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:** 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

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.
Ask the right questions from the start.

In A Nutshell

SMALL BUSINESS LENDER INQUIRY GUIDE

Inquiry Questions

- Ask the right questions from the start.
- Step 1: Inquiry Stage
- Small business lenders inquiring guide
- In A Nutshell
- Small business lender inquiry guide
**Common Business Structures**

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

* 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**

**KEY ITEMS**

**BUSINESS BORROWER**

1. **How many owners are there?**
   - 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?

2. **Business Address**

3. **Loan Amount**
   - 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 do you have to put toward the project? What other cash sources will be utilized to put towards the project?

4. **Guarantors**

5. **Collateral**
   - What assets do you or the business have to use as collateral for the loan?
   - Can you give me an idea of what you think the collateral is worth, and what was the reason for the valuation?
   - How will this collateral help your business?

6. **Conditions**
   - Are they related to this Business Borrower and if so how?
   - Financial/Guarantor questions.

**FINANCIAL/BUSINESS INQUIRY GUIDE**

<table>
<thead>
<tr>
<th>INQUIRY QUESTIONS</th>
<th>KEY ITEMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who are they?</td>
<td>BUSINESS BORROWER</td>
</tr>
<tr>
<td>Who are they related to?</td>
<td>BUSINESS BORROWER</td>
</tr>
<tr>
<td>Are they related to this Business Borrower and if so how?</td>
<td>BUSINESS BORROWER</td>
</tr>
<tr>
<td>Financial/Guarantor questions.</td>
<td></td>
</tr>
</tbody>
</table>
Loan Amount

What amount of money are you asking for?  

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.*

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

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**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?

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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?

<table>
<thead>
<tr>
<th>Sources and Uses</th>
<th>Your Organization</th>
<th>Other Lender</th>
<th>Owner Hard Equity</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Description</td>
<td>$0</td>
<td>$0</td>
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<td>Description</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$0</strong></td>
<td><strong>$0</strong></td>
<td><strong>$0</strong></td>
<td><strong>$0</strong></td>
</tr>
</tbody>
</table>

**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.**

Could you fill it out with the info you have? **ABSOLUTELY!!**
Example 1: Refinance

<table>
<thead>
<tr>
<th>Sources and Uses</th>
<th>Owner Hard Equity Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refinance OverLend</td>
<td>$50,000 $25,000 $75,000</td>
</tr>
<tr>
<td>Plus interest</td>
<td></td>
</tr>
<tr>
<td></td>
<td>67% 33% 100%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Sources and Uses</th>
<th>Your Institution</th>
<th>Equity</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>OverLend Refinance</td>
<td>$50,000</td>
<td>$0</td>
<td>$50,000</td>
</tr>
<tr>
<td>Working Capital</td>
<td>$50,000</td>
<td>$0</td>
<td>$50,000</td>
</tr>
<tr>
<td>Equipment Purchase</td>
<td>$100,000</td>
<td>$20,000</td>
<td>$120,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$200,000</strong></td>
<td><strong>$20,000</strong></td>
<td><strong>$220,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Owner Hardness</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>91%</td>
<td>100%</td>
</tr>
</tbody>
</table>

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### 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?

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.

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
**Key Analytical Factors**

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
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? Hmmm.

The C…

Character Measures...

Reputation for repaying debts. Obtained from...

Credit Report & Background Key Item
The C... Measures...

**Capital**

Cash the client will or has put toward the project.

Obtained from...

**Loan Purpose Key Item**

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The C... Measures...

**Collateral**

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

Obtained from...

**Collateral Key Item**
7(a) Community Advantage Program

**Purpose:** Mitigate a Collateral weakness.

**NOT a mitigant for Primary and Secondary repayment sources**

*Requirements:
Prudent Underwriting is practiced.*

**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 $$*
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?

The C…

**Conditions**

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

*Remember SWOT*

Obtained from…

Background & Conditions Key Items
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
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

Business Debt Coverage Ratio = Business Cash Available to Service Debt
÷ Business Debt Service

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

Personal DSCR = Personal Cash Available to Service Debt
÷ Personal Debt Service from PFS and Credit Report
Traditional (or Free) Cash Flow Method

Simple Calculation – Combined / Global Cash Flow Analysis

\[
\text{Business Cash Available to Service Debt} + \text{Business Debt Service} + \text{Personal Cash Available to Service Debt} + \text{Personal Debt Service}
\]

\[
\frac{\text{COMBINED CASH AVAILABLE}}{\text{COMBINED DEBT SERVICE}} = \text{COMBINED DEBT COVERAGE RATIO}
\]

Now let’s try this!
Traditional (or Free) Cash Flow Method

Simple Calculation – Business:

Business Borrower Net Income
+ Interest Expense
+ Depreciation Expense
+/- Non-Recurring Expenses / Income

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Business Debt Service

Excess Business Cash Flow

Business Debt Coverage Ratio = \frac{\text{Business Cash Available to Service Debt}}{\text{Business Debt Service}}
**Chance of Default**

 Fits within the institution’s risk appetite?  **YES!!!!!**

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**Cash Flow and Underwriting Resources**

- **Rex Beach Shockproof Trainings** - [https://www.shockproof.biz/](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](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**

  
  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](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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