Intro Revolving Loan Fund

The Decision Process

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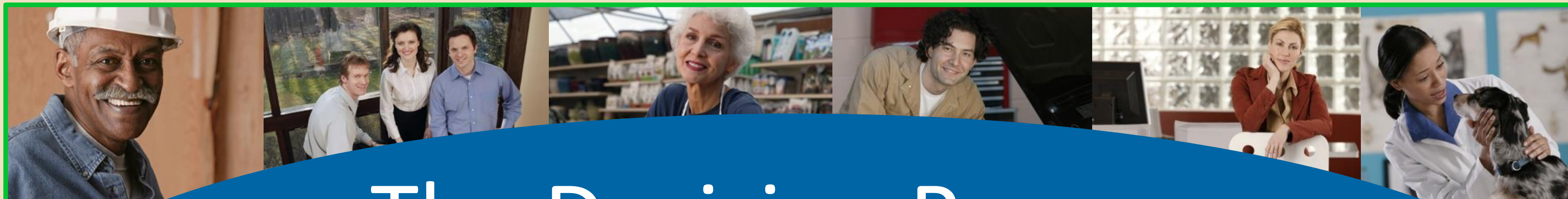
Dallas, TX

Idaho Housing and Finance Association

www.ihfa.org

The Decision Process

- Keep in mind the "mission" of the RLF
- Loans made through a RLF are generally loans traditional Lenders (Banks) would not make
- If you underwrite to the same standards as a traditional Lender, then there shouldn't be a need for the RLF
- RLF however is not there to make all the loans turned down by traditional Lenders



The Decision Process

The RLF should always underwrite with the expectation that the loan will be repaid –

- From the businesses’ cash flow
- *Other Sources (salaried income, etc.)*
- Traditional financing once the business is solid enough to be bankable through traditional financing sources

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The Decision Process

- Underwriting loans through a RLF is a similar process as to how Banks and Credit Unions analyze credit
- Difference is a RLF has more latitude in working with the small business
- RLF guidelines are generally not as restrictive as traditional Financial Institutions

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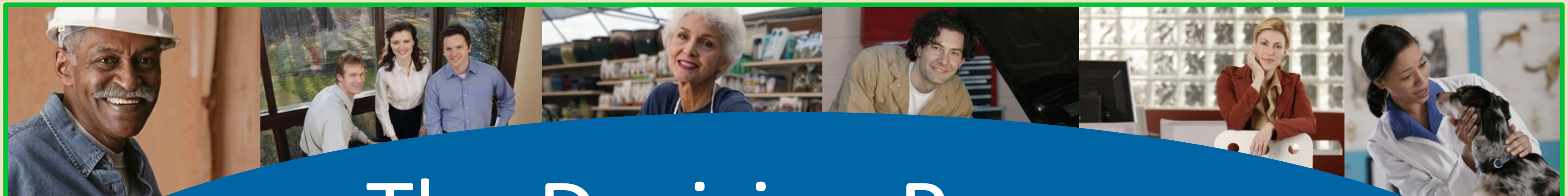

The Decision Process

Primary difference is the RLF is willing to accept a higher degree of risk to accomplish its mission:

- Higher advance rates on collateral
- Less reliance on collateral as a secondary source of repayment
- Lower amounts of required cash injection/down payment
- Lower debt coverage levels

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The Decision Process

- Flexibility in analyzing personal and business credit reports
- Limited financial information
- Projection reliant businesses
- Lending to borrowers in industries perceived to have a higher degree of risk

RLF is accepting a higher degree of risk, mitigating as many weaknesses as possible, and pricing accordingly for the extra risk

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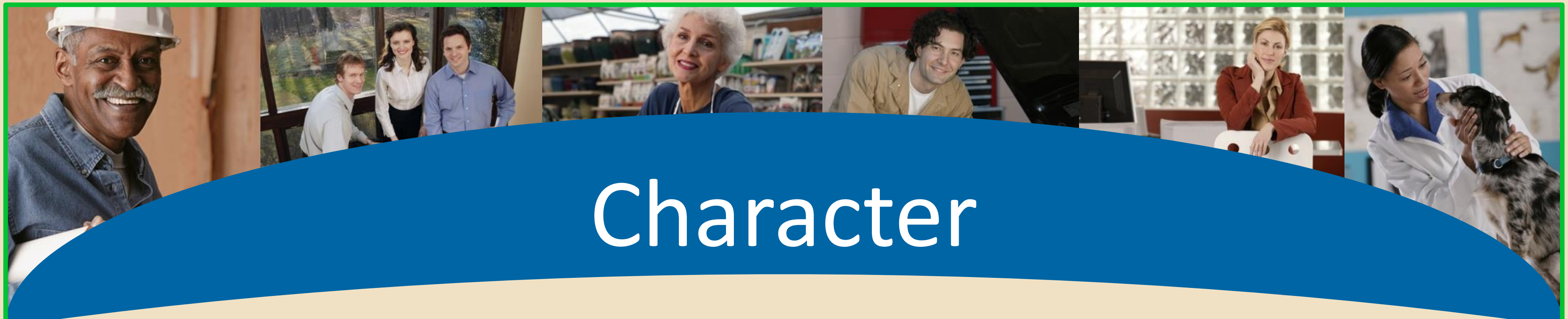

Character

A subjective measure of BOTH the borrower's willingness AND ability to repay the loan

Resources to assist in underwriting Character

- Owner/Principal(s) Personal Credit Reports
- *Bank statement analysis*
- Business Credit Reports
- UCC search with the Secretary of State
- Inquiries with suppliers and sub-contractors

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Character

- RLF lending allows for greater flexibility when analyzing a borrower's credit
- For the majority of loan requests, this will be reviewing and understanding the owners' personal credit report
- Important to be prudent and complete the proper due diligence to gain a solid understanding of the credit report

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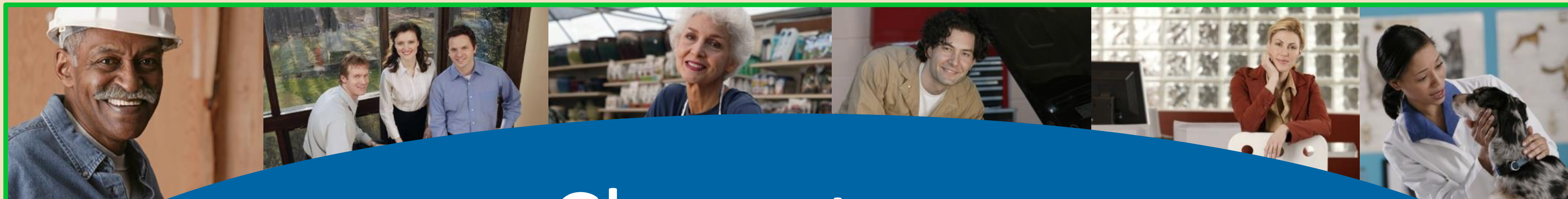

Character

It's more than just a FICO score…

- A 720 FICO or higher doesn't always mean the borrower has good credit
- A 620 FICO or lower doesn't always mean the borrower has poor or questionable credit

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Low FICO / Character Example

RLF loan to open a new restaurant

RLF Financing: $175,000 (term for FF&E and TI)

$ 50,000 (RLOC for start-up and WC)

Two Sisters partnering to open the restaurant –

Bonne 715 FICO/Credit Score

Shauna 603 FICO/Credit Score

Bankruptcy/Discharged

- Shauna has solid experience/expertise
- Together, sisters injected 20% of total project costs in cash

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Capacity

Borrower's financial capacity to repay the loan

Information needed to determine repayment ability

- Profit and loss statements
- Tax returns
- Projections
- Other outside sources of recurring income

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Capacity

- Performing a historical cash flow analysis for existing businesses
- New or start-up business, relying on projections prepared as part of the business plan
- Other verifiable sources of income
  - Salaried owner's income or a spouse's income
  - Investment income (i.e. rental or contract income)

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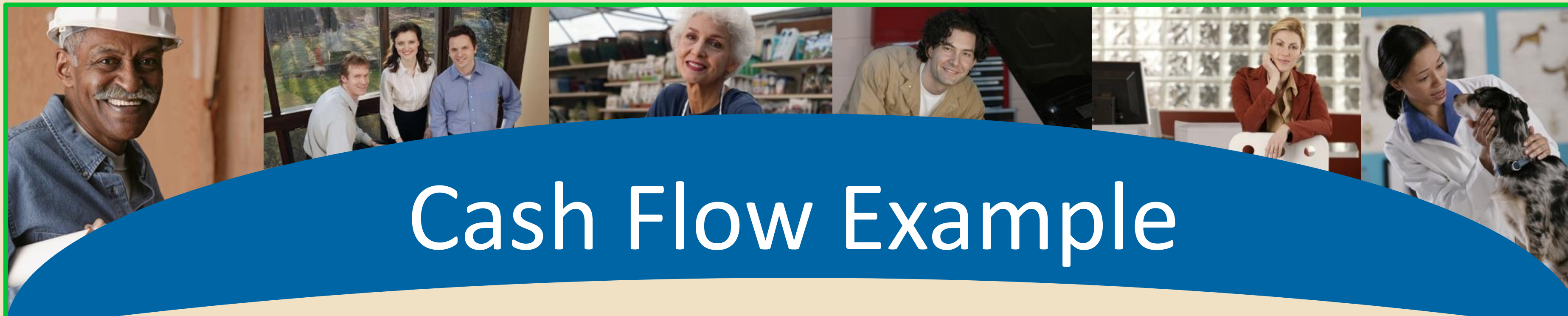

Cash Flow Example

Purchase of an existing business.

Bank Financing: $508,000

RLF Financing: $256,000

	Interim	Projections – Yr 1	Projections – Yr 2
CF	$59,900	$85,800	$89,800
DSR	(66,400)	(66,400)	(66,400)
DSC	0.90x	1.29x	1.35x

- Solid outside guarantor on this loan providing additional secondary support.

Capital

Borrower's investment in the business or project

Where to look to identify capital invested or available to invest –

- Business Balance Sheet
- Owner's Personal Financial Statement
- Business Plan

Capital

Capital can be in many different forms –

- Contributions made by owner(s) still retained in the business
- Assets owned “free and clear” that are available to pledge as security on a new loan
- Retained earnings / Net worth / Equity
- Liquid assets (cash) available to inject/invest

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Capital

This step in the underwriting process will be –

- Determining the amount of capital that needs to be invested or pledged in order for the RLF to grant the loan
- Determining the level of capital/equity necessary in order for the business to be viewed as strong enough to grant the loan to

Business Balance Sheet

Assets		Liabilities	
Current Assets	146,982	Current Liabilities	77,267
Fixed/LT Assets	664,286	LT Liabilities	725,556
Total Assets	811,268	Total Liabilities	802,823
Equity	8,445		

- Current Assets are primarily cash and inventory
- Fixed assets are primarily land, building, equipment, and goodwill (non-compete)
- Liabilities include the Bank and RLF loans
- Highly leveraged business balance sheet

Owner/Guarantor's PFS

Assets		Liabilities	
Current Assets	101,143	Current Liabilities	0
Retirement	209,100	Mortgage	197,793
Real Estate	253,038	Installment	13,103
Other	54,964		
Total Assets	618,245	Total Liabilities	210,896
Personal NW	407,349		

- Net worth is centered primarily in retirement accounts, equity in personal residence, and note receivable.
- Minimal personal debt in a mortgage and two small installment loans

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Conditions

Current economic and political conditions and how they impact the businesses' operations

Sources of information to assist with this analysis

- Industry publications
- Financial publications
- Economic forecast publications
- Google searches specific to economic conditions within industries

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Collateral

The secondary source of repayment

Resources to determine collateral and its value

- Business Balance Sheet
- Owner's Personal Financial Statement
- Purchase Orders/Invoices
- Valuation Publications
- Independent Appraiser's Opinion of Value

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Collateral

- Identify the collateral that can be used to secure the RLF loan
- Determine a fair market value for the collateral
- Determine a discounted or liquidation value for the collateral
- Assess if the discounted value is adequate as a secondary source of repayment on the loan
- Be prepared to liquidate if it's necessary

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Collateral Analysis on RLF Loan

Business Assets			
Restaurant Equipment	80,000	50%	40,000
Tenant Improvements	75,000	0%	0
Inventory	14,000	25%	3,500
Personal Vehicle	7,620	50%	3,810
Total Collateral Value			47,310
Loan Amount			225,000
Deficit			(177,690)
CCR			0.21

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The Decision Process

#1 - Not all loan requests should be approved

Observations:

- The borrower/owner(s) should ALWAYS have some "skin in the game"
- Borrower should have a realistic business plan, even if it's an existing business
- An under-funded business is almost always destined to fail

The Decision Process

- For start-ups, it's critical they've had extensive counseling and fully understand the risks
- If projection reliant, pick through the financial package with a fine tooth comb and underwrite based on worst case scenario
- Cash flow AND character will repay the loan

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Loan Characteristics

Common traits of a “good” loan:

- Borrower who has a solid understanding of the business he/she is operating (or going to operate)
- Borrower who has experience/knowledge in the industry
- Borrower with capacity to repay the loan
- Borrower with outstanding character
- Borrower who is willing to put his/her resources into the business venture
- Borrower who can provide secondary sources of repayment

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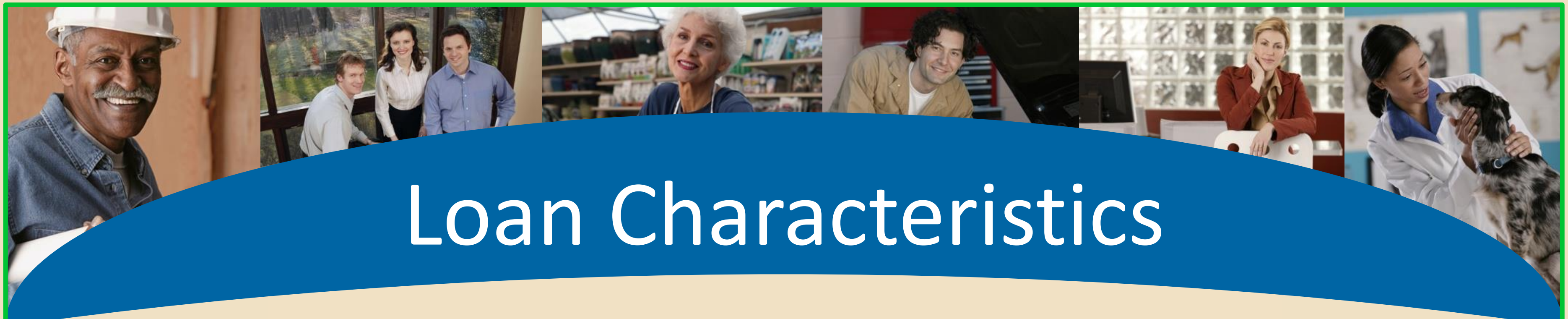

Loan Characteristics

Common traits of a “bad” loan:

- Borrower who doesn’t fully understand the industry or market in which the business is (or will be) operating in
- Borrower who doesn’t have the resources necessary for the business to succeed
- Borrower who has no tie financially to the business
- Borrower who doesn’t fully understand the ramification(s) of purchasing or starting a new business
- Borrower who doesn’t have 100% buy-in to the business plan and projections

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A BAD Loan

- When politics get involved…
- RLF funded from city proceeds.
- Managed by an independent CDC.
- CDC declines the loan.
- Owner calls the Mayor.
- Mayor tells the CDC to grant the loan.
- No personal guarantee.
- $300,000 total loss.