Small Business Lending

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Consulting for Change
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Agenda

- Introductions and Overview
- Small Business Credit Analysis
  - Cash Flow: Financial Analysis
  - Collateral
  - Credit
  - Character
  - Capital
  - Community Benefit
- Putting it all together
- After the loan: getting paid

Introductions

- Name
- Organization
- Most important thing you want to take out of this class

Goals for this Training

1. Gain greater perspective on CDFI small business lending activity
2. Share a framework for small business lending from application to approval
3. Improve underwriting skills
4. Review a case study
5. Integrate training into day to day operations

The Five Cs of Credit, plus

- ✓ Cash Flow, AKA Capacity
- ✓ Character
- ✓ Collateral
- ✓ Credit
- ✓ Capital
- ✓ And, for CDFIs, community benefit

Cash Flow

- Also Capacity, ability to repay
- "Cash is King"
- Quality of Statements, Tax returns
  - Difference from non-profits
  - Corporations, partnerships, and sole proprietorships
  - Incentive to report low profits - low taxes

The Major Financial Statements

- Balance Sheet: Snapshot in time of what is owned & owed
- Income Statement: Flow of funds; revenues and expenses

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Beginning Balance Sheet — Income Statement — Ending Balance Sheet

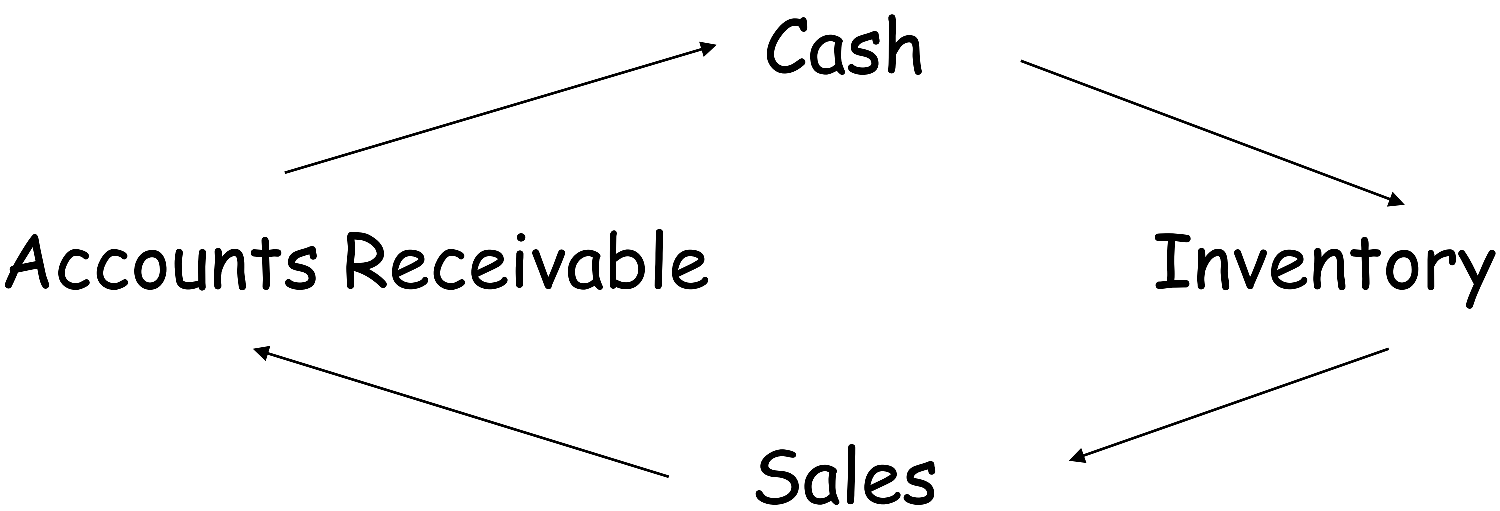
Current vs. Long Term

- Current
  - Assets: is or will become cash in 1 year or less
  - Liabilities: is due to be paid in one year or less
- Long Term
  - Assets: will last more than one year (also called fixed assets)
  - Liabilities: does not have to be paid in the coming 12 months

Balance Sheet - Current Assets

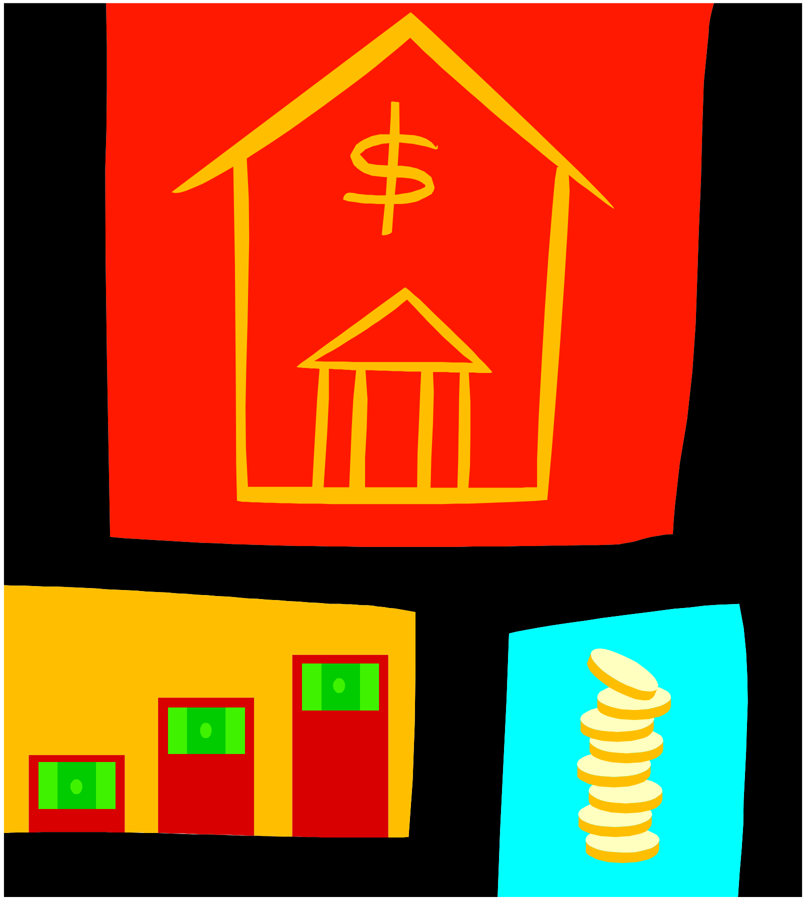
- Snapshot of what the business owns and owes

Current Assets - Operating Cycle



Balance Sheet - Assets

- Fixed (or Long Term) Assets
- Other Assets
- Red Flags
  - High levels of Accounts Receivable
  - Old Inventory
  - Lack of Investment in Fixed Assets



Balance Sheet - Liabilities

- Current Liabilities
  - Accounts Payable, Accruals, CLTD
- Long Term Liabilities
  - Loans
  - Officer's Debt
- Red Flags
  - Unpaid Taxes
  - Too much debt

Balance Sheet - Net Worth

- Net Worth

  Initial Investment

  \+ Retained Earnings

- Assets = Liabilities + Net Worth

Red Flags

- Negative Net Worth = Losses
- Little or no owner investment
- Withdrawals of retained earnings

Income Statement

- Flow of Revenues and Expenses
  - Cash Vs. Accrual
  - Sales
    - Is there a market for this product? At this price?
    - Who are the competitors?
  - Expenses: Variable and Fixed
    - Variable: Inputs: COGS, labor, supplies
    - Fixed: Overhead: rent, insurance, support staff

Income Statement: COGS

- In a *retail or service* setting:

  Opening Inventory
  + Purchases
  - Ending Inventory

- In a *manufacturing* setting:

  Opening Inventory
  + Direct Labor
  + Manufacturing Overhead
  + Purchases
  - Ending Inventory

Income Statement: Expenses

- SG & A Expenses
  - Officer's Salary
  - Rent
  - Interest
  - Depreciation
- Net Income Before Tax

Income Statement

- Red Flags
  - Losses
  - Large Fluctuation in Gross Profit as a % of Sales
  - Inventory levels stay the same
  - Fixed Costs rising rapidly
  - Owners taking out too much income
  - “Missing” Expenses

Debt Service Coverage

- What is the annual cost of the proposed loan?
  - Fixed principal Vs fully amortized
- Calculating Cash Available for debt service:

Net Income

+ Non Cash Expenses
- Existing CLTD (principal)
- New Expenses
+ Expense Savings
= Cash Available to pay for new debt
- Proposed Debt Service
=Cash Flow After New Debt

Debt Service Coverage

- Debt Service Coverage Ratio:

  = Cash Available to pay for new debt/Proposed debt service

- What level of coverage is acceptable?
  - Should be more than 1.0!!
  - (Banks often require 1.4!)
  - Can you squeeze out some expense savings?

Cash Flow from Projections

- Difference between a startup and an existing company's projections
- Evaluating the reasonableness of projections
  - Compare to past performance
  - Compare to industry averages
  - Basis for increased revenues
  - Make sure all costs are covered

Dealing with inaccurate financials

- What are Material inaccuracies?
- Common issues
  - Inventory never changes
  - Mixing accrual and cash method
  - Missing Expenses
  - Others you've seen

Dealing with inaccurate financials

- Owner doesn't understand financials
  - Bookkeeper?
  - Accountant?
- Is it a tax-dodge?
- When to "recast," provide TA, reject
- Doing sensitivity analysis
- Monitoring issues if you approve

Common Financial Ratios

- Current Ratio
  - Current Assets/Current Liabilities
  - Can the business meet its obligations?
- Quick Ratio
  - Cash + A/R/Current Liabilities
  - Is the business liquid enough to meet obligations?
- Debt to equity
  - Liabilities/Net Worth
  - How leveraged is the business?

Operating Cycle

- Compares financial performance as sales change

  - Day Receivable: Accounts Receivable X 360

    Annual Sales

  - Days Inventory: Inventory X 360

    COGS

Operating Cycle

- Days Payable: $\dfrac{\text{Accounts Payable X 360}}{\text{COGS}}$

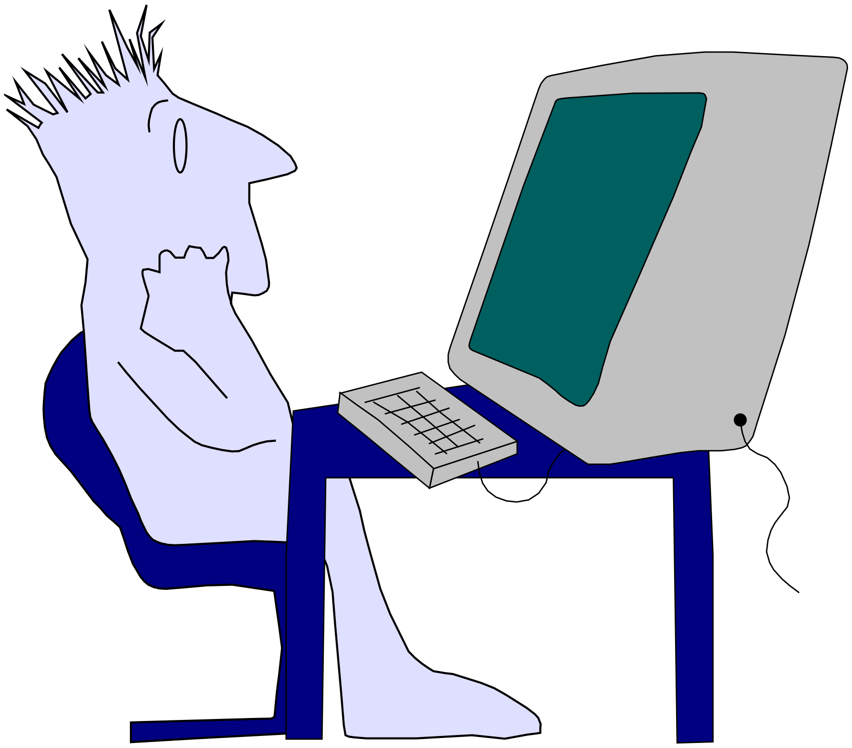
- Days Accruals: $\dfrac{\text{Accruals X 360}}{\text{Sales}}$

Other Financial Considerations

- Trends
  - Sales
  - Profits
  - Investment
- Industry Comparisons
- Financial Management & Sophistication
  - How has the company managed growth? Downturns?

Conclusion: Cash Flow

- Can the borrower repay?
- Is the borrower well managed financially?
- Do you feel comfortable with the loan so far?

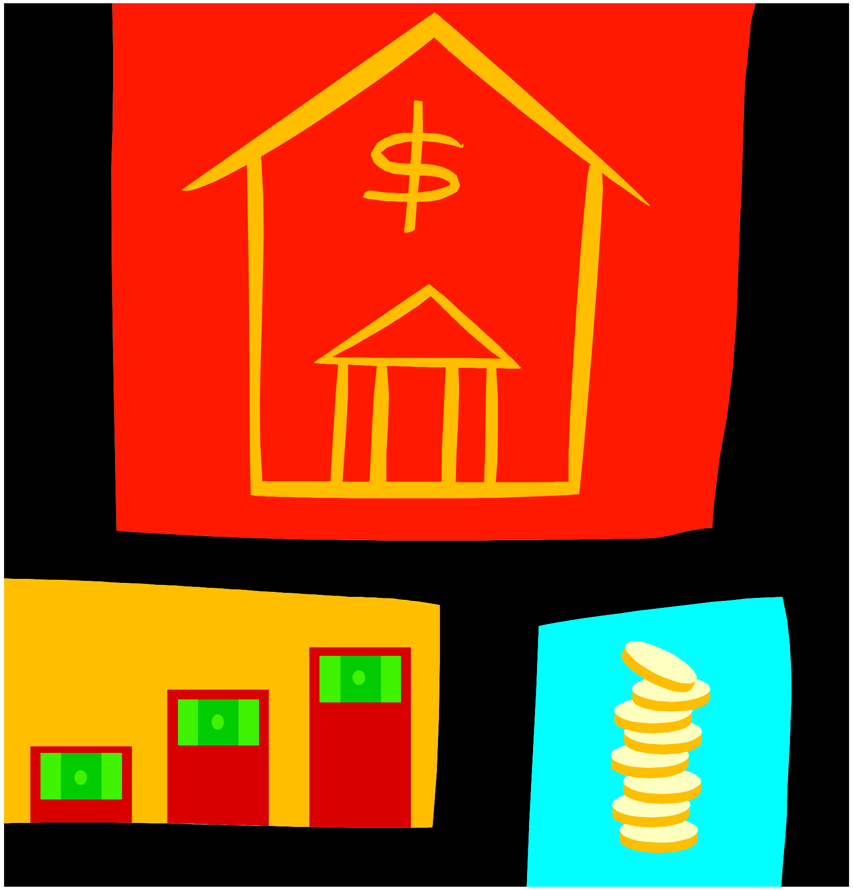


Collateral

- Collateral as the “second way out”
- Value of Collateral at collection time
  - Real Estate - 80%
  - Equipment - 60 - 80% (or less if older, specialized)
  - Accounts Receivable & Inventory - 50% (or less)
- Personal Guarantees
- Lien on personal real estate
- Tradeoff between cash flow & collateral

How to Value Collateral

- Vehicles
  - Kelly Blue Book - www.kbb.com
- Equipment
  - Book Value
  - Equipment Suppliers
  - Junk Value
- Real Estate
  - Appraisal



Credit

- Credit History of Business & Owner
- Business
  - Supplier checks
  - Other lenders
- Owner
  - Credit report
  - Property search

Credit

- How to evaluate a “bad” credit report
  - Pattern of late, non-payments Vs one time or one period
  - Acceptable reasons for one time problem
    - Attempt to repair credit
    - Honesty counts for a lot!
  - Red Flags:
    - Tax Problems
    - Bankruptcy

Character

- AKA Management Ability
- What are the owner's management strengths & weaknesses?
  - Is the owner the only manager?
    - Inside vs. outside "man"
  - What is the owner's support system?
  - Is there a management team? Who manages the financial aspect?

Capital

- AKA Equity
- Represents owner's financial commitment to business
  - Officer's Debt: Is it equity or debt?
- Can/Will owner put equity into this deal?
- Equity as a barrier to business ownership, especially for minorities

And, for CDFIs, community benefit

- What is the mission? What can be measured?
  - Jobs created & retained
  - New businesses created
  - Minority, women, low income ownership
  - Progressive managements
  - Alternative ownership structure
  - Qualitative Measures
- How often do you monitor?

Structuring the Loan

- Term
  - Matching the term to the use of the loan
  - Making it easy for the borrower to make the payments
- Rate: Fixed vs. Floating
- Collateral Requirements
- Guarantees
- Loan Covenants

Putting it all together

- Cash Flow
  - Can the borrower repay the loan from cash flow?
- Character
  - Does the owner have the skills?
- Collateral
  - Can we recover via the “2nd way out?”
- Credit
  - Has the applicant honored obligations in the past?
- Capital
  - Is the owner financially invested in the business?
- Community Benefit
  - Will the loan create social benefit? Will the applicant cooperate?

Putting it all together

- Evaluate strengths and weaknesses
- Cash Flow is a MUST!
- How many weaknesses sink a deal?
- Can Technical Assistance make up the gap?
- What else could help you recommend this deal?

After the loan is closed . . .

- Getting paid
- Technical Assistance
- Collections

Getting paid

- ACH improves payment results
  - If not ACH, monthly invoices
- The "can't pay" vs. the "won't pay"
- If they don't pay, call right away
  - Hold borrowers accountable
- When to recast a loan?

Technical Assistance

- What do you offer?

- What do small businesses need?
  - Financial Management & Analysis
  - Help with pricing
  - Marketing
  - H.R.
  - Other?

Collections

- If nothing else works . . .
- Have a definite schedule for dealing with late payments!
- How to make collections a priority
- Effective collections can prevent foreclosure
- When to go to foreclosure
  - Evaluate collateral value
  - Understand the legal process in your state

Final Thoughts . . .

- Credit Analysis
  - Five Cs
- Which weaknesses sink a deal?
- Can a deal be “too strong?”
- Credit Review Process
- How can you add value throughout the process
- How can you be more customer oriented?

Return to the Real World . . .

- How will I use what I learned in this training in my work with small businesses?