Small Business Lending 101

Agenda

- Introduction
- Lending Lifecycle
- Portfolio Management
- Questions
Who is new to Small Business Lending?

- CDFIs with expertise in other areas
  - Housing
  - Community Facilities
  - Commercial Real Estate
  - Microfinance
- CDCs
- 504 Lenders
- Technical Assistance Providers
- Business Incubators
- Community Development/Economic Development organizations

Small Business Lending Comparison

<table>
<thead>
<tr>
<th>Primary Financing Sector</th>
<th>Borrowed Funds Average Interest Rate (%)</th>
<th>Average Interest Rate Charged (%)</th>
<th>Average Term (in months)</th>
<th>90+ Delinquency Ratio</th>
<th>Net Charge off Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business</td>
<td>3.0%</td>
<td>6.8%</td>
<td>88</td>
<td>6.0%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Commercial Real Estate</td>
<td>3.7%</td>
<td>6.8%</td>
<td>66</td>
<td>4.0%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Community Facilities</td>
<td>2.4%</td>
<td>6.3%</td>
<td>70</td>
<td>5.8%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Housing to Individuals</td>
<td>2.7%</td>
<td>6.0%</td>
<td>206</td>
<td>4.5%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Housing to Organizations</td>
<td>2.5%</td>
<td>5.5%</td>
<td>87</td>
<td>3.4%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Microenterprise</td>
<td>2.0%</td>
<td>9.3%</td>
<td>51</td>
<td>4.5%</td>
<td>10.3%</td>
</tr>
<tr>
<td>Totals</td>
<td>2.7%</td>
<td>6.4%</td>
<td>91</td>
<td>4.0%</td>
<td>3.2%</td>
</tr>
</tbody>
</table>

- Riskier lending than most sectors
- About the same spread as the average
- Execution is critical to success

Source: OFN 2010 Member Data
Look at the Lending Lifecycle

- Loan Origination
- Loan Approval
- Loan Servicing
- Portfolio Mgmt
- Underwriting
- Loan Closing
- Troubled Loan Mgmt

Support Functions of Lending

- Loan Origination
- Loan Approval
- Loan Servicing
- Portfolio Mgmt
- Underwriting
- Loan Closing
- Troubled Loan Mgmt

MIS and Technology
Organizational Structure/ Staffing/ Professional Development
Reporting
Quality Control
Productivity
**Before you start lending…..**

- How does Small Business Lending fit with your mission?
- Who is your target market?
- Who are eligible borrowers?
- What are eligible uses (and ineligible)?
- What loan products will you offer?
- Establish clear staff roles & responsibilities

**Loan Origination**

- Variety of sales channels
- Vetting checklist or pre-application:
  - Industry
  - Eligibility
  - Underwriting criteria
  - Fit for loan program or source of funding
- Meet borrower and visit the business
- **Expect only 20-30% of inquiries to result in completed applications**
- Recommend appropriate Technical Assistance
Underwriting

- Decentralized or centralized underwriting
- Credit analysis to evaluate/rate risk:
  - Earnings
  - Cash Flow
  - Asset Quality
  - Leverage
  - Management
  - Guarantors
  - Collateral
  - Industry/Market/Competition
  - Financial Reporting
- Determine how to work with borrowers with challenges

<table>
<thead>
<tr>
<th>Operating Margin/Cash Flow</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt service coverage (DSC) calculations are based on 12 months of historical financial information or projections that include our loan using EBITDA and D10 of all lines processes.</td>
<td>20.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance Sheet: Tangible Net Worth</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Based on the profile after our loan [lies]</td>
<td>12.5%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance Sheet: Working Capital</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Based on the profile after our loan lines)</td>
<td>12.5%</td>
</tr>
</tbody>
</table>

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<tr>
<th>Management/credit history: highest score of principal(s)</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>(To choose rating – all of descriptor must be true)</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Collateral/secondary source of repayment collateral analysis</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan to value (LTV) = total loans (including our loan) / collateral value.</td>
<td>15.0%</td>
</tr>
</tbody>
</table>
Loan Approval/ Closing

- Internal Loan Committee/Board Loan Committee
- **Expect 75-90% approval rates due to prior vetting**
- Ensuring the guarantee is critical – quality control and compliance are core competencies
- 10-15% of approvals may fail to close due to changing circumstances of borrower

Loan Servicing

- Must balance three critical components:
  - Is the borrower meeting their obligations?
  - Is the viability of their business on track?
  - Are we maintaining our collateral/guarantee?

- Important administrative function
  - Staff and technology
- Relationship with the borrower
  - On-going support, with Technical Assistance
**Loan Servicing - ongoing risk rating**

- Risk rate annually, at a minimum
- Evaluate more frequently for riskier credits
- Monitor larger trends related to:
  - Industries
  - Geographies
  - Loan types
  - Originators
  - Borrowers with more than one loan

**Troubled Loan Management**

- Clear delinquency processes
- Defined non-accrual/watch/write-off policies
- Troubled Loans/Watch List reviewed by management and board
- Write-off according to policy, but keep engaging the borrower
- Know how and when to exercise applicable guarantees
Portfolio Management

- Essential tool of risk management
  - Concentration risk; Migration of risk in the portfolio
  - Board and senior management priority
- Customize concentration analysis to size, complexity, mission, and investor restrictions of the lender

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<tr>
<th>Industry</th>
<th>Geography</th>
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<tr>
<td>Market Served</td>
<td>Lending Product</td>
</tr>
<tr>
<td>Security</td>
<td>Family of Borrowers</td>
</tr>
<tr>
<td>Asset Size of Borrower</td>
<td>Loan Size</td>
</tr>
</tbody>
</table>
Conclusion

Questions

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