

# SMALLER BUSINESS LENDING

Dev Strischek, Principal  
Devon Risk Advisory Group  
Atlanta GA

[Dev.Strischek@devonrisk.com](mailto:Dev.Strischek@devonrisk.com)

Or LinkedIn  
404-394-6294

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## INTRODUCTION—IT'S A SMALL WORLD

- Smaller business lending success
  - "The road to success is dotted with many tempting parking spaces." *Will Rogers*
- Big business lending to smaller businesses
  - "One pill makes you larger, and one pill makes you small; And the ones that mother gives you don't do anything at all. *Jefferson Airplane, White Rabbit*
- But how to make money on small business lending?
  - "Having more money doesn't make you happier. I have 50 million dollars, but I'm just as happy as when I had 48 million. *Arnold Schwarzenegger*

**SMALL BUSINESSES**

- TOTAL OVER 23 MILLION IN THE U.S. ALONE
- ACCOUNT FOR 60% OF ALL JOBS
- REPRESENT 97% OF ALL U.S. EXPORTERS OF GOODS
- PRODUCE 13 TIMES MORE PATENTS PER EMPLOYEE THAN LARGE FIRMS

**HUG A SMALL BUSINESS OWNER TODAY**

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## DOING THE DEAL MEANS KNOWING YOUR CLIENT

- What resources does borrower need to be successful in market and industry?
- What resources does borrower have now?
- What is borrower's track record?
  - Business
  - Financial
  - Credit
- What can you do to help your client be successful?
  - Trusted financial advisor
  - Understand borrower's business—what you need to know

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## WHAT YOU NEED TO KNOW ABOUT YOUR BORROWER'S LIKELY FINANCING NEEDS

- Frequent Request—line of credit
- Typical Purpose—support seasonal sales
- Common Use—acquire inventory, carry receivables, pay suppliers
- Useful Facility—able to borrow as needed and pay down when able


Working capital	Beginning of year	Peak of season	End of year	Change Beg to end
AR	100	200	100	0
Inv	50	300	50	0
WC Assets	150	500	150	0
AP	35	150	35	0
WC Gap	115	350	115	0
Gap covered by AP		115		
Gap covered by lender		235		

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## TYPES OF CREDIT FACILITIES

- Purpose
  - Acquire assets
    - Working capital assets
    - Long-term assets
  - Pay liabilities
    - Trade credit and other operating liabilities
    - Take out other lenders
  - Reduce net worth
    - Dividends
    - Treasury stock
- Types of Facilities
  - Term loan
  - Revolver/term loan
  - Line of credit



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## TYPES OF FACILITIES—TERM LOANS

- Term Loan
  - Acquire long-term assets, replace existing debt, reduce NW
  - Non-revolving, reduced by periodic P+I payments
    - Generally term note, not demand
- Revolver/term loan
  - Combination of revolving line of credit for first 2-3 years, then outstanding balance termed out over 3-5 years
  - Useful for growing borrowers with hard-to-predict results
    - Line of credit portion allows some flexibility in what kinds of activities are undertaken—asset acquisition, debt replacement, capital modifications
    - After growth stabilizes, then permanent need is now visible, and can be termed out while seasonal needs are funded with a seasonal line of credit

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## TYPES OF FACILITIES--LINES OF CREDIT

- Seasonal line of credit
  - Seasonal **working capital**
    - Acquire inventory
    - Carry receivables
    - Keep payables current
    - Repaid from collection of receivables
    - Rest period 30-60 days
  - Non-seasonal line of credit
    - Permanent **working capital**
      - Finance additional working capital assets needed to support sales growth
      - Repaid from cash flow generated by incremental revenue growth
      - Revolver period followed by terming out balance when revenue stabilizes

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## BIG BUSINESS IN SBL?

- What type of facility is most used by your SB borrowers?
  - Line of credit
  - Time loan
  - Term loan
  - Equipment loan
  - Other?
  -

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## WORKING CAPITAL FINANCING IMPACTS CASH FLOW

- Working capital needs also vary over a borrower's life cycle
  - Cash absorbing to support growth
  - Cash neutral at sustainable growth
  - Cash generating in declining sales periods
- Cash not consumed in working capital can be used for other purposes
  - Pay creditors
  - Reward owners
    - Pay dividends
    - Build shareholder value
- How to monitor and evaluate performance
  - Internal trends
  - Industry ratios

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## SOME COMMON INDUSTRY WC MEASURES

- Cash
  - Cash turnover =  $\text{sales}/\text{cash}$
  - Days cash =  $365/(\text{sales}/\text{cash})$
- Receivables
  - Receivables turnover =  $\text{sales}/\text{receivables}$
  - Days receivable =  $365/(\text{sales}/\text{receivables})$
  - Days AR  $\leq$  firm's credit terms
- Inventory
  - Inventory turnover =  $\text{Cost of Goods Sold (COGS)}/\text{inventory}$
  - Days inventory =  $365/(\text{COGS}/\text{inventory})$
  - Days Inv  $\leq$  firm's production period
- Payables
  - Payables turnover =  $\text{COGS}/\text{accounts payable}$
  - Days payable =  $365/(\text{COGS}/\text{accounts payable})$
  - Days AP  $\leq$  supplier's credit terms
- Working capital
  - Sales/net working capital
  - Changes in Net working capital/changes in sales

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## INDUSTRY MEASURES OF WKG CAPITAL APPROPRIATENESS

Some industry measures of working capital (WC) appropriateness

Industry WC item	Measure	Borrower Financial Data			
		FY'16	FY'17	2016	2017
Cash	cash/TA %	6.1	6.5	7.7	5.8
Accts receivable	AR/TA %	18.5	15.4	14.7	15.0
Inventory	Inv/TA %	24.0	27.6	28.6	28.1
Current assets	Tot CA/TA %	50.6	50.8	54.8	52.4
Accts payable	AP/TA %	9.0	9.5	11.0	10.3
Notes payable	NP/TA %	14.4	13.3	11.4	11.3
AR turnover	days rec	37	29	26	25
Inventory TO	days inv	28	25	26	23
WC efficiency	sales/NWC (x)	15.1	14.3	11.7	9.7

• Observations

- Cash increased over 2-year period, higher than average levels
- AR decreased to almost industry averages
- INV increased but still close to industry averages
- Shift from NP to AP, trade debt less than average, NP a little above average
- General improvement in WC efficiency, could attain industry average by reducing cash and inventory further

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## WORKING CAPITAL ASSET CONVERSION CYCLE

- How long does it take for cash to cycle through a business?

• Example

	SLOGO	FUEGO
Days cash	10	15
Days receivable	60	30
Days inventory	90	60
Sub-total	160	105
Days payable	-40	-30
Asset Conversion cycle	120	75

- Faster cycling allows lower level of WC to support sales

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## TRUSTED FINANCIAL ADVISOR (TFA) TIPS: WORKING CAPITAL CONVERSION CYCLE STRATEGIES



- If faster cycling allows lower level of WC to support sales, what strategies would accelerate cycling for
  - Cash
    - Zero-balance account
    - Overdraft financing
    - Other?
  - Receivables
    - Cash only
    - Accept credit cards
    - Raise cash discounts for early payment and/or increase time period for early payment
    - Other?
  - Inventory
    - Reduce breadth and/or depth of inventory
    - Consignment inventory
    - Floor samples/catalog sales
    - Other?
  - Payables
    - Lean on trade
    - Other?
- Are strategy options viable for borrower's industry?

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## INDUSTRY INFLUENCES ON WC

- Cash
  - Cash-and-carry sales
  - COD trade terms or limited credit terms
  - Labor/capital assets ratio and payroll frequency
- Receivables
  - Cash or credit card sales—restaurants, stores
  - credit terms as competitive tool—no payments for 6 months
- Inventory
  - Volatility of values—commodities
  - Perishability—fresh food vs. canned goods
- Payables
  - Demand for creditor-seller's goods and services
  - Industry trade terms

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## A NOTE ON SALES TERMS

- $2/10/\text{net } 30 = 36\% \text{ APR}$
- Terms do vary from industry to industry
  - $1.5\%/10, \text{net } 60$  canned goods
  - $2/10, \text{net } 60$  stationery
  - $5/10, \text{net } 4 \text{ months}$  jewelry
- Why?
  - Shelf life of goods
  - Seasonality of demand
  - Availability of supply
  - Supplier credit strategy



$2/10 \text{ net } 30 = 36\% \text{ APR}$   
 $2\% \text{ opportunity cost for } 20 \text{ days;}$   
 $2/20 = x/360 = x = 36\%$

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## TFA TIP: WORKING CAPITAL COMPETITIVE STRATEGY OPTIONS

- Working capital competitive strategy options
  - Match competitors in inventory breadth and depth—impact on inventory turnover?
  - Match competitors in customer-friendly credit terms—impact on receivables turnover?
  - Match competitors in favorable terms from suppliers—bulk purchases, consignment inventory?



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## STRUCTURE—MAKING SURE WE GET REPAYED

- Structure deals to ensure borrower repays
  - In full
  - On time
  - As agreed
- As agreed means setting some conditions and covenants
  - Conditions-what we expect from borrower at inception
  - Covenants-what we expect borrower to do or not do over life of loan



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## HOW COVENANTS WORK

- We use covenants to make sure our borrowers can repay their loans
  - From operating cash flows
  - From liquidation of collateral
  - From guarantors
  - From any other sources
- Covenants require actions or restrict actions of borrowers that impact repayment ability
  - Affirmative covenants require borrowers to take some action or meet some minimum criteria
  - Negative covenants prohibit borrowers from taking some action or restrict borrowers to some maximum criteria
- Covenants may be quantitative or qualitative
  - Quantitative covenants set numerical limits
  - Qualitative covenants govern future activities

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## EXAMPLES OF COVENANTS

Covenant Examples	Affirmative	Negative
Quantitative (Financial)	Current Ratio $\geq$ 2.0x  NWC $\geq$ \$500,000	Debt/Worth $\leq$ 3.0x  Annual CAPEX $\leq$ \$100,000
Qualitative	Quarterly financial statements within 15 days of quarter-end  Annual unqualified audited financial statements prepared by CPA satisfactory to Bank submitted within 120 days of FYE	No borrowing from other lenders without Bank's prior approval  No acquisition or disposition of subsidiary entities without Bank's prior approval

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## SOME TYPICAL FINANCIAL COVENANTS

- Balance Sheet
  - Debt/Worth (x)
  - Current Ratio (x)
  - Quick Ratio (x)
  - Minimum NW (\$)
  - Minimum NWC (\$)
- Bal Sht Observations
  - (+) Hard to manipulate
  - (+) less volatile

- Income Statement
  - DSC (x)
  - Interest Coverage (x)
  - Debt/EBITDA
  - Minimum EBITDA
- Inc St Observations
  - (-) manipulable
  - (-) volatile

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## MANAGE THE ENDS, NOT THE MEANS

- Manage the results, let the borrower manage how to achieve them:
  - Set a net worth & NWC minimum, if the borrower decides to pay dividends or pay bonuses, borrower still has to meet NW and NWC minimum
  - Let borrower figure out how to balance CAPEX, NWC, cash balances, officers' compensation, dividends, draws, etc.
- Monitor & manage covenant compliance
  - Timely receipt of financials & compliance certificate, e.g., NLT 30 Days of month-end, quarter-end, etc.
  - Prompt written response OK'd by credit approver to out-of-compliance event, e.g., 30 days of receipt of compliance certificate
  - Waiver should come at a cost to borrower, e.g., higher interest rate, reduction in exposure, more frequent monitoring, etc.
  - But only monetary defaults are worth calling the loan . . .

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## BIG BUSINESS IN SBL?


- Does your organization require covenants in credit extended to your SB borrowers?
  - YES
  - NO

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## INDICATORS THAT IT'S TIME TO SHUT OFF & TERM OUT BORROWER'S CREDIT EXPOSURE

- Slowdown in receipt of interim financial info
- Credit inquiries from trade suppliers and other creditors
- Decline in credit bureau and credit agency scores
- Financial condition and performance
  - Slowdown in asset conversion cycle
  - Higher leverage, especially short-term debt
  - Borrower's ratios compare unfavorably to industry ratios
- Line fully funded
- Proceeds used to acquire fixed assets instead of WC assets
- Overdrafts
- Delinquency
- Covenant defaults



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## LINE OF CREDIT MITIGATION

- Re-evaluate purpose
  - Still seasonal or is borrower also financing permanent assets?
    - Review borrower's sales growth
    - Review borrower's expenses and profit margins
    - Update cash flow projections to determine estimated time needed to repay line of credit balance
- Update credit risk rating
  - Still pass credit or now a criticized asset?
    - If still pass credit, then consider terming out line of credit remaining balance and offering seasonal line of credit
    - If criticized asset, then consider transferring to problem asset unit for term out

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## FITTING SMALL BUSINESS LENDING INTO YOUR BANK

- Credit considerations are critical regardless of size of borrower or loan
- But how do we incorporate small business lending into the bank?



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## LINES OF BUSINESS

- Wholesale
  - Commercial & Industrial
  - Commercial Real Estate
  - Business Banking
  - Private Banking
  - Others?
- Retail
  - Consumer
  - Residential Mortgage
- Merchant Services
  - Retail
  - Commercial PCard





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## WHAT'S THE BIG DEAL WITH SMALL BUSINESS LOANS?

- Purpose
- Type of Facility
  - Term
  - Amortization
  - Amount
  - Pricing
  - Source of repayment
  - Collateral
  - Guarantees
  - Covenants and conditions
- Risk rating
- Approval




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## BIG CHALLENGES IN SMALL BUSINESS LENDING

- Small transaction size vs profit opportunity
  - Pricing vs cost of funds
  - Depository relationship
  - Potential for other bank services
- Administrative costs
  - Prospecting, analysis, underwriting, approval, booking, funding
  - Monitoring—credit risk premium, compliance



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## COMMERCIAL LOAN TYPES

- Typical Loan Types
  - Revolving Lines
  - Acquisition
  - Asset Based Lending
  - CRE-Owner Occupied
  - CRE-Investment Real Estate
  - Equipment
  - Letters of Credit
  - SBA 504 / 7A
- Do smaller businesses need any of these?
  - Standard "6-pack" approach
    - line of credit
    - Letter of credit
    - term loan
    - Equipment loan/lease
    - CRE owner-occupied mortgage
    - Purchase card
    - Others?

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## COMMERCIAL LOAN STRUCTURE



- Structure
  - Term
  - Rate
  - Amortization
  - Fees
  - Term Sheets
- Don't smaller business loans have these attributes, too?

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## COMMERCIAL LOAN COLLATERAL

- Assets in existence at loan's inception
  - Cash
  - Investments
  - Receivables
  - Inventory
  - Fixed assets
  - Intangibles
- Assets subsequent to loan's inception
  - New or replacement assets
  - Rents, leases, and other pledged cash flows
    - Contracts to validate and support certainty of cash flows
    - Secure receipt of flows via lockbox

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## COLLATERAL ANALYSIS

- Analysis
  - Liquidity
    - Now is better than later
  - Marketability
    - Commodity vs. one-of-a-kind asset, e.g., red #2 wheat vs. DaVinci's Mona Lisa
    - Publicly traded market vs. no ready and willing buyers,
  - Perishability
    - Crops and livestock vs. equipment and buildings
    - Expiration of licenses, copyrights, patents
  - Control
    - Physical possession
    - Perfect lien on asset supported by lockbox, physical audit, lockbox
    - Perfected lien on asset
    - Blanket lien
    - Abundance of caution
    - Springing lien
    - Negative pledge
    - Unsecured
    - Claims of other lenders and creditors?
  - Typical LTV's
    - Current value at loan's inception is not always value at point of loan's default
    - So maximum LTV should reflect loss given default, 75% LTV means value can decline 25% and remaining value is enough to repay the loan

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### COLLATERAL VALUATION SUMMARY

Collateral Asset Options	Factors to Consider in Collateral Value Analysis				
	Liquidity	Marketability	Perishability	Control	Typical LTV's
Cash	-Immediate -restrictions on liquidation	-face value	Not applicable	Physical Possession	Cash- 90 to 100%
Investments	-margin call	-market value -SEC 144 -closely held stock	-not applicable	--physical possession or tri-party agreement	-50-75%
Receivables	Collection period	-quality of customers	Not applicable	Perfection w/UCC	50-80%
Inventory	Production period	-raw materials (RM) -Work-in-progress (WIP) -Finished goods (FG)	Foodstuffs	Perfection w/UCC	RM- 50 to 75% WIP- 20 to 50% FG- 50 to 75%
Fixed Assets	Depends on type of FA	-Depreciated value -mobility	Maintenance	Perfection w/mortgage	Land- 50 to 60% Bldgs-50 to 80% Equip-50 to 75% F&F- 10 to 50%
Intangibles	Depends on type of intangible	-depends on demand for item	Expiration of patent, copyright	Perfection w/UCC	Depends . . .

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### REAPER CORPORATION ASSETS

The company's assets available for collateral:

Cash	\$25,000
Receivables, Net	275,000
Inventory:	
• Caskets	\$250,000
• Embalming supplies	100,000
• Burial wardrobes	50,000
• Total	400,000
Net Fixed assets:	
• Land	\$100,000
• Building	50,000
• Equipment	35,000
• Vehicles	15,000
• Total	200,000
Trademark	100,000
<b>Total Assets</b>	<b>\$1,000,000</b>





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Reaper Corporation Assets Available for Collateral	Collateral Valuation Summary						
	Current Value (\$)	liquidity	marketability	perishability	control	LTV %	Collateral Value (\$M)
Cash	25,000					90	22.5
Receivables, net	275,000					80	220.0
Inv-caskets	250,000					50	125.0
Inv-embalming supplies	100,000					50	50.0
Inv-burial wardrobes	50,000					50	25.0
NFA-land	100,000					80	80.0
NFA-bldg	50,000					80	40.0
NFA-equipment	35,000					50	17.5
NFA-vehicles	15,000					50	7.5
Trademark	100,000					0	0
<b>Total</b>	<b>1,000,000</b>					<b>59</b>	<b>587.5</b>

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## BIG BUSINESS IN SBL?

- Does your organization expect loans to SB borrowers to be collateralized?
  - YES
  - NO

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## GUARANTORS & OTHER CUSHIONS OF PROTECTION

- Small business borrowers
  - Closely held—owners manage the business
  - Personal assets and business assets comingled
- Guarantors
  - Owners, principals
  - Degree of guarantee
- Other cushions of protection
  - Letters of credit
  - Insurance
  - Bonding
  - Comfort letter alias keepwell letter



I'm not so much interested in the return ON my money as I am in the return OF my money.

— Bill Royen —

AZ QUOTES



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## WHY WE EXPECT OWNERS/PRINCIPALS TO GUARANTEE

- Why we expect owners & principals to guarantee
  - Commitment
    - Owners/principals willing to support their own enterprise?
    - “psychological commitment”
  - Liability
    - Corporate legal form limits owner’s liability to investment
    - Personal guarantee “pierces corporate veil”

- Degree of guarantee
  - Full
    - Unconditional, joint & several, and unlimited as to amount & time
  - Limited
    - conditional, individual, and limited as to amount & time




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## GUARANTOR EVALUATION

- What do guarantors have at point of borrower's default?
  - Market value vs. liquidation value
- What wealth do guarantors have outside of borrower's influence?
  - Ownership interests in privately held entities
  - Liquid, easily marketable securities
  - Sole vs.. joint ownership issues
- What is realizable value of guarantor's assets?
  - Real property—home, land, investment properties?
  - Personal property—cars, art, jewelry, furnishings?
- Do guarantors know all their liabilities?
  - Contingencies—guarantees, warranties?
  - Taxes—sales, income, capital gains?
- Is PFS accurate
  - Questionable assets
  - Under-reported liabilities
  - Common errors



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## COMMON ERRORS ON PFS

- Stocks, bonds, cars, homes, and other assets are typically valued at original cost because the individual can obtain that information more readily than current market value.
- Insurance is often disclosed at its face value, not its cash surrender value
- Income tax liabilities are usually ignored
- Guarantees of other debts are not disclosed
- Capital gains taxes are not calculated on the equity gains in long-held assets

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## TYPICAL QUESTIONABLE ASSETS AND UNDER-REPORTED LIABILITIES

- Questionable assets
  - Interests in privately held company
  - Personal property—cars, jewelry, art, hobby stuff
  - Amounts due from related parties
- Under-reported liabilities
  - Income taxes
  - Capital gains taxes
  - Co-borrowing
  - Guarantees

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## BROTHERS GRIMM GUARANTORS PERSONAL FINANCIAL STATEMENTS (PFS)

- PFS shows guarantors are worth \$4MM+:

Total assets	\$7,243,000
-Total liabilities	<u>- 3,106,500</u>
Net worth	\$4,136,500

- But how much support can guarantor provide if borrower defaults?

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## ANW TEMPLATE

- Total Assets
- Total Liabilities
- Net Worth, unadjusted
- declines in value of stocks and bonds
- investment in borrower's firm
- amounts due from related parties, such as affiliates, subsidiaries, parent company, employees, stockholders, and officers.
- fractional ownership interests, that is, less than 50%
- net equity in personal residence if lender does not hold mortgage
- personal assets such as furniture, fixtures, jewelry, art autos, planes, and boats.
- jointly owned assets for which not all jt owners are borrowers or guarantors
- any other assets of unsubstantiated value
- estimated personal and corporate income taxes (for owners of S corporation)
- any other liabilities not already disclosed
- +appreciated value of stocks, bonds, and real estate
- +overstated portion of any liabilities due to reduced income tax debts or favorable settlement of lawsuits
- Net Worth, adjusted

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## ANW FOR SLIM JIM GRIMM & DIM TIM GRIMM\*

ANW Summary	Slim Jim	Dim Tim	Total
Total Assets	\$4,641,500	\$2,601,500	\$7,243,000
Total Liabilities	- 108,500	-2,998,000	-3,106,500
Net Worth, Unadjusted	\$4,533,000	(\$396,500)	\$4,136,500
Adjustments:			
- reduction of NYSE Stock to current market value			(\$11,000)
- reduction of junk bonds to current market value			(33,000)
- Investment in cousin' Dum Sim's Asian restaurant partnership			(50,000)
- guarantors' investment in cousin Tree Lim's privately held tree trimming company			(2,000,000)
- guarantors' loan to Dum Sim's restaurant entity			(1,000,000)
- receivable due from brothers' father			(4,000)
- loan to Slim Jim's son for college tuition			(135,000)
-Personal and business vehicles			(260,000)
-Delete face value of life insurance			(1,000,000)
+Add back cash surrender value of life insurance			+ 40,000
-Life insurance loan			(37,000)
-investment in cousin Win Vin's vineyard in Acapulco, Mexico			(165,000)
-1965 Mustang, 1987 Dodge Caravan, Boston Whaler boat			(84,000)
- Other personal assets—furnishings, antiques, art, clothing			(400,000)
-Additional consumer debt reported on credit cards			(14,000)
-Estimated capital gains tax on appreciation in home value			(435,000)
<b>48</b> Subtotal, Adjustments			<u>(5,588,000)</u>
NET WORTH, ADJUSTED			<u>(1,451,500)</u>

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## CHECKLIST FOR NW ADJUSTMENTS

Checklist	Net Worth (NW) Adjustments
1-Assets	<ul style="list-style-type: none"> <li>•Eliminate from net worth (NW) assets related to the borrower:                             <ul style="list-style-type: none"> <li>•Investment in the borrowing entity.</li> <li>•Amounts due from borrowing entity.</li> <li>•Any other assets derivative of the borrowing entity or related parties—stockholders, owners, principals, officers, directors, family members, etc.</li> </ul> </li> <li>•Eliminate from NW assets of questionable liquidation value:                             <ul style="list-style-type: none"> <li>•Personal assets, such as household goods, antiques, jewelry, art, cars, planes, boats, etc.</li> <li>•Investments in closely held entities or minority shares of entities.</li> </ul> </li> <li>•Reduce NW to reflect market value of all publicly traded securities, such as stocks, bonds, etc.</li> </ul>
2-Liabilities	<ul style="list-style-type: none"> <li>•Calculate and subtract from NW                             <ul style="list-style-type: none"> <li>• estimated taxes on capital gains, income, and other taxes.</li> </ul> </li> <li>•Investigate and subtract any extra consumer debt.</li> <li>•Guarantees of other debts</li> </ul>
3-Contingencies	<ul style="list-style-type: none"> <li>•Note any pending tax audits, legal action and amounts claimed, e.g., IRS audits, lawsuits, judgments, liens, etc.</li> </ul>
3-Math Check	Double-check the PFS for arithmetic errors and omissions, such as guarantees of other debts, pending legal action, IRS audits, etc.

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## BIG BUSINESS IN SBL?



- Does your organization require borrower’s owners to guarantee?
  - YES
  - NO

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## THE ODDS OF BEING REPAYED

- We hope the borrower has the management to figure out how to be successful in his line of business
- We also hope the borrower is able and willing to repay, but if the borrower defaults, we reduce the chance of loss by taking collateral and obtaining guarantees
- So our sources of repayment are based on
  - First, the borrower's cash flow to mitigate the probability of default
  - Second, collateral and guarantees to reduce the loss given default
- In a perfect world, we have it all . . .

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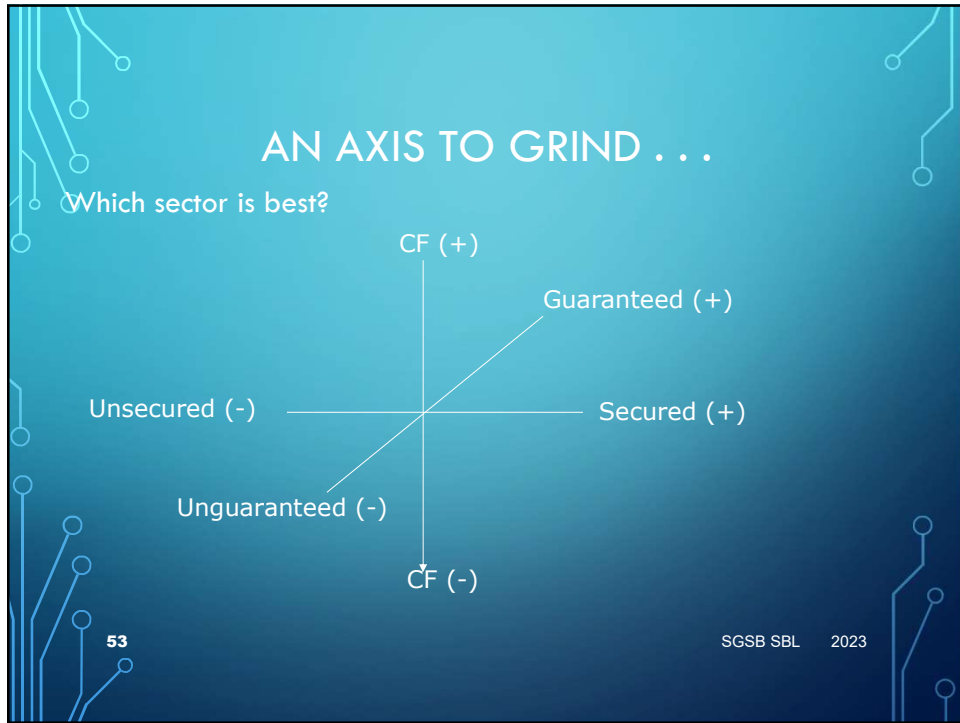
## WE BANKERS ALSO EXPECT TO SEE ALL 3 REPAYMENT SOURCES “INSIDE THE BOX”

Repayment Sources	Inside the box	Outside the box
Cash Flow	<ul style="list-style-type: none"> <li>■ Sufficient</li> <li>■ <math>CF \geq (P+i)</math></li> </ul>	Insufficient
Collateral	<ul style="list-style-type: none"> <li>■ Secured</li> <li>■ <math>Coll \geq (P+i)</math></li> </ul>	Unsecured
Guarantees	<ul style="list-style-type: none"> <li>■ Guaranteed</li> <li>■ <math>Guar \geq (P+i)</math></li> </ul>	Unguaranteed (non-recourse)

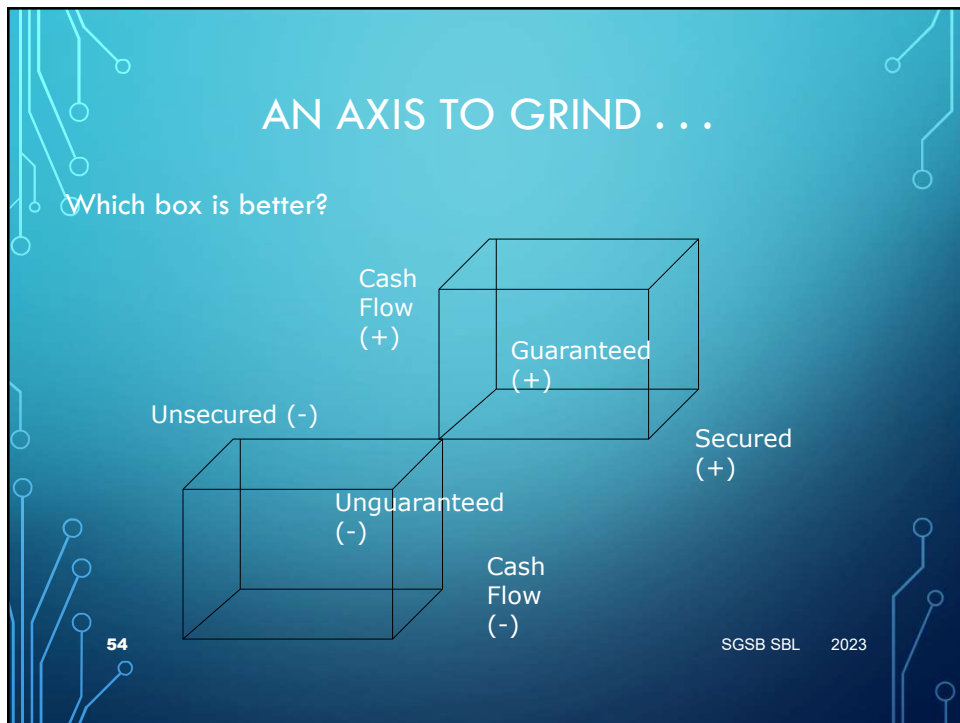
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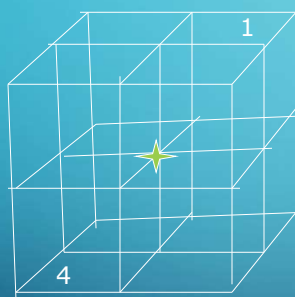
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## POSSIBLE OPTIONS

1 cube = 8 little boxes



Options	CF	Sec	Guar
1 (right box)	+	+	+
2	+	+	-
3	+	-	-
4 (wrong box)	-	-	-
5	-	+	-
6	-	+	+
7	-	-	+
8	+	-	+

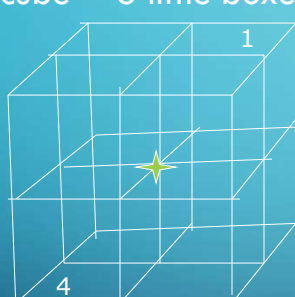
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## POSSIBLE OPTIONS—TYPICAL BORROWERS

1 cube = 8 little boxes



Options	CF	Sec	Guar	Borrower
1 (right box)	+	+	+	Ideal borrower
2	+	+	-	CRE property
3	+	-	-	Fortune 500
4 (wrong box)	-	-	-	Special assets
5	-	+	-	Large ABL
6	-	+	+	Small ABL
7	-	-	+	Rich relative
8	+	-	+	Services firm

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We bank 7 of the 8 boxes willingly, and to do so requires us to rely upon one or more of the secondary sources . . .

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## GLOBAL CASH FLOW (GCF) AND GLOBAL DEBT SERVICE COVERAGE (GDSC)

- Global Cash Flow
  - Total cash flow generated by borrowing entity and its guarantors
- Repayment
  - Global Debt Service Coverage—enough GCF from borrowers and guarantors to repay loan + interest,  $GCF \geq (P+i)$ 
    - Usually expressed as GDSC ratio:  
= Borrower and Guarantor Cash Flow / (existing and proposed  $P + i$ )
- Secondary Repayment Sources
  - Collateral—collateral liquidation value  $\geq (P+i)$
  - Guarantees—guarantors' adjusted net worth (ANW)  $\geq (P+i)$

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## WHY GLOBAL CASH FLOW (GCF)?

- Comingling and disaggregation of funds in closely held business
  - Many owners lend to and/or borrow from their businesses
  - Tax laws encourage separation of business into two or more parts, e.g., sale-leaseback
  - Owner-guarantors manage salaries, bonuses, benefits, dividends, etc. to minimize taxable income
- Putting Humpty-Dumpty back together
  - Bank loan funds will be used directly or indirectly by borrower-guarantors
  - So GCF puts all the cash inflows and outflows back together again
- Regulatory guidance
  - The OCC's Internal Guidance from April 9, 2008:
    - “ *An analysis of the guarantor's global cash flow should consider inflows, as well as both required and discretionary cash outflows from all activities. This may involve integrating multiple partnership and corporate tax returns, business financial statements, K-1 forms, and individual tax filings. Anything short of a comprehensive global cash flow analysis diminishes confidence in the assessment of guarantor strength, even in the face of significant liquid assets since that liquidity may be needed to fund contingent liabilities and global cash shortfalls.*”

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## HOW DO WE MEASURE CASH FLOW (CF)?

- Common CF measures
  - Traditional cash flow(TCF) ? (See Appendix C)
    - After-tax profits + non-cash charges (D&A)
  - EBITDA? (See Appendix D)
  - FAS 95 cash flow?
    - Operating
    - Investing
    - Financing
  - Other measures (See Appendix D)?
    - NCAO (net cash after operations)
    - NCI (net cash income)
    - CADA (cash after debt amortization)
    - FCF (free cash flow)
    - Global Cash Flow



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## WHICH CF MEASURE?

Reaper	2008	2009	2010
<b>EBITDA</b>	45	40	68
<u>+R</u>	.5	12	20
<b>EBITDAR</b>	50	52	88
-T	-10	-3	-2
-Div	-3	-4	-8
-Capex	-37	-102	-91
<u>-chg NWC</u>	-2	-38	-35
sub-total, needs	-52	-147	-136
<b>=FCF avail for existing DS</b>	<b>-2</b>	<b>-95</b>	<b>-48</b>
-R	-5	-12	-20
-P	-10	-5	-14
<u>-I</u>	<u>-7</u>	<u>-11</u>	<u>-16</u>
<u>=Dbt Svc (DS)</u>	<u>-22</u>	<u>-28</u>	<u>-50</u>
<b>=FCF Cash (+/-) avail for new dbt</b>	<b>-24</b>	<b>-123</b>	<b>-98</b>

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## COMPARISON OF NCAO WITH FCF FOR REAPER CORPORATION

• <b>NCAO, NCI, &amp; CADA (\$MM)</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
• Cash collected from sales	566	616	666
• -production costs	-460	-526	-537
• -operating costs	- 82	-104	-123
• -other income (expenses)	<u>5</u>	<u>22</u>	<u>25</u>
<b>net cash after operations (NCAO)</b>	<b>29</b>	<b>8</b>	<b>31</b>
-existing interest expenses	- 7	- 11	- 16
-dividends	<u>- 3</u>	<u>- 4</u>	<u>- 8</u>
<b>net cash income (NCI)</b>	<b>19</b>	<b>- 7</b>	<b>7</b>
-existing principal repayment	<u>- 10</u>	<u>- 5</u>	<u>- 14</u>
<b>cash after dbt amrtzn (CADA)</b>	<b>9</b>	<b>- 12</b>	<b>- 7</b>
-CAPEX for existing nt fxd assets	<u>- 37</u>	<u>-102</u>	<u>- 91</u>
<b>NCAO surplus (deficit) avail for new debt</b>	<b>- 28</b>	<b>-114</b>	<b>- 98</b>
<b>FCF surplus (deficit) avail for new debt</b>	<b>-24</b>	<b>-123</b>	<b>-98</b>

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## HOW OWNERS AS GUARANTORS IMPACT REAPER GCF AND GDSC

- Borrower: GREAT (Grimm Real Estate Asset Tower), Inc., S-corporation that owns and operates office building
  - Brothers Grimm want a \$500M 5-year term loan for GREAT secured by its building
  - 83%-17% owned by Slim Jim Grimm and Dim Tim Grimm
  - GREAT pays \$30M in annual dividends to Brothers Grimm, \$25M to Slim Jim and \$5M to Dim Tim
- Grimm Brothers' Reaper Corporation
  - Reaper Corporation, a funeral supplies wholesaler
  - Owned 50-50 by the Brothers Grimm
  - Each brother is paid annual salary of \$100M
  - occupies 50% of space , and other 50% is leased out to other tenants
  - Reaper pays \$20M rent to Great
- Guarantors:
  - Slim Jim Grimm and Dim Tim Grimm
  - Reaper Corporation
- Collateral
  - GREAT office building

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## INDIVIDUAL REPAYMENT ANALYSIS

Personal Cash Flow (PCF) available to help Reaper

2010 PCF Analysis (\$)	Slim Jim	Dim Tim	Total
Salaries from Reaper	100,000	100,000	200,000
Interest Income	20,000	10,000	30,000
Dividend income from GREAT	25,000	5,000	30,000
Sub-total, income	145,000	115,000	260,000
-FIT and other taxes	-50,000	-30,000	-80,000
-Alimony and child support	0	-40,000	-40,000
-Personal expenses	-20,000	-10,000	-30,000
PCF available to service existing debt	75,000	35,000	110,000
Existing debts	-25,000	-30,000	-55,000
DSC	3.00x	1.17x	2.00x
PCF available to service Reaper and GREAT debt	50,000	5,000	55,000

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## CHECKLIST FOR PCF UNDERWRITING

Checklist	Key Elements
1-Data sources	<ul style="list-style-type: none"> <li>•Personal tax returns, personal financial statements, credit bureau reports</li> </ul>
2-Income Estimation	<ul style="list-style-type: none"> <li>•Reliable, stable, predictable</li> <li>•OK: wages, bond interest, dividends</li> <li>•Not OK: lottery winnings, capital gains, insurance proceeds</li> </ul>
3-Expense estimation	<ul style="list-style-type: none"> <li>•Borrowers and guarantors have existing obligations that must be met                             <ul style="list-style-type: none"> <li>•Loans—mortgage, vehicle loans and leases, student loans, credit cards, other debt?</li> <li>•Priority of payment—pay existing debts vs. new debts?</li> <li>•Priority of payment—pay house and car first, all others second?</li> </ul> </li> <li>•Taxes                             <ul style="list-style-type: none"> <li>•Federal and state income taxes, Medicare and social security, and real estate taxes</li> <li>•Other taxes?</li> </ul> </li> <li>•Typical personal expenses                             <ul style="list-style-type: none"> <li>•Groceries</li> <li>•Utilities</li> <li>•Transportation</li> <li>•School tuition</li> <li>•Alimony and child support</li> <li>•Other personal expenses?</li> </ul> </li> </ul>

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## OTHER GUARANTOR OPTIONS

- Borrowing entity is GREAT
  - Owned 83% by Slim Jim and 17% by Dim Tim
- But Reaper Corporation is related entity
  - Owned 50-50 by Brothers Grimm
- So what's Reaper Corporation worth?
  - LTV on \$1MM in total assets => \$588M
  - Net Worth = \$888M
- Now what the office building worth?

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## GREAT'S INCOME & VALUATION

- Income Producing Property Income and Valuation and Analysis

Cash Flow (\$)	2010
Potential Gross income (\$20psf x 20,000sf)	400,000
Less: vacancy (5%)	-20,000
Gross income	380,000
Operating expenses* (\$13psf x 20,000sf)	-260,000
Rollover expenses** (\$2psf x 20,000sf)	-40,000
Depreciation (750,000 / 15 years)	-50,000
Net Income before dividends	30,000
Dividends	-30,000
Net income after dividends	0
Cash flow available for debt service (NIAD + Depreciation)	50,000
NIBD / 4% cap rate = 30,000 / .04 =	750,000
*utilities, taxes, management fees, maintenance, marketing, insurance, legal, accounting, etc	
**expenses incurred to attract new or renewal tenants—renovation, reconfiguration, redecorating, etc., aka tenant improvements	

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### CHECKLIST FOR INCOME & VALUATION ANALYSIS

Checklist	Key Elements
1-Net Rentable Space	*Are non-rentable spaces such as common areas--hallways, stairs, corridors, entrance ways--excluded?
2-Rental Prices	*Owner-occupied paying a market rate? *Other tenants paying a market rate?
3-Leases	*Prices *Owner-occupied tenant paying market rate? *Other tenants paying market rate? *Lease terms long enough to cover proposed loan term *Rollover expenses *Cash dollars being paid or rent concessions? *Who is being paid to perform tenant improvements--related parties? *Is dead time from TI construction factored into vacancy rate?
4-Vacancy rate	*Realistic?
5-Operating expenses	*Are taxes current? *Is insurance adequate--coverages, deductibles, exclusions? *Who is receiving management fees--related parties? *Deferred maintenance? *Marketing expenses--what are they and who is being paid--related parties?
6-Cap rate	*Type of project? *Reflective of local economic conditions?
7-Maintenance & repair	*Curb appeal *Deferred maintenance?
8-Sensitivity analysis	*Interest rates and impact on DSC *Values--cap rate changes and impact on LTV

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### REVISED GREAT'S CASH FLOW

Income Producing Property Valuation

Cash Flow (\$)	2010	Adjustments	2010 Revised
Potential Gross income (\$20psf x 20,000sf)	400,000	\$19psf x 19,000 sf	361,000
Less: vacancy (5%)	-20,000	9.9% vacancy	36,000
Gross income	380,000		325,000
Operating expenses* (\$13psf x 20,000sf)	-260,000	\$12psf x 19,000 sf	228,000
Rollover expenses** (\$2psf x 20,000sf)	- 40,000	\$3x 19,000	57,000
Depreciation (750,000 / 15 years)	-50,000	400,000/20	20,000
Net Income before dividends (NIBD)	<b>30,000</b>		<b>20,000</b>
Dividends	-30,000		20,000
Net income after dividends	0		0
Cash flow available for debt service (NIBD + Depreciation)	50,000		40,000
<b>NIBD / 4% cap rate = 30,000 / .04 =</b>	<b>750,000</b>	<b>20,000 / .05 =</b>	<b>400,000</b>

\*utilities, taxes, management fees, maintenance, marketing, insurance, legal, accounting, etc  
\*\*expenses incurred to attract new or renewal tenants--renovation, reconfiguration, redecorating, etc., aka tenant improvements

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## INITIAL GLOBAL CASH FLOW (GCF)

- Brothers Grimm are asking for a \$500M 3-year, 5% i-only facility secured by the \$750M building

GCF (\$M)	Reaper (A)	Slim Jim Grimm	Dim Tim Grimm	GREAT	2010 TOTAL	2011	2012	2103
FCF	-48	75	35	50	112	125	150	200
Existing DS	-50	-25	-30	0	-105	-60	-60	-60
DSC for existing debt	Na	3.00x	1.17x	Na	1.07x			
Available for new debt	-98	50	5	50	7	65	90	140
New Debt (\$500)						-25	-25	-25
GCF surplus/deficit						40	65	115
GDSC for all debt						1.47x	1.76x	2.35x

(A) Refer to earlier analysis for details of Reaper's FCF

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## INITIAL GCF-GDSC PROJECTION

- (A) Will existing creditors agree to lower projected DS?
- (B) Is interest only realistic?
- Other issues?

GCF (\$M) & GDSC (x)	2010					Projection		
	Reaper	Slim Jim Grimm	Dim Tim Grimm	GREAT	Total	2011	2012	2013
FCF	-48	75	35	50	112	125	150	200
<b>(A) Existing DS</b>	-50	-25	-30	0	-105	<b>-60</b>	<b>-60</b>	<b>-60</b>
DSC for existing debt	Na	3.00x	1.17x	Na	1.07x	2.08x	2.50x	3.33x
Available for new debt	-98	50	5	50	7	65	90	140
<b>(B) New Debt (\$500)</b>					0	<b>-25</b>	<b>-25</b>	<b>-25</b>
GCF surplus/deficit					7	40	65	115
GDSC for all debt					1.07x	1.47x	1.76x	2.35x

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## REVISED GCF-GDSC PROJECTION

GCF (\$M) & GDSC (x)	2010					Projection				
	Reaper	Slim Jim Grimm	Dim Tim Grimm	GREAT	Total	2011	2012	2013	2014	2015
FCF (a)	-48	75	35	50	112	105	130	180	190	200
Existing DS (b)	-50	-25	-30	0	-105	-90	-75	-60	-45	-30
DSC for existing debt	Na	3.00x	1.17x	NA	1.07x					
Available for new debt	-98	50	5	50	7	15	55	130	145	170
New Debt (\$300) (c)					0	-78	-74	-71	-68	-64
GCF surplus/deficit					7	-63	-19	59	77	106
<b>GDSC for all debt</b>					<b>1.07x</b>	<b>0.19x</b>	<b>0.74x</b>	<b>1.83x</b>	<b>2.12x</b>	<b>2.65x</b>

(a) Adjusted to reflect revised cash flow from Great, \$10M less each projected year; plus \$10M less dividend income--\$8.3M less dividend income for Slim Jim and \$1.7M less dividend income for Dim Tim

(b) Existing debt's actual scheduled repayment

(c) Adjusted value of \$400M x 75% = \$300M, payable at \$60M for 5 years with 6% interest; interest expense of \$18M, \$14M, \$11M, \$8M, and \$4M for 2011, 2012, 2013, 2014, and 2015 respectively.

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## GRIMM REAPER REPAYMENT ABILITY & OPTIONS

Repayment Source	Results		
Cash flow	Negative for first 2 years; 0.19x for 2011, 0.74 for 2012		
Collateral	Great Original LTV = \$500M/\$750M = 75% Great Revised LTV = \$500/\$400M = 125% Reaper Corporation = \$588M		
Guarantees	Brothers' ANW = (\$1,451,500) Reaper Corporation = \$888M		
GCF Cash Flow Enhancement Options			
Options	Reaper	Brothers Grimm	Great
Increase Cash Inflow	-Raise prices	-Raise salaries -Increase interest and dividend income	-Raise rent -Increase depreciation expense
Decrease Cash Outflow	-Reduce cost of goods sold -Cut overhead -Reduce taxes -renegotiate debt service requirements	-Reduce taxes -Reduce personal expenses -Reduce personal expenses -Renegotiate alimony and child care expenses -Renegotiate debt service requirements	-Reduce operating expenses -reduce rollover expenses -reduce dividends -renegotiate debt service requirements

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## MANAGEMENT CHECK GRID

Management Check Grid for Global Debt Service				
GDSC Calculation	Global Cash Flow			
	borrower	guarantor	CRE property	Total
FCF	(A)	(B)	(C)	(F)
Existing DS	(D)	(D)	(D)	(D)
New DS	(D)	(D)	(D)	(D)
DSC	(E)	(E)	(E)	(E)

(A) Use FCF available to cover existing debt, which is after T, Div, and Capex  
 (B) Same as A, and for individuals after personal expenses  
 (C) Use NI + depreciation, but check underlying assumptions on rental income psf, rentable space, vacancy rate, operating expenses, and rollover expenses  
 (D) Be sure principal is amortizing over reasonable term and interest rate is realistic  
 (E) Remember that 1.10 DSC means a 10% cushion, so the less reliable your income and expense assumptions, the higher you should set your minimum DSC  
 (F) Ensure that financial statements are same date, projections are realistic; projection period covers the entire term of loan

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## BIG BUSINESS IN SBL?

- Which cash flow measure does your organization favor in evaluating SB borrower repayment ability?
  - Traditional cash flow (after-tax profits + non-cash charges)
  - EBITDA or EBIDA
  - FASB 95 (ASC 230) cash flow from operations
  - Free cash flow
  - Other?

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## AGENDA

- Credit considerations in lending to smaller businesses
- **Fitting smaller business lending into bank**
- Establishing standardized credit and operations processes and policies for smaller business lending (SBL)



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## BIG BUSINESS IN SBL?

- If your organization makes loans to SB's, where is it housed?
  - Retail side of the bank
  - Commercial side of the bank
  - Somewhere else

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## SBL ROLES & RESPONSIBILITIES

- Business Banking
  - Prospecting
  - Calling
  - Selling
  - Negotiating
  - Closing
- Credit Administration
  - Underwriting
  - Decisioning
  - Monitoring
- Loan Operations
  - Booking
  - Funding
- Others?




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## INFRASTRUCTURE NEEDED TO SUPPORT SMALLER BUSINESS LENDING

- Credit Administration
  - Enough info—loan applications
  - Analysis
    - Cash flow
    - Collateral
    - guarantees
  - underwriting
    - Structuring
    - Covenants and conditions
    - Policy exceptions
    - Risk rating
  - Approval
  - Monitoring
    - Credit scores of borrowers and guarantors
    - Loan and deposit performance
    - Covenant and tickler management
- Problem Assets
- Loan Operations
  - Note Department
  - Documentation Preparation and Review
  - Approval = Closing = Booking = Funding?
  - Loan Doc Exceptions
- Specialty Lending
  - Ag lending
  - CRE lending
  - ABL
  - SBA lending

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## SBA LENDING

- SBA Risks
- Program Requirements
- Product Criteria
- Contractor Bonding
- SBA Lending Policy Guidance
- Credit Scoring
- Underwriting Matrix



Sweet deal . . .

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## SBA LENDING RISKS

- **Credit risk**
  - Higher risk—adverse selection, smaller, younger, etc.
  - Repayment ability heavily dependent on projections
  - Collateral—unaudited values
  - Guarantees—borrowers typically have only limited or no outside net worth
  - SBA guarantee—more like insurance
- **Operational risk**
  - Booking loan that meets SBA requirements
  - Long-tail loan maintenance
  - Potential loss of SBA guarantee
- **Strategic risk**
  - Betting the bank on SBA loan production

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## SBA LENDING PROGRAM REQUIREMENTS

- SBA Program Requirements
  - Prospective borrower must be underwritten under bank's traditional credit criteria before borrower is considered for SBA guarantee
  - SBA loan candidates must meet these basic requirements:
    - Active for-profit business
    - Located in USA
    - Meet SBA size requirements
    - Eligible type of business
    - Able to demonstrate need for credit and no availability of funds from other sources
    - Able to demonstrate repayment ability from cash flow and also show management capability, sufficient collateral, and owner equity
  - SBA Programs (See Appendix A)
    - SBA 7(a) Loan Guaranty Program
    - SBA 504 Certified Development Company Loan Program
    - SBA Microloan Program
    - Small Business Investment Companies (SBIC)

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## SBA CRITERIA 7(A) AND 504 (SEE APP A FOR OTHER PRODUCTS)

- SBA 7(a) Loan
  - 85% guarantee  $\leq$  \$150,000, 75% guarantee  $>$  \$150,000
  - Minimum loan: none—banks may impose their own minimums
  - Maximum loan: \$5,000,000
  - Maximum term
    - Permanent working capital and inventory financing: 5-7 years
    - Equipment and fixed assets: 10 years
    - Real estate: 25 years
  - No lines of credit allowed under this program
  - Construction financing now permitted—competes with 504?
- SBA 504
  - Fixed rate financing for fixed assets, owner occupied RE construction
  - Term based on useful life, minimum typically 10 years, maximum 25 years
  - Bank loan secured by first lien at 50% LTC, CDC lien at 40% backed by 100% SBA guaranteed debenture

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## SBA SURETY BONDING PROGRAM

- SBA will help contractors to get bonding
- Eligible contractors
  - Specialty contractors up to \$16MM in revenues
  - Heavy contractors up to \$36.5MM in revenues
- Other eligible firms
  - Service, supply, and manufacturing firms working under contracts
- SBA also has a FAST approval product for jobs up to \$250M

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## SBA LENDING POLICY GUIDANCE

- SBA eligibility
  - Active for-profit business
  - Located in USA
  - SBA size requirements
  - Eligible type of business
  - Able to demonstrate need for credit and no availability of funds from other sources
    - must be able to demonstrate repayment ability, AND
    - Sufficient collateral, owner equity, and management capability
- Bank may set its own more restrictive criteria
  - Time in business– 3 year minimum preferred
  - Start-up's generally ineligible but if less than 3 years, then
    - Minimum credit score of 700 on principals
    - 5 years of related, relevant experience
    - 75% maximum tangible collateral
    - Principals have injected at least 25% of total start-up costs as equity
  - Ineligible industries
    - Not-for-profits, restricted patronage, coops, pyramid sales, etc.,
    - Not targeted by bank

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## SBA LENDING POLICY GUIDANCE

- Specialty lending (See App B for specialty lending guidance)
  - Stringent SBA underwriting, booking, and monitoring requirements
  - Not a book-don't look opportunity
- All SBA loans should be underwritten and approved only by SBA unit
  - But total credit exposure must be decided by final credit approver before any exposure can be booked
- SBA SOP's (SOP 50 10 5) overrule bank policy when in conflict, e.g.,
  - Environmental audits
  - Appraisals  
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- All modifications to SBA loan must be approved by SBA unit before communicated to borrower, e.g.
  - Release or substitution of guarantors or collateral
  - Rate, term, or amortization changes
  - Sale of business or change of ownership
- Credit files
  - SBA standard must be followed

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## TOP 11 GOOFS THAT CAUSE INCOMPLETE SBA CREDIT MEMOS


1. Life insurance not addressed
2. Certification that financials were verified against IRS transcripts not included
3. Schedule of collateral missing or incomplete
4. Credit memo contradicts draft loan authorization
5. Use of proceeds unclear
6. Note(s) to be refinanced not clearly identified
7. Sufficient justification for refinance not provided
8. Need for working capital not addressed
9. Derogatory credit not addressed
10. Collateral shortfall not addressed
11. Justification for projections missing

Source: US SBA Office of Capital Access  
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## SBA CREDIT SCORING

- SBA's implemented credit scoring for loans ≤ \$350M effective July 2014:
  - Credit scoring means banks can stop doing:
    - DSC
    - Projected cash flows
    - Credit histories of all principals
    - Analysis of business strengths
  - Banks still must do these:
    - Brief history of business
    - Description of management team
    - Owner/guarantor analysis
    - IRS form 4506 to get access to tax returns
    - Prudent lender test of D/W ratio and equity injection
    - List of collateral
    - Analysis of affiliate(s) impact on GCF



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## EXAMPLE OF SBA UNDERWRITING MATRIX


Sample Bank Underwriting Criteria	SBA Programs				
	SBA 7(a)	SBA 504	SBA Express	SBA Export	SBA Patriot
Min Loan Size	250,000	250,000	100,000	25,000	25,000
Max Loan Size	5,000,000	5,000,000	350,000	500,000	\$500,000
SBA Guarantee %	≤ \$150M = 85% >\$150M = 75%	Not applicable	50%	≤ \$350M = 90% >\$350M = 75%	90%
Min SBFE score	541	541	561	541	541
Min Personal Credit Score	650	650	650	650	650
Min DSC	1.00 historic 1.35 projectd	1.00 historic 1.25 projectd	1.25 hist 1.35 projectd	1.10 hist 1.35 projectd	1.10 hist 1.35 projectd
Max Term	All programs mirror term/amortizations allowed by SBA				
Max Amrtzn	All programs mirror term/amortizations allowed by SBA				
Min Liquidity	10% or 6 months of debt service, whichever is greater				

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## SO HOW TO SET UP A SBL UNIT

- Define SBL
- Assign SBL to LOB
- Staff and train unit
- Establish minimum RAROC
- Set portfolio limits
- Set asset quality standards
- Write SBL policy



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## AGENDA

- Credit considerations in lending to smaller businesses
- Fitting smaller business lending into bank
- **Establishing standardized credit and operations processes and policies for smaller business lending (SBL)**



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## SOME CRITICAL ELEMENTS OF SBL POLICY

- Scope—market served, transaction/exposure limit
- Roles and responsibilities—relationship managers, analysts, underwriters, loan documentation, loan operations, credit administration
- Loan processing—financial information requirements, credit package
- Analysis and underwriting—time in business, appropriate guarantees, satisfactory credit history, minimum credit scores, minimum DSCR, collateral LTV's, maximum term and amortization, minimum liquidity, risk rating, appraisal and environmental requirements
- Conditions and covenants—bank depository account, no additional borrowing, no liens, taxes current
- Approval—pricing, policy exceptions, doc exceptions, overrides
- Loan documentation—demand vs. time note, standardized loan docs vs. attorney-prepared docs,
- Monitoring—asset quality, risk rating migration, credit score changes, stale annual reviews, continuous monitoring, policy exceptions, loan doc exceptions, stale risk ratings
- Problem asset management—bankrupts, deceased borrowers, all substandard loans, 90-day past-dues, non-accruals, charge-offs, OREO
- Pricing and policy discipline is critical . . .

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## ROLES & RESPONSIBILITIES

Responsible Party	Summary of Roles and Responsibilities
Relationship Managers (RM)	<ul style="list-style-type: none"> <li>• Obtain all financial information needed to underwrite the transaction.</li> <li>• Interact with the borrower to ensure all nonfinancial information is attained to complete the underwriting process.</li> <li>• Coordinate the underwriting with internal underwriting and closing personnel.</li> </ul>
Portfolio Manager (PM)	<ul style="list-style-type: none"> <li>• Underwrite CLU-eligible transactions based on appropriate policy requirements.</li> <li>• Obtain all financial information needed to underwrite the transaction.</li> <li>• Interact with the borrower to ensure all nonfinancial information is attained to complete the underwriting process.</li> </ul>
PM, Sr. PM , Geography Relationship Manager (GRM)	<ul style="list-style-type: none"> <li><input type="checkbox"/> Approves transactions based on their authority <a href="#">ERGEN-1010 Credit and Lending Authorities Credit Policy</a>.</li> </ul>
Real Estate Construction Administration (RECAD)	<ul style="list-style-type: none"> <li><input type="checkbox"/> Refer to Commercial Real Estate Operating and Management Policy for RECAD's specific responsibilities.</li> </ul>
Loan Closers	<ul style="list-style-type: none"> <li>• Prepare loan documentation based on what was approved in the appropriate approval document.</li> <li>• Ensure that the Bank has a legally enforceable loan transaction.</li> <li>• Ensure that the loan was properly booked.</li> </ul>

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### UNDERWRITING GRID EXAMPLES

	Secured Other than Real Estate	Owner Occupied Real Estate	Non-Owner Occupied Real Estate	Unsecured Blkt Lien, A/R, Inv or Leases ≤ \$50,000	Unsecured or Blkt Liens, A/R, Inv or Leases > \$50,000	ACH Exposure ≤ \$100,000 (Min 3-Day Hold)	ACH Exposure ≤ \$100,000 (No Hold)
Minimum FICO Score (All Guarantors)	650	650	N/A	680	680	680	680
Minimum SBFE Score	560	560	N/A	560	560	560	560
Minimum Global DSCR	N/A	N/A	N/A	1.40	1.40	N/A	DSC ≥ 1.25
Maximum Amortization	5 years	7 years	N/A	5 years	5 years	N/A	5 years
Liquidity Requirement <sup>(6)</sup>	N/A	N/A	N/A	20%	30%	See Risk Limits in ACH U/W guide	See Risk Limits in ACH U/W guide

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### SBL UNDERWRITING GRID EXAMPLES

	Secured Other than Real Estate	Owner Occupied Real Estate	Non-owner Occupied Real Estate	Unsecured or Blanket Liens, A/R, Inv., or Leases	Secured by Liquid Collateral
Minimum Global DSCR	1.25	1.25	1.35 w/ NOI(2)	1.35 int only, 1.25 amortized over five years	1.00x if standalone line of credit; 1.20x if additional loans included
Maximum Amortization	5 years			5 years	Interest expense only for lines of credit, Amortization period for term debt
Liquidity requirement(6)			10%	30%	

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## ACH UNDERWRITING GRID EXAMPLE

	ACH Risk Exposure Up to and including \$100,000 (pre-funded) (4)	ACH Risk Exposure \$100,001 and Greater (unfunded)
<b>3 day hold for 100% of the ACH debit file (1)</b>	Yes	No
<b>STI DDA Account (2) (3)</b>		
- <b>3 or Less NFS over 12 Months</b>	Yes	Yes - No Overdrafts Resulting in Loss
- <b>3 Months DDA and/or Analysis from former institution</b>	Yes	Yes
<b>Minimum DSC for Current Year</b>	N/A	1.25x
<b>Minimum DSC for Previous Fiscal Year</b>	N/A	1.00x
<b>(1)</b> Clients unwilling or unable to accept the standard 3-day 100% hold required on the pre-funded product are subject to full underwriting for the ACH Risk Exposures \$100,001 and Greater.		
<b>(2)</b> Existing deposit clients must have maintained a <b>3 or less DDA</b> in good standing with no more than three NSF occurrences over a twelve (12) month period; no overdrafts resulting in losses to the Bank.		
<b>(3)</b> New deposit clients must provide three (3) months of DDA and/or analysis statements from their former financial institution. Statements will be used for the risk based ACH qualification/approval process.		
<b>(4)</b> Minimum time in business does not apply.		

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## TRANSACTION PRICING DISCIPLINE

Minimum Rate Based on collateral and guarantees	Risk Rating		
	1-3	4-5	6-9
Secured by liquid collateral	P	P + 1	P + 1.5
Secured by properly margined real estate	P + 1	P + 1.5	P + 2.0
Secured by properly margined receivables or inventory	P + 1.5	P + 2.0	P + 2.5
Secured by any other assets	P + 2.0	P + 2.5	P + 3.0
Unsecured	P + 2.5	P + 3.0	P + 3.5
If guaranteed, reduce minimum rate by factor based on guarantor's risk rating	1-3 rated guarantor = reduce minimum rate by 1.0 4-5 rated guarantor = reduce minimum rate by 0.5 6-9 rated guarantor = reduce minimum rate by 0.25 If multiple guarantors, use average rating weighted by guaranteed exposure		

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## CREDIT POLICY EXCEPTIONS

- Selection
  - Evaluate problem loans
    - lenders, credit approvers, loan review officers, work-out specialists look for common analytical and underwriting defects, e.g., insufficient or inadequate repayment sources—cash flow, collateral, guarantees—resulting in loss to bank
  - Analyze the defects to determine most significant PE's
    - Decide which PE's to "track"
      - Validate connection between TPE's and problem assets
  - Define PE
    - clear and measurable
      - Quantitative—minimum or maximum
      - Heuristic—yes or no
      - Specificity—not ambiguous, e.g., "should,"
    - Avoid ambiguity and excessive conditionality
      - "should," "prefer," "encourage," "discourage"
      - PE is cited if A or B but not if B also includes C or D is greater than A . . .



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## COMMON "TRACKABLE" POLICY EXCEPTIONS

- 10 guaranty
- 11 borrower
- 12 minimum DSC
- 13 loan term
- 14 amortization
- 15 financial statements
- 16 total credit exposure
- 17 undesirable industry
- 18 undesirable collateral
- 19 maximum LTV
- 20 LTV > FDICIA
- 21 appraisal
- 22 environmental audit
- 23 spec purpose
- 24 pre-leasing/pre-sales
- 25 min occupancy rate
- 26 min release prices
- 27 maximum LTC
- 28 minimum equity
- 29 min clean-up period for line of credit
- 30 leveraged financial transactions

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## OBLIGOR – OBLIGATION TPE'S

- Most TPE's are obligation-specific, e.g.,
  - One obligation may be guaranteed, another may not be
  - One obligation may meet LTV requirements, another may not
- But a few TPE's are obligor-specific, e.g., financial info, DSC, etc.
  - For example, count financial statements once against obligor, not against each obligation
  - Likewise, cite DSC against obligor, not against each obligation
- Obligation and obligor TPE's

Obligation	Obligor
10 guarantor	11 borrower
13 loan term	12 DSC
14 amortization	15 financial statement quality
18 undesirable collateral	16 TBE
19 max LTV	17 higher risk/undesirable industry
20 exceeds FIDICIA LTV	30 time in business
21 appraisal	55 LFT
22 environmental risk	
23 speculative purpose	
36 unsecured LOC	
50 LOC clean-up	
40 pre-leasing/pre-sales	
41 leasing/occupancy rate	
43 release prices	
44 max LTC	
45 min equity	



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## TPE'S—CITATION ISSUES


- Recognition
  - at inception, renewal, or other credit action
  - By lender, approver, or loan reviewer?
- Approval options
  - Recognition vs decision to make loan
  - Recognition vs waiver of TPE
  - “One-up” approval required of loans with TPE
- Post-recognition
  - Point-in-time vs over life of loan
  - Potential for TPE to be cured over time

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## TPE REMEDIATION

- Training options
  - All lenders
  - Lenders with high rate of TPE's
  - Other participants?
- Consequences
  - Lending authority—reduction, suspension?
  - Compensation—"credit administration" factor in performance review
  - Job—transfer to problem asset unit or loan review unit, probation or termination



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## SMALL BUSINESS LENDING POLICY ISSUES

- Which LOB responsible for small business lending
- Which LOB responsible for SBA lending?
- Definition of small business borrower and small business loan
- Centralized or decentralized underwriting, approval, closing, booking, funding, monitoring?
- Problem asset management
- Small business lending policy—separate or supplemental to overall credit policy?




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## IN-CLASS ASSIGNMENT

- Set small business lending (SBL) policy elements
  - Define small business borrower and loan sizes
  - Assign SBL to an LOB
  - Decide whether to centralize or decentralize
    - Analysis and underwriting
    - Approval and closing
    - Booking and funding
    - Monitoring and managing
  - Set minimum information/loan package requirements
  - Establish underwriting criteria
    - Minimum years in business, guarantee requirements
    - DSC, LTV, minimum credit scores
    - Other?
- Team presentations

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## IN-CLASS ASSIGNMENT: SET UP YOUR SBL POLICY

Policy Components	Recommendations?
1-Define small business borrower, loan sizes, other metrics?	
2-Set basic minimum underwriting criteria: <ul style="list-style-type: none"> <li>• Years in business</li> <li>• DSC requirements</li> <li>• Collateral requirements</li> <li>• Guarantee requirements</li> <li>• Credit scores</li> <li>• Pricing guidance</li> <li>• Policy exceptions</li> <li>• Documentation exceptions</li> <li>• Other?</li> </ul>	
3-Decide whether to centralize or decentralize <ul style="list-style-type: none"> <li>• Analysis and underwriting</li> <li>• Approval and closing</li> <li>• Booking and funding</li> <li>• Monitoring and managing</li> <li>• Other?</li> </ul>	
4-Decide where to house your SBL unit in your organization	
5-Other components?	

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## SMALLER BUSINESS LENDING (SBL) CLOSING AND SUMMARY

- SBL is big business for bankers
- But lots of little loans can be costly
- And credit risk and ops risk can add up to big risks
- Mitigate both risks by standardizing credit and loan processes
- Set policy and adhere to it
- Extra—references & appendices!



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  - Analyzing a Borrower's Repayment Ability (CI: 9/10)
  - Share and Share Alike in the Risk of Participations (CI: 10/10)

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## APPENDICES

- App A: SBA programs
- App B: Specialty lending
- App C: Traditional cash flow
- App D: EBITDA
- App E: Glossary



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## APPENDIX A-1: SBA PROGRAMS

- SBA 7(a) Loan Guaranty Program ([www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/sba-loan-programs/7a-loan-program](http://www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/sba-loan-programs/7a-loan-program))
  - Express Program –less paper, faster approval
    - SBA Express-50% guarantee, \$350M max loan
    - Patriot Express-for veterans and military community members
    - Export Express-lenders use own forms, 36-hour turnaround
  - Advantage Program ([www.sba.gov/content/advantage-loan-initiatives](http://www.sba.gov/content/advantage-loan-initiatives))
    - Small and Rural Lenders Advantage Initiative-up to \$350M for rural areas
    - Small Loan Advantage Initiative—encourage lenders to make smaller-dollar loans
    - Community Advantage –up to \$250M for under-served markets
  - Export Programs ([www.sba.gov/content/export-loan-programs](http://www.sba.gov/content/export-loan-programs))
    - Export Express-\$500M max loan, 36-hour turnaround
    - Export Working Capital Program-90% guarantee up to \$5MM loan for exporters
    - International Trade Loan Program-up to \$5MM loan to finance exporter's fixed assets or borrowers adversely impacted by imports

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## APPENDIX A-2: SBA PROGRAMS

- Various Special Purpose Loan Programs
  - CAPLines ([www.sba.gov/content/caplines](http://www.sba.gov/content/caplines))
  - Community Adjustment & Investment Program (CAIP) to assist firms in US negatively affected by NAFTA ([www.sba.gov/content/caip](http://www.sba.gov/content/caip))
  - Employee Trusts Program to assist ESOP's ([www.sba.gov/content/employ-trusts](http://www.sba.gov/content/employ-trusts))
- SBA 504 Certified Development Company (CDC) Loan Program to offer L-T, fixed rate financing of fixed assets ([www.sba.gov/financing/sbaloan/cdc504.html](http://www.sba.gov/financing/sbaloan/cdc504.html))
- SBA Microloan Program for intermediaries to lend up to \$50M to small firms & N-F-P child care centers ([www.sba.gov/content/microloan-program](http://www.sba.gov/content/microloan-program))
- Small Business Investment Companies (SBIC) are licensed by SBA to match private capital on 2:1 ratio ([www.sba.gov/inv](http://www.sba.gov/inv))
- Small Business Lending Fund provides Tier 1 capital to community banks under \$10B to encourage them to lend to small businesses ([www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx](http://www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx))

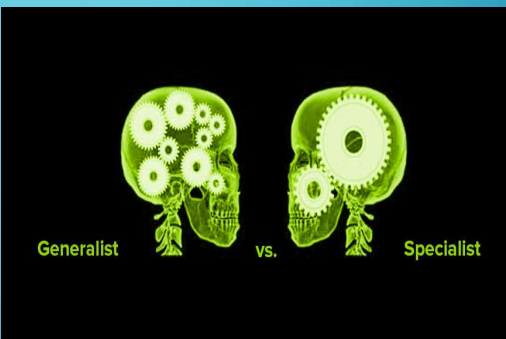
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## APPENDIX B-1: SPECIALTY LENDING

- Ag lending, SBA lending, ABL Lending, Energy Lending have much in common:
  - Specialty lending
    - Needs to be underwritten, decisioned, and managed by experienced and competent personnel
  - Unique secondary repayment issues
    - Ag lending—perishable collateral
    - SBA lending—SBA guarantee comes after bank has exhausted its remedies
    - Auto lending—credit score, DTI, and LTV plus pressure to push paper makes exceptional loans
    - Energy lending—underground and out of sight



Generalist vs. Specialist

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## APPENDIX B-2: SPECIALTY LENDING

- These specialty lenders need strong underwriting and approval policies, processes, and procedures
  - So look for evidence that bank has specialized lending requirements in place:

Specialized Lending Requirements	Ag	SBA	Auto	O&G
1-Specific policy	X	X	X	X
2-underwriting & policy exceptions	X	X	X	X
2-experienced lending-credit team	X	X	X	X
3-risk-based specialty approval	X	X	X	X
4-support infrastructure	X	X	X	X
5-monitoring & reporting	X	X	X	X
6-limits specific to specialization	X	X	X	X

- Watch out--non-bank, unregulated competitors are willing to take on specialty risk—private equity groups, Fintech, etc.—if banks can't & won't, they probably will

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## APP C-1: TRADITIONAL CASH FLOW (TCF)

- Seasonal working capital (SWC) commitments were sometimes called short-term inherently self-liquidating (STISL), their repayment coming from the “cash conversion cycle”
  - Cash → inventory → receivables → cash
- A key assumption to SWC financing is that SWC is temporary, and after the seasonal peak, it contracts back to its starting point

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## APP C-2: TRADITIONAL CASH FLOW (TCF)

- If working capital growth is truly seasonal, then cash flow from operations (CFO) is equal to profits and non-cash charges (TCF)
- Take a look at Reaper Corporation:

<u>CFO Calculation</u>	<u>Reaper (\$M)</u>	
after-tax profits	20	
depreciation	7	
amortization	<u>1</u>	
S-T, TCF		28
changes in AR	0	
changes in Inv	0	
changes in AP	<u>0</u>	
S-T, NWC changes	<u>0</u>	
CFO		28

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## APP C-3: CONSEQUENCES OF TCF ASSUMPTIONS

- Consequences of using TCF to measure cash flow :
  - TCF = CFO only if
    - NWC always returns to its starting point, so no sales growth
  - But what if company does grow?
    - Sales growth requires assets to support growth
      - Additional NWC investment
      - Additional CAPEX
    - Additional NWC and fixed assets usually means additional borrowing to acquire assets
  - But NWC and CAPEX investment compete with debt repayment for cash in growing companies
  - Adding back depreciation expense means no \$\$ available to replenish fixed assets
    - Depreciation usually covers only about 50% of replacement costs, anyway
  - TCF ignores NWC and CAPEX investment , so it overstates CF available to repay debt
- So how about EBITDA? Let's look again at Reaper Corporation . . . See Appendix F

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## APP D-1: EBITDA DEFINED

• EBITDA spelled out:	<u>Reaper (\$M)</u>	
• E	profit after taxes	20
• B	before .. .	
• I	+ interest expense	7
• T	+ taxes	10
• D	+ depreciation	7
• A	<u>+ amortization</u>	<u>1</u>
• =	EBITDA	45

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## APP D-2: BUT TCF AND EBITDA ADD UP TO THE SAME PROBLEM . . .

• E	20	• E	20
• B		• +D	7
• +I	7	• <u>+A</u>	1
• +T	10	• =TCF	28
• +D	7	• +T	10
• <u>+A</u>	1	• <u>+I</u>	7
• =EBITDA	45	• =EBITDA	45

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## APP D-3: EBITDA'S APPEAL—WHY IT'S USED

- Easy to calculate
  - Uses only P&L data, no balance sheet needed
- Bigger, positive number
  - Offers larger number for value multiples
  - Positive, stable number
- Investment banker mystique and cache
- Borrowers like EBITDA-based covenants
  - Easy to calculate
  - Hard to violate

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## APP D-4: EBITDA'S DRAWBACKS

- It's not all available to service debt because:
  - It ignores sales growth demands for
    - NWC
    - CAPEX
  - It ignores taxes
  - It ignores dividends
- Its use induces aggressive accounting tactics
- Its overstated CF leads to bad credit decisions
- EBITDA-based covenants don't work

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## APP D-5: QUICK FIXES TO EBITDA

- Two solutions to EBITDA
  - FASB-based cash flow from operations (CFO)
    - Accurate . . .
    - . . . But harder to calculate than EBITDA
    - Several variations on CFO
      - NCAO
      - NCI
      - CADA
  - Free cash flow (FCF)
    - Not quite as accurate, but maybe close enough
    - Starts with EBITDA, so easier to follow

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## APP D-6: COMPARISON OF NCAO, NCI, AND CADA FOR REAPER CORPORATION

<b>NCAO, NCI, &amp; CADA (\$MM)</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
• Cash collected from sales	566	616	666
• -production costs	-460	-526	-537
• -operating costs	- 82	-104	-123
• -other income (expenses)	<u>5</u>	<u>22</u>	<u>25</u>
<b>net cash after operations (NCAO)</b>	<b>29</b>	<b>8</b>	<b>31</b>
-existing interest expenses	- 7	- 11	- 16
-dividends	<u>- 3</u>	<u>- 4</u>	<u>- 8</u>
<b>net cash income (NCI)</b>	<b>19</b>	<b>- 7</b>	<b>7</b>
-existing principal repayment	<u>- 10</u>	<u>- 5</u>	<u>- 14</u>
<b>cash after dbt amrtzn (CADA)</b>	<b>9</b>	<b>- 12</b>	<b>- 7</b>
-CAPEX for existing nt fxd assets	<u>- 37</u>	<u>-102</u>	<u>- 91</u>
<b>NCAO surplus (deficit) avail for new dbt</b>	<b>- 28</b>	<b>-114</b>	<b>- 98</b>

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## APP D-7: CONVERTING EBITDA TO FCF

<b>Reaper</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
<b>EBITDA</b>	<b>45</b>	<b>40</b>	<b>68</b>
+R	<u>5</u>	<u>12</u>	<u>20</u>
<b>EBITDAR</b>	<b>50</b>	<b>52</b>	<b>88</b>
-T	-10	- 3	- 2
-Div	- 3	- 4	- 8
-Capex	-37	-102	-91
-chg NWC	<u>- 2</u>	<u>-38</u>	<u>-35</u>
sub-total, needs	<u>-52</u>	<u>-147</u>	<u>-136</u>
<b>=FCF avail for existing DS</b>	<b>- 2</b>	<b>-95</b>	<b>-48</b>
-R	- 5	-12	-20
-P	-10	- 5	-14
-I	<u>- 7</u>	<u>-11</u>	<u>-16</u>
<b>=Dbt Svc (DS)</b>	<b>-22</b>	<b>-28</b>	<b>-50</b>
<b>=FCF Cash (+/-) avail for new dbt</b>	<b>-24</b>	<b>-123</b>	<b>-98</b>

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### APP E: GLOSSARY

*ABD	Acquisition & Development	*LOB	Line of Business, e.g., commercial lending, CRE lending, private banking, consumer lending, mortgage banking, etc.
*ALLI	Allowance for Loan & Lease Losses	*LT	Long-Term
*ABL	Asset Based Lending	*LTC	Loan to Cost ratio
*AP	Accounts Payable	*LTV	Loan to Value ratio
*AR	Accounts Receivable	*Max	Maximum, $\leq$
*CA/CL	current assets to current liabilities ratio, aka current ratio	*Min	Minimum, $\geq$
*CAMELS	Bank rating system assessing Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk	*NOI	Net Operating Income
*CAPEX	Capital expenditures	*NW	Net Worth
*CCO	Chief Credit Officer	*NWC	Net Working Capital
*CoRECI	non RECI borrower who decides to engage in RECI activity, e.g., doctors who borrow to buy office building	*OAE	Other Assets Especially Mentioned, aka Special Mention (SM)
*CRE	Commercial Real Estate	%	percentage, e.g., LTV = 80%
*CRO	Chief Risk Officer	*PD	Probability of Default
*CRM	Credit Risk Management	*PRAC	Product Risk Assessment Committee
*Doc	Documents, documentation	*RAROC	Risk-Adjusted Return on Capital
*DSCR	Debt Service Coverage ratio	*RE	Real Estate
*D/W	Debt to Worth ratio	*RECI	Real Estate Developer-Investor, full-time professionals in CRE
*EL	Estimate of Loss	*ROA	Return on Assets
*FA	Fixed Assets	*SB	Smaller Business
*FCF	Free cash flow	*SBA	Small Business Administration
*FDICIA	FDIC Investment Act	*SBL	Smaller business lending
*Inv	Inventory	*SM	Special Mention, aka OAE
*LGD	Loss Given Default	*ST	Short-Term
		*TBE	Total Borrower Exposure
		*TPE	Trackable Policy Exception
		*TFA	Trusted Financial Advisor
		*x	ratio, e.g., DSCR = 1.2x

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