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MEMPHIS CHAPTER

Workshop on C&I and Asset Based Lending Principles

April 12, 2011

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Workshop Goals:

- Understand and be able to apply basic evaluation methods for the categories of collateral that make up the collateral pool for C & I or Asset Based Line of Credit.
- Be able to determine with relative confidence the quality of collateral offered for a loan transaction.
- Be able to structure a loan transaction with appropriate advance rates.
- Be able to confidently monitor the loan on an ongoing basis.

What is C&I and Asset Based Lending?

- C&I and Asset Based Lending is secured lending based on a formula applied to commercial accounts receivable and inventory to generate immediate working capital.

- Typically receivables less ineligibles are included in the borrowing base at 75% to 85% of invoice total.

- Typically raw materials and finished goods inventory are included in the borrowing base at not greater than 50% of cost or liquidation value.

- The borrowing base is adjusted on a periodic basis via a Collateral Loan Report.

- To have an accurate borrowing based facility companies must have a perpetual inventory system.

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Cash Flow Cycles of C&I and Asset Based Loans are determined by the relationships between A/R Turns, Inventory Turns, & A/P Turns.

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Clients to Avoid

- Construction Receivables
- Medical A/R
- Progress bill A/R
- Sub-contract bill A/R
- International Receivables
- Inventory at numerous locations
- Inventory in transit from foreign countries
- Foreign inventory

Basic Collateral Evaluation Skills: Accounts Receivable

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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)?

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
    - Dated Receivables (Seasonal)
    - Consignment / Guaranteed Sale

- Is the sale complete?
  - Complete with Documentation (Bill of Lading, Verification, Etc.) - Most Desirable
  - Lacks Shipment or Additional Work to Be Complete - Least Desirable
    - Percentage Billings (payments based on % completed)
    - Progress Billings (payments made at set intervals until completion)

- 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

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- How long is the collection cycle (A/R turnover)?
  - Consistent with or Better than Industry Averages - Most Desirable
  - Extended Collection Cycle, Higher than Industry Averages - Least Desirable

Standard Ineligible Categories for Accounts Receivable:

- Accounts Over 60 or 90 Days from Invoice Date
- Cross Aged Receivables
- Receivable balances over predetermined credit limit
- Contra Accounts
- Credit Memos
- Governmental Accounts
- Foreign Accounts
- Intercompany or Affiliated Accounts
- Progress Billings
- Guaranteed Sales

Receivables Availability

- Total Accounts Receivable minus Ineligible Accounts Receivable = Eligible Receivables
- Eligible Receivables multiplied by Receivables Advance Rate = Receivables Borrowing Base
- Receivables Borrowing Base plus Inventory Borrowing Base = Total Borrowing Base
- Total Borrowing Base minus Outstanding Principal = Availability

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Rules of Thumb in Establishing Account Receivable Advance Rates:

- Accounts Receivable Advance Rates typically range from 65 to 90%. 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%)

Case Study
Account Receivable

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Basic Collateral Evaluation Skills: Inventory

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Editorial Comment: "Underwriting Accounts Receivable is a Science. Underwriting Inventory is Witchcraft."

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

Standard Ineligible Categories for Inventory:

- Work in Process
- Inventory in remote locations
- Consignment Inventory
- Obsolete Inventory

Inventory Availability

- Total Inventory <u>minus</u> Ineligible Inventory = Eligible Inventory
- Eligible Inventory <u>multiplied by</u> Inventory Advance Rate = Inventory Borrowing Base
- Accounts Receivable Borrowing Base <u>plus</u> Inventory Borrowing Base = Total Borrowing Base
- Total Borrowing Base <u>minus</u> Outstanding Principal = Availability

Rules of Thumb in Establishing Inventory Advance Rates:

- Inventory Advance Rates typically are much less than against accounts receivable. Typical ranges are 25-50%.
- 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.

Case Study: Inventory

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Monitoring C&I and Asset Based Loans

The Collateral Loan Report is the primary document used to monitor a C&I or ABL Loan.

The quality of information provided in the Collateral Loan Report is **critical** to the collectability of the loan.

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The Collateral Loan Report is a reconciliation of all changes to the Collateral Base; that brings Borrower and Lender up to the present.

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The Collateral Loan Report Should Reflect:

A) The collateral underlying the Loan at a point in time and

B) What changes have occurred in the collateral base since the last report.

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The Collateral Loan Report is meaningless without appropriate supporting documentation. The Report should always be supported by the following:

- Completed collateral loan report as of month end.
- A report of new billings (sales journal) for the month.
- A report of collections (cash receipts journal) for the month.
- An A/R Aging as of month end.
- An inventory listing as of month end.
- A monthly P&L balance sheet.

Frequency of Reporting

The Frequency of Reporting should be determined based on:

- Percentage Line Utilization
- Quality of Collateral
- Strength of Credit (earnings, leverage, etc.)
- Quality of Accounting Function
- Most bank C&I Loans require monthly reporting, but do not hesitate to require more frequent reporting.

Important Reconciliation Items

- Additions to Accounts Receivable *(Line 2)* should reconcile to monthly sales journal and sales on income statement.
- Cash collections *(Line 3a)* should reconcile to monthly cash receipts journal and bank deposits.
- Total gross accounts receivable *(Line 4)* should reconcile to month end A/R aging and balance sheet.
- Total Inventory *(Line 7)* should reconcile to month end inventory report and balance sheet.
- Outstanding low balance should reconcile to balance sheet and bank records, as month end.

Questions?