Credit Write up Sample

Background/Sponsorship/Management

Dry Supply is a wholesaler of dry cleaning equipment, cleaning supplies, and laundry soap. The company, which is located in New Baneshwor, has been in business over 10 years. Dry Supply was founded in 2007 as a Private Limited Company by Mr. Jugal Kishor (50%) and his two sons Harish (25%) and Shyam (25%). All three shareholders are employed by the company. Mr. Jugal Kishor looks after overall business as the CEO, Harish looks after the purchases and finance and Shyam looks after the sales. The trio has been able to run the company profitably for last 10 years. Additional three employees are also hired who are responsible for accounts, delivery and collection. In short, this is a family-run business and likely to remain so in the foreseeable future.

By the analysis of documents and the information received, following conclusions have been drawn about the management.

With two sons and the founder now active in the business, it appears that Dry Supply intends to remain family-owned. However, we do not have any information about a formal succession plan.

With two family generations active, and current owners in place for roughly 10 years now, it appears that Dry Supply's management has good industry experience and acceptable depth at key positions.

Management has shown a willingness to support the business by loaning it funds that can potentially be subordinated to the bank and considered as a type of equity. This indicates a commitment of the owners for the success of the business and is also an indicator of borrower's character.

There do not appear to be any unusual issues in terms of regulatory oversight, organized labor and ability to attract workers.

So far, we have been receiving financial and other information as requested.

Banking Relationship

Borrower is a new customer to the bank therefore we do not have account history with us. The client has been marketed by the RM by customer calling efforts after determining the reasonableness of credit of the borrower.

The loan has been proposed at the rate of 12% pa and one time processing fee of 0.75%. It is expected to generate a net spread of 5% (without taking into account the processing fee and taking pool cost of fund at 7% pa) resulting in a gross margin of NPR 270,000.00. Taking 70% of overhead expenses, the net return on capital will be 12.27% which is above the benchmark.

Exposure and Relationship with other banks

Dry Supply does not have any bank loan outstanding with other banks as disclosed by the borrower and confirmed by checking their balance sheet and verifying the same with CICL report. The company had at times borrowed funds from other banks but these loans have now been settled.

Dry Supply has been maintaining a current account with National Bank and the current balance in the account is NPR 1,500,000.00. After approval of the loan, the account will be closed and balance transferred to our bank.

Facility Structure

Borrower, being the wholesaler of dry cleaning items requires sufficient number of delivery vans for the smooth operation of the business. Since most of the existing vans have become old, the company has started replacement of older vehicle. In the process, It has purchased one van last year and is planning to purchase 3 vans this year for which it has requested for the loan. The need for the purchase is apparent as almost 70% of its assets have been depreciated.

The delivery vans are fixed assets for the borrower and help company generate income for several years to come. As such the loan shall be repaid through the cash generated over many years. Depending upon the strength of cash flow, loan is proposed to be repaid in 60 monthly installments of Rs.100,000.00 each plus the accrued interest. As the useful life of the vans is estimated to be over 7 years, five-year loan is on safer side.

Collateral Analysis

The loan will be secured by the three brand new Mahindra delivery vans to be purchased, by registration of the vans in the bank's name. The total value of the security at the time of loan disbursement will be the purchase price of NPR 8,500,000.00 of three vans. The loan to value ratio will be 70% at the beginning and is expected to improve with each installment repaid as the useful life of the vans is much longer than the loan. As such the realistic realizable value estimated around the LTV, in case of default, is expected to cover the loan and the interest.

Despite having the security perfected in favour of the bank by registration, it may be difficult and costly to locate the vehicle without the cooperation of the borrower, in case of default. Once the possession is obtained it may involve costs to park the vehicle until they are sold.

As the vans can be used for multiple purposes, selling them with borrower's cooperation or through auction shall not be a problem.

Though we will obtain Hypothecation Charge over the current assets as well, the inventory being specific use items may not be sold at distress and therefore, its value is not taken as security.

In addition to taking the vehicles as collateral, we will obtain joint and several personal guarantees of Mr. Jugal Kishor and his two sons Harish and Shyam. Their combined net worth has been estimated to be NPR 30 million. This gives us a comfort that we can recover our loan fully even if recovery from the sale of vehicles is partial only.

Given the above analysis, it can be concluded that the collateral is sufficient, fairly controllable, and fairly liquid and adequately secures the loan.

Guarantor Analysis

We have proposed joint and several personal guarantees of the three owners of the company as the tertiary source of repayment. The combined net worth of the three is enough to provide comfort for this size of loan. Details of net worth is provided below.

NPR'000

	Jugal	Harish	Shyam
Liquid assets	500	300	700
Non-marketable securities or ownership in related businesses	-	-	-
Real estate assets, including personal residence	30000	-	-
Other significant assets(car/mobike)	2000	150	100
Amount and type of liabilities	-	-	-significant
Any material contingent liabilities	-	-	-
Income, and cash flow items (Salary)	250	150	100
Total net worth	**32500**	**450**	**800**

The three live in a joint family and the sons are not married. The building they live in is owned by Jugal Kishor and is free of any charge. It is located in the good residential area of Baneshwor. Site map enclosed.

Industry and Market Analysis

The borrower is a wholesaler of dry cleaning items, and being trading business, for which fixed costs are low. There are three other traders in the city catering to around 100 dry cleaners. The goods are mostly imported from India and some of them are available locally as well. The culture of dry cleaning is slowly picking up among the city dwellers and demand is expected to grow modestly.

Industry Risk:

Demand for dry cleaning services should be modest to average. To the extent that the need to clean certain types of fabrics does not depend on the economic cycle, a certain level of demand should be fairly constant. However, clothing that is dry-cleaned tends to be job-related, and job loss or partial unemployment typically occurs in an economic downtown would also reduce a portion of dry cleaning demand.

This industry has a high degree of asset concentration in accounts receivable and inventory, so needs for fixed assets appear to modest.

This industry does not appear to be heavily regulated, although certain chemicals that are used can be very harmful to the environment. Incidence of lawsuits and organized labor appear to be minimal. Overall, this area appears to be neutral.

Market risk:

The threat of new competition is perhaps the strongest for Dry Supply, due to fairly low barriers to entry and a lack of brand names in the industry.

Position in industry and market share—At best, Dry Supply is a local and regional player with modest market share, and likely not to be a pricing leader.

Competitive advantage—No competitive advantages, other than length of time in business and a loyal base of customers, has been identified.

Stability or growth of demand—Demand appears to be stable, with low expectations for growth.

Customer loyalty—As noted earlier, this appears to be strength for Dry Supply

Financial Analysis

One of the major strength of Dry supply is that it has been in business for a period of 10 years now and the management is running the business profitably with its experience in the field. The analysis of last three years of financials reveals the following suggesting it to be an acceptable risk for the bank.

Financial Reporting

Dry Supply has financial statements audited by a Registered Auditor, has met all requests from the bank for financial information. I have been able to get information such as accounts receivable aged listings and product mix as requested. It appears that Dry Supply can provide adequate detail in most areas, and also on a timely basis.

Earnings and Operating Cash Flow Trend

An analysis of income statement and with the discussion with the borrower it is revealed that the company has an established customer base (total 60 out of 100 in the market) with many loyal customers. The company sells various products such as liquid cleaners, plastic bags, metal hangers etc. and does not depend on one or two items or customers. Dry Supply does not appear to be heavily concentrated in a single product or limited no. customers.

It has an increasing profit trend despite the decrease in sales in the recent year. Major contributor for the increase in profits is the ability of the management to reduce the cost of goods sold. Pretax profit margin and return on assets showed improvement over the last three years, while the rupee amount of net income also grew steadily. Overall this appears to be a modest or average profile.

However, it appears that the customer is reaching its maximum shipping capacity as evidenced by the backlog orders it has and therefore continued future customer and sales growth is in question. The proposed purchase of delivery vans can help improve this condition.

Recently the company has added few new customers of which the ability to pay is uncertain.

The interest coverage ratio for 2017 indicates Dry Supply is generating about Rs.4.60 of pretax profit (before interest expense) needed to pay each rupee of interest expense. The fixed charge ratio is similar with about Rs.4.30 of earnings before interest and deprecation available to cover debt service. Both ratios have been at a high level and fairly steady over the three-year period, because the company does not carry long-term debt. Additionally, if Dry Supply does continue the policy of not paying dividends, it will have plenty of capacity to cover interest expense on additional debt, should current profit levels continue.

Dry supply has reported strong cash from operations (NPR 29,000) in both the years 2016 and 2017. This cash flow has been sufficient to cover not only the interest payment but also capital expenditure. Even if the shareholder’s loan of 67,000 were to be paid over reasonable time (say in 3-4 years), the existing level of cash flows are sufficient. As the major component of the cash flow is the cash profit generated from the business, company’s cash flow can be considered strong. Provided this cash flow trend continues, repayment of outstanding debt as well as proposed debt will not see any problem. These factors suggest a modest risk profile.

Assets and Liabilities Values

Dry Supply's asset mix represents that of a typical wholesaler comprising of around 75% of current assets and is steady over three years. The liquid assets (current assets) are appropriate and even favorable as measured by the current and quick ratios over the last three years. Because Dry Supply at 15/07/2017 has about $1.80 of current assets for every rupee of current debt, it should be able to continue to handle its current liabilities and take advantage of trade discounts. An examination of Dry Supply's balance sheets shows that although current liabilities decreased, current assets remained somewhat level. This situation reduced the company's need for short-term borrowings to support its current asset base, thus increasing its current ratio at 15/07/2017.

Using the narrower measure of the quick ratio at 1.2x, Dry Supply should be able to cover current liabilities with cash, marketable securities and accounts receivable – all of which usually can be converted to cash more quickly than inventory. Both of these ratios, as well as the rupee amount of working capital, have improved over the three-year period. It shows the company is fairly liquid.

The quality of the assets is also very good as revealed by the aged listing of account receivables where delinquent accounts are only two percent. However, quality of few customers added in 2016 is still to be tested. Moreover, My Shop, one of the customers of Dry Supply, owes almost 20% of the total receivables and some concentration risk is evident. Comfort can be drawn from the fact that My Shop is the oldest and biggest dry cleaner in the city with the highest turnover among all dry cleaners. Thus quality of assets and liquidity fit in an average risk profile.

Essentially, Dry Supply depends on inventory sales to repay short-term debt. Inventory sales result in accounts receivable, which then need to be collected. The accounts receivable turnover of 45 days indicates the company sells to accounts capable, for the most part, of paying on time, and that Dry Supply has adequate collection practices. This statement is further supported by the study of the aged listings of Accounts Receivables which shows that problem or delinquent accounts are small and pose little risk. This ratio has been stable over the three-year period.

Inventory turnover is 39 days and has improved slightly over the three-year period. A 39-day holding period does not seem high for a wholesale business. Altogether, it takes approximately 84 days (accounts receivable 45 days plus inventory 39 days) for inventory to convert to cash in order to repay current liabilities, including suppliers, then purchase inventory and start the cycle over again. Accounts payable turnover is 18 days. It appears that the company is paying on time and maintaining a good relationship with its trade creditors.

There is a gradual growth in current assets over three years but the current liabilities have been in a decreasing trend. Accounts payable has decreased as one of its suppliers went bankrupt and substitute supplier is selling on cash only. Therefore Dry Supply's credit availing capacity has been reduced. But it appears that current liabilities are being replaced by retained earnings and shareholder's loan which has created a mismatch by short term assets being funded by long term liabilities but for a lender this is strength and represents no more than an average risk. We can obtain a debt subordination agreement to make our position stronger.

Dry Supply rents its facilities. The fixed assets are somewhat evenly split between furniture/fixtures and transportation equipment, but with recent increases in transportation equipment. Company's fixed assets have already been depreciated by around 70% and this creates an uncertainty as to what the owners will do about the replacement. However, as the company's debt capacity is still high and company is making good amount of operating cash, even replacement may not be a problem. Overall, the assets are about two-thirds depreciated, but being replaced or increased on a regular basis, including a pending loan request related to trucks. With the case information so far, this is likely to be an average risk.

Financial Flexibility and Debt Capacity

Among the leverage ratios, the debt to net worth ratio is 1.9x and probably appropriate for a wholesale business that must carry high levels of accounts receivable and inventory. Tangible leverage is the same 1.9x since Dry Supply does not have any intangible assets to be subtracted from net worth for this ratio. Both ratios have shown steady improvement over the three-year period.

The decreasing tangible leverage (debt to tangible net worth) ratio suggests that Dry Supply's net worth (consisting primarily of retained earnings) has been sufficient to fund its balance sheet growth in the same or in better proportions over the three-year period. This could have resulted from a conscious management decision to use the company's leverage less aggressively. Dry Supply's increasing net profits for fiscal years 2015 to 2017, together with its dividend policy (a dividend payout ratio of zero), appears to support this conclusion.

Further, with subordinated debt included as net worth, leverage drops to 0.7x at 15/07/2017, continuing a decreasing trend (improving) since 15/07/2015. This value presents much less risk to all creditors, including a bank.

Dry Supply's operating cash flow, as measured by net cash from operations, appears to be able to support current as well as additional debt service, but significant capital expenditures will likely need to be financed with long-term debt. Combined with modest to small working capital financing needs, company is in a good position to repay loan.

DSC ratios and levels of cash after debt amortization indicate an ability to add debt, or even convert the shareholder loan to a bank loan. This profile fits average risk.

Dry Supply appears to have maintained several banking relationships, but with nominal borrowings through the years, since there is not active bank debt at 15/07/2017. It appears that company is capable of raising debt easily.

Key Risks and Mitigating Factors

1. In addition to the profitability, Dry Supply's financial strength has been the shareholder's loan and profit retention. If the owner's loan is paid or if dividend is distributed, the cash

flow will not remain as strong and repayment of loan and growth prospect may be jeopardized. As such to avoid this risk, we will put a covenant that shareholder's loan be subordinated and dividend to be distributed with bank's consent only. Bank will provide the consent after analysis and only if it is established that taking out dividend will not hamper repayment and growth.

2. Present management's experience, character and depth have been crucial for the success of Dry Supply. Scenario may change if the ownership were to be changed. Therefore, to protect the bank from this risk, we will put a covenant that change in ownership and management can be done only with the consent of the bank. Bank will provide such consent only after proper analysis of the abilities of the prospective owners and managers to its satisfaction. If the bank is not satisfied and shareholders still want to sell, bank will ask for repayment of entire dues before the change in ownership.
3. Low level of debt/equity ratio has been the strength of dry supply and a component of better risk grade. If the company adds further loans without the bank knowing, it will increase our risks. Therefore a covenant restricting the company to make additional borrowing is proposed.
4. In order to properly monitor the loan, we need to obtain stock and receivable reports every three months and will have to make site visit to inspect the stock and overall business including the condition of the vans proposed to be financed. We will also need interim financials every six months and audited financials each year. We will put a covenant to this effect. Moreover, in case of default, owner of the rented property may not allow the bank to enter the premises to take control of the assets citing the reason that his rents are not paid and therefore he wants to control the assets. To avoid this, we will make it a pre-condition that borrower arranges for a lessor's agreement authorizing the bank to enter the premises if the bank guarantees rent payment from the proceeds of liquidation.
5. Looking at the long history of profitable operation, the Average (3) risks grade and character of the borrower, the proposed covenants and pre-conditions appear sufficient.

Pro forma Debt service coverage

The company has projected a sales growth of 5% next year making total sales of 964,000 citing the increase in sales by the purchase of 3 delivery vans and the assumption is convincing. This will result in after tax profit of NPR 24,000. But as there will be additional depreciation of NPR 12,000 considering the useful life of the vans to be 7 years, the net profit will be NPR 12,000 only. But the cash profit will still be 37,000 (12,000+13,000+12,000) and even if the increase in receivable (5%) and inventory (5%) uses NPR 8,000 cash, 29,000 of net cash after operation will be there which will be sufficient to pay NPR 12000 principle, and the interest.

Even if the sales are down by 5% instead of the increase, there will be enough cash to service the debt.

Risk Rating Conclusion

The borrower falls under risk category 3 (average risk) as per the attached Risk Grade Worksheet and as explained below.

- Industry risk appears to be *modest* to *average*, based on modest to no cyclicality, modest to average capital intensity, a neutral legal, regulatory and labor outlook.
- Market risk appears to fall squarely in the *average* category, based on limited competitive forces, a local presence and being a price follower, limited competitive advantages, stable and low growth in demand, but good customer loyalty.
- Management risk appears to be average, based on two generation of the family being involved, some 10 years of experience of the father and sons as owners/manager, and cooperation in providing financial data to the bank.
- Earnings and operating cash flow trends appear to have modest risk, based on improved profit margins, profits and operating cash flow; no existing bank debt and have capacity to take on additional debt; and a lack of concentrations of products or customers.
- Asset and liability values appear to have average risk, based on a heavy reliance on current assets, as expected for a wholesaler; a strong equity position with little debt; and rented facilities with owned fixed assets consisting of relatively new trucks.
- Financial flexibility and debt capacity appears to have average risk, based on an indicated ability to add debt, using DSC ratios and levels of cash after debt amortization indicate an ability to add debt, or even convert the shareholder loan to a bank loan; several banking relationships in prior years, but with nominal borrowings; and operating cash flow, as measured by net cash from operations appears to be able to support additional debt service
- Financial reporting appears to have average risk, based on audited business financial statements, plus providing other financial data on a timely basis.

Summary and Recommendation

I hereby recommend the loan of NPR 60,000 to Dry Supply for the purchase of 3 delivery vans and to be repaid in monthly installments over 60 months for the following reasons:

- The loan falls under the acceptable category as per banks policy and appetite.
- The cause of borrowing need is clear, and preceding analysis has revealed satisfactory character and capacity of the borrower to repay the loan.
- Risk rating of the loan is one step better than acceptable level. The strengths of the borrower outweigh the weaknesses by a margin sufficient to cover any uncertainty posed by the loan.
- The earnings from the loan will yield a return on capital above our benchmark.
- The loan will be properly and adequately secured.

Recommended by:

Ramchandra
Relationship Manager