

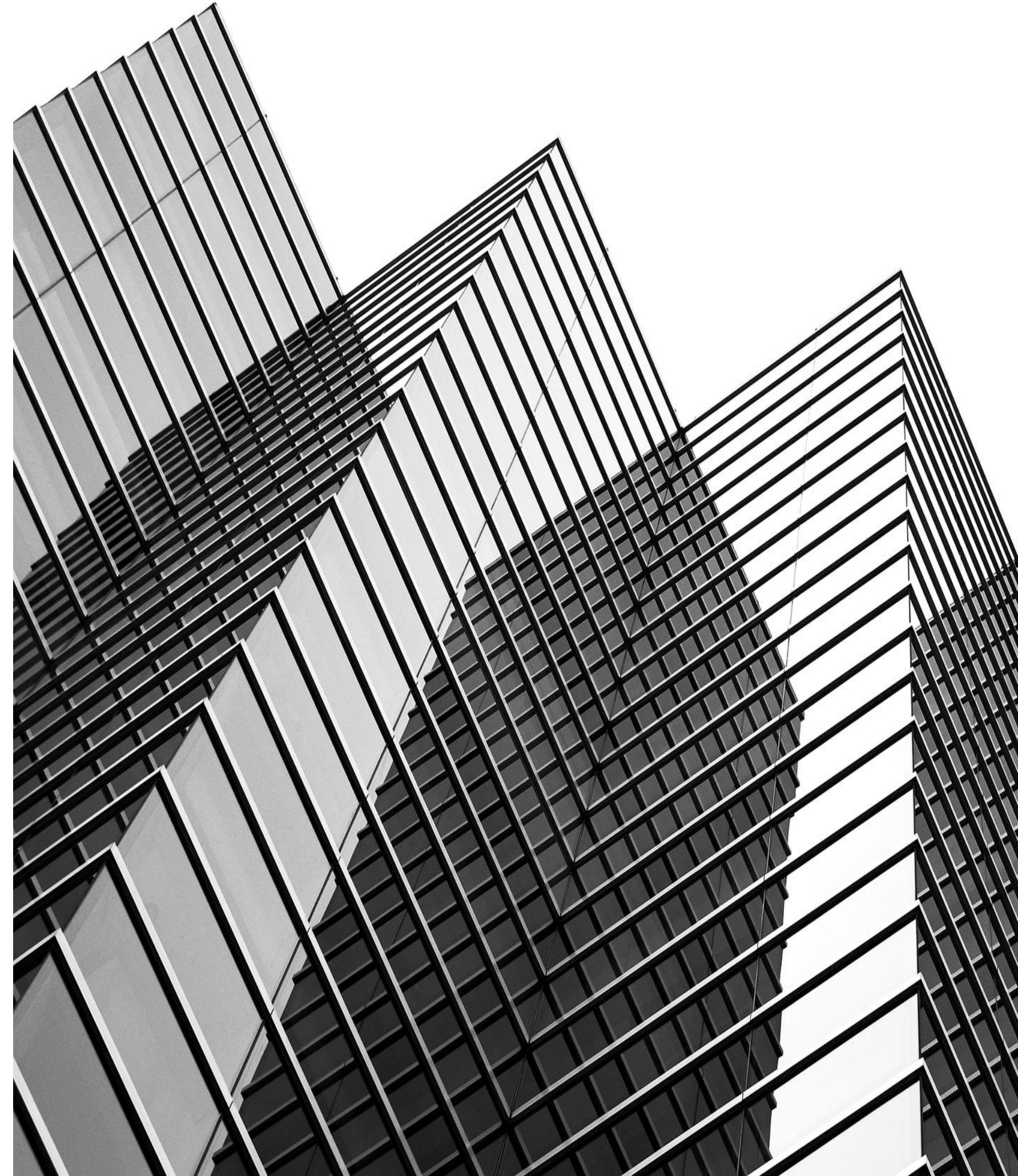


**Entrepreneur
& Family**
BUSINESS COUNCIL

The Five C's of Credit

The Five C's of Lending

Presented By Wintrust & Matt Hammer





Matt Hammer
Wintrust

mhammer@wintrust.com

Office: 847.590.7042

Cell: 708.214.6002

Background

Group Senior Vice President & Division Manager in Wintrust's Commercial Bank managing Chicago based middle market privately held businesses. Matt has 20+ years of commercial banking experience, including helping lead Wintrust's growth since 2013 with a diverse experience with manufacturing, distribution and service companies. Matt joined Wintrust in 2013, and prior to that worked at LaSalle Bank and its successor Bank of America for 10 years.

Graduate of Purdue University, Krannert School of Management with focus in Finance and Marketing.



What are the 5 C's of Commercial Lending

A number of factors go into a companies need to potentially borrower money. There is no One-Size-Fits-All in terms of experience, industry, capital needs, and long-term objections. Five (and sometimes more) key factors go into bank's decisions when making lending decisions.

Character

Capacity

Capital

Collateral

Conditions

Character

- **Business track record:** Start-up may be considered anything with less than three years of operations.
- **Personal Credit Score:** 720 and above and great, 650 and above is good and items causing credit scores to be low need to be explained and may simply need to be cleaned up over during the application process.
- **Known to the bank:** Do you know your banker and/or their Senior Management/Decision Making team for a period of time?
- **Referrals:** if new to a bank, were you referred in by another client or Center of Influence that is known to the bank?
- **Personal Guarantees:** Banks may require a personal guarantee of owners with greater than 20% based on the age of the company and overall financial position.

Capacity (1)

- Evaluate borrower's ability to repay a loan, looking at income, debt levels, and cash flow. “Cash Flow”
- “Ability to repay debt”
- “EBITDA”
 - Earnings aka Net Income
 - + Before aka add-back
 - + Interest
 - + Taxes
 - + Depreciation
 - + Amortization

Capacity (2) Free Cash Flow

◦ “Free Cash Flow:” Cash Flow available to service debt:

- CAPEX: Gross Capital Expenditures
- Distributions (for tax and discretionary)

· Example:

· Net Income:	\$500,000	
· Income Tax:	-	
· Interest:	55,000	
· Depreciation:	25,000	
· Amortization:	12,000	
· EBITDA:	592,000	
· Less CAPEX:	(100,000)	
· Less Distributions:	(175,000)	... Distributions for S-Corp & LLCs often assumed to be 30-40% of Net Income
· Free Cash Flow:	317,000	

Capacity (3) Lines versus Term Loans

- Lines of Credit
 - Often tied to working capital assets (AR & Inventory)
 - Sizing of lines of credit
 - Service based companies (5-10% of Revenue)
 - Manufacturing & Distribution companies (10-20% of Revenue)
- Term Loan Amortization
 - Secured Term Loans: Machinery & Equipment
 - 5-10 year amortization (typically 6-7yrs) maybe with a 5-year balloon.
 - Under collateralized term loans: Acquisitions with little collateral
 - 3-7 year amortization (typically 3-5yrs)
 - Real Estate Loans
 - 20-25 year amortization with a 5-10yr balloon.
- Amortization may vary as principal + interest (P+I) vs Principal & Interest (P&I).
 - P+I will save a borrower interest over the life of a loan but requires a higher monthly payment while P&I has a lower monthly payment but slightly higher overall interest expense over the life of a loan.

Capacity (3) Ability to repay debt

- Sample debt structure:
 - Line of credit: \$1,000,000 @ 7% Interest Rate = \$70,000
 - Equipment Term Loan: \$750,000 @ 7% with a 5 – Year Amortization = \$129,000 of principal and \$49,000 of Interest (total annual cost \$178,000).
 - Total Debt Service Cost: \$248,000
- Prior Example EBITDA: \$592,000
- Free Cash Flow: \$317,000
- Debt Service Coverage = Free Cash Flow / (Principal and Interest) =
 $\$317,000 / \$248,000 = 1.28x$.
- Goal should be greater than 1.0x and ideally with a 20% cushion of 1.20x.

Capital (1) Balance Sheet Leverage

Refers to a borrower's net worth and investment in the business, demonstrating their financial commitment.

Two main types of Leverage:

- Balance Sheet Leverage
- Cash Flow Leverage

Balance Sheet Leverage:

- Compare Total Liabilities / Tangible Net Worth
- Tangible Net Worth = Equity or Net Worth less Prepaid Expenses, Goodwill or Other Miscellaneous Assets.
- Banks (and companies) long-term goal is to have Net Worth as high as possible and Leverage as low as possible. Goal < 3.0x Leverage
- Example: Total Liabilities = \$2,500,000 and Total Tangible Equity = \$1,000,000 equals balance sheet leverage of 2.50x.

Capital (2) Cash Flow Leverage

While balance sheet leverage compares Total Liabilities to Tangible Net Worth, Cash Flow leverage compares total DEBT (Bank or Shareholder Debt) to EBITDA.

Debt is truly bank or shareholder debt and not total liabilities which include Accounts Payable and Accrued Liabilities.

The goal again for Bank and Borrowers is to have this ratio as low as possible but again a goal $< 3.0x$

Example: Total Bank Debt = \$2,250,000 and total EBITDA = \$1,500,000, total Cash Flow Leverage = 1.50x.

Cash flow leverage can vary (be higher) if the debt is secured by real estate and equipment. Manufacturers and Distributors are inclined to have slightly higher leverage than service-based companies due to equipment needs.

Collateral (1)

Banks like a combination of cash flow and collateral. Collateral is when a borrower pledges its assets as security for the loan, offering lenders a recourse in case of default.

- **Secured lending vs unsecured lending**: Most banks require a lien on an asset to be considered secured, while only very strong companies that rarely borrower may be able to qualify for “unsecured lending.”
- **An all-asset blanket lien UCC filing** (a UCC-1 financing statement) establishes a lender's security interest in all or a broad range of a borrower's business assets, rather than specific items, as collateral for a loan.
- **Equipment loans**: Banks may take a Purchase Money Security Interest (PMSI) on a specific piece of a equipment outside of a general UCC filing.
- **Real Estate Loans**: Banks would file a Mortgages and Assignment of Rents and Leases on real estate outside the normal course of action for a business loan.

Collateral (2) – Advance Rates

Advance Rates may vary based on the type of collateral that is pledged:

- . Cash: 100%
- . Securities: 50-80% depending on the type of fund:
 - . Equities
 - . Bonds
 - . Equity funds
 - . Privately held stock
 - . Partners loans that buy into a business.
- . Accounts Receivable: 75-85% (typically 80%).
- . Inventory: 25-60% (typically 40-50%).

Banks may be able to conduct an independent 3rd party “field exams” to verify and justify higher levels of lending to support higher advance rates.

- . Machinery & Equipment: New Equipment 80-100% financing versus used equipment 60-80%.
- . Real Estate: 80% for a bank to hold the loan itself, up to 90% if a bank uses an SBA 504 loan program.

Conditions (1)

This refers to the economic climate and industry trends that could impact the borrower's ability to repay the loan.

- . Not all companies have continued growing Revenue and Profits as a result of internal or external factors during the life cycle of their business.
- . Banks can account for a number of things as “Add-Backs” to Cash Flow to help support and mitigate
 - . Companies may have had one-time start-up costs.
 - . Litigation between feuding business partners.
 - . One time write-off of bad debt (A/R) from a customer.
- . What do banks like to see when reviewing a client's financial position:
 - . 3 years of CPA Financial Statements or Tax Returns.
 - . If mid-year, current interim statement and prior year interim.
 - . Current Accounts Receivable and Accounts Payable Aging.
 - . One-year projections.
 - . Revenue By Customer

Conditions (2)

SBA Loans for “Start-Ups” defined as companies with less than 2-3 years of operations.

Banks like to analyze trends which can include “Trailing Twelve Months Analysis which not only uses the most recent Fiscal Year End but then also uses the Current Interim Period compared to the Prior Interim Period:

Current Period Interim + Prior Fiscal Year – Prior Interim Period

Appraisals:

Equipment Appraisals

“Orderly Liquidation Value” (OLV) – defined as normal market time and banks may lend 70-90% against OLV.

“Forced Liquidation Value” (FLV) – defined as rapid sales process and will have a lower valuation but banks may lend 80-100% against FLV.

Real Estate Appraisals:

FIRREA requires banks to order all appraisals to be lent against and must be within 12 months. Banks may also require an Environmental Assessment.

Thank you



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