



**Entrepreneur
& Family**
BUSINESS COUNCIL

The Five C's of Lending



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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 company's need to borrow 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: less than three years of operations.
- **Personal Credit Score:**
 - 720+ is great
 - 650+ is good
 - Items causing lower credit scores need to be explained and may need to be cleaned up during the application process.



Character cont.

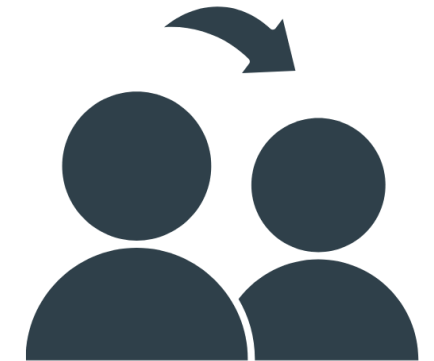
- **Known to the bank:**

- Do you know your banker and/or their Senior Management / Decision Making team? How long have you known them?



- **Referrals:**

- If you are new to a bank, were you referred by another client or Center of Influence that is known to the bank?



- **Personal Guarantees:**

- Banks may require a personal guarantee of individuals with greater than 20% ownership based on the age of the company and overall financial position.



Capacity

- Banks evaluate the borrower's **ability to repay a loan.**
- Key considerations:
 - income
 - debt levels
 - cash flow



Capacity: Free Cash Flow



What does “EBITDA” stand for?

Capacity: Free Cash Flow cont.

“EBITDA”

- Earnings (net income)
- Before (add-back)
- Interest
- Taxes
- Depreciation
- Amortization

Capacity: Free Cash Flow cont.

Free Cash Flow

=

Cash Flow available to service debt

Example:



Net Income:	\$ 500,000
Interest:	\$ 55,000
Taxes:	-
Depreciation:	\$ 25,000
Amortization:	\$ 12,000
EBITDA:	\$ 592,000

Example:



Net Income:	\$ 500,000
Interest:	\$ 55,000
Taxes:	-
Depreciation:	\$ 25,000
Amortization:	\$ 12,000
EBITDA:	\$ 592,000
Less CAPEX:	\$ (100,000)
Less Distributions:	\$ (175,000)*
Free Cash Flow:	\$ 317,000

*Distributions for S-Corp & LLCs often assumed to be 30-40% of Net Income

Capacity: 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)

Capacity: Lines versus Term Loans cont.

- **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** → principal + interest (P+I) vs. Principal & Interest (P&I)

- **P + I** will save interest over the life of a loan but has a higher monthly payment

- **P & I** slightly higher interest expense over the life of a loan but has a lower monthly payment

Capacity: Ability to Repay Debt

Example Debt Structure:



Line of Credit: \$ 1,000,000 at 7% Interest Rate = \$ **70,000**

Equipment Term Loan: \$ 750,000 at 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

Example Debt Structure:



Total Debt Service Cost:	\$ 248,000
Prior Example EBITDA:	\$ 592,000
Prior Example Free Cash Flow:	\$ 317,000

Debt Service Coverage =

$$\frac{\text{Free Cash Flow}}{\text{Principal and Interest}}$$

=

$$\frac{\$ 317,000}{\$ 248,000}$$

=

$$1.28$$



The goal is greater than 1.0x, ideally 1.20x

What You Have
What You Owe

Capital: Leverage

- Leverage refers to a borrower's net worth and investment in the business, demonstrating their financial commitment.
- Two main types of Leverage:
 1. **Balance Sheet Leverage**
 2. **Cash Flow Leverage**

Capital: Balance Sheet Leverage

- Balance Sheet Leverage compares **Total Liabilities to Tangible Net Worth**
 - Tangible Net Worth = Equity or Net Worth less Prepaid Expenses, Goodwill or Other Misc. Assets
- Banks' (and borrowers') goal is to have Net Worth as high as possible and Leverage as low as possible. **< 3.0x**
- Example:
 - Total Liabilities = \$2,500,000
 - Total Tangible Equity = \$1,000,000
 - Balance Sheet Leverage = **2.50x** ✓



Capital: Cash Flow Leverage

- Cash Flow Leverage compares **Total DEBT (Bank or Shareholder Debt) to EBITDA***
- Banks' (and borrowers') goal is to have this ratio as low as possible. **< 3.0x**

- Example:

- Total Bank Debt = \$2,250,000
- Total EBITDA = \$1,500,000
- 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.

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

Collateral

Banks like a combination of Cash Flow and Collateral.

- **Collateral** = a borrower pledges its assets as security for the loan, offering lenders a recourse in case of default

Secured lending vs unsecured lending:

- **Secured lending:** Most banks require a lien on an asset to be considered secured.
- **Unsecured lending:** Very strong companies that rarely borrow may be able to qualify for “unsecured lending”.

Collateral

- **UCC filing:**

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 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: Advanced 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%)
- **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.

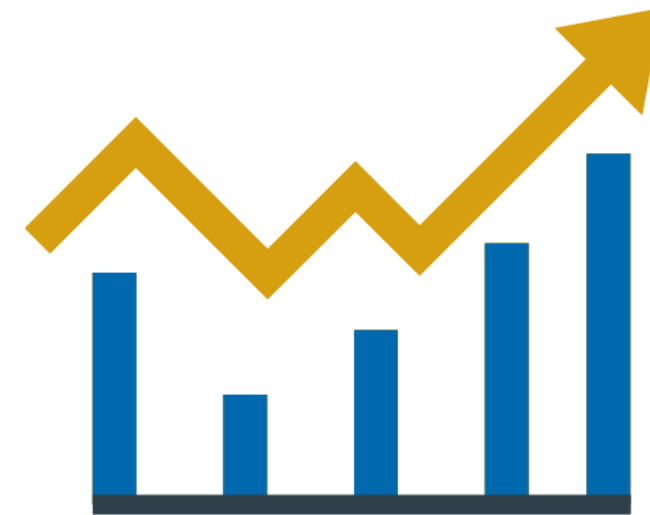
Note: Banks may be able to conduct an independent 3rd party "field exams" to verify and justify higher levels of lending to support higher advance rates.

Conditions

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



Economic Climate



Industry Trends

Conditions cont.

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 various factors.

Example Factors:

- One-time start-up costs
- Litigation between feuding business partners
- One time write-off of bad debt (A/R) from a customer

Conditions cont.

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 cont.

- **SBA Loans for “Start-Ups”**
 - “Small Business” = companies with less than 2-3 years of operations
- **Banks like to analyze trends.**
 - **“Trailing Twelve Months Analysis”** = most recent Fiscal Year End AND the Current Interim Period compared to the Prior Interim Period:

Example
date ranges:



Conditions: 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.

Summary

Several factors go into a bank's decisions when making lending decisions.

These can be grouped into 5 categories:

1. Character

The borrower's reputation and track record

2. Capacity

The borrower's ability to repay the loan from cash flow

3. Capital

The borrower's own financial stake or net worth

4. Collateral

Assets pledged to secure the loan

5. Conditions

The broader environment considering internal and external factors

Thank You



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