OVERVIEW OF CREDIT AND COMMERCIAL LENDING PROCESS

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By
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Credit

- Credit is a form of trade where present purchasing power is traded for future purchasing power
- It is the exchange of value for a promise
- Both lender and borrower gain from the trade
- Financial Intermediaries specialize on this trade

Credit Risk

- Risk of default by the borrower is Credit Risk
- While market risk provides opportunities for profit as well as loss, Credit Risk can result only in loss.
- The most common reason by far for the failure of banks is loan losses.

Sources of Credit Risk

- Reliance on promises
- Information Asymmetry and Adverse Selection
- Pricing
- Weak monitoring and control

However, credit risk cannot be avoided. The key is to manage it carefully and keep it under control.

Business and Commercial Lending: Stages and Steps

Stage One: Preliminary Opportunity Assessment

Owners/Managers or Development of Targeted Bank Call List

Preliminary Screen for Business and Portfolio Fit

Preliminary Screen for Business Financial and Nonfinancial Qualifications

Business and Commercial Lending CURRICULUM

Understanding Business Borrowers

Business and Commercial Lending: Stages and Steps

Stage Two: Credit Proposal Development and Approval	Business and Commercial Lending CURRICULUM
Initial Meetings with Business Develop Credit proposal Structure, Assign Risk Rating to the Transaction/Borrower ⇩ Bank Approves, Modifies or Denies Credit Proposal ⇩ Preliminary Screen for Business Financial and Nonfinancial Qualifications ⇩	Analyzing Business Financial Statements Qualitative Analysis and Determining a Credit Risk Rating

Stage Three: Presentation of Loan Proposal

Customer Accepts, Denies or Seeks Modified Credit Proposal

Stage Four: Loan Documentation and Closing

Loan Agreement is Structured based upon Agreed Terms and Conditions; Loan is Closed

Stage Five: Loan Monitoring

Monitor Loan performance and Credit Risk Rating

Stage Six: Problem Loan Assessment and Action Steps

Take Appropriate Problem loan Actions if Business Does Not Perform as Planned

Business and Commercial Lending
CURRICULUM

Loan Structuring, Documentation, Pricing and Problem Loans

training course content.docx

UNDERSTANDING BORROWERS

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Business Sectors

Diversity- the biggest challenge for Relationship Manager

Business Sectors and Operating Cycles

The lender needs to screen for general fit within the portfolio and goals of the bank.

Questions arising

- Is the firm in an acceptable or targeted industry?
- Is the firm within the bank's defined market area?
- Does the loan cause the bank to exceed bank limits for the industry or the type of loan to be made?
- Does the loan meet regulatory requirements? (such as Productive Sector, Deprived Sector etc.)
- Does this loan allow the bank to earn an acceptable return given the probable transaction risk?

Understanding the Borrowers- Business Sectors and Operating Cycles

Understanding the industry, type of business, and operating cycles helps in developing Financial and Non-financial assessment of risks, since it is typically done prior to an in-depth analysis of detailed financial information.

Business Sectors

Operating Cycles

The operating cycle is the average period of time required for a business to make an initial outlay of cash to produce goods, sell the goods, and receive cash from customers in exchange for the goods.

- **EVERY BUSINESS HAS AN OPERATING CYCLE.**
- **IT PURCHASES RAW MATERIALS OR PRODUCTS, PREPARES PRODUCTS FOR SALE, MARKETS AND SELLS THE PRODUCTS OR SERVICES.**
- **THIS PROCESS OF CONVERTING ASSETS TO CASH IS THE CORE OF ALL BUSINESS ACTIVITY.**
- **THE BETTER YOU UNDERSTAND THE CHARACTERISTICS OF A BORROWER'S ASSET CONVERSION CYCLE, THE EASIER IT WILL BE FOR YOU TO ANTICIPATE OPPORTUNITIES TO PROVIDE BANKING SERVICES.**

Operating Cycles

A business operating cycle illustrates how a company uses cash to produce a product or provide a service. The cycle begins and ends with cash.

Typical Operating Cycle

Operating Cycles

The length of the operating cycle varies among industries and businesses. It affects the amount of working capital needed.

Operating Cycles of Various Businesses

Understanding Borrowers- Operating Cycle\Operating Cycle- Agriculture and Manufacturer.docx

Understanding Borrowers- Operating Cycle\Operating Cycle- Wholesaler and Retailer.docx

Understanding Borrowers- Operating Cycle\Operating Cycle- Service Business and Construction Company.docx

Sectorial Characteristics and Risks

Agricultural Business

Agricultural Loan Purposes	Agricultural Business Risks	Agricultural Business Financial Characteristics
• Purchase seed, plants, fertilizer, or livestock • Purchase equipment • Finance land • Fund living and operating expenses • Pay labor	• Adverse weather • Falling crop prices • Increasing seed, fertilizer, and operating costs • Maintenance and repair costs • Quality of labor • Declining land values	• Fixed assets are largest asset at about 50 percent of total assets • Inventory is next largest asset, but only 18 percent of total assets • Liabilities evenly split between current and long-term • Leverage as high as 4.0x • Gross profits about 35 percent of sales

Sectorial Characteristics and Risks

Manufacturer

Manufacturer Loan Purposes	Manufacturer Risks	Manufacturer Financial Characteristics
• Fund raw materials purchases • Fund work-in-process and labor • Carry accounts receivable • Purchase plant or make improvements • Purchase equipment	• Inability to sell product • Quality of raw material used • Labor costs and availability • Collection of accounts receivable • Efficiency of plant operations • Knowledge of operating costs • Accurately assigning costs to products	• Inventory is largest asset • Fixed assets are next largest • Current liabilities more than double amount of long-term liabilities • Leverage as high as 2.5x • Cost of goods sold is largest expense • Very thin (1 percent) net profit margin

Sectorial Characteristics and Risks

Wholesaler

Wholesaler Loan Purposes	Wholesaler Risks	Wholesaler Financial Characteristics
• Fund finished goods purchases • Fund new product purchases • Carry accounts receivable • Purchase plant or expansions • Purchase equipment	• Quality of product • Inability to market product • Credit approval policies • Collection of accounts receivable • Relationship with vendors	• Inventory and accounts receivable are largest assets at about 30 percent each of total assets • Fixed assets are next largest at about 15 percent of total assets • Current liabilities comprise about 80 percent of total liabilities, with accounts payable as largest liability (about 25 percent of total) • Leverage as high as 2.5x • Gross profits about 8-15 percent of sales • Stronger (2.2 percent) net profit margin

Sectorial Characteristics and Risks

Retailer

Retailer Loan Purposes	Retailer Risks	Retailer Financial Characteristics
• Fund permanent inventory purchases • Fund seasonal inventory purchases • Fund leasehold improvements • Purchase equipment	• Inability to sell product • Product quality and mix • Service provided by employees • Employee theft (shrinkage) • Relationship with vendors	• Inventory is largest asset at about 50 percent of total assets • Fixed assets are next largest at about 20 percent of total assets • Current liabilities (mostly accounts payable) about 2.5x the amount of long-term liabilities • Leverage as high as 2.5x • Gross profits about 40 percent of sales • Net profit margin of about 2 percent

Sectorial Characteristics and Risks

Service Industry

Service Business Loan Purposes	Service Business Risks	Service Business Financial Characteristics
• Carry accounts receivable • Fund fixed asset purchases • Fund leasehold improvements	• Quality of service provided • Credit approval process • Collection of accounts receivable • Quality and capacity of fixed assets • Demand for service	• Accounts receivable is largest asset at about 35 percent of total assets • Fixed assets are next largest at about 30 percent of total assets • Liabilities evenly split between current and long-term • Leverage as high as 2.5x • Gross profits about 100 percent of sales • Net profit margin of about 7.5 percent

Sectorial Characteristics and Risks

Construction Business

Construction Business Loan Purposes	Construction Business Risks	Construction Business Financial Characteristics
• Fund construction materials purchases • Pay subcontractors • Fund equipment purchases • Pay operating expenses • Standby letter of credits	• Under-bidding projects • Labor costs and availability • Collection of accounts receivable and retainages • Subcontractor work quality • Completing projects on time (weather and other disruptions) • Unexpected conditions such as poor soil • Change orders	• Accounts receivable is largest asset at about 40 percent of total assets and consisting primarily of progress billings • Cash and equivalents are next largest at about 20 percent of total assets, with a relatively small 15 percent in fixed assets • Liabilities primarily short-term, with about one-half in trade payables • Leverage as high as 2.5x • Gross profits low at about 17 percent of sales • Net profit margin of about 2.5 percent

Analyzing Financial Data

Typical Financial Profiles for Various Businesses (Wood Tables Example)						
	Agriculture (logging)	Manufacturer (wood furniture)	Wholesaler (furniture)	Retailer (furniture)	Service (ware-housing)	Contractor (industrial buildings)
Accounts receivable	10%*	22%	37%	14%	18%	40%
Inventory	13%*	33%	29%	50%	2%	2%
Net fixed assets	53%*	28%	13%	18%	55%	16%
Accounts payable	5%*	15%	22%	18%	8%	30%
Long-term debt	30%*	21%	9%	11%	7%	7%
Gross profit	31%**	31%	29%	41%	100%	15%
Operating expenses	28%**	28%	27%	39%	83%	13%
Profit before taxes	<1%**	1%	1%	2%	8%	2%

*Percent of total assets or total liabilities and equity **Percent of sales

Business Sectors and Operating Cycle- Exercise

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Understanding Borrowers- Operating Cycle\Business Sectors and Operating Cycles Exercise II.docx

Understanding Borrowers- Operating Cycle\Suggested Results for Exercise I.docx

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Thank you