

# **MASSACHUSETTS BANKERS ASSOCIATION**

## **Fundamentals of Commercial Lending**

### **Day 1**

**9:00 – 10:15**

#### **Foundation Concepts in Commercial Lending**

Purpose of Financial Analysis

- Evaluate Prior Performance

- Project Future Performance

- Identify Risk, Quantify Risk, Make Judgments About Acceptable Risk

- Evaluate Borrowers Ability to Service Debt

- Evaluate Borrower's Ability to Withstand Adversity

Focus of Financial Analysis

- Adequacy/Growth/Volatility of Sales

- Gross Margin

- Operating Costs/Leverage

- Working Assets

- Structure of Liabilities

- Financial Leverage

- Adequacy/Volatility of Cash Flows

Multiple Roles of Lender

- Arbiter of Risk

- Financial Consultant

- Trusted Advisor

Basic Lending Questions

- Who is the Borrower?

- What is the Request?

- What is the Financial Condition of the Borrower?

- What is the Best Way to Structure the Loan to Meet the Needs  
of the Customer and the Bank?

The Five C's of Credit

- Character

- Capacity

- Capital

- Conditions

- Collateral

Loan Evaluation Equation  $S-W > U$

## Analytical Tools

- Prescreening the Application
- Mental Picture
- Component Analysis
- "30 Second" Analysis
- Comparative/Common-size Analysis
- Ratio Analysis
- Loan Screening Worksheet
- Cash Flow Analysis
- Pro Forma/Projection/Cash Budget

## **Prescreening the Application**

- Are There Owners of the Business Other Than the Applicant(s)?
- Do the Applicant(s) Have their Business and Personal Accounts with Your Bank?
- Did the Applicant(s) Fully Complete the Application and Debt Schedule?
- Did the Applicant(s) Provide Comprehensive Financial Information Including K-1s?
- Do the Company and Its Principals Have Good Reputations?
- Has the Borrower Been in Business for Three Years?
- Has Business Been Profitable Two of the Last Three Years?
- Is the Borrower's Industry on the Bank's High Risk or Restricted Industries List?
- Common Deficiencies in Applications

## **10:15 – 10:30 Break**

## **Mental Picture**

- Framework
  - Asset Mix
    - Accounts Receivable
    - Inventory
    - Fixed Assets
  - Liability Mix
    - Accounts Payable
    - Short-Term Debt
    - Long-Term Debt
  - Owner's Equity
- Income Statement
  - Sales Trend
  - Cost Structure
  - Gross Margin

- Operating Expenses
- Profitability
- Key Variables
- Financial Reporting
- Working Asset
  - Mix of Assets
  - Appropriate Mix of Liabilities
  - Cost Structure/Operating Leverage
  - Volatility of Earnings/Cash Flow
  - Appropriate
    - Term
    - Financial Leverage
    - Loan to Value
    - Debt Service Coverage
- Operating Cycle
  - Nature of Financing Need
  - Level of Financing Required
  - Source/Timing of Repayment
  - Risk Associated with Repayment
  - Management Requirements
  - Common Lender Mistakes
  - Working Capital
    - Definition
    - How Working Capital Needs Arise
  - Financing Gap
- Fixed Asset Cycle
  - Debt Structure
  - Cost Structure
  - Vulnerability to External Environment
  - Volatility of Earnings and Cash Flow
  - Prudent Financial Leverage
- Profit Cycle
  - Accounts Receivable - Uncollected Sales
  - Inventory - Unrecognized Costs
  - Prepays - Unrecognized Expenses
  - Accounts Payable - Unpaid Purchases
  - Accruals - Unpaid Expenses
- Cash Cycle
  - Classifying Cash Flows
    - Operating
    - Investing
    - Financing

## Cash Flow Questions

What is Causing More Cash To Go Out Than Come In?

What Will Change?

When Will It Change?

What Can Go Wrong

## Key Variables

Typical Financing Requirements

Typical Sources of Repayment

Exercise — Prestige Painting Inc. - Constructing a Mental Picture

## **12:00 – 12:45 Lunch**

## **Accounting for Business Operations**

Classifying Businesses

Legal Entity

Sole Proprietorship

Partnership

General

Limited

Corporation

C

S

Limited Liability Company (LLC)

Single Member LLC aka Disregarded Entity

Series LLC

Limited Liability Partnership (LLP)

Business Function

Manufacturer

Wholesale

Retail

Service

Challenge of Getting Financial Information

Golden Rule

Summary of Financial Information Requirements

Contacting the Borrower's Accountant

Demonstrating Benefit to the Borrower

Statement Preparer

Borrower

Financial Statement/Tax Return

Cash

Accrual

- Tax Return
  - Schedule C
  - Schedule M1
  - Schedule M2
  - Schedule K-1
  - Schedule of Debt
- Accountant
  - Compilation
    - Non-Disclosure
    - Full Disclosure
  - Review
  - Audit
    - Unqualified
    - Qualified
    - Adverse
    - Disclaimer
  - Management Letter
- Types of Financial Statements
  - Fiscal
  - Interim
  - Consolidated/Consolidating
  - Pro Forma
  - Projection
  - Cash Budget
- Limitations of Financial Statements
- Exercise — John Barr, Forest Products, Prestige Painting – Cash Basis
- Financial Statement

## **Component Analysis**

- Opinion
- Balance Sheet
  - Assets
    - Current
      - Cash
      - Accounts Receivable
      - Inventory
      - Prepaid Expenses
    - Fixed Assets
    - Investments in Affiliates
    - Loans to Officers, Shareholders, Affiliates
    - Intangibles – Goodwill

Liabilities

Current

Accounts Payable

Notes Payable

Current Maturities of Long-Term Debt

Accrued Expenses

Long-term Debt

Loans to Officers, Shareholders, Affiliates

Subordinated Debt

Owner's Equity

Common Stock

Preferred Stock

Retained Earnings

Treasury Stock

Tangible Net Worth

**2:15 - 2:30 – Break**

Income Statement

Sales

Cash

Accrual

Percentage of Completion

Completed Contract

Cost of Goods Sold

Inventory Valuation

FIFO

LIFO

Retail

Specific

Depreciation

Cost

Life

Accounting

Useful

Salvage

Methods

Straight-Line

Accelerated

Gain or Loss on Sale

- Sales, General and Administrative Expenses
  - Accruals
  - Expenses vs. Capitalization
  - Depreciation
  - Leases
  - Bad Debt Expense
    - Direct Write Off
    - Allowance for Bad Debts
  - Interest
  - Tax Loss Carrybacks/Carryforwards
- Statement of Retained Earnings
  - Sales of Stock
  - Dividends
  - Treasury Stock Purchases
  - Retirement Stock
- Statement of Cash Flows
  - Direct
  - Indirect
- Notes
  - Reporting Entity
  - Method of Revenue Recognition
  - Method of Inventory Valuation
  - Method of Depreciation
  - Disclosure of Contingent Liabilities
  - Disclosure of Borrowings and Leases
  - Disclosure of Subsequent Events
- Exercise – Results in Mailing. - Component Analysis

### **Using Financial Statements to Identify Opportunities to Broaden and Deepen the Relationship with the Borrower**

- Funding for Replacement Capital Expenditures
- Debt Refinance/Restructure
- Electronic Banking
- Ownership Succession Planning
- Alternative Lending Products e.g., Leasing
- Opportunities to Involve Strategic Partners e.g. Treasury/Wealth Management

### **3:45 – 4:00 Break**

## **Comparative/Common-size Analysis**

- Percentage

  - Sales

  - Assets

- Internal Trend

- External Comparisons

  - RMA - The Risk Management Association

  - Dun & Bradstreet (D&B)

- Industry Comparisons

  - First Research

  - IBIS World

  - Vertical IQ

- Exercise - Trainer, Inc. - Comparative/Common-size Analysis

## **"30 Second" Analysis**

- Trend

  - Sales

  - Gross Margin

  - Operating Expenses

  - Tangible Net Worth

  - Current Liabilities

- Exercise - Trainer, Inc. — "30 Second" Analysis

## **5:00 – Day 1 Session Ends**

## **Day 2**

**8:30 – 9:45**

## **Ratio Analysis**

- Definition of Ratios

- Classes of Ratios

  - Liquidity

    - Current

    - Quick

  - Financial Leverage

    - Debt/Equity

    - Equity/Assets

    - Assets/Equity

  - Profitability

    - Return on Sales (ROS)

    - Return on Assets (ROA)



- Return on Equity (ROE)
- Utilization/Activity
  - Asset Utilization
  - Receivables Turnover/Days
  - Inventory Turnover/Days
  - Payables Turnover/Days
- Expense
  - Depreciation, Depletion/Sales
  - Lease and Rental Expense/Sales
  - Officer's Compensation/Sales
  - Interest Expense/Sales
- Coverage
  - Times Interest Earned
  - Traditional Cash Flow/Current Maturities of Long-Term Debt
  - EBITDA/CMLTD + Interest
  - Comprehensive Ratio
- Critical Ratios
  - Financial Analysis
    - Financial Leverage – Tangible Net Worth
    - Liquidity – Current Ratio
    - Debt Service Coverage
  - Loan Agreement
  - Growth
    - Total Debt and Short-term Debt
    - Owner Compensation and Distributions
    - Purchasing Non-productive Assets Using Short-term Debt
- Loan Screening Worksheet
- Exercise - Trainer, Inc. - Ratio Analysis

## **9:45 – 10:00 Break**

### **Cash Flow Analysis**

- Perspectives on Cash Flow
  - Traditional
  - EBITDA/EBIDA/NOI
  - FASB
    - Direct/Indirect
  - Uniform Credit Analysis (UCA)
  - Core Cash Flow
  - Personal Cash Flow
  - Global Cash Flow
- Interpreting a Statement of Cash Flows – Sources and Uses

Exercise – Results in Mailing – Accountants Direct Presentation  
Analyzing Cash Flows

Cash Flow Questions

What Is Causing More Cash to Go Out Than Come In?

What Will Change?

When Will It Change?

What Can Go Wrong?

Adequacy

Replacement Capital Expenditures

Scheduled Debt Service

Working Capital Requirements

Fixed Asset Additions

Distributions/Dividends to Owners

Volatility

Risk

Appropriate Term

Appropriate Financial Leverage

Adequate Cash Flow

Adequate Debt Service Coverage

Priorities for the Use of Cash

Working Capital Requirements

Owner's Lifestyle

Amortize Revolving Debt

When is Enough - Enough?

Exercise - Trainer, Inc. - Cash Flow Analysis

**11:45 -12:30 Lunch**

**Analyzing Corporate Tax Returns**

Common Legal Structures

Sole Proprietorship – Schedule C Form 1040

Partnership – Form 1065

Corporation

C – Form 1120

S – Form 1120S

Limited Liability Company – Form 1065

Limited Liability Partnership – Form 1065

Single Member LLC aka Disregarded Entity – Schedule C Form 1040

Series LLC – Form 1065

Tax Return

Schedule C

Schedule K

Schedules M-1 and M-2  
Schedule K-1  
Schedule of Debt  
Exercise – Acme Printing - Analyzing a Corporate Tax Return

## **2:00 – 2:15 Break**

### **Analyzing Personal Financial Statements (PFS) and Tax Returns**

Personal Financial Statement Initial Review

Signed by all Parties  
His/Hers/Ours  
Current Date per Policy  
Addressed to Bank  
All Schedules Complete  
Math Correct

Review of Personal Financial Statement

Assets

Owned by Borrower  
Fairly Valued  
Liquid  
Marketable  
Pledged to Other Creditors

Liabilities

Fully Disclosed  
Payment Schedule  
Contingent Liabilities

Outside Net Worth

Tangible Net Worth

Adjusting Personal Net Worth

Purpose

Determine Liquid/Marketable Net Worth  
Identify Primary/Secondary Source of Repayment

Eliminations

Assets Jointly Owned or Owned by Spouse if not Co-maker  
Personal Assets  
Pledged Assets  
Overvalued Assets  
Closely Held Businesses  
Retirement Accounts  
Minority Ownership Interests i.e. <50%

### **3:30 - 3:45 Break**

#### **Analyzing Personal Tax Returns**

- First Steps Personal Tax Return

  - Whose Return

  - Signed

  - Preparer

  - Sources of Income Supported by Assets

  - Complete Return Including Supporting Schedules (K-1s)

- Review of Personal Tax Returns

  - Forms

  - Schedules

  - Key Differences Adjusted Gross Income and Cash

- Personal Cash Flow

  - Net Wages, Salaries

  - Net Other Personal Income

  - Net Business/Investment Activity

- Global Cash Flow

  - Purpose

  - Criteria

- Exercise – Thomas Jones - Analyzing Personal Financial Statements and Tax Returns

### **5:00 – Day 2 Session Ends**

## **Day 3**

**8:30 – 9:45**

#### **Evaluating Management**

- Who is Management?

  - Owner

    - Character

    - Core Competence

    - Leadership/Management Skills

    - Strengths/Weaknesses

    - Priorities

    - Evidence of Testing

  - Management Team

    - Complimentary Competence

    - Depth

    - Succession

    - Changes in Management

- Little People i.e., Support Staff
- Outside Advisers
  - Board of Directors
  - Accountant
  - Attorney
  - Banker
- Evidence of Testing
- Systems
  - Financial Reporting
  - Knowledge of Costs
  - Internal Controls
- Assessing Borrower Credit Quality
  - Keys to Success
  - Keys to Quality Loan
- Exercise – Select Distributors – Evaluating Management

## **9:45 – 10:00 Break**

### **Loan Structure**

- Balance Sheet Equation -  $A = L + OE$
- Loan Purposes
  - Purchase Assets
  - Rearrange Liabilities
  - Replace Owner's Equity
- Sources of Repayment
  - Conversion of Assets
  - Restructure Liabilities
  - Increase Owner's Equity
- Elements of Loan Structure
  - Purpose
    - Purpose vs. Use of Proceeds
      - Temporary vs. Permanent Investment in Current Assets
      - Working Capital
    - Recurring vs. Non-Recurring
    - Productive vs. Non-Productive
  - Sources of Repayment
    - Primary
      - Related to Loan Purpose
      - Tied to Asset Financed
    - Secondary
      - Independent of Primary Source
      - Longer Lived than Primary Source

- Amount
  - Appropriate and Sufficient
  - Fixed Asset Additions
  - Working Capital Requirements
- Term
  - Excess Cash
  - Reasonable
  - Collateral
    - Depreciable/Useful Life
  - Note vs. Loan
- Loan Support
  - Collateral
  - Guaranty
  - Loan Agreement
  - Subordination Agreement
- Framework for Monitoring/Establishing Expectations
  - Financial Reporting
  - Financial Performance
  - Terminating Out a Line of Credit
- Loan Structure Issues
  - Adequacy of Cash Flow
    - Debt Service
    - Fixed Asset Requirements
    - Working Capital Requirements
    - Dividends/Distributions
  - Volatility of Cash Flow
    - Operating Leverage
    - Debt Service Coverage
    - Acceptable Liquidity
  - Support Provided by Collateral
    - Collateral Advance Rates
    - Required Monitoring
  - Acceptable Financial Leverage
    - Volatility of Cash Flows
  - Acceptable Term
    - Loan Policy
    - Life of Asset Financed
    - Core Cash Flow vs. Outstanding Debt
  - Monitoring Requirements
    - Financial Statements
    - Covenants Loan Agreement
    - Collateral

## Common Debt Structure Questions

- How Do I Properly Finance Working Capital?
- What is the Appropriate Term for a Loan to Purchase Fixed Assets?
- When Do I Convert Revolving Debt to Amortizing Debt?
- How Do I Finance a Service Company with Few "Hard" Assets?
- How Do I Know When to Encourage Management to Slow Their Growth?
- How Do I Determine the Appropriate Clean-Up Period for a Seasonal Line?
- How do I Define Cash Flow and Debt Service?

## 11:45 – 12:30 Lunch

### Loan Support

#### Components

- Collateral
- Guaranties
- Loan Agreements
- Subordination Agreements

#### Objectives

- Provide Secondary Source of Repayment
- Preserve Borrower's Strengths
- Protect Bank from Borrower's Weaknesses
- Provide Framework for Monitoring

#### Collateral

##### Unsecured Loans

- Short Term
- Fund Current Assets
- Well Defined Repayment Source
- Proven Performance
- Strong Financial Condition
- Competent Management

##### Secured Loans

- Collateral is Not
  - Substitute for Character
  - Substitute for Creditworthiness
  - Way to Make Bad Loan Good
  - Way to Ensure Loan Will be Repaid

##### Required

- Erratic Earnings Performance
- Incomplete Credit History
- Inadequate/Weak Secondary Repayment Source
- Erratic Cash Flow
- Excessive Leverage

- Longer Term
- Rapid Growth
- Type of Loan
- Restrict Ability to Pledge to Others
- Collateral Considerations
  - Locate It
  - Identify It
  - Lay Legal Claim to It
  - Sell It for Enough to Recover
    - Principal
    - Interest
    - Liquidation Costs
- Determinants of Collateral Quality
  - Liquidity
  - Marketability
  - Dependability of Value
  - Controllability
- Collateral Valuation
  - Cost
  - Market
  - Income
  - Liquidation
- Collateral Monitoring
  - Landlord's Waiver
  - Listing of Aged Receivables
  - Listing of Aged Payables
  - Listing of Inventory
  - Listing of Fixed Assets
  - Borrowing Base Certificate
  - Lockbox/ACH
  - Field Audit

## **2:00 – 2:15 Break**

- Guaranty
  - Reasons to Obtain Guaranty
    - Demonstrate Owner(s) >20% Commitment
    - Minimize Ability to Transfer Business Assets to Personal Name
    - Gain Leverage in Problem Loan Situation
    - Potential Secondary Source of Repayment



## Types of Guaranties

- Limited vs. Unlimited
- Secured vs. Unsecured
- Payment vs. Liquidation
- Continuing
- Joint and Several vs Fractional
- Co-signors vs Guarantors
- Spousal Guarantees
- Government Guarantees
- Notice Requirements

## Loan Agreement

### Objectives of Loan Agreement

- Establish Basis for the Lending Relationship
- Establish Expectations Regarding
  - Financial Information
  - Financial Performance
  - Projected Performance
  - Terming Out a Line of Credit
- Provide Framework for Monitoring Borrower Performance
- Provide Remedies in the Event of Default
- Defense Against Lender Liability

### Term Sheet/Commitment Letter/Loan Agreement

- Outlines Basic Terms and Conditions
- Basis for Further Discussion of Loan Request
- Outlines Steps in Underwriting, Approval and Documentation of
- Term Sheet is Basis for Comparing Competitive Offers
- Serves as Template to Draft Final Documents
- Basic Elements of a Term Sheet

### Key Issues in Loan Structure Provide the Foundation for Loan Agreement

- Primary Source of Repayment
  - Adequacy of Cash Flow
  - Volatility of Cash Flow
- Secondary Source of Repayment
  - Support Provided by Collateral
  - Acceptable Financial Leverage
  - Acceptable Liquidity
- Acceptable Term including Forcing Term Out of Line of Credit

### Role of Loan Agreement

- Preserve Strengths e.g., Affirmative Covenants
- Protect Against Weaknesses and Uncertainties e.g., Negative Covenants
- Framework for Monitoring

## Loan Agreement Components

- Definitions
- Loan Terms and Conditions
- Representations and Warranties
- Affirmative Covenants
- Negative Covenants
- Conditions of Lending
- Events of Default
- Remedies

## Covenants

### Role

- Full and Timely Disclosure of Information
- Preservation of Core Business
- Maintenance of Adequate Cash Flow
- Maintenance of Asset Quality
- Preservation of Net Worth
- Maintenance of Orderly Growth
- Limitations on Leverage/New Indebtedness
- Continuance of Quality Management
- Assurance of Legal Existence and Going Concern

### Financial Covenants

- Working Capital (Step-ups)
- Current Ratio
- Debt Service Coverage
- Minimum Tangible Net Worth (Step-ups)
- Debt to Tangible Net Worth

### Non-Financial Covenants

- Reporting Requirements
- Bankruptcy
- Deposit Accounts
- Capital Adequacy
- Limitations on Purchase/Sale of Assets
- Change in Ownership/Management
- Limitations on Additional Loans
- Maintenance of Insurance
- Limitations on Salary/Dividends
- Limitations on Employee/Intercompany Loans

### Key Loan Agreement Covenants

- Liquidity e.g., Current Ratio
- Debt Service Coverage
- Debt/Tangible Net Worth
- Minimum Tangible Net Worth with Step-ups

- Minimum Working Capital with Step-ups
- Financial Reporting Requirements
- Objectives of Key Covenants
  - Constrain Growth
  - Constrain Total Amount of Debt Relative to Tangible Net Worth
  - Constrain Amount of Short-Term Debt
  - Constrain Investment in Non-productive Fixed Assets Funded with Short-term Debt
  - Constrain Owner Withdrawals e.g., salary/Distributions
  - Define Criteria for Terming out Revolving Debt
  - Keep Loan Agreement Relevant e.g., Step-ups
- Why Borrowers Get in Trouble
  - Grow Too Fast
  - Take on Too Much Debt Especially Short-term Debt
  - Owners Take Too Much Out of the Business
  - Invest in Non-Productive Fixed Assets
  - Reluctant to Term Out Revolving Debt
- Setting Covenants
  - Clear and Specific Definitions e.g., Cash Flow/Debt Service
  - Borrower's Projections
  - Appropriate Default Thresholds
  - Cross Collateralization/Default
  - Interrelationship to Minimize Potential for Borrower Manipulation
  - Performance-Based
- Default Provisions
  - Financial
  - Non-Financial
  - Pricing for Performance
  - Right to Cure
- Monitoring
  - Importance of Monitoring
  - Borrower Certification
    - Compliance Certificate
    - Borrowing Base Certificate
  - CPA Certification
  - Bank Monitoring
    - Lender
    - Portfolio Manager
  - Approval Criteria for Waiving Defaults
  - Notice Requirements

## Remedies

- Assert the Default e.g., Notice and Right to Cure
- Waive the Default
- Assert the Default but Defer Exercising Remedies
- Invoke Financial Penalties e.g., Default Rate of Interest
- Accelerate the Debt e.g., Demand Payment
- Proceed to Foreclosure/Liquidation

## Benefits of a Loan Agreement

- Well Structured Loan Agreement is Good for Borrower and Bank
- Outlines Bank's Expectations About Financial Performance Which
  - Ensures Borrower Maintains Financial Health and Bank's Investment is Protected
- Objective of Loan Agreement is Not to Put the Borrower Out of Business Opportunity to Bring Concerns to Attention of Borrower Provide the Borrower an Opportunity to Address Concerns
- Avoids Surprises
- Loan Agreements do not Assure the Loan Will be Repaid

## Subordination Agreement

### Definition

### Types

- Full/ Partial
- Right to Payment
- Liquidation
- Interest?

## Landlord's Waiver

Subordination, Non-disturbance and Attornment (SNDA)

## 3:30 – 3:45 Break

## Case Study

Redwood Manufacturing – Loan Structure and Support

## Common Loan Structuring Mistakes

- Failure to Correctly Project Peak Seasonal Needs
- Failure to Provide for Working Capital Requirements When Financing Fixed Assets
- Failure to Provide for Replacement of Fixed Assets
- Allowing Advances on a Line of Credit to be Used to Purchase Longer Lived Assets
- Requiring an Annual Clean-Up on a Non-seasonal Line Used for Other Than

### Liquidity Purposes

Failure to Properly Margin Collateral or Relying on a Single Advance Rate

Failure to Tie Amortization of a Loan for the Purchase of Fixed Assets to the

Shorter of The Depreciable or Useful Life

Failure to Periodically Term Out Revolving Debt

Failure to Maintain a Reasonable Relationship Between Stabilized Core Cash

16Flow and Revolving Debt

Failure to Inspect and Properly Monitor Collateral

Failure to Monitor Covenants in a Loan Agreement

## **4:30 Day 3 Session Ends**

### **Case Studies**

Prestige Painting

John Barr

Forest Products

Results in Mailing

Trainer, Inc.

Acme Printing

Thomas Jones

Select Distributors

Redwood Manufacturing