Mueller Prost PC
CPAs + Business Advisors

FINANCIAL LENDING NOTES

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The Pendulum Swings Back to C&I Loans

The financial crisis that began more than three years ago has changed virtually every aspect of commercial lending - from tighter credit criteria and less risk exposure on the part of banks to greater scrutiny on financial institutions by federal regulators.

For example, regulatory guidance now effectively caps the amount of capital commercial banks can invest in commercial real estate (CRE) and acquisition, development and construction loans as a percentage of total capital. As a result, many banks are now focusing on making more commercial and industrial (or C&I) loans in order to diversify their portfolios.

Back in the Game

Having been out of C&I lending for so long, however, some banks are finding it's not easy to get back in the game. Many new commercial lenders have very little (if any) experience in C&I lending, and fewer have the kind of formal credit training most lenders received a decade or two ago. And many lenders who are trained in C&I would admit that their skills have grown rusty after having focused heavily on CRE for so long.

Also, the underwriting process for C&I lending is substantially different from how underwriting is performed on other types of commercial loans.

The fact is, most community banks aren't equipped with the systems or infrastructure required to understand and control the supporting collateral of C&I loans or monitor the borrowing base. Nor do they have staff adequately trained in this level of collateral monitoring. You need lenders who know how to physically inspect and value collateral - there's more to it than just counting boxes.

If your bank is shifting its focus to C&I lending, your first step should be to make sure you don't end up making what are essentially unsecured C&I loans without even realizing it. This is what often happens when a community bank takes a blanket lien on receivables and inventory without understanding the nuances involved in monitoring this kind of collateral.

Borrower Collateral Requirements

When presenting receivables and inventory as collateral for a C&I loan, borrowers should be required to provide regular financial statements, a listing of aged receivables and payables, and a detailed summary of inventory, as well as submit to regular site inspections by the lender. Employ a borrowing base that specifies what does and does not qualify as eligible collateral; e.g., foreign receivables and receivables more than 90 days old do not qualify.

Similarly, when it comes to equipment pledged as collateral for C&I loans, you need to have a good understanding of exactly what the equipment is, its potential resale value and how easy or difficult the equipment might be to resell. For example, is the pledged equipment general purpose or special purpose?

There's an old saying that bankers shouldn't finance based on equipment that's bigger than the doors of the building - because you have to physically get the equipment out of there. Also keep in mind, depending on the building's ownership structure, owners could assert their right as landlord to deny a lender access to the property to repossess the equipment pledged as collateral if rent is delinquent.

When accepting owner-occupied real estate as collateral for C&I loans, remember that it's the cash flow from the business that should be the source of repayment for the loan. Therefore, the loan should be underwritten with the business as the primary source of repayment and the real estate as the

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secondary source, with the real estate valued as investor owned, not owner occupied.

True Asset-Based Lending

Finally, you could structure a formal asset-based lending arrangement with borrowers for C&I loans. This would involve formula-based advances on a line of credit, periodic inspections of collateral, and bank control of proceeds from receivables, which would be sent directly to a specially designated post office box or bank account controlled by the bank. Such arrangements, however, are expensive and time consuming on the part of the bank and require specialized lender expertise.

One alternative for community banks is to hire a CPA firm to provide field reviews for non-attest clients. Another is to partner with a secured lender who specializes in asset-based lending. This way, the bank can maintain the primary relationship with the customer - including retaining customer deposits and fee-based services and perhaps making other types of loans - while allowing the asset-based lender to make the C&I loan or provide assistance in monitoring the collateral.

Forging relationships now with asset-based lenders in your community could pay big dividends down the road. When looking for asset-based lenders to partner with, be sure to investigate them carefully: How long have they been in business? How well capitalized are they? What is the quality of their internal systems for monitoring collateral? How many local banks have used (or are using) them? Professional experience and adequate capitalization are especially crucial.

What's Your Value Proposition?

Portfolio diversification and regulatory guidance aside, you must offer small businesses a true value proposition if you want to gain or retain them as your customers - regardless of the kinds of loans or services you can provide.

Community banks have traditionally accomplished this by positioning themselves as a trusted advisor small business owners can go to for more than just loans and banking services, but for every aspect of small business financial management. Be sure to keep this in mind as you plan your bank's strategies for the new year.

Give us a call if you'd like to discuss your bank's lending strategies in more detail.

Spotting Financing Needs

A keen examination of your small business customers' financial statements may reveal financing needs in the not-too-distant future, which could present opportunities for new C&I loans. For example:

- Does accumulated depreciation exceed net fixed assets? If so, fixed assets will need to be replaced before long.
- Are balloon payments coming due or is debt maturing at another bank? If so, the debt may need to be refinanced.
- Is there a large accumulation of short-term debt on the balance sheet? If so, it may need to be termed out.
- Are sales and revenue rebounding? If so, the customer may be entering a growth phase and may soon need to replace fixed assets, replenish inventory, etc.
- What are the interest rate and terms on existing debt? You might be able to offer customers the opportunity to refinance at a lower rate or better terms.

How Do You Calculate Debt Service Coverage?

Debt service coverage is a critical component of loan underwriting. Given its importance, it's surprising how little uniformity there is in how debt service is calculated - not only from one bank to the next, but within the same bank.

Virtually every bank establishes a minimum debt service coverage ratio for borrowers as part of its loan policy - generally 1:2 or 1:2.5. But there are multiple ways the ratio can be calculated (see chart below for two examples).

Two Commonly Used Formulas to Calculate Minimum Debt Service Ratio

$$\frac{\text{Net Income + Depreciation \& Other Non-Cash Charges}}{\text{Interest + Current Maturities of Long-Term Debt}}$$

or

$$\frac{\text{EBITDA (Earnings Before Interest, Taxes, Depreciation \& Amortization)}}{\text{Interest + Current Maturities of Long-Term Debt}}$$

Right or Wrong?

Neither method is necessarily right or wrong, but they can lead to different results, which can lead to disagreements within the bank about whether a borrower cash flows or not. Not surprisingly, the lender will probably use the method most likely to result in getting the loan approved, while the analyst will tend to use the method that provides the most protection for the bank.

Absent guidance, new lenders you've brought on board will probably calculate debt service coverage the way they were trained to at their previous bank - which may or may not be the way you want them to.

Here are a few nuances to keep in mind with regard to calculating debt service coverage:

Remember that because EBITDA is a pre-tax measure of cash flow, the loan's principal payment should be tax-affected. To make a principal payment of $50,000, for example, a borrower will need to earn $76,000 pre-tax (at a 34 percent tax rate). Failure to tax-affect the principal payment could result in a significant overstatement of the borrower's ability to earn debt service.

For this reason, EBIDA (which doesn't factor in taxes) is often considered to be a more accurate measure of a company's ability to earn its debt service. But don't forget to subtract an estimate of distributions in lieu of taxes (e.g., 34 percent of net income) for S corps, partnerships and LLCs.

Current maturities of long term debt are considered to be principal payments due within the next 12 months. But do you use this year's or last year's current maturities?

If you are measuring compliance with loan agreements or assessing a borrower's ability to earn debt service this year, use last year's current maturities. If you're projecting a borrower's ability to earn debt service on a new loan, use this year's current maturities.

When adding back depreciation, keep in mind that borrowers will have to replace these fixed assets at some point. Therefore, you should subtract an estimate of replacement capex. If you don't, you're implying that the bank will fund replacement capex, which you may or may not be prepared to do.

When calculating debt service coverage for revolving debt and lines of credit, are you assuming the line will be paid down at some point during the year, or that it will be termed out and included in the debt service coverage calculation? If the intent is to term out the line of credit at some point, an assumed amortization of the line should be included in the debt service coverage calculation. Also, do you assume the line of credit is fully funded?

Cash *Available* For Debt Service

It's important to note that the debt service coverage ratio only measures a borrower's ability to *earn* its debt service - it doesn't address how much cash is actually available to service debt. The company could invest earnings in new receivables and inventory to support growth, for example, or the owner could take earnings as distributions to support his or her lifestyle.

This is where the Uniform Credit Analysis (UCA) cash flow statement comes into play. UCA measures how much cash is available for debt service by highlighting changes in the balance sheet that impact cash. Consider these two ways of using a UCA cash flow statement:

1. Cash After Operations – Essentially, this is EBITDA less changes in working capital. This will often be negative for a company that is growing and positive for a company in financial distress, making it very misleading.

2. Cash After Debt Amortization (CADA) – Positive CADA indicates that a company has enough internally generated cash to cover working capital requirements, operating expenses, taxes, owner distributions and debt service. Only mature companies or growing companies with large gross margins and short operating cycles usually have a positive CADA, and neither of these is typically a large borrower.

Bank management should define within its loan policy how debt service coverage will be calculated. Not doing so opens the door to disagreements, misunderstandings and inaccuracies that can derail good credits or result in problem loans.

Charge-off Recovery: Now Is the Time

One effect of the financial crisis and uneven recovery is the huge amount of loan and lease charge-offs that banks have taken against loss reserves.

The good news is that the total loan and lease charge-off rate has steadily declined since peaking at 3.04 percent in the fourth quarter of 2009 - it was down to 1.68 percent in the second quarter of 2011 (seasonally adjusted). Given this, there may be opportunities now and in the near future to recover some of the charge-offs your bank has taken over the past few years.

Keep in mind that problem borrowers are like phoenixes: They often rise from the ashes. So establishing a robust charge-off recovery operation now could pay off handsomely in the form of hundreds of thousands (if not millions) of dollars in loan recoveries. It's not unusual for banks to recover 15 percent to 25 percent of charged-off loans after a recession.

Depending on the amount of your bank's loan and lease charge-offs, you could hire someone internally who specializes in this or retain an asset recovery firm to pursue charged-off loans. In previous downturns, this type of cottage industry has emerged, and the severity of this downturn may present even more opportunities.

Some asset recovery firms buy portfolios of charged-off loans, while others take a percentage of the debt they recover. Here are two important points to keep in mind with regard to recovering charge-offs:

1. If you negotiate a charge-off as part of a debt resolution by writing down a portion of a borrower's outstanding debt, be sure to negotiate a mechanism for recovering the charged-off debt under certain circumstances in the future.

2. Recovering any portion of a charged-off loan will add to your allowance for loan and lease losses (ALLL) - even if you never make a charge to the provision for ALLL. This will bolster your capital ratio and also minimize the need for additional ALLL provisions.

For more details on recovering charge-offs, please contact our office.

Mueller Prost PC is a team of CPAs and business advisors headquartered in St. Louis. From humble beginnings on a ping-pong table in 1983, the corporation has grown into one of the leading CPA and business advisory firms in the area, operating out of two locations with more than 80 staff members. By ***Advising with Vision***®, we offer clients new and unique ways to look at their businesses. Our forward-thinking CPAs and advisors stand ready to provide depth of expertise, strategies and resources required to help clients set and achieve their goals at every stage of the business lifecycle. As a member of both the PKF North America and PKF International networks (associations of independent CPA firms), our team has the ability to leverage national and global resources when needed to benefit client engagements.

The firm offers a full range of professional tax, audit, accounting and management advisory services and collaborates with bankers and commercial lenders to meet client needs.

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