Commercial and Industrial Lending Evaluation

Objective

- *C&I Lending Risk* – Understanding steps to take while reviewing C&I financial performance; get the underlying financial information to conduct sufficient deep dive root cause analysis

Expectations

- *C&I Yellow and Red Flags; take necessary steps to mitigate risk and reduce loss exposure as early as possible, especially before an* economic downturn

Financial Performance, Other Considerations

Creditor Analysis of borrower's Ability to Repay – Take a deep dive analysis into your borrower's financial performance of revenues, profit margins, income and cash flow, leverage, liquidity, and capitalization. Look at the last three fiscal years and year-to-date (YTD) or the last quarterly performance to identify trends and anomalies that may have affected its past operating performance. Also, uncover the repayment potential after determining the root causes behind any financial deterioration, for the following:

Cash Flow

- *Debt Service Coverage Ratio; Global Cash Flow;* Monitor and know the adequacy of the borrower's ability to repay on a continuous basis. Closely observe and evaluate the cash flow trends, particularly declining trends, including a comparison to industry peer performance. Consider the level and trend of the DSCR in assigning a credit risk rating. In an economic downturn, focus on a true global cash flow analysis, by getting all the appropriate current FS' and TRs upfront by each obligated borrower and guarantor. Insist on these data if you must.

Profitability

- *Sales top line revenue performance, Expenses, & Profits* – Measure efficiency and trends in sales revenues, gross and net profit margins, and determine how well the borrower is controlling other notable costs with expense ratios. Determine the reason behind any material changes in key metrics, identify material expense trend increases as a percentage of sales, and what the outlook is. Understand what is driving the profit margins and what needs to happen in the future to improve the same. Ask any necessary questions until you are satisfied

Efficiency

- *Inventory Days; Accounts Receivables Days; and Accounts Payable Days* – Request detailed inventory reports that can be used to conduct an inventory inspection by sample testing and to ensure accurate reporting; hold the borrower to account for any material discrepancies. If there are material differences in the 'Days on Hand' (DOH) by comparison of values of similar, same industry companies, dig deeper until you know what is driving the differences. Determine if and how much functional or technologically obsolete inventory there is in stock. With a detailed current A/R ledger, and A/R Customer List reports on hand, carefully analyze ineligible A/R (past dues, concentrations, etc.), and determine their collectability by asking the borrower "how much, and when" for all material receivables. Get a clear idea of how much cash will be collected and by when. As suppliers obviously play a key role in the success of operations, carefully analyze the A/P repayment capacity over time, to help determine how efficient operations really are, and if the borrower is not able to pay supplier creditors on time. Similarly, with an A/P Aging report in hand, ask "how much, and when" for material past due payables as to when these will be paid, and how that will affect future inventory purchases

Leverage

- *Funding Sources and Capacity: earnings, debt capital, equity capital, to meet obligations; ability to manage finances)* – Determine the viability of each funding source and if those sources of capital are available or sustainable. They will determine how possible refinancing might be, and at what cost and on what terms. Ask if either the sponsor or guarantor are both able or willing to inject additional capital. Check to see if the projected period to de-lever to a sustainable level is reasonable or acceptable. Confirm if the cash flow analysis relies on overly optimistic or unsubstantiated projections, and even stress test the projections for a downside case. Go deep. Determine the ability of the borrower to meet its obligations, and the extent of any variances to its performance to plan. Document any poor loan structure elements of each loan in each relationship, like limited or light covenants, and seek to install meaningful covenants going forward. Finally, check to see how vulnerable the borrower is to a sharp economic downturn and any business cycle swings.

Liquidity

- *Sources (cash on hand, short-term funds, cash flow management, secondary sources, cash burn)* – Analyze the borrower's liquidity needs, if primary sources are sufficiently available, or if secondary sources need to be liquidated to meet current obligations. This will include a review of current loan maturities, the size and timing of repayments, interest rates, uncollected receivables, and obsolete inventory. Determine the root cause for liquidity problems, and analyze whether there is any net cash burn. If there is cash burn, confirm how much time is needed before returning to positive cash flow, and the sources to recapitalize. Ask the borrower to defend the cash burn rate and how it intends to lower it

Performance to Plan (P2P)

- *Budget vs. Actual Variance Analysis* – Variances need to be understood and explained as to why they occurred. Ask enough questions until you get and maintain confidence with the borrower's budgets, and whether they need to be 'stressed' or adjusted for your internal underwriting purposes, the lender's base case (stressed) pro forma. Will future pro forma forecasting be based on historical variances, and if not, what reasonable adjustments are necessary? Is the budget overly optimistic? If there is any doubt, ask more questions. Monitor any revisions to plan if necessary. Depending on the P2P results, ask to prepare a variance analysis on a stepped-up monthly, quarterly, or annual basis

Pro Forma Outlook

- *Realistic Outlook; Assumptions; Cash Budget* – During times of economic downturn, use pro forma statements to structure workout or loan modification repayment solutions. Ensure these statements are conservative in both revenue and expenses, and include upcoming one-time expenses. Regardless of how severe the current economic conditions are, expect the borrower to prepare its own repayment plan supported by its own pro forma statements. The borrower should bring detailed, well-supported, and foot-noted explanations on the assumptions used. It can also propose temporary repayment terms that are supported by the pro forma statements, with the updating and reporting frequency adjusted as necessary. Assign and adjust credit risk ratings as the repayment risk changes according to regulatory guidance (be accurate and timely all the time). If necessary, have the borrower prepare a cash-in and cash-out monthly pro forma budget to show possible debt repayment solutions on a simplified basis

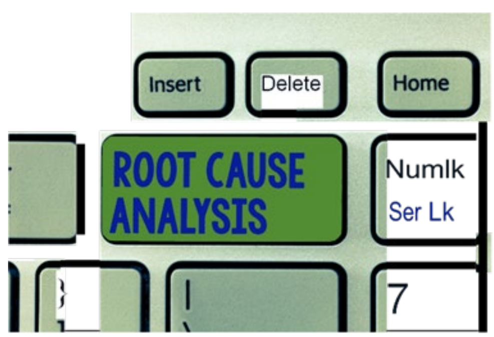
Management

- *Succession Plan* – Economic challenges must be successfully unmanaged by skilled leaders, and you will need to understand the borrower's succession management tools and planning for all key positions, not just at the most senior level. Identify any recent or pending retirements, and how might those changes and their tangible contributions in staffing, impact borrower operations, and competitiveness

Competition

- *New or Pending Direct Competition; Customers Lost to Competition* – New competition can affect your borrower's operations and ultimately its ability to repay its loans. Know the potential loss of market share because of lost customers, and the decline in revenue and profits. Determine if increased price competition is likely with new competitors that enter the market with lower prices, affecting profit margins, and impact its repayment ability. Perhaps this will affect increased marketing and advertising expenses. Tso, seek to understand the borrower's strategies it plans to use in being proactive in mitigating new competition risk, how it will differentiate itself from its competitors.

Root Cause Considerations



Getting to Understand the Root Causes – Seek to transact safe and sound underwriting, understand your borrower's company's management, its industry, all in conformity to the credit policies, with any material exceptions adequately mitigated and documented. Remember that sound underwriting provides protections, including the effective use of financial performance and reporting covenants and having sufficient collateral, thereby increasing the likelihood of collection or full repayment. Make sure you are comfortable with the management team, its overall character, capability, and stability. Competency and integrity cannot be overstated. Finally, in a downturn, seek to understand the conditions in which the borrower operates its business, elements like cyclicality, competition, and technological changes it is also likely to experience.

Structural Weaknesses and Underwriting Deficiencies; Be on the Lookout – Identify any structural weaknesses in your borrower's loans, that may compromise your ability to control any credit relationship when economic or other events adversely affect the borrower. Before an economic downturn, and especially during seasons of default and restructuring, creditors, it will become quickly apparent if there are structural weaknesses in your lending relationships.

Yellow and Red Flags; Indicators of Potential Repayment Problems

Here are 18 yellow and red flags, or otherwise indicators of potential problem loans:
(Federal Reserve Bank – Commercial Bank Examination Manual, Section 2080.1)

- *Working-Capital Advances Used for Funding Losses* – A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility

- *Working-Capital Advances Funding Long-Term Assets* – A business will use working-capital funds to purchase capital assets that are normally associated with term business loans

- *Trade Creditors Not Paid Out at End of Business Cycle* – While the lender may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the lender to support funding needs that were previously financed by trade creditors

- *Overextension of Collateral* – The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the lender's credit policy for the specific asset being financed

- *Value of Inventory Declines* – If a business does not pay back the lender after inventory is converted to cash or accounts receivable, the value of the inventory declines (vendor retains a senior lien interest in the inventory superior to the lender's interests). Other causes of inventory devaluation include obsolescence; a general economic downturn; or, in the case of a commodity, market volatility. Declines in inventory value will commonly put a working-capital facility in an out-of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business

- *Collectability of Accounts Receivable Declines* – The increasingly past-due status of accounts receivable or, deteriorating credit quality of account customers, both result in the non-collection of receivables. This can also cause an out-of-borrowing-base situation for the lender

- *Working-Capital Advances Used to Fund Long-Term Capital* – Funds may be inappropriately used to repurchase company stock, pay off subordinated debt holders, or even pay dividends on capital stock

- *Accounts Receivable* – A slowdown in the receivables collection period. This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts

- *Inventory* – Noticeably rising inventory levels in both dollar amount and percentage of total assets. Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins

- *Slowdown in Inventory Turnover* – This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results

- *Existence of Heavy Liens on Assets* – Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable

- *Concentrations of Noncurrent Assets Other Than Fixed Assets* – A company may put funds into affiliates or subsidiaries for which the lender may not have a ready source of information on operations

- *High Levels of Intangible Assets* – Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit

- *Substantial Increases in Long-Term Debt* – This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment

- *A Major Gap Between Gross and Net Sales* – This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability

- *Rising Cost Percentages* – These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses

- *A Rising Level of Total Assets in Relation to Sales* – If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Examiners should be concerned when assets are increasing faster than sales growth

- *Significant Changes in the Balance-Sheet Structure* – These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business.