Commercial Lending

A Training Guide to Secured Financing

First Edition

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Introduction to Commercial Lending

Commercial Lending is a division within a bank or other lending institution that strictly serves the needs of a commercial enterprise or other business entity. Commercial Lending does not provide products or services to consumers.

A simple form of modern banking was practiced by the ancient temples of Egypt, Babylonia and Greece, which loaned at high rates of interest the gold and silver deposited for safekeeping. Records indicate that private banking existed by 600 BC and was further developed and refined by the Greeks, Romans and Byzantines. Modern banking evolved during the Medieval period as banks were frequently chartered for a specific purpose. For instance, the Bank of England and the Bank of Venice were involved in loans to the government. Modern banking evolved rapidly to support the expansion of industry and trade.

Banks have traditionally been distinguished according tho their primary functions. Commercial banks, which include National and State (N.A.) chartered banks, trust companies, stock savings banks and industrial banks, have traditionally rendered a wide range of services in addition to their primary functions of making loans and investments and handing demand as well as savings and other deposits. Commercial banks further differentiate themselves via their requirement/ability to expand or contract their loans and investments in accordance with changes in reserves and reserve requirements as set forth in governing bodies.

Savings banks which generally only accept savings and other time deposits are often limited to the types of loans and services they can offer. Generally, these services are strictly tailored to a consumer borrower. Other types of financial institutions are savings and loans, mortgage companies, finance companies (such as factors, asset-based lenders and equipment lessors), insurance companies and credit agencies. Savings and loan associations, which are State institutions, provide such services as residential mortgages, automobile loans, building loans, etc. Funds are loaned from the deposits of it's members. Finance companies, make loans and other financial accommodations from funds obtained from invested capital and/or other commercial sources. Credit Unions are institutions owned cooperatively by groups of persons having a common business, fraternal or other interest. Credit Unions strictly serve the interests of their members.

What is Commercial Lending?

Commercial Lending is the process by which a bank, loan company or individual lends sums of money, in return for a rate of interest, to individuals or companies for the support of a business. The successful operation of the enterprise, as opposed to the securing collateral, represents the primary source of repayment of the interest and monies borrowed. The lender "underwrites" the loans or credits in order to measure the risk that the lender will not be repaid and to identify primary and secondary sources of repayment. Lenders always expect to fully collect the funds they advance and the interest and fees earned for the extension of credit.

Repayment of a loan can be amortized over a period of time using monthly, quarterly, semi-annual or annual payments with rates generally floating at some margin to the Prime Rate. Larger banks usually set their own Prime Rate while smaller banks will often utilize the Prime Rate as published by the Wall Street Journal. The usage of LIBOR (London Interbank Offered Rate) is becoming more prevalent in Commercial Lending borrowing scenarios.

Advanced Topic / Writers Point of View

LIBOR has generally tracked the U.S. Prime Rate at a margin of approximately 300 basis points below the Prime Rate (1 percent equals 100 basis points; therefore, 300 basis points equals 3 percent). The record low levels of the Prime Rate have contracted the margin between Prime and LIBOR. For instance, on December 10, 2004, the Prime Rate was 5 percent and LIBOR was 2.48 percent, just over 250 basis points below Prime.

- J. Todd

The rate of interest is negotiated between the lender and the borrower. In addition to the interest charged on the loan, a lender may charge the borrower ancillary fees such as origination, application, credit reports, appraisals, underwriting and for other services in conjunction with making the loan.

Many banks will require a potential borrower to open a non-interest bearing deposit relationship which is commonly referred to as “compensating balances.”

Why Businesses Borrow?

Commercial loans are made to businesses to finance day-to-day activities and to finance other long/short term needs. Businesses may borrow to fund inventories, payroll requirements, supplier demands, new equipment, general expansion or the acquisition of plant and/or property. Many businesses are usually undercapitalized and the owners are often unable to contribute additional capital which creates the need to borrow.

Many companies simply have insufficient funds on hand to fund current operating or indirect expenses such as utilities, office staffing and those expenses often referred to as overhead. Often times, a business will have too little working capital and have day-to-day problems meeting current expenses simply because of a mismatch between the time expenses are incurred and the time that revenue is received.

Businesses borrow for many reasons. Some of the most common are:

1. Leverage working capital and retained earnings;
2. Acquisition of real estate or other large fixed assets;
3. Future liquidity purposes;
4. Cover short term working capital shortfalls;
5. Insufficient working capital.

Businesses generally have three types of borrowing needs:

1. **Long Term Financing**
   Long term financing is often connected to the acquisition or financing of new or additional facilities or equipment. Maturity for these types of loans generally ranges anywhere from 5 to 20 years.

Example 1.

Sample Company, Inc.

Long Term Financing Requirement

Sample Company, Inc., requires a specialized machine to manufacture a new product line. Sample Company has an ample customer base in which to fulfil orders which will cover the costs associated with the new equipment. Without the equipment, the company cannot efficiently manufacture the goods. Sample Company, Inc., cannot afford to tap into cash reserves to directly purchase the equipment. Sample Company, Inc., can effectively demonstrate the machines usefulness and the profit potential should it have the means to acquire the equipment through a long term amortizing loan.

2. **Short Term Borrowing**

Businesses often need to borrow because they experience timing differences between the time expenses are incurred and the time that the business collects for the goods or services they provided. Lines of credit are short term loans. A lender may commit to a LOC for up to 3 or 5 years.

Example 2.

Sample Company, Inc.

Short Term Financing Requirement

Sample Company, Inc., is an accounting firm and prepares an audit for a business, including tax returns. The process may take eight weeks or more to complete. The accounting firm must pay the salaries and travel expenses incurred during the audit. Typically, Sample Company, Inc., collects a portion of the total estimated charges up-front or during the engagement; however, there are significant non-overhead expenses that the accounting firm must pay before it collects the remaining balance of their fees. Sample Company, Inc., lacks sufficient internal working capital and therefore requires a line of credit to support the day-to-day operating shortfalls.

3. **Working Capital Loans**

Working capital loans are used to fund fixed operating costs that are not associated directly with goods or services sold, such as utilities and office operations. Working capital loans typically (term loans) have terms between 5 to 10 years.

Businesses will borrow when the business does not have sufficient retained earnings, cash flow or when the owners are unable to contribute additional capital.

Ideal Candidates

Commercial Lending is available to absolutely every business imaginable. There are no biases relating to whom the borrower is providing goods or services to, in what quantity to borrow, what industry or geographic location. Unlike factoring or asset-based lending, Commercial Lending is the most unobtrusive form of financing available today. There's only one catch! The qualifications to obtain a commercial loan product can be difficult.

All banks have similar underwriting standards as they operate within a heavily regulated and competitive industry. Almost 99 percent of banks are strictly cash flow lenders where they simply rely on the profits generated by the business to service the debt load. Many banks have collateral divisions in which they utilize an asset-based lending approach when structuring the loan.

For the purposes of this publication, broad stroke's are required as banks all share a similar form of preliminary qualifications. Generally, those basic preliminary qualifications are:

- Time in business
- Management experience
- Credit of guarantors
- Industry
- Collateral
- Profitability

Let's examine each preliminary qualification in detail:

1. Time in business. All banks consider the time a business has been in operation as a critical component in making a credit decision. Banks are looking to extend credit facilities to those business that have an established/proven track record. Businesses that have remained in business for a minium of three (3) years are normally considered to be established businesses.

   A three year period provides a track record and allows an underwriter to consider and evaluate the historical business trends.

   Start-ups or new business ventures are often difficult to finance unless they are well capitalized and the owners or management team has an exceptionally strong track record in the business. Along with time in business, a bank may also consider how long the current management team has been in place. A business with significant operating history that was recently acquired may receive additional scrutiny.

2. Management experience. The importance of determining the ability of and likelihood that the owners/managers can and will operate the business successfully cannot be understated. When a bank lends money, they are essentially becoming a partner to the borrower business. Because they are a "silent" partner, they absolutely require the operator of the business to have excellent experience in the business. Management capacity generally will encompass a broad based understanding and a certain level of competence in all facets of the businesses operations, policy and administration. The result of a competent management team is the stability ,growth and profitable operation of the business.

3. Credit of guarantors. Banks without question are "character" lenders in which the owners/officers personal credit is critical. With all lending relationships, character is of paramount importance. Personal habits have a significant correlation between a principal's personal credit and the financial well being of the business. Banks do not lend to individuals who have weak personal credit.

4. Industry. All banks have their own unique appetite for borrowers and loan transactions. Industry preferences are a large portion of the menu for most banks. Many banks prefer to lend to businesses that provide goods as opposed to simply services.

   Goods businesses produce a tangible product as opposed to a service business that simply provides a service. It is important to understand the industries in which you're preferred lenders participate.

   Another consideration is the state of the "industry." A lender must evaluate the overall economic environment of the industry a borrower participates within. Depending on the state of the industry (depressed, stable, growth oriented, etc.), a lender must adjust their approach to lending.

Example 3.

Sample Company, Inc.
Industry Preferences

> Start-up restaurants represent one of the most difficult business segments to finance because of their high failure rate. Franchises are no exceptions unless the franchisee has a track record for operating franchised restaurants in similar markets. Quick stop markets or auto service centers selling petroleum products or other chemical users can be difficult to finance because of environmental concerns.
>
> Seasonal businesses, such as ski slopes and other tourist attractions can be difficult to finance because of the uncertainty of weather and because of the additional liabilities associated with public attractions.

5. Collateral. Banks require an adequate amount of collateral to secure any loan. Many banks require a minimum collateral requirement above 1.5:1 percent. A borrower must have sufficient liquid or marketable collateral to satisfy a banks collateral requirement. Without collateral, there is no deal.

6. Profitability.

Pre-qualification

It is necessary to first fully understand the commercial loan products and second to understand simple procedures to effectively qualify a commercial loan prospect. The ultimate goal is to submit a qualified candidate to various lenders and obtain approval and closing shortly thereafter.

Commercial lending like all other forms of financing utilizes simple yet effective methods to determine the feasibility of qualifying a business for a loan. These methods are commonly practiced by business development and underwriting personnel throughout the banking industry. There are four basic rules to remember when pre-qualifying a prospective client.

1. Work over the phone
2. Ask basic questions
3. Justification
4. Competition

Working Over the Phone

Today, business can be conducted over the phone, fax and internet. These are invaluable tools in the pre-qualification process. There is no reason to immediately move into a presentation about commercial loan products and all of their benefits. First, you may consider simply informing your prospect about your role as a commercial finance consultant.

Once you have established your position as a consultant, it's time to dig deeper into the prospects situation.

Asking Basic Questions

There are several basic questions that need to be asked to determine the potential viability of qualifying for a commercial loan. Some of the most effective questions to quickly determine feasibility are:

1. **Tell me about your business?**
   Allow a prospect to tell you about their business. This conversation should detail the need for financing. During this stage of questions, you should ask the following:

   a. <u>How long have you been in business</u>? A prospect should be able to support this by forwarding (at a later time) the filed articles of incorporation, articles of organization or d.b.a certificate.

   b. <u>Have there been any changes in ownership within the last 3 years</u>? Remember, a change in the ownership structure may affect how the prospect is viewed by a lender from a time in business perspective. Also, this is an ideal time to determine if there are any partners with more than 20 percent ownership interest.

   c. <u>How is your personal credit</u>? You should always ask how the personal credit score is of the owners/officers who have a majority interest as well as their spouses as they too will often be required to guarantor any credit facility. If their score is below 650, there may not be many commercial loan options available.

   d. <u>Any prior personal or corporate bankruptcies</u>? An individual can substantially rebuild their credit score within 2 years. However, a prior bankruptcy can complicate a commercial loan. If a prospect has had a prior bankruptcy, it is important to determine how long ago and what reasons forced the entity to file. A detailed explanation may be required at a later date.

2. **What type of credit facility are you looking for?**
   This is a critical question to determine the method in which to proceed further. A prospect will generally outline a "usage of funds," or what they intend to utilize the loan for.

3. **What is your current financial condition?**
Obviously, from the tone of the conversation you will quickly ascertain how cooperative and forthcoming the prospect is. This will be a judgement call on your part. You may choose to forego any questions relating to the financial condition of the company if you determine a reluctance to divulge sensitive information about their financial condition. However, if the prospect called you, there should be little reason for a prospect to withhold any financial information.

You should ask your prospect the following questions regarding their financial condition:

- Does the company have a positive net worth? If yes, what is the net worth?
- Is the company profitable? If yes, for how long?
- Is the company leveraged? If yes, by how much?

From the response, you will be in a better position to determine if further questioning is warranted.

4. **How soon are you looking to put a credit facility in place?**
This is necessary to determine if your prospect is truly motivated.

Justification

The assessment of the prospect's needs versus qualification is where you must make a preliminary decision based on your initial conversation if the transaction has some degree of validity.

By now, enough information has been gathered to at least initially surmise whether this is a good candidate for a commercial loan. Is the prospect's request sensible? If the prospect is a start-up and they are looking for $250,000 line of credit with poor personal credit and no collateral, there is a low likelihood that this transaction will close. You will be in a position to make certain assumptions based on the information provided.

Your primary objective is for you to simply get a gut feel for the overall proposed credit request and prospects qualification.

Are you competing

It is always helpful to learn if the prospect is seeking financing from other banks or lending institutions. If they are talking with a competitor that you know cannot offer the terms or has industry or other preferences, it would give you a distinct competitive advantage.

Let the prospect know that you feel you can help them. Your role as a commercial finance consultant is to find the absolute best lender for each of your prospects and you would like an opportunity to package and present their application package to select lenders on their behalf.

However, you maybe in the situation where the prospect has already received commitments or is in dialogue with other lenders. In that event, you may consider asking the following questions:

1. **Whom have you been speaking with?**
   Again, this may give you a distinct advantage to know which lenders the prospect is having serious dialogue with. Once this is known, it can influence the way you present the product or aid in the structuring or pricing in some instances.

2. **Do you have a commitment letter?**
   If the prospect has a commitment letter in hand and is willing to share the contents, it can greatly improve your position. The existing commitment letter will serve as a benchmark in your search. Not only will you know who you are competing against, but what rates, terms and conditions they are proposing.

3. **Is there something special you are looking for?**
   If there is something distinct about your prospects borrowing requirements or business, you will need to identify it quickly. Your prospect may be seeking a unique financing arrangement, greater borrowing capacity, seasonal increases, etc.

4. **What are your key issues regarding the lender you select?** Are there any conditions that must be considered or met for your prospect to consider or accept an offer? Is there an institutions that your prospect will not work with or knows will not qualify?

   It is always important to find out what key issue(s) will ultimately determine which lender the prospect chooses.

Presenting the Products

Commercial lending is the most widely utilized financing vehicle today. Most banks that have a business or commercial lending department offer a wide variety of commercial loan products. A bank may divide a business borrower into one of three categories. The first being small business (in many circles this is considered a borrower that is doing less than either 5 or 10 million per year in sales) and the second is middle market businesses.

Products for both types of business are generally the same, however the loan amount and general underwriting parameters may vary. Most business owners know when their business has insufficient working capital and feel the results of such undercapitalization. However, a vast majority of business owners are unaware of the commercial loan financing vehicles that are available to them nor which vehicle would be best suited to meet their requirements.

As a commercial finance consultant, it is important to first identify the prospects need and secondly to identify which product(s) may benefit the prospect and which they may qualify for.

Generally, most banks have a wide suite of standard products available to a qualified borrower and may have additional complimentary products such as cash & treasury management services, insurance, leasing, letter of credit products, etc.

For the basis of this publication, we will focus on the following products:

- Lines of credit
- Term loans
- Revolving loans
- SBA guaranteed loans

1. **Line of Credit**

   A line of credit (LOC) is a fixed amount provided to a borrower over a specified future period. Generally, a line of credit is made available for a one year term and are often reviewed by the bank annually. Often, lines of credit are available until the bank provides notice that the line has become due (on demand).

   Lines of credit are generally suited for those businesses who have seasonal or temporary needs. Such needs may include payroll and associated costs, satisfaction of trade creditors, mobilization on new products and inventory requirements.

   Lines of credit are excellent financing vehicles for:

   - Acquisition of inventory
   - Reoccurring expenses (fixed overhead)

2. **Term Loans**

   Term loans are generally fixed-term business loans with a maturity of more than one year, providing a business with working capital to acquire assets or inventory, or to finance plant and equipment requirements.

   A term loan is the most common form of intermediate term financing arranged by commercial banks with one of the most diverse structures. A maturity may be structured from one to fifteen years with the most common being from one to five year periods. Interest on a term loan is normally payable monthly, quarterly, semiannually or annually.

Term loans are excellent financing vehicles for:

- Acquisition of equipment that has a depreciable life of five or more years;
- The finance the purchase of buildings used in the business;
- To purchase properties that will be held for rent or lease;
- Working capital loans.

3. **Revolving Loans**

Similar in nature and intended to be used like a line of credit except that the bank is obligated to make loans to the borrower until the maximum agreed upon amount has been reached. If the borrower remains in compliance with the terms of the loan, they will be allowed to borrow from it again. Revolving loans generally do not have a fixed repayment schedule and the borrower may repay the loan at any time without penalty.

Revolving loans are excellent financing vehicles for:

- Short term working capital requirements
- Non-reoccurring overhead (production expenses)

4. **Small Business Administration Guaranteed Loan Programs**

The Small Business Administration (SBA) is an independent federal agency chartered in 1953 to provide financial assistance to small businesses. The SBA does make direct loans to businesses who have proven their inability to obtain commercial loans and participates in loans originated by financial institutions. Today, a greater percentage of all functions performed by the SBA are in connection with their preferred lender program, therefore, obtaining a loan directly with the SBA is less likely.

Under the preferred lender program, the SBA provides loan guarantees to banks and other approved financing institutions. Essentially the SBA provides insurance to a bank or another financing institution. In the event a loan they have mutually approved defaults, the SBA will pay a certain percentage of the loan value back to the institution.

The SBA offers numerous loan programs to assist small businesses. Its important to remember that the SBA is primarily a guarantor of loans made by private and other institutions.

The most common forms of SBA Programs:

- **7(a) Loan Guaranty**

The 7(a) loan guarantee serves as the SBA's primary business loan program to help qualified small businesses obtain financing when they are unable to obtain financing through normal lending channels.
The 7(a) program is often considered to be the most flexible program to help qualified businesses, since financing under this program can be guaranteed for a variety of general business purposes.

Under the guaranty concept, commercial lenders make and administer the loans. A prospect will apply directly to a lending institution and the lender will decide if they will make the loan internally or if the application has some weaknesses which, in the lenders opinion, will require an SBA guaranty if the loan is to be made.

7(a) loan proceeds can be used for most sound business purposes including working capital, machinery and equipment, furniture and fixtures, land and building (including purchase, renovation and new construction), leasehold improvements, and debt refinancing (under special circumstances).

Generally, loan maturity for the 7(a) program is up to ten years for working capital and up to twenty-five years for fixed assets. The SBA generally offers this guaranty for start-ups and small businesses.

- **504 Loan Program Certified Development Company (CDC)**

The 504 Loan Program provides long-term fixed rate financing to small businesses to acquire real estate or machinery or equipment for expansion or modernization. Typically, a 504 project includes a loan secured from a private-sector lender with a senior lien, a loan secured from a CDC (funded by 100 percent SBA guaranteed debenture) with a junior lien covering up to 40 percent of the total cost, and a contribution of at least 10 percent equity from the borrower.

The maximum SBA debenture generally is 1 million (and up to $1.3 million in certain circumstances).

The 504 Loan Program is ideally suited for those businesses who seek “brick and mortar” financing. These loans are generally delivered through local Certified Development Companies (private, nonprofit corporations set up to contribute to the economic development of their communities or regions).

- **7(m) Microloan Loan Program**

The 7(m) Microloan program provides short-term loans of up to $35,000 to small businesses and not-for-profit child care centers. These loans are designed for working capital purposes, purchase of inventory, supplies, furniture, fixtures and/or machinery & equipment.

Generally, proceeds granted under a 7(m) program are not used to pay existing debts or to acquire real-estate. These loans are made to an intermediary, who in turn makes the microloan to the applicant. These organizations also provide technical assistance and management to the business. Microloans are not guaranteed by the SBA.

7(m) Microloan program is designed for small businesses and not-for-profit child care centers needing small scale financing and technical assistance for start-up or expansion.

Fundamentals of Borrowing

Commercial lending like all forms of financing has fundamentals in which a borrower must adequately meet. Many business owners fail to understand that banks and other commercial lenders are required to operate by certain Federal and State rules. These rules are generally designed to protect the depositors who create the backbone of any bank.

There are generally five fundamentals when in comes to borrowing:

Credit Worthiness

The ability for a business to obtain a credit facility when it is truly needed is critical to the success or going concern of any business. A lender must be able to determine if a business is creditworthy. Generally, a lender will ascertain answers through a series of questions and/or the evaluation of information provided.

In general, a lender is looking to answer the following questions:

1. What is the credit standing of the owners/guarantors? The answer to this question correlates directly to the character of the borrower. Remember that lenders are generally heavily dependent on character lending.

2. What experience do you have in the industry? A lender needs to be absolutely comfortable that the owners/officers/managers are competent to first operate within their industry and second, to operate a business.

3. Usage of funds? A lender must determine if the borrowers rational for obtaining a credit facility makes sense. From this conversation, a lender will determine what type of financing product would be best suited to match the requirements of the borrower.

Financial Data

A lender is relying on the borrowers ability to provide accurate and reliable financial data in which the lender can utilize to underwrite a loan. A lender only will make a loan to a business that is solvent, profitable and growing.

A lender will need to ascertain what financial information a potential borrower has as well as the following:

1. Are books and records up-to-date? There is no value to financial data if it is not current.

2. Who performs the accounting/bookkeeping functions? A lender needs to make a determination if the person responsible for the accuracy of the records is competent to hold such a position. In accurate record keeping is generally an immediate reason for denial.

3. Position of accounts receivables & accounts payables? A lender must determine the situation of the accounts receivables and accounts payables. Is there a leveraged position? Is there a potential bad debt? What is the DSO? What types of credit policies and procedures are in place? Are their any significant concentrations?

4. Accuracy of income statement & balance sheet? These are utilized to measure the overall temperature of the business. A lender is generally looking for a continuous series of this information for analysis purposes. A lender will weigh the information supplied from financial statements in varying light. This depends on who generated the financial statements.

Advanced Topic / Writers Point of View

The quality or should I say accuracy of information contained within a financial statements varies. In the hierarchy of quality, keep this in mind:

- Internally Produced Financials

Can be subject to question depending on the level of detail an accuracy. This is produced internally by the business without any outside evaluation. Generally not considered to be very reliable.

- Compilation of Financials

Can also be subject to question as a CPA or accountant has taken information supplied by a business without any professional assurance as to the conformity or accuracy of the information provided. Generally not considered to be very reliable.

- Reviewed Financials

Generally better than a compilation as a CPA or accountant has provided some assurance as to the accuracy/reliability of information provided. Stronger credibility granted to information provided.

- Audited Financials

A complete examination of the borrowers accounting records and financial statements. An opinion is then formed by a CPA as to the financial condition of the company. Audited Financials are what every lender is looking for. Therefore, credibility of the information submitted is not in question.

- J. Todd

Amount Requested

A commercial lender will require a borrower to confidently identify a specific amount of credit requested. Generally, this will be accompanied by a "usage of proceeds" in which a borrower will detail how they intend to utilize the funds over a period of time (generally 12 months through a budget and cash forecast). A lender will also require what type of credit the borrower is seeking, i.e. short or long term.

Collateral

Commercial lenders without question require additional assurance that any money borrowed will be paid. This assurance comes in the form of collateral. The type of collateral requirement will depend on the lender and situation of the borrower. If the lender cannot justify the loan amount by simply a review of the financial condition of the business, generally a pledge of additional collateral will be required to bridge any gap.

Collateral can come in many forms from a borrower/guarantor. The most common forms of collateral in commercial lending are:

- Commercial real-estate
- Accounts receivables
- Inventory
- Equipment/fixed asset

Additional boot collateral may come in the form of:

- Life insurance
- Certificates of deposit
- Stocks & Bonds
- Personal real-estate
- Cash

Source of Repayment

All business that qualify for a loan have demonstrated/proven that they have a source of repayment of the obligation. A lender must have absolute assurance that repayment is likely based on a historical successful track record and/or justifiable projections which produce enough in profits to cover the obligation.

Determining the source of repayment can be accomplished by a review of the following:

1. Demand for goods or services. A lender must be able to determine that a businesses products or services are going to be in demand for the foreseeable future.

   - Obsolescence. Once upon a time, buggy whips were hot items. When the automobile surpassed the horse & buggy as the preferred method of transportation, buggy whip manufacturers became extinct.

   - Industry Trends. Changing economic conditions and trade pacts can positively/negatively affect a business overnight. The southeastern portion of the U.S. has long been a hub for the furniture and apparel industries. Foreign competition and labor practices have forced many of these businesses out of business.

   - Trends & Fads. Popularity of consumer items based on trends or fads can drive a business from rags to riches overnight. Subsequently, a funeral can be planned for the following day.

2. Management experience & skill set. The importance of documenting the experience and success of a business owner or management team is critical in obtaining any credit facility. A lender must be able to determine the ability and likelihood that the owners(s) or manager(s) can and will operate the business successfully cannot be understated.

3. Guarantors. All lenders will require a guarantee of payment and performance from the owner(s) and spouse(s) for all or a major portion of any credit facility. There are few exceptions to this rule. Occasionally, a lender may entertain a third party as a secondary source of repayment, however a credit facility should be underwritten with the sole thought that the owner(s)/spouse(s) are the primary guarantor.

Commercial Finance Consultants cannot provide commercial lenders with substandard prospects or products. Assessing the ability of an owner or management team and their overall creditworthiness is critical to a successful loan placement.

Commercial lending is on the top of the "food chain" when it comes to business financing. With that position, comes a duty to lend to only those borrowers who are well qualified candidates.

Relationship & Credibility Building

Commercial Finance Consultants build their business and their income's by relationship building. Business owners are concerned about long term financing relationships rather than immediate needs. This desire stems from the amount of work and stress involved in obtaining any credit facility whether it's factoring, asset-based lending, trade finance, equipment financing or a commercial loan. Business owners are simply seeking a relationship in which there is some assurance that future financing will be available.

Relationship & credibility building is a process. Not only is it necessary to build and foster productive and meaningful relationships with referral sources but it is also necessary with every prospect you speak with. The reason is simple. As a Commercial Finance Consultant, you will become an invaluable resource to a business owner for the life of their business. Often times, you will become more valuable than legal counsel. The reason is simple, you know where to find money.

Commercial Finance Consultants often times never meet their clients as the phone, fax and internet has broken all barriers to business. If you are a local or regional service provider, you will inevitably have opportunities to meet your prospects face to face. If your marketing efforts are successful, you will only need the opportunity to have a brief meeting with a business owner or manager to quickly discuss your services.

If you utilize an appointment method as opposed to simply dropping in, it can be a considerable time saver. Setting an appointment defines the purpose for your visit and allows you to visit the potential client at an opportune time. Obviously, you should have as much information available about a prospects industry or business situation prior to your meeting. If the prospect originated from a referral source, you will be equipped with pre-supplied information which should help guide your line of questioning.

If you are unable to obtain an personal appointment, simply send a letter thanking the person for speaking with you and indicate that you will give them a call at a later time. Persistence pays in this industry.

Occasionally, you will have to work with CFO's (Chief Financial Officers), COO (Chief Operating Officers) or Controllers, which is an excellent place to start as often times these individuals are tasked with identifying financing vehicles. Time spent building relationships with these people is time well spent as these are excellent introducers to owners.

Face to face meetings may sometimes be required with certain clients. Certain business owners are reluctant to divulge sensitive financial data until a level of rapport, trust and credibility has been established.

During any conversation with a prospect, a key element to developing rapport and trust is to simply listen.

Advanced Topic / Writers Point of View

Listen first to understand. Not to respond.
Listen first to understand. Not to respond.
Listen first to understand. Not to respond.
- M. Marin

During any conversation with a prospect ask open ended questions about the clients business and existing borrowing relationship(s), attempt to ascertain what he/she does likes or dislikes about the relationship. Identify the products or services they could utilize and would receive benefit from. Listen carefully to what the client is saying and what he/she is not saying. You will not be able to identify a borrowers preferences without listening.

Remember that a prospect may be completely satisfied with their existing relationship(s). However, as circumstances change so may their ability to borrow. Prospects are often in need of products or services that are not offered by their existing lender(s) and because of the flexibility and resources a Commercial Finance Consultant has access to, you are an excellent candidate to provide such services to a prospect.

As a Commercial Finance Consultant it is necessary that you are always building credibility with your prospects and referral sources. This is accomplished through knowledge of a prospects business and by asking pertinent questions and listening carefully to the responses.

Information Gathering

Once you have answered the prospects questions, it is time to request the necessary information in which you can properly review the transaction and develop a loan package for submission to various commercial lenders.

The activities necessary to determine the viability of the proposed transaction from an initial phone or personal contact with the prospect until approval, closing/funding or as the case may be declining of the transaction can be involved.

A commercial finance consultant may consider adopting a similar due diligence and underwriting process as the writer uses which is outlined below:

Six major phases of due diligence and underwriting:

- Discovery and analysis
- Structuring of the facility
- Packaging of the facility
- Presentation of the transaction to the lender(s)
- Negotiation, rebuttal and discussion
- Approval, closing and funding

1. **Discovery and Analysis**

   While you were conducing your interview and performing the pre-qualification techniques outlined earlier, you were "discovering" and "analyzing" their request and how this may translate into a potential client relationship.

   Working over the phone, asking basic questions, researching the internet are all phases of due diligence and underwriting.

2. **Structuring the Facility**

   In the pre-qualification section outlined earlier, when you begin to assess and justify the needs of the prospect, question the presence of competition and formulate in your eyes if the transaction is viable, you may unconsciously structure the facility.

3. **Packaging the Facility**
Once you have gathered the necessary information from the prospect and reviewed all support documentation, you should have ample information to present in an organized and professionally packaged format to your commercial lenders.

4. **Presentation of the Transaction**
This is basically self-explanatory. You can provide a narrative write-up which should be married with the loan package. This is then forwarded to the commercial lenders for consideration.

5. **Negotiation, Rebuttal and Discussion**
Once the loan package is received by the commercial lenders with time for preliminary review, you can expect a period of time for negotiation with the lender on behalf of your prospect. This may be the turning point in the deal as the term sheet or proposal will usually get generated at this time. In addition, back and forth negotiations will take place directly with the prospect. This is a critical time for a commercial finance consultant. Any objections by either the lender or prospect must be rebutted or overcome. A considerable amount of discussion on key issues may surface. This may be the time in which the deal is made or broken.

6. **Approval, Closing and Funding**
This is the point in time where the lender has competed their due diligence. Any further underwriting completed or necessary field examinations or audits along with any independent appraisals.
By now, the loan committee has met and decided if you have a transaction that is ready to fund. Be prepared if something is uncovered in the audit, appraisal or loan committee that causes a dramatic change from the original proposal. This is a critical point in the process in which professional expertise is required. Rely on your commercial lender at this point.

Loan Package Composition

If you are satisfied that the prospect appears to be viable it is time to begin the underwriting of the loan package.

It is critical that the packaging and presentation phases of due diligence and underwriting be as through as possible with attention to detail. If properly packaged, it can be quickly presented to commercial lenders.

Your goal is to identify viable candidates for commercial lenders. Time spent on marginal transactions (poor guarantors, limited time in business, weak financial data, obsolete collateral, etc.) is generally time wasted.

1. **Application**

   Although most commercial lenders have their own formal loan application that must be completed and returned by the prospect, a commercial finance consultant must utilize a generic application as he/she may not immediately know which commercial lender to utilize. For that reason, many commercial finance consultants have generated a variety of applications that are acceptable to many lenders.

   All applications must have a location where an officer, owner or director is to execute on behalf of the company. It is important that at a minimum an application contains the following language:

   > The forgoing information is true and correct to the best of my knowledge and is given to (your company) or its agents, assigns, factors, funders or lenders to induce these agent's, assigns, factors, funders to consider entering into a financing relationship with this company. I hereby do authorize (your company) agents, assigns, factors, funders to verify and investigate any and all of the foregoing statements, including but not limited to, my/our creditworthiness and financial responsibility, in any way they may choose. I/We grant (your company) or its agents, assigns, factors, funders the right to procure any and all credit reports pertaining to any party listed in this application, including, but not limited to, all principals of the applicant's company. By my signature below, I am duly authorized by all parties listed above to grant this permission on their behalf.

2. **Financial Statements**

   In any commercial lending facility, it is critical to have information of a historical financial nature as part of the loan package. Most commercial lenders will require at least three fiscal years of reports and the most recent interim financial statement as part of the package.

As a general rule of thumb, you should ask for a minimum of 4 years of historical financial information.

Some commercial lenders that are considering a term loan may also ask for a 5 or 10 year spread in historical financial information. This will show salient financial information for trend purposes. If the lender is making a 15, 20 or 25-year term loan on commercial real-estate, this will often times be a requirement.

The prospect should include the balance sheet, income statement and any or all notes or attachments that an accountant may include in a prepared statement. This may also include a breakdown on cost of goods sold, separate schedules of G&A expenses, cash flow statements, etc. It is always best to get an original bound copy of the fiscal reports, not a photocopy (no pages of the report(s) should be missing).

On an interim basis, you should expect to receive a current interim financial statement, which may be in-house prepared or done by a bookkeeping service. It should not be more than 6 months old to be of value to the commercial lender. Many businesses running Quickbooks or Peachtree or any other common form of accounting software, should be able to provide this information with a click of the mouse.

3. **Personal Financial Statement**

Because most prospective client companies are closely held, it is almost always a routine to include the personal financial statement (PFS) of the principals. A principal in most cases, is an officer/owner of 20 percent or more of the common stock of the applicant company. If it is a partnership, proprietorship or LLC, you must include all of the PFS's for these individuals.

The PFS is helpful to the lender to determine the financial strength (or weakness) of the owners and potential guarantors. Remember, in most commercial lending relationships, principals and owners along with their spouse(s) will be expected to personally guarantee the loan facility. Another matter to keep in mind is that the personal financial statement should be within 90 days of the application date and properly executed by the individuals.

4. **Projected Income & Balance Sheets/Cash Flow Statement**
Whenever a term loan is being requested or considered, this will always be a requirement. Even when the facility is to be a revolving loan, many commercial lenders will request this.

An commercial lender needs to have projections on the positive implications of the new loan and how it may affect the borrowing relationship. If the prospect is projecting a downturn (planed reduction of product line, removal of certain sales, market conditions, etc.) or an upward trend (increased sales, new product line, etc.), the commercial lender needs to be aware and plan appropriately.

The format that most commercial lenders prefer to see is a month-by-month for the coming 12-month period, then perhaps an annual projection or forecast for the following year, sometimes up to 3 to 5 years or more. Outlandish or "pie-in-the-sky" forecasts/projections do not gain favor with the commercial lender and may even prejudice the lending decision.

5. **Accounts Receivable Aging Reports**
Considering the liquidity of accounts receivables and the emphasis placed on them from a collateral value, it goes without saying that attention will be placed in this area. Aging reports should come in the following formats:

- Detailed A/R Report. This lists all open invoices by number, customer, days outstanding, etc.
- Summary A/R Report. This simply lists the customer and the open balances.
- Invoice Date. Customers should set their software to track receivables from the date the invoice was generated as opposed to only tracking it after the "due date".

An aging report should always be within 15 days of its most recent reconciliation. Any specific issues regarding a customers balance (high concentration, significant amount in the 60 or 90 day columns, retainage, disputes, etc.) should be highlighted and provided under separate cover.

Revolving Loans/Lines of credits are based on the overall credit quality of the accounts receivables and exposures of the individual account debtors. Emphasis will be placed on the owners/managers and their ability to exercise proper credit extension and receivables management.

The only exceptions would be the rare cases when the lending facility is solely against fixed asset collateral, such as machinery or commercial real-estate.

6. **Accounts Payable Report**

The trade payable situation is always of importance to a prospective commercial lender. Whether the loan is against revolving or fixed asset collateral or both, the commercial lender must insure that the prospect is in good standing with their trade creditors. If, for example, payables are seriously delinquent, the commercial lender must address whether or not the proposed credit facility will sufficiently cover the payoff of any such delinquency. If not, the commercial lender may be in danger of jeopardizing its position in the overall lending relationship.

Contra accounts can also be identified against the aging report through analysis of the accounts payables. A payables report should always be within 15 days of its most recent reconciliation.

7. **Tax Returns / Personal and Corporate**

All commercial lenders will require a minimum of three years of both personal and corporate tax returns for any type of credit facility. There are few exceptions to this rule. All schedules should also be attached.

8. **Customer / Vendor List**

It is highly recommended that the prospect provide a complete customer and vendor list. In the event that the commercial lender chooses to perform additional due diligence on the customer or vendor database, they can easily revert to this information.

9. **Articles of Incorporation**

Always obtain a copy of the complete organizational papers. Utilize the following guidelines:

- Corporations. Articles of Incorporation;
- Limited Liability Company. Articles of Organization;
- Partnership. Partnership Agreement;
- Trade Names. Obtain any Doing Business As (d.b.a.) Or fictitious name filings;
- Foreign Corporations. Obtain Foreign Status Certificates from the State in which they have a physical location. For instance, a company may be organized in Delaware but operating in Florida. This is therefore a Delaware Corporation recognized by the State of Florida as a Foreign Corporation operating within its borders.

All information listed above should be submitted with any amendments or certifications by officers to reflect the amended structure.

10. **Narrative Description of Business**

The prospect should provide information regarding their business. This may take the place of a business plan, collateral marketing material, website information, etc. This should be enough information in which you can prepare a general outline of the prospects's business.

11. **Recent Resumes of Principals**

All commercial lenders will want to know the experience level and background of any potential borrower. For that reason, it is recommended that the principals include or update their resume that concisely outlines their experience and background in thumbnail fashion.

12. **Optional Items**

Whenever a term loan is being contemplated, the commercial lender will always require an appraisal. Thus, if the prospect is requesting such a loan, it would be helpful to enclose any recent apprisal for review by the commercial lender. Appraisals are generally acceptable up to 1 year old and should be rendered in the commercial lender's name.

Some commercial lenders will accept a recent MAI Appraisal on real-estate or a recent FLV (Forced Liquidation Value) appraisal on machinery and equipment. Usually, this is based on knowledge and reliance upon the individual appraisal firm.

Other items that may be optional and germane only to term loans, particularly real-estate are color photographs of the real-estate and/or machinery (inside and outside of the buildings and grounds) and company and personal tax returns for the last 3 years. Some lenders will also require copies of deeds and notes covering proposed real-estate facilities.

For businesses that are applying for any form of SBA backed credit facility a business plan with projections is generally required.

Narrative Write-up

Once your prospect has submitted all of the necessary information you feel is required to evaluate the transaction, you will need to present the loan opportunity in the form of a narrative or client write-up. This is the critical explanation and outline of the transaction.

Generally, most senior underwriters or loan committee members will review a write-up before diving deeper into the information presented by the prospect. Information represented in a write-up is factual and based completely on the information provided by the prospect with emphasis placed on specific areas. Underwriters who have a history with a commercial finance consultant trust their initial evaluation of the transaction and will place weight on a well written write-up.

In order to write the best possible narrative, you will need to have all of the aforementioned information plus anything you feel would support the credit facility. One is dependent on other; you cannot prepare a quality write-up without all of the necessary elements.

Generally in a write-up the following items are generally explained in greater detail:

1. **Historical Information / Nature of Business**
   It's critical that the commercial lender understand the history of the business. How and when was the business started? How long has it been in operation? What type of legal entity is it? What is its primary product or service? Who owns the company? Ordinarily, a brief paragraph or two should detail this information at the beginning of the write-up.

2. **Type of Facility Being Requested**
   What is the prospect seeking? How large of a facility do they need? What collateral is available to support the request? Is there an existing lender that needs to be paid off or subordinated? This can also be accomplished in a brief paragraph.

3. **Disclosure and Disclaimer**
   Since commercial lenders will be relying on the information you are presenting to them, it is critical that any commercial lender or any lender for that matter understand your role as a commercial finance consultant. You need to be careful not to convey any possible indication or impression that you are presenting information in an absolute fashion. Bear in mind that commercial lenders will be relying on the information that you are presenting to them.

   Typical disclosure and disclaimer language:

> (Your company) does not guarantee, warrant or represent in any way the accuracy or completeness of client's financial statement's, financial information, aging of accounts, valuations of assets, or any other material herewith submitted for your review and hereby provides notice to you accordingly.
>
> (Your company) does not maintain facilities for verification of information through audit or other activity, belong to credit-reporting agencies (such as D&B, Experian, CBI, NACM, etc.), and hereby gives notice to lender that this shall be the lender's responsibility. All financial information is being submitted to you in the exact form received from the client and it will be the lender's responsibility to verify the accuracy thereof, including audit routine, if such is your practice.

In those instances where there are significant operating issues to be dealt with, it is considered a professional courtesy to inform the commercial lender of this situation prior to submittal of the actual loan package.

4. **Notice of Engagement by Prospect**
It is critical that any lender you are working with, that you disclose the nature of your relationship. The commercial lender needs to be aware of your role and responsibilities in the transaction.

Below is typical lender notification:

Notice of Engagement

(Your company) has executed our standard Financial Services Agreement with the client company. Under terms of this Agreement, you as the potential lender, are authorized in writing to deduct and disburse the net fee due (Your company) from the proceeds of the initial assignment and/or funding. You are being provided a copy for your files and for disbursement activity upon funding.

If there is any reason whatsoever that your firm cannot honor this Agreement and comply with this disbursement procedure, please immediately contact (Your company) and so advise. Otherwise, (Your company) will expect the spirit and intent of item 6 and the Agreement to be complied with.

Advanced Topic / Writers Point of View

It should be noted that on occasion you may be forced to submit prospects to lenders without your consulting agreement executed.

Competition will dictate how you approach a prospect and areas in which you will consider making accommodations. In those cases, it is best to inform the commercial lenders not to contact the prospect directly. Instead, any questions that the commercial lender may have should be directed through the commercial finance consultant. It will then be your responsibility to obtain resolution of those questions on behalf of the commercial lender.

In the likely event that you reach advanced negotiations with the commercial lender, you can then ask your prospect to execute your consulting agreement. Only then, do they become your client!

- M. Marin

5. **Collateral Discussion**

Next, is the discussion about the "nuts and bolts" of the proposed credit facility. Just what does the collateral being offered look like?

Here you will set forth the accounts receivable aging information, concentration analysis, terms of sale, days sales outstanding and other pertinent information (including top customers and their specific aging status) for any revolving facility. Also, we will outline the proposed advance formula the prospect is seeking (provided it is reasonable for the prospects industry).

It is also important to outline salient categories of the inventories, such as finished goods, work in process and raw materials, taking time to carefully break out each category by recent dollar amounts. This will be the location where the proposed advance formula on inventory will be discussed and what inventory is stale, obsolete or worthless (to the best of your knowledge, if any), etc.

For the fixed assets, if we have the benefit of recent appraisals, we would outline when the appraisal was preformed, by whom, how it was valued and any opinions of value that may have been offered by the prospect, his bankers, accountants, etc.

A brief description of the fixed assets should be offered, even if we do not have the benefit of recent appraisals. In this manner, we provide the lender(s) with our general impression of the capital assets involved.

6. **Financial Discussion**

For many commercial lenders, this is where the validity of the transaction is justified. Most commercial lenders will welcome a professional write-up which outlines where the prospect started, where they are today and what the future holds.

What the history of profitability or losses has been, etc. If there was a recent downturn, what caused it? How does the prospect compare to the industry being served? What actions has management implemented to correct the overall company situation.

In addition, this section should include comparative historical figures of salient financial barometers such as analysis of the balance sheet and income statement of a historical nature. Ordinarily, it is suggested that you include a comparative of three or more years on a columnar heading basis.

The key elements will include (in no particular order), but not limited to gross sales, gross profit margin, net profit or loss, key expense categories that bear investigation, depreciation, amortization, interest and certain key elements of the balance sheet such as net worth, total debt, current assets, current liabilities, working capital, trade receivables and payables and inventories.

The more financial information you present and explain here, the less you will ultimately have to answer and explain to the commercial lender later on. Moreover, if there is something that is negative or positive, it needs to be presented here. Remember, no lender likes unpleasant surprises. You will earn respect and credibility that is critical to your success by being forthright, complete and concise in the presentation of your lending facility.

7. **Personal Financial Statements / Antecedent Discussion**

As part of the collected loan package, you will have copies of the owners personal financial statements. In addition, you may have learned about their backgrounds by the resumes or in conversations. If you had the client complete the application, the prospect will have divulged and explained antecedent history.

If we have knowledge of any suits, judgements, liens, prior bankruptcies or other critical information, this is the time to give detailed information relating to anything discovered. This forms one of the three C's of credit. Character, is a direct reflection of the character of the principals and is thus of great importance.

In addition, comments of a general nature should be directed concerning the elemental breakdown of the items on the PFS. Is it a liquid asset situation, with lots of cash, CD's, money market and brokerage accounts?

Or are the assets centered in real-estate with large mortgages against them? If there is no true equity in the assets reflected on the PFS, what value is the personal guaranty? Is there is a need to rely on personal assets/boot collateral to shore up a potential credit facility? These are questions the lender will be asking when the personal financial statements are analyzed.

Preliminary Due Diligence

Obtaining a commercial loan depends heavily on the success of the borrowing business in generating enough cash flow to pay for its raw materials, cover operating expenses, provide return to the owners and most importantly, enough to repay the loans.

Performing basic preliminary due diligence on a prospect is critical as many areas of interest need to be properly addressed to secure a credit facility for a prospect.

Many commercial lenders underwrite a prospects application utilizing a three tiered approach. The first involves understanding a prospects business/industry (including best & worst case scenarios) and the second involves a standard mix of what is commonly referred to as the 5 C's of credit and the third involves analysis of the financial statement.

Knowing the Borrowers Business and Industry

Performing preliminary due diligence should start with the following areas of interest identified:

- Understanding the product/service
- Identifying the customer base
- Determining the business cycle
- Product/service demand
- Management ability
- Past performance/future success

1. **Understanding the product/service**
   Understanding the product or service a prospect offers should be relatively simple. If a prospect is in a "high risk" industry such as restaurants, construction or other niche industry, it will be important for you to identify and present these types of transactions to only those lenders who have an appetite for these types of industries.

   Information on a prospects business or industry or their "competitive advantage" may be found within their web page or corporate literature. If this information is not available, a simple conversation with the prospect should outline the highlights of their products or services.

2. **Identification of the customer base**
   It is necessary to properly identify a prospects customer base for a multitude of reasons. A commercial lender will be interested in identifying if the product/service being offered by the prospect meets a wide range of customers or is a niche service only of value to a select group of customers.

   Revenue is dependent on sales and the larger the pool of prospects, the greater the opportunity the prospect will have to generate sales which equates to the repayment of a loan. If it is a niche product or service, greater emphasis will be place on the likelihood the prospects products/services will be in demand.

3. **Determining the business cycle**
   Understanding the business cycle is important as any loan must adequately match the borrowings a business needs. Understanding the business cycle involves understanding the time between a business incurs costs (associated with producing or delivering goods or services) and the time payment is received.

   The greater the gap between the beginning of the cycle and receipt of payment, the more working capital a business will need.

Example 4

Sample Company, Inc.

Business Cycle

Sample Company, Inc., provides temporary labor to other businesses (staffing company). Outside of overhead associated with office operations the only expenses incurred are those associated with weekly payroll.

Sample Company, Inc., invoices it's customers on Monday for the prior weeks services performed on a net 30 basis. Sample Company, Inc., pays it's employees weekly

Sample Company's business cycle is as follows:

Day 1	**Day 5**	**Day 50**
Customer invoiced	Employee paid	Payment received

In this example, Sample Company, Inc., has a business cycle of 45 days. Realistically, Sample Company, Inc., will need a credit facility at least 2.5 times their gross monthly sales.

4. **Demand of the product/service**

It will be necessary for the prospect to explain in detail (if not obvious) what the demand is for the product/service. Demand for the products/services directly equates to sales/revenue. A credit facility cannot be granted to a prospect who does not have the capacity to generate sales.

Commercial lenders must identify any detrimental areas as they pertain to:

- Obsolescence
- Industry trends
- Trends & fads

Any negative aspects of the aforementioned will need to be carefully addressed.

5. **Management Experience**

Any commercial loan will depend heavily on the experience of the owners or management team. The importance of documenting the experience and success of a business owner or management team is critical in obtaining any credit facility. A lender must be able to determine the ability and likelihood that the owner(s) or manager(s) can and will operate the business successfully cannot be understated.

The easiest way to determine the owners or management teams experience is simply to obtain an updated resume. It may be useful to expand or provide greater detail regarding the information contained within a resume.

6. **Past Performance/Future Success**

A prospect will be required to submit historical financial information as well as projections into the foreseeable future. It may become necessary to review the financial information provided with a prospect to identify three areas:

1. What made the business successful in the past.
2. How they intend to repeat the success
3. Any downturns (loss of sales, financial performance, etc) should be adequately explained. This may inform a potential lender that the prospect has identified certain areas in the business that pose operating issues and the owners/management can take the necessary steps to avoid such circumstances in the future.

Five C's of Credit

The five C's of credit have been around for many years and generally serve only as a judgmental method of evaluating a potential borrower's creditworthiness; based on five criteria: character, capacity, capital, collateral and conditions. The first four deal with a borrower's ability to pay, whereas the last point refers to general business conditions in the borrower's industry.

1. **Character**

Character is subjective and is a general impression that you or a commercial lender will make of the prospect. A person of high character will have a high propensity to repay their debts.

Your determination of whether the borrower is trustworthy and likely to repay the funds borrower is based on your discussion with the prospect, other lenders, suppliers and a review of the borrower's credit reports. For the purposed of commercial lending, a person of high character generally will pay their debts in the agreed upon manner.

A prospect' educational background and experience, and perhaps more importantly, his references from other lenders or associates will give you an indication of their character.

Often a lender will encounter an individual(s) who have the capacity and capital, but will not pay according to the terms of a loan agreement. Those individuals with strong character have a high propensity to repay as agreed.

Character in a prospect/borrower cannot be overlooked.

2. **Capital**

Capital is simply the amount of money the prospect has available to invest in the business or more simply put, what he/she has at risk should the business fail. Capital for investment in addition to the investment in the project financed, is as important as a secondary source of funding should the business not perform as planned.

The larger the amount of capital that a prospect has invested in the project, the greater the propensity they will have to repay the loan. Prospects with little or no capital invested by the borrower are difficult transactions for commercial lenders.

Transactions that have "sweat equity" as capital or equity capital represents work that the owner may have done without compensation. Sweat equity is difficult to determine as it is subjective. Commercial lenders exercise extreme caution when considering sweat equity.

3. **Conditions**

Conditions refer to the usage of funds and the surrounding local economy or within the prospects industry. A commercial lender will require an understanding of how the prospect intends to utilize the funds, whether for working capital, purchase of additional plant or equipment or to finance inventory.

Commercial lenders will always want to know the use of funds in detail as the usage of funds will have a significant bearing on the terms of the credit facility. Economic conditions are also an important consideration.

Example 5

Sample Company, Inc.

Economic Conditions

Sample Company, Inc., is a textile manufacturer in North Carolina. Sample Company, is looking for a working capital and a term loan facility.

Because of the decline in the U.S. textile market, a commercial lender will need to scrutinize this transaction for many reasons. With the competitive nature of foreign manufacturers, Sample Company, Inc., must have some realizable competitive advantage to offset the decline in the U.S. textile market to make this an attractive loan candidate.

4. **Capacity**

Capacity refers to the prospect ability to generate enough cash flow to service the debt. All commercial lenders pay close attention to the cash flow of the business, the timing of repayment and the probability of successful repayment of the loan.

Capacity may also include a prospects other sources of repayment should the business or project not perform as planned. To some commercial lenders, capacity is the most important of the five C's of Credit because it represents the ability to fund the required debt service including the return of principal.

5. **Collateral**

Collateral simply provides security to a commercial lender which supports the prospects promise to pay as agreed or stated within the loan documents.

Collateral represents value to the prospect provided by investment or earnings. The threat of losing the value through foreclosure or repossession increases the prospect's propensity to repay the loan. Collateral itself does not pay loans. Collateral provides a lender with additional comfort should the borrower become unable to repay the loan.

Collateral is often buildings, equipment, accounts receivables and inventory. A guarantee may also serve as collateral if the person granting the guarantee is financially capable.

Many commercial lenders will not lend to small businesses or closely held corporations without the guarantee of the owner and/or owner's spouse. Valuing collateral is a tricky business.

Financial Statement Analysis

Reviewing and understanding a prospects financial statement will increase your ability to find the right solution for your prospects needs. Proficiency in understanding and interpreting information contained within a financial statement will allow you to ask the right questions.

Advanced Topic / Writers Point of View

The purpose of the following section is not intended to convert you to a financial analyst; however, the more you understand basic underwriting parameters, the less likely you will waste your time and that of your prospect. Reviewing and analyzing financial statements is not rocket science, but is more a process of understanding what the various items represented within a financial statement represent.

- J. Todd

Analyzing the financial situation/stability of a prospect is the most critical function in commercial loan underwriting. A person with strong character will stop at nothing to repay a loan, but if the business is not financially sound, the prospect's best efforts may not be enough.

A commercial finance consultant is expected to properly gather information, perform preliminary analysis on the information provided and package the prospects application appropriately.

In order to begin to properly analyze financial statements you must understand the individual components which comprise the financial statement. There are two components of a financial statement:

- Balance sheet
- Income statement

Financial statements show the value of the company, the amount of investment in the company, whether the company is making money, how often the inventory turns and how the owner finances the business.

Advanced Topic / Writers Point of View

> Always remember that the amount of reliance & belief placed on a financial statement is in direct relation to how and whom prepared the statements. Lenders are always aware of this fact.
>
> - J. Todd

Larger companies and all public companies are required to have their financial statements audited under guidelines of the Public Company Accounting Oversight Board (PCAOB) and generally accepted accounting principles (GAAP) so investors, lenders and others with a need or right to know the financial condition of the company have statements that can be relied upon for investment, lending, insurance or for other purposes.

Audited statements will include an opinion letter that contains language similar to the following:

> "We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board" (generally found within the first paragraph.)
>
> In the final paragraph of the opinion letter, an audited statement will say, "In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the {company name} as of {the company's fiscal year end} and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America".

Smaller companies generally will have a compilation or review prepared by an accountant that looks similar to audited statements. Compiled statements usually have a letter attached, and the letter must state that the auditor "compiled or reviewed" the data and must not include the language shown in the proceeding paragraphs.

In a review or compilation, the accountant takes the numbers provided by the business and presents the numbers in a normal accounting format without verifying the numbers via an audit.

It is necessary to read the accountant's letter to determine if the report has been audited according to GAAP or if the statement is only a review or compilation.

Balance Sheet Considerations

The **balance sheet** is a statement of a businesses resources, financial obligations and ownership interest. It is always "as of" or "at" some date, a snapshot of where the entity stands on the last day of the period being measured.

Assets are always listed in order of declining liquidity (less value) with cash, the most liquid asset is at the top, with each succeeding asset less liquid that the preceding asset.

Measuring **liquidity** determines how capable a business is of covering its obligation to creditors. **Leverage** represents how the business is financed and to what extend the businesses utilizes creditor money/trade payables (liability) and to what extend the businesses utilizes its own equity to finance the business.

The basis for Balance Sheet is the accounting equation

Assets (uses of funds) = **Liabilities** + **Equity** (sources of funds) or
Assets (items owned) - **Liabilities** (amounts owed) = **Equity** (net worth)

Current Assets are those assets which can be converted into cash in one year or less. Current assets are generally identified as cash, marketable securities, accounts receivables, inventory and prepaid expenses.

Property, **Plant & Equipment** are tangible assets that will last more than one year, typically used in the production processes. Also referred to as **Fixed Assets** and generally identified as land, buildings, computers, vehicles, furniture, equipment and fixtures.

Other/Miscellaneous Assets are generally considered longer-term assets not meeting the description of PP&E. Often items such as long term receivables, long term investments and intangible assets.

Current Liabilities are those obligations due in one year or less, including accounts payables, short term debt, current maturities of long term debt and accrued expenses.

Long Term Liabilities are those obligations of more than one year, including loans and deferred taxes.

Owner's Equity details net worth, including capital stock, additional paid in capital, retained earnings and treasury stock. It is titled uniquely for different business structures:

- Corporation. Stockholders Equity
- Partnership. Partners' Capital
- Proprietorship. Capital
- Not for Profit. Net Assets or Fund Balance

Liquidity analysis is arguably the single most important element considered by commercial lenders and vendors in making credit decisions. The question on their mind is simply- can the bills be paid?

Working Capital

Current Assets (those assets convertible into cash in one year or less)
minus
Current Liabilities (those amounts due in one year or less)

Many financial professionals and commercial lenders recommend that a business have no fewer than four to eight weeks of expenditures in working capital. **Increases** in **Working Capital** may be the result of operating profits, new sale of equity, sale of property or equipment and new long term borrowing. **Decreases** in **Working Capital** may be the result of operating losses, dividends or stock purchases, purchase or property & equipment and reduction (payment) of long term debt.

<u>Current Ratio</u>

Current Assets
Minus
Current Liabilities

The **Current Ratio** is **Working Capital** minus **Current Liabilities**. Commercial lenders are concerned that there is sufficient working capital to support the business. Many commercial lenders look for a minimum of a 2:1 ratio but often check trends and industry comparisons to determine where the prospect falls amongst it's peers.

The most basic test of liquidity is the determination that vendors, lender obligations and payroll can be satisfied when due. Current ratios are often illusions and may need further investigation. An overly large balance in accounts receivables may indicate an inability to collect invoices in a timely fashion or unusually long trade terms. An overly large balance in inventory my indicate an inability to produce and/or sell product efficiently or adverse market conditions have made the inventory obsolete.

Quick Ratio is a tougher test that the current ratio because it simply utilizes the "quick" converting assets (cash, securities, and accounts receivables) will be adequate to cover current obligations.

Generally, many commercial lenders consider a quick ratio of 1:1 satisfactory but will check industry averages as the rule of thumb frequently changes among industries.

<u>Quick Ratio</u>

Cash + Securities + Accounts Receivables
Minus
Current Liabilities

Days Sales Outstanding (DSO) may also be referred to as the average collection period. Commercial lenders are concerned with the business cycle. Accounts receivables are among the largest assets on the balance sheet and converting it to cash efficiently is critical in covering payroll, trade and other obligations.

Ideally, many industries attempt to keep DSO below 1.5 times payment terms, which is an increasingly difficult task considering today's business environment where large companies regard their vendors as a source of financing.

<u>Days Sales Outstanding</u>

Accounts Receivable Balance
Multiplied by the number of days in accounting cycle
Divided by
Sales in the accounting cycle

If accounts receivables are increasing, it may be caused by increased sales, slow payments, bad debt, poor collection efforts or an increase in credit sales. If accounts receivable are decreasing, it may be caused by downturn in sales, increase in collection time, improved collection efforts or an increase in cash sales.

Inventory Turn/Days Sales in Inventory (DSI) is a measure of the time it takes inventory to convert into sales. This is a critical ratio for those businesses that carry inventory as an inefficiency can tie-up critical working capital. This ratio is generally stated in terms of the number of inventory turns per year or number of days in inventory. Determining these numbers is industry dependent and no general guidelines are available.

<u>Inventory Turnover</u>

Annual Net Sales (cost of goods sold)
Divided by
Inventory Cost

If inventories are increasing, it may be caused by an increase in sales, a change in LIFO to FIFO, slow or obsolete inventory or change in inventory mix. If inventories are decreasing, it may be caused by a decrease in sales, a change in FIFO to LIFO, implementation of a "just in time" system or a change in inventory mix.

Days in Accounts Payable (DPO) is the opposite of DSO and determines how quickly a business satisfies its trade obligations. The time a trade creditor allows a business to pay bills is "free" financing and is often a desirable and obtainable alternative to commercial lending. The challenge is to hold onto cash as long as possible without affecting trade relations.

Days in Accounts Payable

Accounts Payable best determined by using a prior reporting period
Multiplied by 365
Net Purchases or **Cost of Sales**

Cash Conversion Cycle is the combination of three previous ratios. This indicates the number of days of internal financing (working capital) required to maintain business operations.

Cash Conversion Cycle

Days Sales in Inventory (DSI)
Plus
Days Sales Outstanding (DSO)
Minus
Days in Accounts Payables (DPO)
Equals
Cash Conversion

A business raises initial cash from a stock offering or a commercial loan. It then invests that cash in productive elements such as labor, raw materials, merchandise inventory and incidental costs of delivering services.

These elements work through the businesses production process and eventually become finished goods or services available for sale. The sales department turns the finished goods or services into a credit sale. The credit sale becomes an account receivable. The account receivable is collected and the cycle is closed.

During the cycle, the company is without cash and during this time, this portion of the cycle must be financed. Part of this cycle is financed through vendor terms and the balance must be financed through working capital, a commercial loan or other financing source.

Accounting is far from a precise science; textbooks usually define it as an "art." The art of accounting is personified in all the choices (in accounting methods) an accountant employs in valuing the assets on the balance sheet and their implication on the income statement as well. Some examples of these valuations are:

1. **Accounts Receivables (A/R)**
   Accountants often reduce the value of the accounts receivables listed on the balance sheet for an Allowance for Doubtful Accounts which is an estimate of uncollectible accounts which is recorded on the income statement as bad debt expense.

2. **Property & Equipment**
   Upon purchase, long lived tangible property is place on the balance sheet at its historical cost. As it wears out, the asset is gradually transferred to the income statement as a depreciation expense. Valuation issues may include: the method of depreciation (straight line or accelerated methods), establishing the asset life and determining whether the item should be a capital asset depreciated over time or an operating expense item that never appears on the balance sheet. All have a significant impact on both the balance sheet and income statement.

3. **Intangible Assets**
   The rules of accounting require that intangibles such as goodwill, patents, copyrights & trademarks, franchise fees, etc., to be placed on the balance sheet as assets and written off (amortized) on the income statement over their useful lives.

To many commercial lenders, these assets have no practical value.

4. **Inventory**
   The valuation of ending inventory is a major issue in may companies; it has a major impact on both the balance sheet inventory and cost of goods sold on the income statement.

   Several valuation methods are available:

   - **First In First Out (FIFO)**
     Assumes that the first unit purchased or produced is the first to be sold. If prices rise over time, this results in larger inventory balances on the balance sheet and larger profits on the income statement (because cost of goods sold is smaller). Many large public companies use FIFO because of the pressure to continuously improve profits.

   - **Last In First Out (LIFO)**
     Assumes that the last unit purchased or produced will be the first to be sold. If prices rise over time, this results in smaller inventory balances on the balance sheet and smaller profits on the income statement (because cost of goods sold is larger). Many small private companies use a LIFO because smaller net income defers income taxes into the future.

Income Statement Considerations

The **Income Statement** is a statement of revenues, costs and expenses for the period measured. Like the balance sheet, it is always "as of" or "at" some date, a snapshot of where the entity stands on the last day of the period being measured. Income statements are also referred to as a Profit & Loss.

The income statement begins with the amounts billed to customers (sales or revenues), deducts costs of doing business and ends with the organization's "bottom line" which is the profit, earnings or net income for the period. Income statements are based on the principal of matching revenues earned in a period with the expenses incurred in order to earn those revenues. Income statements are designed to measure performance or profitability.

Sales/Revenue are amounts earned by delivering goods or services to customers during the period. Some businesses record gross sales or revenues and reduce this number by discounts, returns & allowances to arrive at a net sales.

Cost of Goods Sold are the costs related directly to the production (raw materials, direct labor and factory overhead) or purchase (merchandise inventory) of the goods or services sold in the sales/revenue category.

Operating Expenses/Overhead are those costs required to operate the organization not previously recorded as cost of goods sold. Overhead is generally classified as general and administrative (G&A), sales and marketing and research & development (R&D) expenses.

Non-operating Items are items of income or expense that are not central to the operation of the business. Examples of non-operating income might include, interest, dividend or investment earnings, gains on sale of capital assets, etc. Non-operating expenses would include interest, expense, changes in accounting method, unusual non-reoccurring charges such as lawsuit settlements, casualty losses, etc.

Provision for Income Taxes is the amount due for taxes from the results of the net income earned on the income statement.

Operating Leverage Analysis is the understanding of the nature of costs and expenses on the income statement which allows one to understand the impact an additional dollar of sales at the top of the income statement will have on bottom line net income. The greater the percentage of fixed costs, the greater operating leverage, or improvement on the bottom line.

Fixed Costs remain the same regardless of business volumes. Common examples include the base salary of the personnel and items such as office rent. In the short term, many costs are fixed, but over time, most costs become variable.

Variable Costs are dependent on business volumes and tend to rise or fall in conjunction with sales. A sales commission or a retailer's costs of sales are typically variable costs.

All businesses have some element of variable cost. When an incremental dollar of sales is added to the income statement, the variable costs rise as well. Only the portion of the incremental dollar of sales that exceeds the growth of variable costs falls to the bottom line. If a dollar of cost is cut, however, that entire dollar (less the income tax effect, if any) falls to the bottom line as net income.

Cutting costs by one dollar grows bottom line net income faster that adding one dollar of sales. This is why effective businesses are oriented towards cost cutting.

Break Even is the sales volume at which a company shows a $0 net income. The break even point of a company can be computed using fixed and variable cost analysis.

Break Even Point

Selling Price
Multiplied by
Sales Volume equals **Variable Cost Per Unit**
Multiplied by
Sales Volume
Plus
Fixed Costs

Trend Analysis focuses on the direction, over time, of the same financial accounts from the same financial statement and typically involves a graphical depiction. Trend analysis is a technique of using past performance to predict future performance and to develop a big picture awareness of positive and negative business direction.

Trend analysis is a good place to start in any business. The more you know about the history of a business, the better off you will become when recommending and presenting financing solutions. The most effective way to perform a trend analysis is to gather financial statements and information from a minimum of three to five years.

Gross Profit Margin is meaningful only to organizations having inventory & cost of sales. Gross profit or margin (sales less cost of sales) is the profit remaining after deducting the direct cost of the goods acquired or manufactured for sale. This ratio is very industry specific and even within industries (particularly manufacturers), comparisons can be difficult because of the gray line between the overhead included in cost of sales and operating expenses deducted below gross profit.

Gross Profit Margin

Gross Profit
Divided by
Net Sales

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially the bottom line net income less non-operating activities and non-cash charges against income. It is in a sense a short hand way of arriving at estimated cash flow for a period.

Operating Margin is arguably the most important number to compare year to year in the same business. The effort is to determine how much money did the business make? **Operating Income** is **Gross Profit** (or net sales if no cost of sales are present) less **Operating Expenses**. Operating expenses are all the costs required to earn operating income except the direct product costs included in cost of sales.

<u>Operating Margin</u>

Operating Income
Divided by
Net Sales

Net Profit Margin (Return on Sales) is the final profit. The net profit margin is the bottom line of the income statement divided by the top. **Net Income** is **Operating Income** plus **Non-operating Income** less **Non-operating Expenses** less **Income Taxes**.

<u>Net Profit Margin</u>

Net Income
Divided
Net Sales

Interest Coverage is a ratio used by commercial lenders to validate that a borrower can make their interest payments. Generally, commercial lenders like to see the interest coverage ratio at 3 times or higher

<u>Interest Coverage Ratio</u>

EBIT
Divided by
Interest Expense

Payment Coverage is a ratio used to verify that lending clients can make their total loan payments (interest and principal). This is a broad guideline is that lenders like to see the payment coverage ratio of 1.2 or higher.

Payment Coverage Ratio
EBITDA
Divided by
Interest & Principal

Narrative Write-up

Once you have completed the preliminary due diligence and the transaction appears to have validity, you will need to present the loan opportunity in the form of a narrative or client write-up. This is the critical explanation and outline of the transaction.

Generally, most senior underwriters or loan committee members will review a write-up before diving deeper into the information presented by the prospect. Information represented in a write-up is factual and based completely on the information provided by the prospect with emphasis placed on specific areas. Underwriters who have a history with a commercial finance consultant trust their initial evaluation of the transaction and will place weight on a well written write-up.

In order to write the best possible narrative, you will need to have all of the aforementioned information plus anything you feel would support the facility. One is dependent on other; you cannot prepare a quality write-up without all of the necessary elements.

Generally in a write-up the following items are generally explained in great detail:

1. **Historical Information / Nature of Business**
   It's critical that the commercial lender understands the history of the business. How and when was the business started? How long has it been in operation? What type of legal entity is it? What is its primary product or service? Who owns the company? Ordinarily, a brief paragraph or two should detail this information at the beginning of the write-up.

2. **Type of Facility Being Requested**
   What is the prospect seeking to accomplish? Are they seeking working capital, term loan or a revolving loan? How large of a facility do they need? What collateral is available to support the request? Is there an existing lender that needs to be paid off? This can also be accomplished in a brief to-the-point paragraph.

3. **Disclosure and Disclaimer**

Since commercial lenders will be relying on the information you are presenting to them, it is critical that any commercial lender or any lender for that matter understand your role as a commercial finance consultant. You need to be careful not to convey any possible indication or impression that you are presenting information in an absolute fashion. Bear in mind that commercial lenders will be relying on the information that you are presenting to them.

Typical disclosure and disclaimer language:

> (Your company) does not guarantee, warrant or represent in any way the accuracy or completeness of client's financial statement's, financial information, aging of accounts, valuations of assets, or any other material herewith submitted for your review and hereby provides notice to you accordingly.
>
> (Your company) does not maintain facilities for verification of information through audit or other activity, belong to credit-reporting agencies (such as D&B, Experian, CBI, NACM, etc.), and hereby gives notice to lender that this shall be the lender's responsibility. All financial information is being submitted to you in the exact form received from the client and it will be the lender's responsibility to verify the accuracy thereof, including audit routine, if such is your practice.

4. **Notice of Engagement by Prospect**

It is critical that any lender you are working with, that you disclose the nature of your relationship. The commercial lender needs to be aware of your role and responsibilities in the transaction.

Below is typical lender notification:

> **Notice of Engagement**
>
> (Your company) has executed our standard Financial Services Agreement with the client company. Under terms of this Agreement, you as the potential lender, are authorized in writing to deduct and disburse the net fee due (Your company) from the proceeds of the initial assignment and/or funding. You are being provided a copy for your files and for disbursement activity upon funding.
>
> **If there is any reason whatsoever that your firm cannot honor this Agreement and comply with this disbursement procedure, please immediately contact (Your company) and so advise. Otherwise, (Your company) will expect the spirit and intent of item 6 and the Agreement to be complied with.**

Advanced Topic / Writers Point of View

It should be noted that on occasion you may be forced to submit prospects to lenders without your consulting agreement executed.

Competition will dictate how you approach a prospect and areas in which you will consider making accommodations. In those cases, it is best to inform the commercial lender(s) not to contact the prospect directly. Instead, any questions that the commercial lender may have, should be directed through the commercial finance consultant. It will then be your responsibility to obtain resolution of those questions on behalf of the commercial lender(s).

In the likely event that you reach advanced negotiations with the commercial lender, you can then ask your prospect to execute your consulting agreement. Only then, do they become your client!

- J. Todd

5. **Collateral Discussion**

Next, is the discussion about the "nuts and bolts" of the proposed facility. Just what does the collateral being offered look like?

Here you will set forth the accounts receivable aging information, concentration analysis, terms of sale, days sales outstanding and other pertinent information (including top customers and their specific aging status) for any revolving facility. If your prospect is seeking a revolving credit facility, this is the area in which you will outline the proposed advance formula the prospect is seeking (provided it is reasonable for the prospects industry).

It is also important to outline salient categories of the inventories, such as finished goods, work in process and raw materials, taking time to carefully break out each category by recent dollar amounts. This will be the location where the proposed advance formula on inventory will be discussed and what inventory is stale, obsolete or worthless (to the best of your knowledge, if any), etc.

For the fixed assets, if we have the benefit of recent appraisals, we would outline when the appraisal was preformed, by whom, how it was valued and any opinions of value that may have been offered by the prospect or their accountants, etc.

A brief description of the fixed assets should be offered, even if we do not have the benefit of recent appraisals. In this manner, we provide the commercial lender(s) with our general impression of the capital assets involved.

6. **Financial Discussion**

For many commercial lenders, this is where the validity of the transaction is justified. Most commercial lenders will welcome a professional write-up which outlines where the prospect has been and what the future holds. What the history of profitability or losses has been.

If the prospect has had a recent or historical operating loss, great effort must be made to throughly explain what caused the loss and more importantly what they did to correct the loss. If there was a recent downturn, what caused it? How does the prospect compare to the industry being served? What overall action has management implemented to correct the overall company situation.

In addition, this section should include comparative historical figures of salient financial barometers such as analysis of the balance sheet and income statement of a historical nature. Ordinarily, it is suggested that you include a comparative of two or more years on a columnar heading basis.

The key elements will include (in no particular order), but not limited to gross sales, gross profit margin, net profit or loss, key expense categories that bear investigation, depreciation, amortization, interest and certain key elements of the balance sheet such as net worth, total debt, current assets, current liabilities, working capital, trade receivables and payables and inventories.

The more financial information you present and explain here, the less you will ultimately have to answer and explain to the commercial lender later on. Moreover, if there is something that is positive or negative, it needs to be presented here. Remember, no lender likes unpleasant surprises. You will earn respect and credibility that is critical to your success by being forthright, complete and concise in the presentation of your lending facility.

7. **Personal Financial Statements / Antecedent Discussion**

As part of the collected loan package, you will have copies of the owners personal financial statements. In addition, you may have learned about their backgrounds by the resumes or in conversations. If you had the client complete the application, the prospect will have divulged and explained antecedent history.

If we have knowledge of any suits, judgements, liens, prior bankruptcies or other critical information, this is the time to give detailed information relating to anything discovered. This forms one of the five C's of credit. Character, is a direct reflection of the character of the principals and is thus of great importance to the commercial lender.

In addition, comments of a general nature should be directed concerning the elemental breakdown of the items on the PFS. Is it a liquid asset situation, with lots of cash, CD's, money market and brokerage accounts? Or are the assets centered in real-estate with large mortgages against them? If there is no true equity in the assets reflected on the PFS, what value is the personal guaranty? Is there is a need to rely on personal assets to shore up a potential credit facility? These are questions the commercial lender will be asking when the personal financial statements is analyzed.

Lending Institutions

Like any type of lending, there is a wide variety of institutions all with unique lending parameters and appetites. In the banking industry there are three types of institutions.

1. **Community Banks**

   A community bank is a smaller bank that is usually located with a relatively small geographical area. Generally, the community bank's target market is within a relatively small geographical area.

   The biggest advantage to consider working with a community bank is the ability to work directly with the decision makers. Often loan officers are given more leeway in making lending decisions and may not have the same level of "red tape" as a larger bank.

   Often, many business owners feel they are able to develop a personal relationship with a lender from a smaller institution. Many community banks often weigh the historical relationship of the borrower and that of the commercial finance consultant rather than relying on strict policies.

   The disadvantage is that a community bank may not have the capacity or resources to accommodate larger borrowers or offer a wide suite of commercial loan products or services.

2. **Regional Banks**

   A regional bank is one that is operating in a specific region of the country. Wachovia, BB&T, Sovereign Bank, Marquette and Zions Bank are good examples of regional banking institutions.

   Regional banks have some of the characteristics of a community bank, but have a greater capacity for lending without some of the bureaucratic processes found in national banks. Like community banks, regional banks sometimes make decisions based upon knowledge of the borrower and their comfort level with you as the commercial finance consultant rather than strict adherence to policy.

3. **National Banks**

National banks, such as Bank of America, Wells Fargo and Citibank, have operations across the United States and internationally. Because of their sheer size and capacity, these institutions are often layered with bureaucracy. Decision making usually relies on predefined policies and may be multi-layered in nature.

The greatest advantage to working with a national bank is there competitive and aggressive product offerings. Additionally, national banks have the greatest capacity in terms of loan amounts.

Glossary

A&D Loan
A&D is the acronym for acquisition and development loan. This term refers to a loan that finances the purchase of land and the construction of infrastructure such as streets and utilities that result in building sites or pads for building usually on a speculative basis. A&D projects can develop land for either residential or commercial purposes.

Accounts Payable
Obligations to pay for goods or services that have been acquired on open account terms from suppliers. Accounts payables are a current liability in the balance sheet.

Accounts Receivable
Amounts due a company on account from a customer who has bought merchandise or received services. Accounts receivables are present as a current asset in the balance sheet.

Accounts Receivables Aging
An accounts receivable aging report shows the amounts owed to a company and whether the accounts are past due and if so for how long. This is important to the lender because failure by a company to collect its receivables in a timely manner can have an adverse impact on the ability to pay its debts in a timely manner.

ADC Loan
ACD is the acronym for acquisition, development and construction. This loan type has the characteristics of an A&D loan except that the ADC loan also provides for vertical construction of buildings on the property, usually on a speculative basis.

Amortizing Loan
An amortizing loan provides for the repayment of both principal and interest in regular installments over a specified period of time. Amortization is influenced by the interest rate, the term and the amount of the loan proceeds.

Appraisal
An appraisal is a written report of a supported estimate of value prepared by an individual with the training and experience to determine an estimate of value for the property being prepared.

Asset
An economic resource that is expected to provide benefit to a business or individual.

Attorney's Opinion
An attorney's opinion is a search of the real estate records to determine what, if any, liens are on the property in order to determine the position of the lien securing your loan.

Audit
An audit is a process employed by a certified public accountant (CPA) to test the accuracy of a company's financial statements using generally accepted accounting principles. Audited financial statements provide the highest level of comfort regarding the financial condition of a company or individual. Small businesses and individuals seldom have audited financial statements.

Balance Sheet
The balance sheet, also know as the "Statement of Condition" is the financial statements that shows an entity's assets or what it owns, liabilities or what it owes and net worth or what is left of a company's assets after the assets are used to satisfy all liabilities.

Bankruptcy Protection
This protection is provided under Federal law and among other things prohibits creditors from attaching and liquidating the assets of an entity without the approval the bankruptcy court. The bankruptcy court exercises tremendous power over the assets of an entity under their protection including reducing the amount of interest that a lender may accrue on the entity's debts and reducing the amount of debt that the debtor owes, even if the debt is secured by real estate.

Basis Point
One-hundredth of a percent (.01%) 300 bp = 3%.

Borrowing Agreement
This document authorizes an officer(s) of a corporation or a partner(s) in a partnership to commit the corporation or partnership to borrower and repay the funds.

Bridge Loan
A bridge loan provides funding until the occurrence of another event. For example, a company purchases a new office building and intends to sell its current office building and use the proceeds from that sale to reduce the debt on the new building. The lender will make the company a loan on the old building for the amount the company expects to invest in the new building. The loan is typically due near the date that the building is expected to sell and close but may be renewed. Bridge loan do not amortize but generally require interest payments on a monthly or quarterly schedule.

Bullet Loan
A bullet loan is a short term loan that requires the repayment of the principal at maturity. A bridge loan is a bullet loan. Bullet loans are made base upon the relative certainty that some event will occur in the near future. Interest is normally paid at maturity if the note is 30-90 days and monthly or quarterly is the maturity date is longer.

Business Cycle
The business cycle is the period between the time that a business makes and/or delivers a product and when it normally receives payment for the goods and services. A business cycle can be as short as daily or can extend for years.

Call or Call Provision
Lenders usually provide provisions in loan agreements with terms exceeding five years or in a Line of Credit document that allow a lender to call the loan, change the rate of interest or to demand payment of the amount due.

Capital
Capital is the cash available to pay for current expenses (working capital) or to make major purchases (capital expenditures). Capital also refers to the cash invested by the owners in a business.

Cash Flow
Cash flow is the actual amount of cash collected and paid out by a business.

Cash Flow Statement
A cash flow statement is included in the financial statements and shows the source of cash provided by the business and the amount used during the reporting period.

Closing
The closing is the process of executing the note and other agreements pertaining to the loan and the disbursement of proceeds.

Collateral Value
The collateral value is the amount that the lender will advance on the security of a class of collateral. For example, typically a lender will advance up to 85 percent of the appraised value of an office building. The 85 percent is considered the collateral value of the property.

Commercial Loan
A commercial loan is dependent upon the successful operation of a business or a property for the repayment of the loan.

Commitment Letter
A commitment letter is a binding commitment from the lender to make a loan under the terms and conditions identified in the written commitment.

Commodities
Commodities vary from intangibles such as farm or financial futures to actual products. Ownership of commodities generally is evidenced by paper and the owner seldom, if ever, takes possession of the underlying commodity.

Complied Statements

These are financial statements that have not been audited but have been placed into financial statement format, generally by an accountant. These statements often look like audited statements but the opinion letter must state that the statements have not been audited.

Cost of Goods Sold

Cost of goods sold is an income statement account reflecting purchases or the costs of manufacturing the product for a manufacturer, less returns and allowances.

Current Assets

Current assets are those assets that can be readily converted to cash and include cash, marketable securities, accounts receivables and inventories.

Debt Load

Debt load refers to the total amount of debt payments that a business must make usually referred to as a percentage of net income before non-cash items and debt service.

Debt Service

Debt service is the amount of periodic payments that an entity has to make on its loans.

Debt Service Coverage

Debt service coverage is similar to debt load. The debt service coverage or DSC is the percentage of net income, before non-cash items (depreciation) and debt service, to the amount required to service the debt (the payments).

Depreciation

Depreciation reduces taxable income by spreading out of the original cost over the estimated life of the fixed assets such as plant and equipment.

Discount Rate

The discount rate is the rate of interest used to determine the present value of future income flows generated by a project.

Dividends
Dividends are non-salary payments to the owners of a corporation.

Draw
A draw refers to the periodic disbursement of loan proceeds under a construction loan or line of credit.

Environmental Survey
A test conducted by qualified engineers to determine if there are chemical or other environmentally damaging material in or on the soil of the proposed collateral property.

Equity
Assets minus liabilities also referred to as net worth.

Facilities
Facilities include the structures used by a business to house its operations and may include office buildings, manufacturing or storage buildings, apartments and other rental structures.

Feasibility Study
A study conducted by qualified individuals who estimate the market's acceptance of a proposed speculative venture.

Financial Statements
Financial statements include the balance sheet or statement of condition, the income statement or statement of operation, the cash flow statement and the notes provided to explain various accounting treatments.

Floating Rate
Floating rate loans have rates of interest that change based on changes in the above rate. Commercial loans typically are tied to a prime rate or LIBOR and can change as they rates adjust.

Floor or Shelf Life
Floor or shelf life refers to the period of time between receiving inventory and selling and delivering the inventory to the customer.

Foreclosure
Legal proceeding initiated by a creditor to take possession of collateral securing a defaulted loan.

Generally Accepted Accounting Principles (GAAP)
Accounting standards established by the Financial Accounting Standards Board to assure that external financial statements are fair representation of the economic circumstances of the company.

Guarantor
A person or corporation who guarantees payment by another. Also referred to as a surety. A guarantor becomes a co-endorser and assumes liability in the event of a default.

Income Statement
Profit and lose statement detailing a firm's financial operations for a specific period, including net profit or loss for the period in question. Usually accompanied by a balance sheet for the end of that period.

Intangibles
Are a balance sheet asset having no physical properties, but thought to represent some future economic benefit to its owner. Intangibles such as goodwill, bank card service marks, patents, franchise and so on are non current assets amortized over the period held.

Inventory
Merchandise or supplies on hand or in transit at a particular point in time. Three types of inventory for a manufacturing company are raw materials, work-in-process and finished goods.

Lender's Risk
The lender's major risk is that the borrower will not repay the loan(s).

Leverage

In general terms: use of borrowed funds to increase purchasing power and ideally to increase profitability of an investment business.

Operations: extent to which a company's costs of operating are fixed (rent, insurance, executive salaries) as opposed to variable (materials, direct labor).

Finance: debt in relation to equity in a firm's capital structure. The more long-term debt there is, the greater the financial leverage. Shareholders benefit from financial leverage to the extend that return on the borrowed money exceeds the interest costs so that the market value of their shares rise.

Liabilities

Amount payable in dollars (e.g. accounts payable) or future services to be rendered (e.g., warranties payable). The party having the liability is referred to as the debtor.

London Interbank Offered Rate (LIBOR)

key rate in international bank lending. LIBOR is the rate at which major banks in London are willing to lend Eurodollars to each other. It is used to determine the interest rate charged to creditworthy borrowers.

Licensed Appraiser

Federal banking regulations require that regulated lenders obtain an appraisal from a "licensed appraiser." Individual States as well as trade associations establish education and testing requirements. Licensed appraisers willingly provide copies of their licenses and certifications.

Line of Credit

A line of credit (LOC) is a credit facility that a borrower can draw upon at will as long as the conditions outlined in the initial LOC documents are met. A LOC can be secured or unsecured. Typically, LOC's have a term of one year or if longer, the lender has the right to review the credit and modify the provisions of the line. Some lenders require that the lien is paid off for a period of at least 30 days each year.

Loan Agreement

A loan agreement defines specific conditions that apply to the loan or line of credit. A loan agreement is separate from the note and security agreement.

Loan Brief

A loan brief (also referred to as a write-up or narrative) is a narrative describing the loan request, the background of the borrower(s) and guarantor(s), the financial condition of the borrower(s) and guarantor(s), the credit history of the borrower(s) and guarantors(s) along with the intended use of the borrowed funds and the source of repayment.

Loan Origination Fee

Lender's fee for making a loan, either at the commitment time or as funds are advanced ast specific stages as in construction financing. There are different types of loan fees: an annual fee to maintain a line of credit, a commitment fee to hold available the unused portion of a loan or line of credit; and a utilization fee for the amount of credit actually drawn down against an approved line.

Loan Limit

Legal lending limit imposed by Federal banking rules limiting the loans extended to a single borrower, generally not more than 15 percent of capital and surplus for national banks (secured loans) and generally 10 to 20 percent for state chartered banks.

Loan Origination

Is the process of obtaining an application, financial information, appraisal and other information necessary for a lender to determine the feasibility of extending a credit facility.

Loan Term

Loan term refers to the time to maturity of a loan. A loan term of 60 months means that the loan is to be paid off within 60 months.

Markup

Refers to the difference between the cost of goods purchased or produced by a business and the price at which it sells the goods.

Money Supply

The money supply of the United States is controlled by the Federal Reserve Board through the adjustment of interest rates that banks must pay to the Fed to borrow and by adjusting reserve rates, the amount of cash that a bank must keep on hand for each dollar of demand deposits.

Net Present Value

Net present value (NPV) adjusts the value of dollars receive in the future to thee value today. The underlying premise is that money that you have today is more valuable to you than money you will receive one year from today.

Net Worth

Owner's equity in a business, computed as accounting assets, less liabilities.

Non-cash Item

A non-cash item are those expenses shown on the income statement that did not require cash outlays such as depreciation of a piece of equipment or building or amortization of mineral rights or goodwill.

Note Payable

Written promise to pay money at a future date. A note payable may be classified as either a current or a noncurrent liability, depending on whether the note id due within one year or less.

Opinion Letter

An accountant issued letter at the end of each audit and the letter usually precedes the financial statements. Any unqualified opinion indicates that the business is a going concern and that the reader of the financials can rely on the condition of the company displayed in the statements. A qualified opinion is cause for concern and a company with a qualified opinion may not qualify for a loan.

Origination

To originate a loan means that there is a willing borrower who has supplied all of the documents required by the lender and a willing lender who ensures that all necessary documents are properly completed and executed. Once this has been completed, funds are disbursed and the transaction is closed.

Over Capitalized
A business that is overcapitalized is one that is not earning enough to provide a return on capital that the stockholders could reasonably expect from another investment.

Overhead
Overhead generally refers to those expenses that occur regardless of whether production or sales occur.

Public Company Accounting Oversight Board (PCAOB)
This board was created by Congress through the Sarbanes Oxley Act of 2002 which was passed by events such as Enron, Worldcom, Tyco and other instances of corporate abuses. The PCAOB is the new governing body of the accounting profession.

Plant & Equipment
Fixed assets used in business operations, including land and buildings; sometimes termed property plant and equipment.

Pre-Sold Unit
This term is used in A&D or ADC lending where sales or reservations have occurred prior to the time that the construction of the pads or buildings is completed.

Prime Rate
Interest rate charged by banks to their most financially sound customers. The prime rate is a reference point for other interest rates-some are lower than the published prime rate, most are higher.

Pro Forma
The term pro forma usually applies to projected financial statements taking into account expected or assumed future events.

Projections
Projections are the documents reflecting the net income and balance sheet that the company expects to achieve over some future time frame. Projections are pro formas.

Qualifying Appraisal

A qualifying appraisal is one that is prepared by an appraiser licenced to prepare and appraisal for the subject property and one that is prepared in accordance with the standards of the licensing State's guidelines and those of the certifying professional organization.

Refinance

Refinancing is obtaining a loan to pay off a previous loan using the same collateral and for the same purpose as the original loan, except the rate or other factor may change.

Repossession

Is the process by which a lender takes ownership of non-real estate property when the loan the property secures defaults. The lender sells the repossessed property to reduce the amount of the debt.

Return on Investment

Are earnings available to shareholders or investors through payment of dividends or capital distribution even though no funds may be distributed.

Riding the Trades

Refers to a business not paying its suppliers in a timely manner. Riding the trades is a form of financing (leverage) because a business will have longer usage of its funds over a longer period of time. Riding the trades is an indication of a company that has insufficient working capital or is poorly managed.

Seasonal

Many businesses have times during the year when demand for their products or services are greater.

Soft Costs

Soft costs are generally associated with A&D and ADC loans and generally include the developer's overhead, interest and other fees associated with the project.

Spec Loan
Is a loan to a business under a speculative venture, typically A&D or ADC loans where the proceeds of the loan are used to develop a real estate product under the hope or speculation that their will be willing buyers for the finished product.

Sweat Equity
Refers to un-reimbursed labor or effort that a borrower may have put into a project. This effort is often indeterminable and is merely a way that a borrower is attempting to show the amount of "time" they have invested.

Title Company
Insures that the borrower has clear title to the real estate property and that the lender will have a good lien against the property.

Trades
Trades is a term that refers to subcontractors such as electricians, masons, plumbers.

Trend
Trend reflects the performance of a business over several periods. Net income of one year may be good, but it is not necessarily indicative of what business can do over time. Lenders generally is looking to obtain net income numbers of a minimum of three years to establish a trend.

Trend Analysis
Is the process of looking at the performance of a business over a sufficient time period that gives the lender an indication of the condition of a business.

Under Capitalized
Under capitalized is the condition of most small businesses. An undercapitalized business has insufficient capital to pay its current debts and to invest in plant and equipment necessary to satisfy its customers' future needs.

Underwriting
Refers to the process in which a lender evaluates the information supplied by a prospect and determines the overall risk a borrower will not or cannot repay the debt.

Vertical Improvements
Vertical improvements refer to buildings or other non-infrastructural improvements constructed on real estate.

Working Capital
Working capital represents cash available to pay current bills and to invest in plant and equipment necessary to satisfy its customers' future needs and or expectations.

