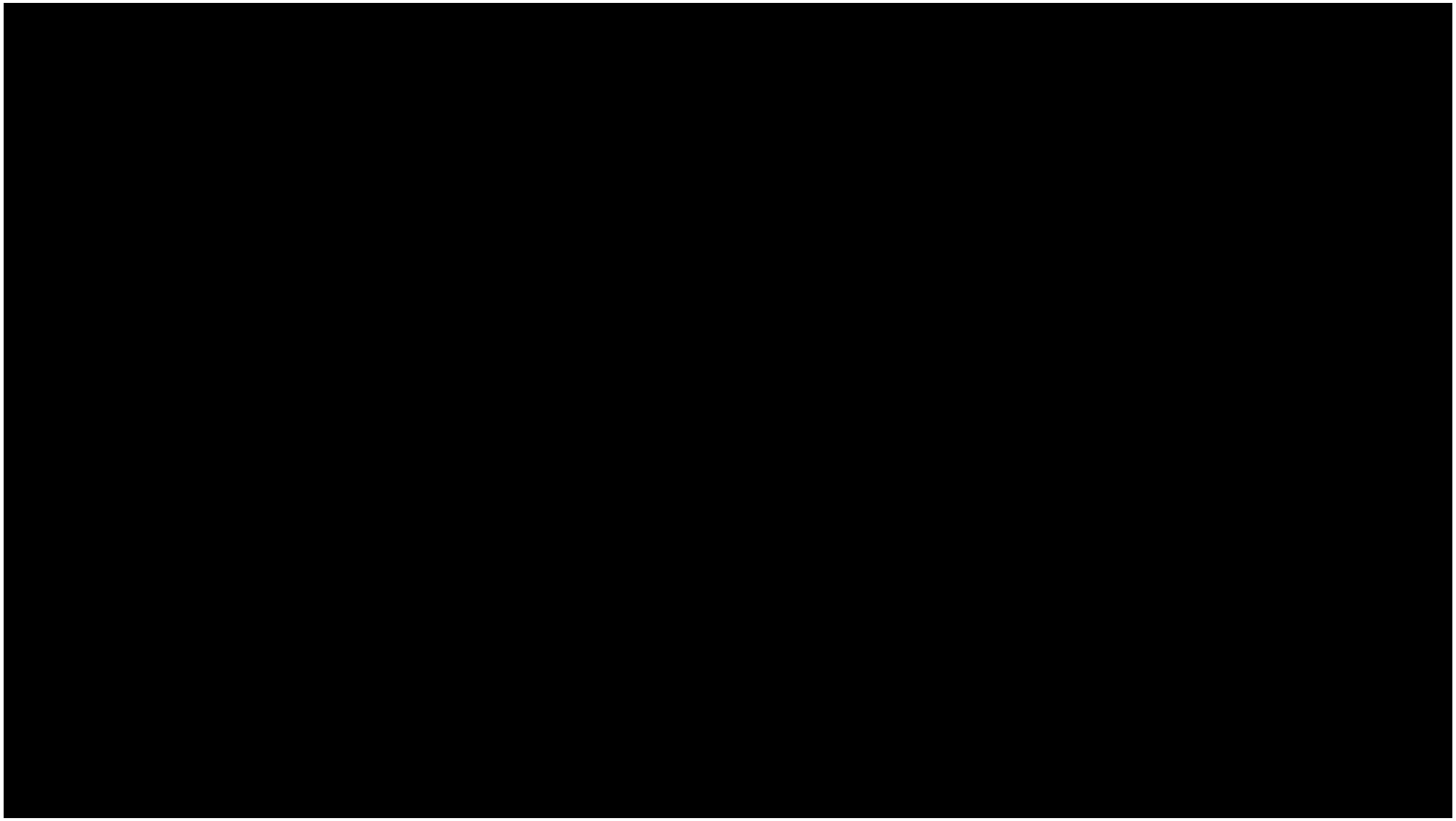
Loan to Value (LTV) Analysis:		Loan Amount /	Collateral Value	= LTV Ratio
1) Senior CREM		$900,000	$1,966,250	0.46
2) #1 + Proposed SMPDC CREM		$1,975,000	$1,966,250	1.00
Debt Coverage Ratio (DCR) Analysis:		Collateral Value	/ Loan Amount	= DCR Ratio
1) Senior CREM		$900,000	$1,966,250	2.18
2) #1 + Proposed SMPDC CREM		$1,975,000	$1,966,250	1.00

Supporting Documentation to the Loan Decision

- Purpose of supporting Documentation
  - Third Party Verification of the Business' Ability to Repay your Loan
  - Guard against Fraud
- Credit Report - personal credit history of the guarantors
- Dunn & Bradstreet Report – credit history of business
- Verification of Tax Returns
- Business Financial Statements
- Business Tax Returns
- Personal Financial Statement
- Copies of Bank Statements
- Copies of Key Credit Items (credit card statement, home mortgage invoice, etc.)
- Verify ownership of assets listed as "contributed equity" to the project

Pepperell Mill Campus

Pepperell Mill Campus



North Dam Mill/Pepperell Mill

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