

THE ESSENTIALS OF SMALL BUSINESS UNDERWRITING

A guide to thoughtful and deliberate small business
underwriting

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Today's Presenters

Myra Girón Jordan

- **Job:** Senior Underwriter, Accion
- **History:** 10+ years community bank Credit Risk; 5+ years volunteer with Accion; 2nd year employee with Accion
- **Industry Passion:** Supporting communities and business through funding challenges
- **First Industry Gig:** Accion Volunteer – Commercial Credit Committee Member

Leslie Hoffman

- **Job:** Principal, LEH Consulting Group
- **History:** 13th year in CDFI industry, former print journalist
- **Industry Passion:** Mission-centered risk management
- **First Industry Gig:** Communications manager for Accion in Albuquerque

Agenda

- Overview of the Framework
- Step 1: Inquiry Stage
- Step 2: Information Gathering and Analysis
- The Most Important Elements of the 5 C's Model
- Resources for Further Learning

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OBJECTIVE:

- Provide a sound, step-by-step process to lead the organization from **Inquiry** to **Decision**.

Assumptions:

Risk tolerance has been identified and established.

Funding and documentation knowledge and ability is in place.

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Step 1: Inquiry Stage

Ask the right questions from the start.



In
 A
 Nutshell

SMALL BUSINESS LENDER INQUIRY GUIDE	
INQUIRY QUESTIONS	KEY ITEMS
What is the name of the business that will be using the loan funds?	BUSINESS BORROWER
What type of business is it? LLC, S-Corp, Corporation, Non-profit, Sole Proprietorship?	BORROWER BUSINESS STRUCTURE
How many owners are there? What is their ownership %?	GUARANTORS
Do you have ownership in any other businesses? Are they related to this Business Borrower and if so how?	Financial / Guarantor questions.
How long has the business been operating? If start up: • What experience do you have in this industry and what led you to decide to start your own business? If existing: • Can you give me a summary of what the business does and a brief history of how the business has evolved since you opened it?	BACKGROUND
Where does it / will it operate? Can I get the physical address?	BUSINESS ADDRESS
What amount of money are you asking for?	LOAN AMOUNT
What will the money be used for? Refinance: • who is the lender, the current loan amount, the collateral on the existing loan, and what was the initial reason for the loan? • How will this refinance help your business? New Debt: • what is the total project cost, and how much cash do you have to put toward the project? What other cash sources will be utilized to put towards the project?	LOAN PURPOSE
What assets do you or the business have to use as collateral for the loan request? Can you give me an idea of what you think the collateral is worth? what entity owns the collateral? Are any liens against the collateral right now?	COLLATERAL
Who are your main competitor/industry hurdles/favorable aspects that give you an edge over your competition?	CONDITIONS

Common Business Structures

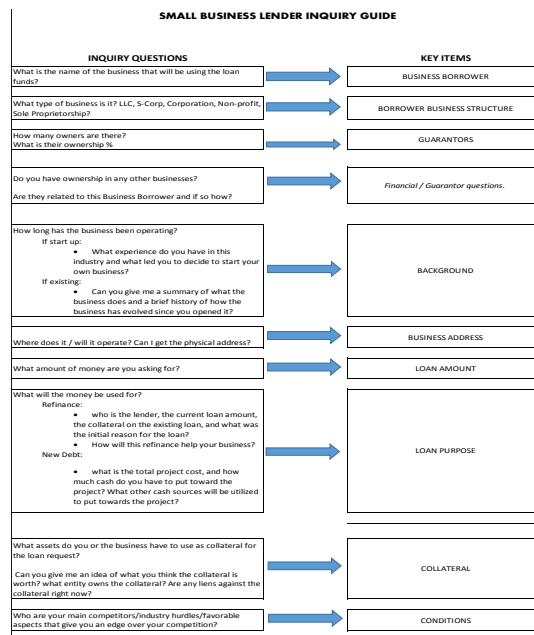
Type of Entity	Ownership	Common IRS Financial Reporting	Business Documents
Sole Proprietorship	One Person	Owner's Personal Tax Return-Schedule C	Name filing as obligated by the State
Limited Liability Company	Member(s)	Tax Return, with it's own EIN	Articles of Organization Operating Agreement Certificate of Good Standing
Non-Profit Corporation	No Direct Ownership	Form 990's or no reporting	Charter of Association Bylaws Certificate of Good Standing
Corporation or S-Corp	Shareholder(s)	Tax Return, with it's own EIN	Articles of Organization Bylaws Certificate of Good Standing

* The Lending Institution should understand what each Business Document includes, so that it can make an informed decision on whether funding without the Document is appropriate or not.



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In A Nutshell



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Loan Amount

What amount of money are you asking for?

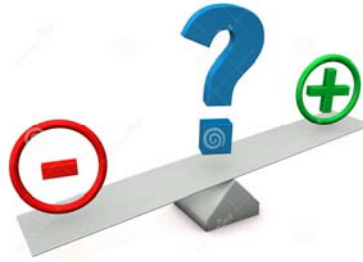


LOAN AMOUNT

The client should have a general idea of what his or her **Project** will cost, and how much of that total Project Cost he or she is asking the Lending Institution to fund. *This amount often starts off as an estimate.*



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The Lending Institution clearly defines what amount of cash is expected from the client, depending on **Loan Purpose.**

Loan Purpose (Project)

What will the money be used for? **This is the Project**

Refinance:

- who is the lender, the current loan amount, the collateral on the existing loan, and what was the initial reason for the loan?
- How will this refinance help your business?

New Debt:

- what is the total project cost, and how much cash do you have to put toward the project? What other cash sources will be utilized to put towards the project?



LOAN PURPOSE

WORD OF ADVICE

DON'T SKIP – accurately identifying the Loan Purpose / Project is crucial. A misunderstanding could lead to an inappropriate Approval or Decline.

Loan Purpose (Project) continued...

If you gathered the right information, you can fill this out, no problem:

Sources and Uses of Funds

SOURCES: what entities are funding the Project?

USES: what will the funds be used for?

Sources and Uses	Your		Owner Hard		Total
	Organizatin	Other Lender	Equity		
Description	\$0	\$0	\$0		\$0
Description	\$0	\$0	\$0		\$0
Description	\$0	\$0	\$0		\$0
Description	\$0	\$0	\$0		\$0
Total	\$0	\$0	\$0		\$0
	#DIV/0!	#DIV/0!	#DIV/0!		#DIV/0!

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Example 1: Refinance

Client is asking for a \$50K Refinance:

You asked:

- who is the lender, the current loan amount, the collateral on the existing loan, and what was the initial reason for the loan?
- How will this refinance help your business?

Client answered:

Refinance a \$50K loan from OverLend originated in 2015 for \$75,000 at 20% to provide cash flow to the Business Borrower. The refinance will reduce monthly debt payments and free up cash flow.

Original PROJECT : \$75,000 =====> *Current PROJECT : \$50,000*

****Client has paid \$25K plus interest to pay down this loan.****

SOURCES and USES Necessary? --- NOPE

Could you fill it out with the info you have?

ABSOLUTELY!!

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Example 1: Refinance

Sources and Uses	Your Org	Owner Hard Equity	Total
Refinance Overlend	\$50,000	\$25,000 plus interest	\$75,000
	67%	33%	100%

Example 2: Multiple Purposes

Client is asking for \$200K:

You asked and client answered:

Loan Purpose(s):
 Refinance \$50K OverLend loan initiated in 2015 to provide cash flow to the organization. The refinance will reduce monthly debt payments and free up cash flow.
 Provide \$100K toward the \$120K purchase of new heavy equipment. Borrower is providing \$20K toward the purchase of the equipment.
 Provide \$50K for working capital to be used for expansion costs during growth.

TOTAL PROJECT COST: \$220,000

Example 2: Multiple Purposes

Sources and Uses	Owner Hard		
	Your Institution	Equity	Total
OverLend Refinance	\$50,000	\$0	\$50,000
Working Capital	\$50,000	\$0	\$50,000
Equipment Purchase	\$100,000	\$20,000	\$120,000
Total	\$200,000	\$20,000	\$220,000
	91%	9%	100%

COLLATERAL

What assets do you or the business have to use as collateral for the loan request?

Can you give me an idea of what you think the collateral is worth? what entity owns the collateral? Are any liens against the collateral right now?



COLLATERAL

Really – what assets will the client pledge if all else fails?

Note: Prudent lenders rely on Primary and Secondary sources of repayment for loan decisions, NOT Collateral value.

Valuation

Underwriting Policies outline how the institution will value collateral, based on:

Type – what is it?

Age – how old is it?

Value Retention – how long does it hold value?

Ability to Resell – is it unique or are there many buyers for this asset?

Step 2: Information Gathering and Analysis

NOW WHAT?

Understand what you are trying to do ---

Gather information –

THEN

Build the story –

THEN

Make a decision.



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Gather the Right Info-Get the Right Story

Personal Cash Flow Documents

- Tax Returns
- Paystubs
- Bank Statement
- Credit Report

Business Cash Flow Documents

- Tax Returns
- Financial Statements (Balance Sheets and Income Statements)
- Bank Statements
- Debt Schedule

Exact Value of Collateral – usually post approval/pre-funding

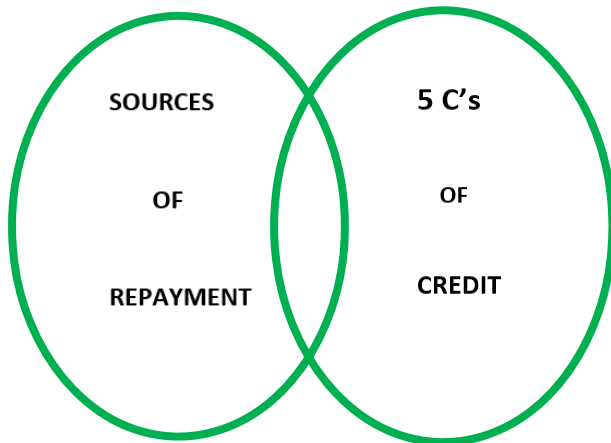
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Key Analytical Factors

KEEP YOUR EYE ON THE PRIZE

Confusion can creep in – DON'T LET IT



Continually ask yourself:

What are the Sources of Repayment

and

How strong are the 5 C's of Credit factors?

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What are the 5 C's of Credit?

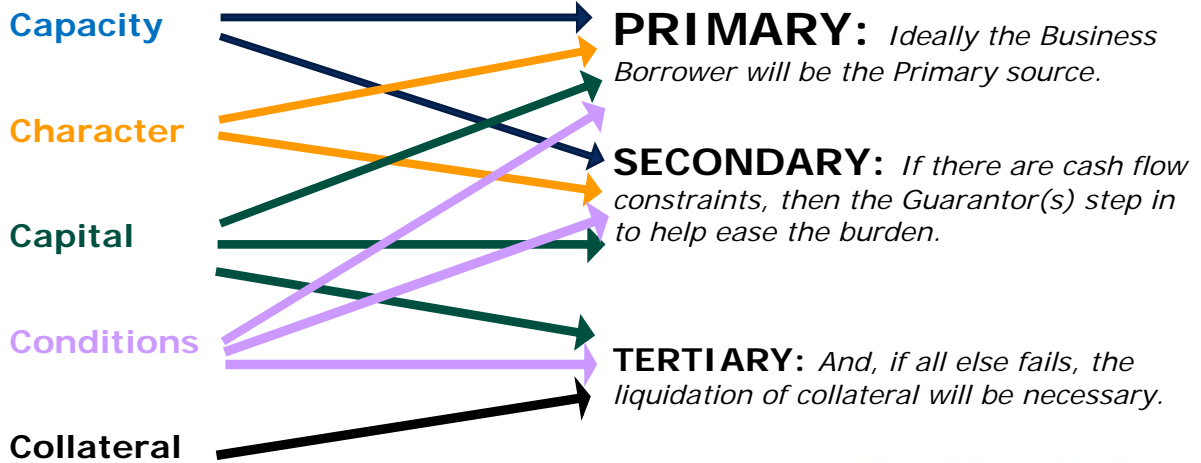
"It's a system used by Underwriters to gauge the creditworthiness of potential borrowers. It weighs 5 characteristics of the borrower / guarantor, all to attempt to estimate the chance of default." - Investopedia



"OKAY, HOW WERE YOU PLANNING TO REPAY THE LOAN ASSUMING YOU DON'T WIN THE WORLD SERIES OF POKER?"

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Sources of Repayment – *how will you get repaid?*



PRIMARY: *Ideally the Business Borrower will be the Primary source.*

SECONDARY: *If there are cash flow constraints, then the Guarantor(s) step in to help ease the burden.*

TERTIARY: *And, if all else fails, the liquidation of collateral will be necessary.*

Notice that Collateral only has one arrow? Hmm.



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The C...

Measures...

Character



Reputation for repaying debts.

Obtained from...



Credit Report & Background Key Item

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The C...
Capital

Measures...



*Cash the client will
or has put toward
the project.*

Obtained from...



*Loan Purpose Key
Item*

The C...
Collateral

Measures...



*Asset(s) the client
offers as
repayment if all
else fails.*

Obtained from...



Collateral Key Item



7(a) Community Advantage Program

Requirements:

Prudent Underwriting is practiced.

Purpose: Mitigate a Collateral weakness.

NOT a mitigant for Primary and Secondary repayment sources

Obtain the RIGHT information

Analyze 5 C's appropriately

Come to a logical Approval decision

SBA CA Guarantee Approval is likely

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7(a) Community Advantage Program

Loan Amount at Write Off

minus (-)

Funds Received from Liquidation of Collateral

NET LOAN AMOUNT

multiplied by (X)

SBA Guarantee %

SBA Guarantee Payout \$\$

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Collateral Valuation Exercise

Here is what you know:

You have a loan request for \$150K to purchase a restaurant.

Your borrower is providing \$20K toward the purchase.

Furniture, fixtures and equipment have been margined at \$20K.

SBA 7(A) provides an 85% guarantee.

What is the estimated collateral coverage?

What is the total exposure to the organization in the event of default?

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The C...

Conditions

Measures...

Economic /
internal factors
that impact or will
impact the
borrower's overall
health.

Remember SWOT

Obtained from...

*Background &
Conditions Key
Items*

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The C...

Capacity

Measures...

*Clients' ability to
repay the loan.*

Obtained from...

Financial documents

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Capacity

Definition: Measures a borrower's/guarantor's ability to repay a loan by comparing cash flow against recurring debt obligations and assessing the borrower's/guarantor's ability to service the recurring debt.

MANY DIFFERENT RATIOS TO ANSWER THIS

----- FOCUS -----

Traditional (or Free) Cash Flow Method

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Traditional (or Free) Cash Flow Method

Simple Calculation – Business:

Business Borrower Net Income
 + Interest Expense
 + Depreciation Expense
+/- Non-Recurring Expenses / Income
Free Cash Flow Available [EBIDA]
- Cash Distributions / + Cash Contributions
Business Cash Available to Service Debt Payments (among other things)
- Business Debt Service
Excess Business Cash Flow

$$\text{Business Debt Coverage Ratio} = \frac{\text{Business Cash Available to Service Debt}}{\text{Business Debt Service}}$$

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Traditional (or Free) Cash Flow Method

Simple Calculation – Personal

Personal Cash income from TR (recurring)
 + Cash Distributions/(Contributions) to Closely Held Companies
 - Tax Obligations/ Other from TR
- Estimated Living Expenses
Personal Cash Available to Service Debt
- Personal Debt Service from PFS and Credit Report
 Net Cash After Debt

$$\text{Personal DSCR} = \frac{\text{Personal Cash Available to Service Debt}}{\text{Personal Debt Service from PFS and Credit Report}}$$

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Traditional (or Free) Cash Flow Method

Simple Calculation – Combined / Global Cash Flow Analysis

Business Cash Available to Service Debt
+
Personal Cash Available to Service Debt

Business Debt Service
+
Personal Debt Service

COMBINED CASH AVAILABLE ÷ COMBINED DEBT SERVICE



COMBINED DEBT COVERAGE RATIO

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Now let's try this!



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Traditional (or Free) Cash Flow Method

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Excess Business Cash Flow

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Chance of Default



Fits within the institution's risk appetite?



YES!!!!



Cash Flow and Underwriting Resources

- Rex Beach Shockproof Trainings - <https://www.shockproof.biz/>
Shockproof! Training provides a full range of commercial credit training, delivered via traditional classroom, self-study, online, or blended classroom and online formats.
- RMA CRC - <http://landing.rmahq.org/CRC>
The CRC program is developed and overseen by the CRC Council and several committees with specific operating responsibilities—i.e., leading credit risk practitioners govern all aspects of the credential, from the questions included in the exam to eligibility requirements. The CRC Exam benchmarks your knowledge of the major areas of credit risk analysis as they relate to the underwriting of a commercial borrower and guarantor.

SBA CA Reference Material

- SBA Community Advantage Participant Guide - <https://www.sba.gov/sites/default/files/files/CA-Participant-Guide-4-December-28-2015.pdf>
The Participant Guide covers all aspects of the CA Program, from how to become a CA approved lender, to how to submit a loan request and how to keep the Guarantee in place.
- SBA Standard Operating Procedures
https://www.sba.gov/sites/default/files/sops/SOP_50_10_5_1_FINAL_Clean_Highlighted_Changes.pdf
The most current SOP which provides a more comprehensive explanation than the Participant Guide.



Thank you!

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