Commercial & Industrial (C&I) Lending in Today's Competitive Market

Author/Lecturer

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I. <u>Introduction: Commercial & Industrial (C&I) Lending</u>

<u>C&I Lending Defined</u>:

Any type of loan made to a <u>business</u> or <u>corporation</u> and not to an individual. Commercial and industrial loans can be made in order to provide either <u>working capital</u> or to <u>finance major capital expenditures</u> (such as equipment).This type of loan is usually <u>short-term</u> in nature and is almost always backed with some sort of collateral.

Renewed emphasis on C&I Lending versus Commercial Real Estate Lending due to changes in the Commercial Real Estate market.

Change of Supply & Demand for Commercial Real Estate Loans

Change of attitude of Banking Regulators- FED, FDIC, OCC, State

Shift Back to Original Banking Roots!

II. Commercial & Industrial (C&I) Loan Products & Structure

a) Working Capital Line of Credit: 12 months, interest only

b) ABL Facility: 12 months, interest only

An asset based business line of credit is usually designed for the same purpose as a normal business line of credit - to allow the company to bridge itself between the timing of cash flows of payments it receives and expenses.

A non asset based line of credit will have a credit limit set on account opening by the accounts receivables size, to ensure that it is used for the correct purpose. An asset based line of credit however, will generally have a revolving credit limit that fluctuates based on the "actual" accounts receivables balances that the company has on an ongoing basis. This requires the lender to monitor and audit the company to evaluate the accounts receivables size, but also allows for larger limit lines of credits, and can allow companies to borrow that normally would not be able to.

Generally, terms stipulating seizure of collateral in the event of default allow the lender to profitably collect the money owed to the company should the company default on its obligations to the lender.

c) Other Financing: Factoring

c) <u>Equipment Financing</u>:

1. Loans: 3, 5, 7, 10 year amortization
2. Leases: 3, 5, 7, 10 year amortization

Note Payable (regular promissory note)

TRAC Lease

This lease contains a Terminal Rental Adjustment Clause (TRAC) that guarantees your business a certain residual price for the vehicle when the lease expires. This is the most common type of lease for business owners who want the option of buying the vehicle for a pre-determined price at the end of the lease.

"True" Lease

Leasing commercial equipment with a True Lease or Tax Lease means you will not have legal ownership of equipment, but will have use of such equipment for the term defined in the lease. If the equipment you need is subject to rapid advancements in technology, such as computers, the Tax Lease/True Lease is could be the best option. Financing commercial equipment with this lease option can mean lower monthly payments and in many cases tax deductions for lease payment amounts. (Lessor often retains "depreciation" rights).

d) <u>Related Products & Structure</u>

1. Letters of Credit (“carve out” of RLC)

    a. Standby

    b. Commercial

2. Bridge/Bullet Loan

3. Seasonal Loan

III. Underwriting C&I Loans

a) Credit Scoring

b) Full-Underwriting

1. **Basic Underwriting: Loan Purpose, Loan Amount, Sources of Repayment, Guarantor Support, Collateral Issues, Management Assessment, Risk Factors & Mitigation of Risk**

2. **Financial Statement Analysis**

3. **Tax Return Analysis**

c) SBA Guarantee (See attached Exhibit # 1)

IV. Accounts Receivable & Inventory Assessment and the Borrowing Base Certificate (BBC)

BBC Defined:

Borrowing base **is the total amount of collateral against which a lender will lend funds to a business. This typically involves multiplying a discount factor by each type of asset used as collateral.**

For example: *Accounts receivable*. 60% to 80% of accounts receivable less than 90 days old may be accepted as a borrowing base. *Inventory*. 50% of finished goods inventory may be accepted as a borrowing base. It is also common for a lender to only use the accounts receivable of a borrower as collateral - it may not accept *any* inventory as part of the borrowing base.

As an example of a borrowing base, ABC International applies for a line of credit. ABC has $100,000 of accounts receivable and $40,000 of finished goods inventory. The lender allows 70% of the accounts receivable and 50% of the inventory as the relevant borrowing base, which means that ABC can borrow a maximum of $90,000 (calculated as $70,000 of accounts receivable and $20,000 of inventory) against its collateral.

IV. Accounts Receivable & Inventory Assessment and the Borrowing Base Certificate (BBC) (Continued):

a) Formula Based:

1. Ineligible A/R

2. Advance Rate

b) Timing: Monthly, Quarterly, Per Advance

c) Basic BBC Example: (See Attached Exhibit # 2)

d) Advanced BBC Example: (See Attached Exhibit # 3)

e) Monitoring: Loan Officer vs. Annual Audit (Time, Costs, Actual Work, etc.)

V. Accounts Receivable Issues

a) General Source & Quality of the A/Rs?

b) Are Governmental A/Rs Always Strong? Collectability? Timing?

c) How Do You Measure the Risk of the Individual A/Rs?

d) Does the Borrower ever "Re-bill" or Make Adjustments to its A/Rs? What about the "Hidden" 30 Day Period?

e) Does the Borrower Use the "Direct Write-Off" Method or the "Allowance Method" for Managing Bad Debt?

VI. Valuation and Quality of Inventory (including Inventory Costing System)

a) Raw Material, Work-In-Process or Finished Goods Inventory?

b) Inventory Costing System (Timing):

FIFO

LIFO

Average

c) Age/Quality of Inventory

d) Site Visit

VII. <u>Equipment Issues in Lending (including Depreciation)</u>

a) Quality/Age of Equipment

b) Value of Equipment (How do you determine the FMV of the equipment?)

c) <u>Depreciation Methods</u>:

1. Straight-Line

2. Units-Of-Production

3. Double Declining Balance

4. Modified Accelerated Cost Recovery System (MACRS)

d) <u>Other Depreciation Issues</u>:

1. Section 179 Depreciation (Form 4562)

2 Bonus Depreciation

VIII. Evaluation of the Financial Statements:

a) Types of Financial Statements:

Four Basic Financial Statements (See attached Exhibit # 4)

1. Income Statement

2. Statement of Retained Earnings (Owner's Equity)

3. Balance Sheet

4. Statement of Cash Flows

a) <u>Types of Financial Statements (Continued)</u>:

<u>Audit</u>

a. Unqualified Audit (including <u>Notes</u> to the F/S i.e. Assessment of A/Rs, Inventory & FF&E)

b. Qualified Audit

c. Adverse

d. Disclaimer

<u>Other</u>

a. Reviewed

b. Compiled

c. Company prepared

VIII. Evaluation of the Financial Statements (Continued):

b) The Five Step Analysis Model

1. Liquidity

2. Activity

3. Leverage

4. Operating Performance

5. Cash Flow

1. **<u>Liquidity</u>:**

Working Capital: Current Assets-Current Liabilities

Current Ratio: Current Assets/Current Liabilities

Quick (Acid) Test Ratio: $\dfrac{\textbf{Current Assets-Inventory}}{\textbf{Current Liabilities}}$

2. **<u>Activity</u>:**

Accounts Receivable Turnover: A/R/Sales X Days in Period

Accounts Payable Turnover: A/P/COGS X Days in the Period

Inventory Turnover: Inventory/COGS X Days in the Period

<u>Related Concept</u>: Cash Conversion Cycle

3. Leverage:

Debt to Equity (Net Worth)

4. Operating Performance:

Net sales	**$5,000,000**	**(100%)**
COGS	**4,400,000**	**(88%)**
Gross Profit	**$600,000**	**(12%)**
G & A Expense	**350,000**	**(7%)**
Net Profit	**$250,000**	**(5%)**

5. <u>Cash Flow</u>:

<u>Traditional Cash Flow</u>

EBITDA	**$1,200M**
Less: Debt Service (P&I)	**<u>500M</u>**
Margin	**$700M**
DCR	**2.4X**

(EBITDA = Net Profit + Interest Expense + Taxes + Depreciation + Amortization)

Sample Contractor, LLC (SampleCont)
Industry Classification: SIC Code:
Balance Sheet - Actual

Prepared: 10:34, 3/30/2011
Page 1
Thousands
CONTR Version D

Statement Date	12/31/2008	12/31/2009	12/31/2010	1/31/2011
Months Covered	12	12	12	1
Audit Method	Compiled	Co.Prep'd	Co.Prep'd	Co.Prep'd
Accountant				
Analyst	D. Osburn	D. Osburn	D. Osburn	D. Osb...
Stmt Type	Annual	Annual	Annual	FY-To-...
CURRENT ASSETS				
Cash-Unrestricted	35	52	28	60
Accts Rec-Progress Billings	111	102	52	68
Supplies	1	1	-	-
Costs In Excess of Billings	14	45	30	48
Prepaids/Deferreds - CP	11	10	10	10
Operating Current Assets	-	-	1	1
TOTAL CURRENT ASSETS	172	210	121	187
NON-CURRENT ASSETS				
Machinery & Equipment	8	8	8	8
Accumulated Deprec (-)	7	7	7	7
Total Fixed Assets - Net	1	1	1	1
TOTAL NON-CURRENT ASSETS	1	1	1	1
TOTAL ASSETS	173	211	122	188
CURRENT LIABILITIES				
ST Loans Payable-Bank	-	82	65	105
Accounts Pay-Subcontractor	5	60	65	68
Interest Payable	-	-	2	2
Other Accruals	-	2	2	3
Total Accrued Liabilities	-	2	4	5
Billings In Excess of Costs	30	120	22	28
TOTAL CURRENT LIABILITIES	35	264	156	206
NON-CURRENT LIABILITIES				
Long Term Debt-Bank	50	-	-	-
Long Term Debt-Framecon	248	248	248	248
Due to Officers/Stkhldrs	64	64	65	65
TOTAL NON-CURRENT LIABS	362	312	313	313
TOTAL LIABILITIES	397	576	469	519
NET WORTH				
Retained Earnings	(224)	(365)	(347)	(331)
TOTAL NET WORTH	(224)	(365)	(347)	(331)
TOTAL LIABS & NET WORTH	173	211	122	188

Sample Contractor, LLC (SampleCont)
Industry Classification: SIC Code:
Income Statement - Actual

Prepared: 10:34, 3/30/2011

Thousands
CONTR Version D

Statement Date	12/31/2008	12/31/2009	12/31/2010	1/31/2011
Months Covered	12	12	12	1
Audit Method	Compiled	Co.Prep'd	Co.Prep'd	Co.Prep'd
Accountant				
Analyst	D. Osburn	D. Osburn	D. Osburn	D. Osb...
Stmt Type	Annual	Annual	Annual	FY-To-...
Contract Revenue	1,091	906	1,412	118
Contract Costs	874	712	1,041	77
GROSS PROFIT	217	194	371	41
General & Admin Expense	194	159	125	10
Officers' Compensation	129	170	188	15
Lease/Rent Expense	-	-	5	-
Depreciation	2	-	-	-
Bad Debt Expense	6	-	6	-
TOTAL OPERATING EXP(INC)	331	329	324	25
NET OPERATING PROFIT	(114)	(135)	47	16
Interest Expense	2	6	6	-
NET PROFIT	(116)	(141)	41	16

Sample Contractor, LLC (SampleCont)
Industry Classification: SIC Code:
Income Statement - Actual and %

Prepared: 10:34, 3/30/2011
Page 3
Thousands
CONTR Version D

Statement Date	12/31/2008		12/31/2009		12/31/2010		1/31/2011	
Months Covered	12		12		12		1	
Audit Method	Compiled		Co.Prep'd		Co.Prep'd		Co.Prep'd	
Accountant								
Analyst	D. Osburn		D. Osburn		D. Osburn		D. Osb...	
Stmt Type	Annual		Annual		Annual		FY-To-...	
Contract Revenue	1,091	100.0	906	100.0	1,412	100.0	118	100.0
Contract Costs	874	80.1	712	78.6	1,041	73.7	77	65.3
GROSS PROFIT	217	19.9	194	21.4	371	26.3	41	34.7
General & Admin Expense	194	17.8	159	17.5	125	8.9	10	8.5
Officers' Compensation	129	11.8	170	18.8	188	13.3	15	12.7
Lease/Rent Expense	-	-	-	-	5	0.4	-	-
Depreciation	2	0.2	-	-	-	-	-	-
Bad Debt Expense	6	0.5	-	-	6	0.4	-	-
TOTAL OPERATING EXP(INC)	331	30.3	329	36.3	324	22.9	25	21.2
NET OPERATING PROFIT	(114)	(10.4)	(135)	(14.9)	47	3.3	16	13.6
Interest Expense	2	0.2	6	0.7	6	0.4	-	-
NET PROFIT	(116)	(10.6)	(141)	(15.6)	41	2.9	16	13.6

Sample Contractor, LLC (SampleCont)
Industry Classification: SIC Code:
UCA Cash Flow

Prepared: 10:34, 3/30/2011
Page 4
Thousands
CONTR Version D

Statement Date	12/31/2008	12/31/2009	12/31/2010	1/31/2011
Months Covered	12	12	12	1
Analyst	D. Osburn	D. Osburn	D. Osburn	D. Osb...
Stmt Type	Annual	Annual	Annual	FY-To-...
Contract Revenue		906	1,412	118
Chg in Accts Rec-Progress Billings		9	50	(16)
Cash Revenue		915	1,462	102
Contract Costs		(712)	(1,041)	(77)
Chg in Supplies		-	1	-
Chg in Accounts Pay-Subcontractor		55	5	3
Cash Purchases		(657)	(1,035)	(74)
GROSS CASH PROFIT		258	427	28
General & Admin Expense		(159)	(125)	(10)
Officers' Compensation		(170)	(188)	(15)
Lease/Rent Expense		-	(5)	-
Bad Debt Expense		-	(6)	-
Chg in Prepaids/Deferreds - CP		1	-	-
Chg in Costs In Excess of Billings		(31)	15	(18)
Chg in Billings In Excess of Costs		90	(98)	6
Chg in Other Accruals		2	-	1
Cash Paid for Operating Costs		(267)	(407)	(36)
CASH AFTER OPERATIONS		(9)	20	(8)
Chg in Operating Current Assets		-	(1)	-
Other Income (Expense) & Taxes Paid		-	(1)	-
NET CASH AFTER OPERATIONS		(9)	19	(8)
NET CASH AFTER OPERATIONS		(9)	19	(8)
Interest Expense		(6)	(6)	-
Chg in Interest Payable		-	2	-
Cash Paid for Dividends & Interest		(6)	(4)	-
CASH AFTER FINANCING COSTS		(15)	15	(8)
Current Portion Long Term Debt		-	-	-
CASH AFTER DEBT AMORTIZATION		(15)	15	(8)
Cash Paid for Plant and Investments		-	-	-
FINANCING SURPLUS (REQUIREMENTS)		(15)	15	(8)
Chg in ST Loans Payable-Bank		82	(17)	40
Chg in Long Term Debt		(50)	-	-
Chg in Due to Officers/Stkhldrs		-	1	-
Chg in Capital(Less Non-Cash Inc)		-	(23)	-
Total External Financing		32	(39)	40
CASH AFTER FINANCING		17	(24)	32
Add:				
Cash-Unrestricted		35	52	28
ENDING CASH & EQUIVALENTS		52	28	60

Sample Contractor, LLC (SampleCont)
Industry Classification: SIC Code:
Ratios

Statement Date	12/31/2008	12/31/2009	12/31/2010	1/31/2011
Months Covered	12	12	12	1
Analyst	D. Osburn	D. Osburn	D. Osburn	D. Osb...
Stmt Type	Annual	Annual	Annual	FY-To-...
LIQUIDITY				
Working Capital	137	(54)	(35)	(19)
Quick Ratio	4.17	0.58	0.51	0.62
Current Ratio	4.91	0.80	0.78	0.91
Net Recs/Payables (incl Retentions)	22.20	1.70	0.80	1.00
Retentions Rec/Retentions Pay	N/A	N/A	N/A	N/A
LEVERAGE / COVERAGE				
Net Worth-Actual	(224)	(365)	(347)	(331)
Tang Net Worth-Actual	(224)	(365)	(347)	(331)
Eff Tang Net Worth-Actual	(224)	(365)	(347)	(331)
Debt/Worth	N/A	N/A	N/A	N/A
Debt/Tang Worth	N/A	N/A	N/A	N/A
Debt Less Sub Debt-Liab/Eff Tg Wth	N/A	N/A	N/A	N/A
Total Liabilities/Total Assets	2.29	2.73	3.84	2.76
Interest Coverage	(57.00)	(22.50)	7.83	N/A
Cash Flow Coverage	N/A	N/A	N/A	N/A
PROFITABILITY (%)				
Return on Assets	(67.05)	(66.82)	33.61	102.13
Return on Equity	N/A	N/A	N/A	N/A
Gross Margin	19.89	21.41	26.27	34.75
Operating Profit Margin	(10.45)	(14.90)	3.33	13.56
Profit Margin	(10.63)	(15.56)	2.90	13.56
Cash Dividend Payout Rate	-	-	-	-
Effective Tax Rate	-	-	-	-
ACTIVITY				
Net Recs (incl Ret) Days on Hand	37.14	41.09	13.44	17.53
Accts Pay (incl Ret) Days on Hand	2.09	30.76	22.79	26.86
Net Revenues/Total Assets	6.31	4.29	11.57	7.53
Net Revenues/Working Capital	7.96	(16.78)	(40.34)	(74.53)
Net Revenues/Net Worth	(4.87)	(2.48)	(4.07)	(4.28)
Net Revenues/Net Fixed Assets	1,091.00	906.00	1,412.00	1,416.00
Profit Before Taxes/Assets	(0.67)	(0.67)	0.34	1.02
Z - Score	2.92	(0.93)	8.06	7.93
GROWTH (%)				
Total Assets Growth		21.97	(42.18)	54.10
Total Liabilities Growth		45.09	(18.58)	10.66
Net Worth Growth		N/A	N/A	N/A
Net Revenue Growth		(16.96)	55.85	0.28
Operating Profit Growth		N/A	N/A	308.51
Net Profit Growth		N/A	N/A	368.29
Sustainable Growth	107.39	62.95	(10.57)	(36.71)

SAMPLE CONTRACTOR, LLC
FINANCIAL ANALYSIS

Liquidity (Ability to meet short-term obligations)

	FYE 12/31/08	FYE 12/31/09	FYE 12/31/10	Interim 1/31/11	RMA Comp.
Working Capital	$137M	($54M)	($35M)	($19M)	N/A
Current Ratio	4.91	.80	.78	.91	2.5, 1.2, .7

Activity (Ability to collect accounts receivable and pay payables)

	FYE 12/31/08	FYE 12/31/09	FYE 12/31/10	Interim 1/31/11	RMA Comp.
A/R Turnover	38 days	42 days	14 days	18 days	0, 14, 35 days
A/P Turnover	3 days	31 days	23 days	27 days	0, 12, 35 days

Leverage (Ability to meet long-term obligations)

	FYE 12/31/08	FYE 12/31/09	FYE 12/31/10	Interim 1/31/11	RMA Comp.
Debt/Net Worth	(1.77)	(1.58)	(1.35)	(1.57)	.8, 0.0, (14.0)

Operating Performance (Profitability through regular operations)

	FYE 12/31/08	FYE 12/31/09	FYE 12/31/10	Interim 1/31/11	RMA Comp.
Gross Profit Margin	19.9	21.4	26.3	34.7	23.5
Net Profit Margin	(10.6)	(15.6)	2.9	13.6	2.6
Net Profit	($116M)	($141M)	$41M	$16M	N/A

Cash Flow (Life Blood)

	FYE 12/31/08	FYE 12/31/09	FYE 12/31/10	Interim 1/31/11	RMA Comp.
EBITDA	($112M)	($135M)	$47M	$16M	N/A
Cash After Debt Amort.	N/A	($15M)	$15M	($8M)	N/A

Bankruptcy Predictor

Scale	FYE 12/31/08	FYE 12/31/09	FYE 12/31/10	Interim 1/31/11
Z-Score	2.92	(.93)	8.06	7.93

Bankruptcy Characteristics:	0-1.80
Gray Zone:	1.81-3.00
Non-Bankruptcy Characteristics:	Over 3.00

IX. <u>Documentation & Collateral Concerns of C&I Loans</u>

a) <u>Standard</u>:

1. Promissory Note
2. Business Loan Agreement
3. Corporate/LLC Resolutions

b) <u>Collateral Position</u>:

1. Security Agreement
2. UCC-1 filing (General description or specific)
3. Vehicle Titles

X. <u>Pricing and C&I Loans</u>

a. <u>Prime Based</u>

1. Wall Street

2. Individual Bank (Base Rate)

b. Other "Short-Term" Pricing: Ex. LIBOR

c. Fees: Commercial Real Estate vs. C&I Loans/Lines

d. Terms: Ex. 25 yr. amort./ 10 yr. call/ 5 yr. rate adjustment

Ex. 5 yr. amort. period!

XI. <u>Managing the C&I Loan Porfolio</u>

a) More “run-off” than Commercial Real Estate

b) More “time, money, and productivity” to create C&I “assets” than Commercial Real Estate Lending (on a <u>dollar</u> per <u>dollar</u> basis)

c) C&I Lending: More diverse, less concentration, in theory, less risk!

d) C&I Lending: Can be “niche” player- specialist!

Ex. Rental Car Fleet

VII. Marketing C&I Loans in Today's Competitive Market

a) Market Situation Analysis:

b) Market Segmentation:

c) Target Market:

d) Marketing Mix:

Four Ps of Marketing:

1. Product

2. Place

3. Price

4. Promotion: Advertising & Personal Selling

VII. Marketing C&I Loans in Today's Competitive Market (Continued):

e) Related Concepts:

1. Life Cycle: Birth, Growth, Maturity, Decline, Rebirth

2. Market Structure Continuum:

Pure Competition	Monopolistic Competition	Oligopoly	Monopoly

XIII. C&I Lending Scenarios

a) You are a VP-commercial loan officer and have worked for most of your banking career with large, “income producing,” commercial real estate loans.

With the “downfall” of the local commercial real estate market, you have been reassigned to work almost exclusively with C&I lending clients providing lines of credit and equipment financing (including “work-out” situations). You realize that you have not worked on a “single” line of credit or equipment deal in over 12 years.

What do you do? Where do you start? What are the actual steps that you would take?

XIII. C&I Lending Scenarios (Continued):

b) You are a branch manager and work extensively with small to medium-sized business customers. You are currently working with a rapidly growing small manufacturing company. They seem to be a good potential client but you were just informed by your “assigned” commercial loan officer that the company is not currently “bankable” due to its growth.

You are perplexed. You know that the manufacturer is a well run company but you know that you will not be able to help this client (or obtain their deposit relationship) if the bank can not provide the requested line of credit.

How could an ABL facility help in this situation? What if your bank does not currently provide ABL financing? What do you do?

XIII. C&I Lending Scenarios (Continued):

c) You are a commercial lending center manager and have recently returned from a meeting with the bank's senior management. You have been given the direction to significantly lower the center's loan portfolio concentration of commercial real estate loans and "immediately" replace these loans with new C&I loans/lines of credit.

You know you must make the transition quickly but you are not that familiar with marketing C&I lending products as your team has traditionally made its "annual" goals through commercial real estate loans.

What do you do (from a marketing standpoint)? Where do you begin?

XIV. <u>Conclusion</u>:

a) C&I Lending is “Old/New” Banking

b) C&I Lending is Here to Stay!

c) C&I Lending Can be Profitable for the Bank!