Commercial Lending for Lenders

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1

Course Overview

"What all do I need to know to get my loan approved?"

2

8 Questions to Ask Yourself

3

What Do I Know About My Borrower?

4

What Do I Know About My Borrower? (continued)

5

What Market Conditions/Trends Exist?

6

Does the Loan Make Business Sense?

- Does the loan purpose align with the business purpose?
- Will the loan purpose drive sufficient cash flow to repay itself without undue risk?

7

Are the Terms and Structure Appropriate?

- Do the repayment terms match the purpose and/or collateral?
- Is the Loan-to-Value acceptable?
- Do the loan covenants pertain to the key credit risks?
- Does the pricing provide an adequate return for the risks?
- Are personal/corporate guarantees appropriate?
- Does the structure fall within policy?

8

Can My Borrower Pay It Back With An Appropriate Margin?

What's the primary source of repayment?

Borrower Cash Flow

9

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

How is borrower cash flow determined?

- EBITDA (Traditional) Cash Flow

  Income statement based with add-backs for interest expense and non-cash expenses

- Uniformed Credit Analysis Cash Flow (UCA)

  Combines income statement and balance sheet changes to categorize cash flow into operations, investing and financing

10

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

Why use EBITDA as a measurement of Cash flow?

- It represents the primary sustainable source of cash flow – INCOME!
- It gives insight into how the company manages via trend analysis of:
  - Gross Profit Margin
  - Net Operating Profit
  - EBITDA Margin
- It is easily measured and is the method of choice for debt coverage covenants

11

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

What are the pitfalls in EBITDA Cash Flow?

- Ignores taxes, although it could be reduced to EBIDA
- Overlooks distributions for tax purposes or shareholder returns on investment, although it could be reviewed on a post distribution basis
- Overlooks working capital requirements for higher A/R and Inventory levels to support growing sales
- Ignores fixed asset replenishment and expansion through capital expenditures
- Ignores changes in short-term and long-term debt

12

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

What are the benefits of using UCA Cash Flow?

- Accounts for the timing of cash inflows/outflows, essentially converting accrual accounting to cash accounting
- Provides insight into the sources & uses of cash

    How they made it (Operating)

    How they spent it (Investing)

    How they funded it (Financing)

13

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

- So, which cash flow method should we use?

Both, of course

14

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

What do we do when EBITDA cash flow is sufficient but UCA cash flow is NOT?

15

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

What do we do when EBITDA cash flow is NOT sufficient but UCA cash flow is?

16

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

What's included in Investments and how do we interpret it?

- Primarily includes capital expenditures and right of use assets; these can be expansionary or replacement
- Could also include business acquisitions, outside investments, related entity investments, etc.
- Interpret by looking at trends. Stable or spikes? Size?

17

Can My Borrower Pay It Back With An Appropriate Margin? (continued)

What's included in Financing and how do we interpret it?

- External financing primarily includes lines of credit, term loans and lease financing; Internal financing includes shareholder loans and related interests
- Interpret lines of credit changes in comparison to changes in A/R, Inventory and A/P
- Interpret term loans and lease financing in comparison to capex and right of use assets
- Interpret internal financing as inflows or outflows and through trend analysis

18

Does the Balance Sheet Reflect Historical Success?

So, what do we review to determine historical success?

Leverage

19

Does the Balance Sheet Reflect Historical Success? (continued)

What types of leverage should we measure?

- Working capital leverage – Current ratio, quick ratio, net working assets ratio
- Balance sheet leverage - Debt to net worth, debt to tangible net worth
- Operating leverage – Funded debt to EBITDA

20

Does the Balance Sheet Reflect Historical Success? (continued)

Working Capital Leverage

- How is working capital generated?
  - EXCESS CASH FLOW after distributions and debt service
  - Additionally, sale of assets and cash out financing
- How is working capital expended?
  - Capital expenditures, less new debt
  - Accelerating/increasing principal debt payments
  - CASH FLOW SHORTFALLS after distributions and debt service

21

Does the Balance Sheet Reflect Historical Success? (continued)

Working Capital Leverage

- Several measurements
  - Current ratio (Current assets/current liabilities)
  - Quick ratio (Current assets minus inventory/current liabilities)
  - Net working assets ratio (Current assets/current liabilities minus CPLTD)
- Anything over 1:1 indicates borrower equity

22

Does the Balance Sheet Reflect Historical Success? (continued)

Working Capital Leverage

- Cash Conversion Cycle (Net Trade Cycle)
  - A/R Days on Hand PLUS
  - Inventory Days on Hand LESS
  - A/P Days on Hand
- Net, indicates how much must be funded by other sources (Line of Credit, Equity)

23

Does the Balance Sheet Reflect Historical Success? (continued)

Balance Sheet Leverage

- Simple calculation (Total liabilities/Net Worth or Tangible Net Worth)
- Could be negatively impacted by accelerated depreciation and shareholder distributions
- Trend is just as important as the actual calculation
- Key driver is undistributed net income

24

Does the Balance Sheet Reflect Historical Success? (continued)

Operating Leverage

- Funded debt primarily includes bank debt and may be noted as Senior Debt in a covenant
- Funded debt may also include other types of debt such as seller financing and loans from shareholders whether subordinated or not
- General rule of thumb is less than 3x senior debt and 4x total funded debt
- As with balance sheet leverage, the trend is important as asset/debt mix may result in deviation from the rule of thumb

25

What Role Does the Existing Banking Relationship Play?

26

What Happens If Something Goes Wrong?

- Raise your hand! Even well structured and well underwritten loans can go bad
- Determine best route for collection
  - Collateral
    - (LTV, marketability, disposal costs, etc.)
  - Guarantor
    - (Liquidity, alternative cash flow sources, other assets etc.)

27

Financial Statement Analysis

Example

123 Metal Recycling Company, Inc.

28

123 Metal Recycling Company, Inc.

Can they pay it back with appropriate margin?

- Pre-distribution EBITDA is sufficient and acceptable in both 2024 & 2025. Pre-distribution UCA is sufficient but weakened in 2025
- Post-distribution EBITDA is sufficient and acceptable for 2025 but slightly short in 2024. Post-distribution UCA is short for both 2024 & 2025
- Variance in EBITDA and UCA almost entirely related to revenue growth, which is generally acceptable
- Positive factor is primarily revenue growth. For 2025, SG&A expense management increased EBITDA margin but not back to 2023 levels.
- Negative factors include gross margin compression and volatility in SG&A expenses, both in dollars and percentages

29

123 Metal Recycling Company, Inc.

Does balance sheet reflect history of success?

Working Capital Leverage

- 2024 decline in working capital $ due primarily to unfinanced cap ex and a little shortfall in cash flow after distributions and debt service
- Equity in working capital remains adequate evidenced by $ level, current ratio and net working assets ratio
- Net cash conversion cycle remains stable with gap funded primarily by the line of credit

30

123 Metal Recycling Company, Inc.

Does balance sheet reflect history of success?

Balance Sheet Leverage

- Debt to worth has crept up over the past 2 years as liabilities (primarily working liabilities – line of credit, A/P) have increased to accommodate growth while net worth took a hit in 2024 with a significant post distribution loss
- Net worth still seems adequate despite the trend, although tangible net worth may be a bit low. Goodwill from business acquisition impacts tangible net worth

31

123 Metal Recycling Company, Inc.

Does balance sheet reflect history of success?

Operating Leverage

- Funded debt to EBITDA has been fairly volatile over the 3 year period
- Debt increases (primarily from the line) have impacted the numerator while inconsistency (primarily 2024) in EBITDA has impacted the denominator
- Ratio is a little elevated but not dramatically given the significant amount of term debt used to finance longer term assets

32

Financial Statement Analysis

Example

ABC Manufacturing Company, Inc.

33

ABC Manufacturing Company, Inc.

Can they pay it back with appropriate margin?

34

ABC Manufacturing Company, Inc.

Does balance sheet reflect history of success?

Working Capital Leverage

35

ABC Manufacturing Company, Inc.

Does balance sheet reflect history of success?

Balance Sheet Leverage

36

ABC Manufacturing Company, Inc.

Does balance sheet reflect history of success?

Operating Leverage

37

Questions?

38

Home Study Problem

39