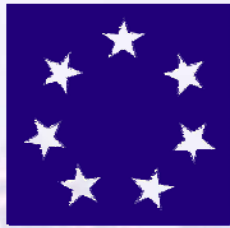

Southeastern
Commercial
Finance, LLC

C&I LOAN EVALUATION

UNDERWRITING GUIDELINES

A Whitepaper

C&I Lending

Commercial and Industrial, or C&I Lending, has long been a cornerstone product for many successful banking institutions. Also known as working capital, line of credit, or asset based lending, C&I Lending provides to the Bank customer an open line of credit by which the borrower may draw up and down depending on collateral availability and line constraints. Because of the liquid nature of the primary source of repayment; accounts receivable and inventory, some have the impression that C&I Lending carries a higher level of risk than real estate and other secured loans. Nothing could be further from the truth. Properly underwritten and managed, charge off and delinquency rates of C&I portfolio loans are generally not greater, and often less than other commercial loan products.

C&I Lending should be a core competency of the Bank Commercial Lending function. The benefits of an active C&I effort are many for the bank. The C&I Lender typically has control of the entire banking relationship. Due to the nature of the C&I relationship, cash management services and commercial deposits are a given requirement of the loan package. Cross sell opportunities are many, making C&I Lending a highly profitable loan product.

More recently the dominion of larger financial institutions, a well defined and targeted C&I loan product can be used to grow assets by financial institutions of all sizes. Particularly attractive for Banks is the small to medium sized business market, as historically regional banks have not effectively penetrated this market due to limited relationships and standardized underwriting. This market provides a significant opportunity for Banks with C&I competence.

Effective C&I Lending is not difficult, but it does require basic disciplines to be effective and profitable. These disciplines must be applied to the prospecting, underwriting, and management of C&I Loans. This Paper explores disciplines needed for Effective Loan Evaluation and Underwriting of C&I Loans, and provides basic evaluation methods for use with specific prospects.

For Further Information or Comments, visit us on the web at www.southeasterncommercial.com, or call us at 205.250.8026.

We welcome your input.

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C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Purpose:

Effective C&I Lending depends on the ability to execute three basic functions: Identify Loan Prospects, Underwrite Loans, and Manage Loans. Long term success is dependent upon the ability to do each of these equally well and at a high level. Continuous improvement in each of these areas should be the goal of every organization. For initial underwriting and ongoing credit review purposes, the following principals serve as guidelines.

Goals:

As a minimum competence level, it is anticipated that every professional with prospecting, underwriting, or loan management responsibilities will:

- Understand and be able to apply basic evaluation methods for the categories of collateral that make up the collateral pool for a C&I Loan facility.
- Be able to determine with relative confidence the quality of collateral offered for a loan transaction.
- Understand the basics of Accounts Receivable agings and be able to evaluate.
- Understand the concept of advance rates, ineligible collateral, and dilution.
- Understand and be able to apply basic evaluation methods to prospects' and customer’s financial statements.
- Understand basic cash flow concepts as they relate to the quality of a prospect or customer.
- Be able to use a practical approach to apply when evaluating a prospective or existing customer.

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Overview:

A cornerstone competency of successful C&I Lenders is the ability to evaluate the characteristics of collateral and financial performance that make a prospective loan customer desirable or undesirable. A continuing focus is on understanding in a practical sense the quality, validity, and collectability of collateral securing the loan. Additionally, there should be focus on performance issues as represented by a prospect's historical financial statements that may impact the viability of the borrower as an ongoing entity. Each professional has an ongoing duty to identify and monitor the ability and capacity to each prospect and customer to repay the loan and their business to succeed. These guidelines include practical guidance and tools to be used in evaluating prospective borrowers and existing customers. The successful professional should understand and be able to apply each of these guidelines and tools on a consistent basis.

Evaluation of Accounts Receivable:

Accounts Receivable are defined as short-term obligations arising from the sale of goods or services in the normal course of business.

The quality of accounts receivable to a lender are influenced by several factors. These include quality of account debtor, size of invoice, expense to collect, unusual terms or conditions of sale, quality of borrower record keeping, borrower credit policies, and others.

Tools for General Evaluation of Accounts Receivable:

- Who is the Receivable from?
- What are the terms?
- Is the sale complete?
- Is there the possibility of dispute of the receivable?
- How long is the collection cycle (A/R turnover)?

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Application of Tools:

- Who is the Receivable from?

Large, Well Capitalized Company	- Most Desirable
Company in Financial Distress	- Least Desirable

- What are the terms?

Standard Terms or Less	- Most Desirable
Extended or Unusual Terms	- Least Desirable

- Is the sale complete?

Complete with Documentation (Bill of Lading, Verification, Etc.)	- Most Desirable
Lacks Shipment or Additional Work to Be Complete	- Least Desirable

- Is there the possibility of dispute of the receivable?

No Dispute, Sale Complete and Verifiable	- Most Desirable
Possibility of Dispute due to Workmanship or Completion of Sale	- Least Desirable

- How long is the collection cycle (A/R turnover)?

Consistent with or Better than Industry Averages	- Most Desirable
Extend Collection Cycle, High than Industry Averages	- Least Desirable

Evaluation of Inventory:

Inventory is defined as goods for sale, or goods used in the production of goods for sale. In the normal course of business, they will convert to accounts receivable or cash through the sale of goods.

The quality of inventory to a lender is influenced by several factors. These include volatility of price of inventory, whether further conversion must be done to sell, size and efficiency of potential sales market, regulatory restrictions in transfer, costs of liquidation and others.

Tools for General Evaluation of Inventory:

- What makes up the Inventory?
- How is it valued?
- Is there a ready market for the Inventory?
- What must be done to prepare Inventory for sale?
- How long is Inventory sales process?

Application of Tools:

- What makes up the Inventory?
  - Commodity Good - Most Desirable
  - Components of Manufactured Goods - Least Desirable
- How is it valued?
  - Price Set By Exchange - Most Desirable
  - Market Driven - Least Desirable
- Is there a ready market for the Inventory?
  - Large Number of Potential Buyers - Most Desirable
  - Limited Number of Industry Competitors - Least Desirable
- What must be done to prepare Inventory for sale?
  - Completed and Ready for Shipment - Most Desirable
  - Assembly Required - Least Desirable
- How long is Inventory sales process?
  - Immediate Buyers Available - Most Desirable
  - Extended Sales Process - Least Desirable

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Evaluation of Accounts Receivable Agings:

The Accounts Receivable Aging is a listing, whether in detail or summary, of all outstanding invoices owed to a Company. The ability to understand and evaluate the Accounts Receivable aging is among the most important and fundamental skills of a C&I Lending Professional.

The Accounts Receivable Aging will typically contain listing of all invoices grouped in categories indicating how long from either invoice date or due date the invoice has been outstanding. Typical groupings might include the following:

Current 30-60 Days 60-90 Days Over 90 Days

An Aging by Invoice Date will begin aging the account upon issuance of the invoice. An Aging by Due Date will begin aging the account after the invoice is past due according to established payment terms. Invoice Date agings tend to be more conservative.

Tools for General Evaluation of Accounts Receivable Agings:

- Is the Aging in Detail or Summary?
- What portion of the Accounts are Past Due?
- Is there a concentration of Accounts due from a limited number of Customers?
- What is the Average Invoice Size on the Aging?
- Does Aging appear reasonable?

Application of Tools:

- Is the Aging in Detail or Summary?
  - Detail - More Information
  - Summary - Less Information
- What portion of the Accounts are Past Due?
  - Less than 5 to 10% - More Desirable
  - Over 10% - Less Desirable

- Is there a concentration of Accounts due from a limited number of Customers?

Reasonable number of Customers	- Most Desirable
High levels of small Customers	- Less Desirable
Very Limited number of Customers	- Least Desirable

- What is the Average Invoice Size on the Aging?

Sizable but manageable Invoice Size ($1,000-$20,000)	- Most Desirable
Small Invoice Size (<$250)	- Less Desirable
Extremely Large Invoice Size ($50,000, $100,000 plus)	- Least Desirable

- Does Aging appear reasonable?

Are unpaid accounts left on Aging for significant periods(>six months)	- Undesirable
Is there evidence of continuing to sell to slow pay or problem accounts	- Undesirable
Do finance charges make up a sizable sum on the Aging?	- Undesirable
Is there evidence of significant partial payments?	- Undesirable
Is there evidence of significant credits, negative balances or other offsets?	- Undesirable
Is there evidence of Contra Accounts?	- Undesirable

Contra Accounts occur when a borrower's customer is also a supplier. This should be apparent when the same company appears on both the receivable and payable agings. Collecting a receivable will likely be very problematic because the borrower’s customer will claim a right of offset.

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Advance Rates, Collateral Eligibility, and Dilution:

The Advance Rate is the percentage of face value a lender will lend on the eligible amount of a particular piece or class of collateral. The first step in determining how much the lender is willing to lend is to decide what collateral is eligible for inclusion in the borrowing base and what collateral is ineligible.

Eligible Collateral is collateral that a C&I Lender is confident will convert to cash for loan repayment, and therefore will lend against. Ineligible Collateral is that portion or percentage of the collateral offered for a loan advance that a lender is not comfortable lending against and therefore excludes from availability.

An effective lender should be highly focused on the dilution of the accounts receivable and will establish and continually review availability criteria to protect against the effects of dilution.

Dilution is defined as that percentage of each invoice that does not convert to cash. Items which affect the dilution percentage includes credits, returns and allowances, bad debts, discounts, advertising allowances, volume rebates, freight allowances, and items.

Standard Ineligible Categories for Accounts Receivable:

- Accounts Over 60 or 90 Days from Invoice Date. This may vary by prospect and customer.
- Cross Aged Receivables. Accounts that are such slow pay that the entire account is in question. For example, using a 25% cross age rule, if over 25% of the invoices on an account are ineligible, the entire account is ineligible.
- Receivable balances over predetermined credit limit. Lenders can and often do establish set credit limits per account debtor. Any amount owed by the particular account debtor in excess of that credit limit is ineligible.
- Contra Accounts.
- Credit Memos
- Governmental Accounts
- Foreign Accounts
- Intercompany or Affiliated Accounts
- Progress Billings.
- Guaranteed Sales

Standard Ineligible Categories for Inventory:

- Work in Process. Goods that are not ready for sale, but must have additional product or work to complete.
- Inventory in remote locations. Bonded Warehouse goods can be and often are an exception, particularly if the value is readily determinable.
- Consignment Inventory
- Obsolete Inventory

Once the amount of eligible collateral has been determined, an advance rate is established to be applied to the eligible amount of each category of collateral. This advance rate should be reviewed at each renewal or credit review.

Rules of Thumb in Establishing Account Receivable Advance Rates:

- Accounts Receivable Advance Rates typically range from 65 to 85%. The most typical advance rate is 75-85%.
- The higher the quality of Accounts, the higher the advance rate.
- A general formula for estimating A/R advance rates = 100% minus (past due percentage + 10%) or 100% minus (dilution percentage + 10%). Every advance rate must be verified by the initial and ongoing collateral audit in addition to monthly trends reports.

Rules of Thumb in Establishing Inventory Advance Rates:

- Inventory Advance Rates typically are much less than against accounts receivable. Typical ranges are 25-35%.
- The more liquid the Inventory the higher the Advance Rate.
- The more commodity in nature the Inventory, the higher the Advance Rate.
- The more control a lender may exercise over the inventory, the higher the Advance Rate.
- It is appropriate to require additional collateral in instances where Inventory Advance Rates in excess of normal ranges are provided. This may be in the form of equipment, real estate, or other acceptable collateral.
- With the exception of certain pre approved seasonal inventory overadvances, inventory advances should not exceed A/R availability.

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Evaluation of Financial Statements

The proper evaluation of financial statements over several time periods should provide a clear understanding of the ongoing business outlook of the prospect and customer. This is and should be an important determinant of the quality of a prospect or customer. Each customer's financial statements should be evaluated on a monthly basis.

In order to make an accurate evaluation of the business's financial prospects, it is important to get a complete package of historical financial information to review. This is imperative in the ongoing evaluation of the customer or prospects progress.

For purposes of evaluating a prospective customer a complete financial package should include the following:

- Last three fiscal year-end Financial Statements (Balance Sheet and Income Statement)
- Interim Financial Statements for the most recent month available and comparable
- Interim Financial Statements for the prior year.
- Financial Projections if available.

Evaluation of the Income Statement

The Income Statement is a document generated monthly and/or annually that report the earnings of a company by stating all relevant income and all expenses that have been incurred to generate that income. It is also referred to as a profit and loss statement.

The Income Statement Shows What Has Happened in the Business Over a Period of Time.

Relevant Definitions:

Income includes all the income generated by the business.

Cost of goods includes all the costs related to the sale of products in inventory.

Gross profit margin is the difference between revenue and cost of goods. Gross profit margin can be expressed in dollars, as a percentage, or both. As a percentage, the GP margin is always stated as a percentage of revenue.

Operating expenses include all overhead and labor expenses associated with the operations of the business.

Net profit is the difference between gross profit margin and total expenses. The net income depicts the business' debt and capital capabilities.

Depreciation reflects the decrease in value of capital assets used to generate income. It is also used as the basis for a tax deduction and an indicator of the flow of money into new capital.

Earnings before interest and taxes shows the capacity of a business to repay its obligations.

Interest includes all interest payable for debts, both short-term and long-term.

Taxes includes all taxes on the business.

Net profit after taxes shows the company's real bottom line.

Tools for General Evaluation of the Income Statement:

- Is the Company making money?
- Are Earnings Increasing or Decreasing?
- Are Interim Earnings Consistent with Prior Year?
- Are Sales Increasing or Decreasing?
- What is the Gross Profit Margin and have there been there significant changes in the Gross Profit Margin or Operating Expenses?
- Does management have an explanation for Changes in the Earnings Profile, and does it make sense?
- If Projections are provided, do they make sense?

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Application of Tools:

- Is the Company making money?

Yes, Healthy Earnings	- Most Desirable
No, Significant Losses	- Least Desirable

- Are Earnings Increasing or Decreasing?

Earnings Steadily Increasing	- Most Desirable
Earnings Deteriorating	- Least Desirable

- Are Interim Earnings Consistent with Prior Year?

Yes, Earnings Profile Similar	- Most Desirable
No, Significant Earnings or Losses in Comparison	- Least Desirable

- What is Gross Profit Margin and have there been significant changes in GPM and Operating Expenses?

Healthy, Consistent Gross Profit Margin and Operating Expenses	- Most Desirable
Small or Inconsistent Gross Profit Margin and Operating Expenses	- Least Desirable

- Does management have an explanation for Changes to the Earnings Profile, and does it make sense?

Comprehensive, Reasonable Explanation	- Most Desirable
Limited Understanding of Business Dynamics	- Least Desirable

- If Projections are provided, do they make sense?

Reasonable and Obtainable with Achievable Dynamics	- Most Desirable
Pie in the Sky, “Hope as a Strategy”	- Least Desirable

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Evaluation of the Balance Sheet

The Balance Sheet is a financial statement that lists the assets, liabilities and equity of a company at a specific point in time and is used to calculate the net worth of a business. A basic tenet of double-entry book-keeping is that total assets (what a business owns) must equal liabilities plus equity (how the assets are financed). In other words, the balance sheet must balance. Subtracting liabilities from assets shows the net worth of the business.

The Balance Sheet is a Financial Picture of the Business As of a Point in Time.

Relevant Definitions:

The top portion of the balance sheet should list the company's assets in order of liquidity, from most liquid to least liquid.

Current assets are cash or its equivalent or those assets that will be used by the business in a year or less. They include the following:

- Cash is the cash on hand. This refers to all cash in checking, savings and short-term investment accounts.
- Accounts receivable are short term obligations due the business arising from sale of goods or services.
- Inventory is goods for sale, or goods used in the production of goods for sale.

"Total current assets" is the sum of cash, accounts receivable, inventory and supplies.

Long-term or fixed assets are assets that are durable and will last more than one year. Examples of long-term assets include the following:

- Fixed Assets or Property, Plant, and Equipment is the book value of all capital equipment and property (if you own the land and building), less depreciation.
- Investment includes all investments owned by the company that can't be converted to cash in less than one year. For the most part, companies just starting out have not accumulated long-term investments.
- Miscellaneous assets are all other long-term assets that are not "capital and plant" or "investment."

"Total long-term assets" is the sum of capital and plant, investments, and miscellaneous assets.

“Total assets" is the sum of total current assets and total long-term assets.

After listing the assets, you then have to account for the liabilities of the business. Like assets, liabilities are classified as current or long term**.**

Current liabilities are debts that are due in one year or less. Here are examples of current liabilities:

- Accounts payable include all costs incurred by the business that are related to purchases from regular creditors on an open account and are due and payable.
- Accrued liabilities are all expenses incurred by the business that are required for operation but are not yet due at the time the books are closed. These expenses are usually the company's overhead and salaries.
- Notes Payable is any obligation from a Lender due in one year or less. Typically this includes any Line of Credit or amount owed to Factors, and also Current Maturities of Term Debt.

Taxes are those payments still due and payable at the time the books are closed.

"Total current liabilities" is the sum of accounts payable, accrued liabilities, notes payable, and taxes.

Long-term liabilities are debts that are due in more than one year. Long-term liabilities include the following:

- Long Terms Debt is all amounts financed on a term basis that won’t be repaid during the current year.
- Other long term liabilities may include deferred taxes, long term contracts payable or other miscellaneous obligations not due within one year.

"Total long-term liabilities" is all Long Term Debt and other obligations not due within the year.

"Total liabilities" is the sum of total current and long-term liabilities.

Once the liabilities have been listed, the **Net Worth** can then be calculated. The amount attributed to **Net Worth** is the difference between total assets and total liabilities.

Total Assets – Total Liabilities = Net Worth

Debt to Worth or Leverage = Total Liabilities/Net Worth

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Tools for General Evaluation of the Balance Sheet:

- Does the Company have a Positive or Negative Net Worth/High or Low Leverage?
- Do Receivable, Inventory, and Accounts Payable Look Consistent with Sales Levels?
- Does The Company Have Significant Long Term Debt?
- Do Accounts Receivable and Inventory appear sufficient to support the Financing Need/Request at an appropriate margin?
- Are there Unusual Items on the Balance Sheet (Large Employee Receivables, Large Accrued Taxes, Non Business Assets or Liabilities, etc)?

Application of Tools:

- Does the Company have a Positive or Negative Net Worth/High or Low Leverage?

  High Net Worth/Low Leverage - Most Desirable

  Deficit Net Worth/High Leverage - Least Desirable

- Do Receivable, Inventory, and Accounts Payable Look Consistent with Sales Levels?

  Consistent with Stated A/R and A/P Terms - Most Desirable

  Turns well past Stated A/R and A/P Terms - Least Desirable

- Does The Company Have Significant Long Term Debt?

  Little or No Long Term Debt - Most Desirable

  Significant Term Debt - Least Desirable

- Do Accounts Receivable and/or Inventory appear sufficient to support the Financing Need/Request at an appropriate margin?

  At Conservative Margin, Excess Availability is indicated - Most Desirable

  Financing Need Much Greater than Accounts Receivable and Inventory can Support - Least Desirable

- Are there Unusual Items on the Balance Sheet (large Employee Receivables, large Accrued Taxes, non- business Assets or Liabilities, etc)?

  All Items on Balance Sheet appear relevant to business Operations - Most Desirable

  Strong Evidence of non-business items on Balance Sheet - Least Desirable

C&I LOAN EVALUATION AND UNDERWRITING GUIDELINES

Loan Evaluation and Underwriting Guidelines Summary

In order to be successful, every professional with prospecting, underwriting, or loan management responsibilities should master basic collateral valuation and credit skills in order to evaluate the feasibility of making a loan, continuing in a loan relationship, or amending the current loan structure. These Guidelines are designed to form a framework for initial and continuing evaluation of the C&I loan portfolio. Proper evaluation of the collateral leads to proper structuring of ineligible categories and advance rates for the financing arrangement. Basic credit skills lead to sound initial underwriting and ongoing risk evaluation. ***The ability to understand and apply these principals and guidelines in accordance with C&I loan policy is directly correlated with long term success.***

By utilizing application of these general tools, lenders with any level of experience should be able to make better and more informed decisions regarding the desirability of a specific loan request. It is recommended that each set of tools be specifically used in the analysis process. Additional training and development in these principals and concepts are available.

Each professional is responsible for acquiring, maintaining, and improving knowledge of each of the guidelines presented. ***If you do not have a high level of understanding of each concept and be in a position to apply them on a practical level, please review with your direct report.*** Additional training in these principals and concepts are available.