



# Small Business Underwriting

The CDFI Fund's Capacity Building Initiative:  
Building Native CDFIs' Sustainability and Impact II

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ICF and First Nations Oweesta Corporation, Inc.



# Disclaimer

*About the creation of this presentation:*

*The development of this presentation was funded by the CDFI Fund, under Contract No. GS00Q14OADU119. The information provided and opinions expressed in this presentation are those of the authors, who are solely responsible for the content, and do not reflect the opinions of the CDFI Fund or any other person, entity, or organization.*

# Introduction

*Feel more confident in your underwriting efforts and process! This webinar is the second part of the two-part series focused on underwriting. This webinar will walk through the underwriting process, focusing on risk assessment for micro and small business lending.*

*While each webinar is designed to stand alone, participants are also encouraged to review to the first webinar in the series, which laid the foundation of the underwriting process.*

## **This Webinar Will Help Participants:**

- Describe the role of a small business underwriter
- Discuss the small business underwriting process
- Describe the key elements of a credit memo
- Perform risk analysis on a small business loan

# Presenters

- Krystal Langholz, Chief Operating Officer
- Emily Trump, Lending and Compliance Manager

# Polls

- Did you participate in the last webinar?
  - Yes/No
- What is your experience level with underwriting?
  - Beginner/Intermediate/Advanced

# The Business Landscape

(How the environment your Native CDFI is working in affects your loans)

- Business start-up/employment decisions often primarily guided by family and community needs, not profit margins
- Disconnect with (or absence of) banks
- Attracting and retaining employees can be a hit & miss proposition
- Growth limited by access to markets, financial resources, and information
- May have little time (or place) for networking
- Commercial space can be very limited
- Very little existing small business infrastructure



# How Much Risk Do CDFIs Take?

- Microenterprise lenders average 3.1% 90+ day delinquencies and 3.4% loss rate
- Business lenders average 2.7% 90+ day delinquencies and 1.64% loss rate
- Average loss rate for all types of lending is 1.21%

-OFN, 2019, *Opportunity Finance Institutions Side by Side: Fiscal Year 2018 OFN Member Data Analysis Twenty First Edition*, <https://ofn.org/articles/annual-side-side-cdfi-reference-guide-now-available>



# CDFIs Best Practices for Managing Risk

## Each Loan

- Strong underwriting that identifies and mitigates risk
- Active monitoring that identifies red flags early on
- Technical Assistance
- Appropriately firm approach to collections that follows your lending policies

## Whole Portfolio

- Loan Policies
- Checks and Balances in Decision Making
- Loan Loss Reserve
- Capital Structure
- Annual Review of portfolio, gathering of lessons learned



# Small Business Underwriting...

1. Helps you make sure you understand the level of risk
2. Helps you determine if there is a way to reduce the risk
3. Then helps you determine if the level of risk is acceptable



# The 10-step Business Lending Process

1. Discovery
2. Intervention
3. Due Diligence
4. Loan Presentation
5. Loan Committee
6. Loan Decisions and Conditions
7. Loan Closing
8. Disbursement of Funds
9. Use of Funds
10. Servicing/Monitoring

# Loan Review Process- Issues

- Process efficiency – cycle time
- Process thoroughness – risk management

# Initial Screening

- Guidelines for the eligibility of borrower, project, and use of funds
- Guidelines to determine the desirability of projects
- Red flags

# Application/Loan Negotiation

- Required documents:
  - Personal financial statements
  - Legal eligibility to apply
  - Credit check
- Formal policy and statement on confidentiality
- Required technical assistance
- Disclosure: Amount, Rate, Repayment, Term, Collateral, Covenants, Fees

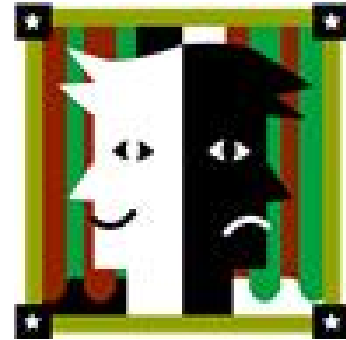
# Combining Development Services to Reduce Lending Risk

- Using the loan application process to assess character
- How much business planning is enough?
- Portfolio stability is needed to make loans at the margin
- Post loan TA needs to be determined in the underwriting process

# Underwriting: Discovery & Intervention

## The Role of the Loan Officer/TA Provider

- Conduct initial interview
- Review personal credit history
- Inform about lending process
- Assist with priority setting process
- Review technical assistance needs/options
- Create resolve for a due diligence process
- Assess level of commitment: Let client know what you will do; let them know what they need to do
- Loan Officer has dual role





# Underwriting a Loan – Due Diligence

## Business Planning Considerations

- What is the aggravation index? *Must balance needs and requirements*
- What are the market issues? *What is the scale of enterprise is necessary to create sufficient profits?*
- What is management capacity? *Can they do it?*

# Underwriting a Loan – Due Diligence, cont...

## Financial Considerations

- How much money do they need now? *Can the business grow to get bigger loans?*
- When will the money be needed? *Loan draws are a good thing!*
- What is the money needed for? *Capacity building or salaries?*

# POP QUIZ– Name the “C’s” of Business Underwriting!



# Due diligence — Looking at the “C’s” Differently

- Character (or credit)
- Capital (and commitment)
- Capability
- Cash Flow
- Conditions
- Collateral
- Community Benefit



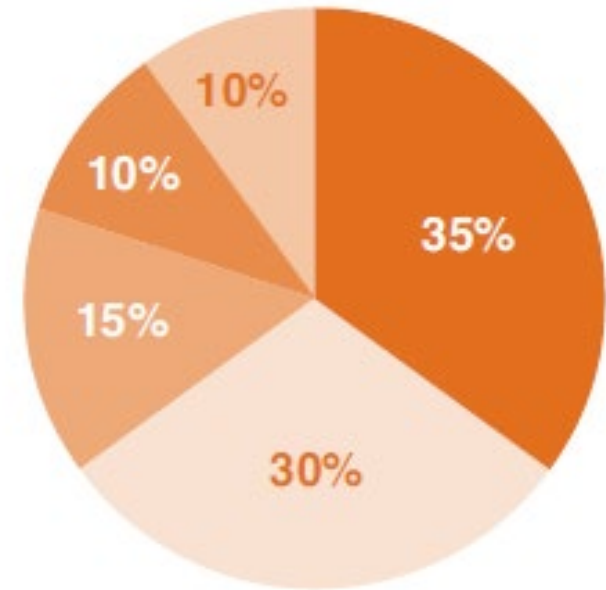
# Determining CHARACTER:

## Will the borrower repay the loan?

- Credit report
- Non-traditional credit history
- Work references
- Stick-to-it-iveness
- Work history
- Loan application (does it match up with other information you have?)
- Loan process

# FICO Scores

- 35% Payment History
- 30% Current Debt
- 15% Length of History
- 10% Types of Credit
- 10% Applications



In 2019, average score was 703, according to Experian

# Credit Scores – What's OK?

720 – 850	Excellent
675 – 719	Good
620 – 674	Fair
Below 620	Poor – subprime

In 2019, average score was 703, according to Experian



# Non-Traditional Credit References

- **When?**

When there is little or no credit on the report

- **Who?**

Bank statements

Utilities

Landlords

Unsecured lenders

Child care providers

Cell phone statements

Other

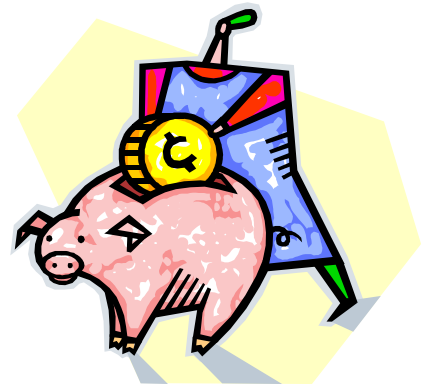
# Reducing Character/Credit Risk

- Controlled disbursements
- Payments to vendors only
- Heavy-duty TA; credit coaching
- Co-borrower or guarantor
- More collateral
- Collection items, child support, and tax liens generally are unacceptable

*Can this risk really be mitigated?*

# Capital: “Skin in the Game”

- Shows commitment
- Does the applicant have savings?
- Has the applicant put any money into the project/business in last 6-12 months?
- Does the business have any reserves?



# Reducing Capital Risk

- Require completion of business planning course
- Require completion of financial literacy training and/or additional savings
- Get a co-borrower/guarantor
- Enroll in IDA program
- Get family investment
- Other?

# Capability

- Business
  - Does the applicant have skills in the particular business they want to start?
  - Does the applicant have time/resources for business?
- Management
  - Does the applicant have business management/ownership skills?
  - Can the applicant develop the skills?

# Reducing Capability Risk

- Require completion of business planning course
- Require working in a similar business as an employee
- Require completion of business-specific training or license
- Require additional key staff/assistance be identified (e.g., bookkeeper, attorney, etc.)
- Other?

# Cash Flow

- Cash Flow is KING!!!
- Can the applicant make the loan payments?
- Look at personal and business financial situations
- Look at historical and projected for the business
- Look at sources of cash flow
- Business plan projection assumptions are CRITICAL



# Business Financial Statements

- Three pieces of the puzzle
  - Cash flow statement
  - Profit/loss or income statement
  - Balance sheet



# How Financial Statements are Related

## How did we do?

### Profit/Loss Statement

Revenue from Sales - Cost of Goods Sold = Gross Margin

Gross Margin - General & Administrative Expenses - Earnings Before Tax - Depreciation - Provision for Tax = Net Profit / Loss

*Match sales to expenses for a period of time*

## Where's the cash?

### Cash Flow Statement

Beginning Cash + Cash In - Cash Out = Ending Cash

*Actual cash in & out for a period of time*

## What do we own? What do we owe?

### Balance Sheet

Assets – Liabilities = Net Worth

*Shows business equity at a given point in time*

# Why Are Financial Statements So Important?...They Tell a Story

- Uncover problems
- Identify opportunities for improvement
- Show owner's understanding of the business

# Capacity – Other Considerations

- Are there other sources of income?
  - Spouse with a job?
  - Second job?
  - Transfer payments?
  - Per capita payments from tribal earnings?
  - Other?

If so, include them in mix.

# Reducing Capacity Risk

- Reduce loan amount
- Longer term or varied amortization
- Debt consolidation/refinance
- Require applicant to save more first
- Question all projection assumptions
- Consider “worst case” scenario
- Have applicant start smaller (e.g., start part-time and keep job)
- Technical assistance

*Under what circumstances should you make a loan if the cash flow isn't positive?*

# Conditions – External Factors

- Regional/national economy
- Local economy
- Specific industry
- Competition
- Legislation/politics
- Product/service desirability
- Ability to weather continued recession

# Reducing Conditions Risk

- Perform market study
- Refine business plan
- Use conservative financial projections
- Revise loan structure, amount
- Explore additional markets available
- Monitor regularly and provide TA
- Require more savings/equity



# Native CDFI Collateral

What types of collateral?



# Collateral Considerations

- Valuing collateral
  - Use community information and industry standards
- Discounting collateral
  - Must discount to allow for depreciation, devaluation, transaction/sale costs
- Match loan term to collateral life
- Generally, loan amount should not exceed discounted collateral value (LTV<100% ):

$$\text{Loan to value (LTV)} = \frac{\text{Amount of Loan}}{\text{Amount of Discounted Collateral}}$$

# Collateral Valuation

Type	Discount Rate	Max Term	Valuation Source/Other
Accounts Receivable	80%	One year then renew if A/R still available as collateral	Detailed list w/ account name Only include A/R <90 days Only accept up to 25% of A/R from one customer
Inventory	75%	3 years	Purchase price
Titled Vehicles	100% if new 80% if used	5 years if new 3 years if used	Purchase price if new NADC or Kelly Blue Book online if used
Equipment	50%	3-5 years	Purchase price if new Auctioneer /online sources if used
Ag Equipment Tractors Harvest equip Tillage equip	60-80% 60-80% 60-80%	7 years 5 years 4-5 years	Purchase price if new Local/regional ag equipment suppliers Auctioneers
Yellow Equipment (construction)	85%	7 years	Purchase price if new Local/regional construction equip suppliers Auctioneers
Residential Real Estate	90%	30 years	Appraisal Tax assessed value times x% (x depends on local market and how tax assessed value compares to market value....can check w/ realtors for this info)
Commercial Real Estate	80%	25 years	Appraisal Tax assessed value times x%

# Reducing Collateral Risk

- Take more of it!
- Make sure it's valuable to the borrower as well as to you
- Hold titles (if legally permissible)
- File liens
- Verify annually
- Require insurance
- Reduce loan amount
- Don't forget it's the "C" of last resort!

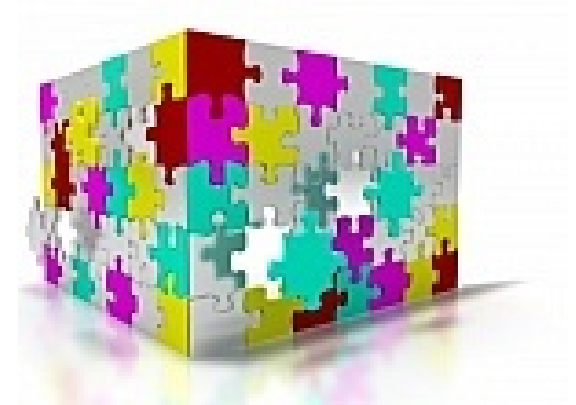
# The “Other” C: Community Benefit

- Does the loan help CDFI meet its mission?
- What does this loan do for the individual? The community? The economy?
- Is there **measurable** social impact?
  - Jobs created, business started, new service provided to the community

*Is there enough community benefit  
to outweigh credit weaknesses?  
(hint: look to your mission)*

# Putting the C's All Together

- Risk Rating Analysis
  - Determine minimum rating to move to Loan Committee
- Evaluate strengths and weaknesses
- Cash Flow is a MUST!
- How many weaknesses sink a deal?
- Can Technical Assistance make up the gap?
- What else could help you recommend this deal?





# Loan Presentation / Loan Committee

- Prepare Risk Rating & Credit Memo for Loan Committee or Executive Director
  - Provide key, summary information
  - Don't overwhelm loan committee with paper
- Loan Officer makes recommendation
  - If it's borderline, what would make it a go?

## NATIVE CDFI, INC. CREDIT REQUEST SUMMARY

**PROGRAM:** *Micro or Small Business*

**DATE PRESENTED:** *DATE PRESENTED TO LOAN COMMITTEE*

**Presented by:** *Name of Loan Officer who did the underwriting*

**NAME:** *NAME OF THE BORROWER – CORPORATION, PARTNERSHIP, OR INDIVIDUAL*

**ADDRESS:** *ADDRESS OF BUSINESS (OR PROPOSED ADDRESS)*

**PHONE NUMBER:**

**E-MAIL:**

**Owners:** *Name and % ownership for each owner*

**Type of Business:** *Very basic explanation of the business or proposed business; if it's a startup, say so*

**Bank of Account:** *Where do they have their business account?*

**Recommendation:** *Explain proposed amount, term, rate, and collateral. If part of the loan is for working capital, justify that number by saying what it is for. If borrower requested something different than you are proposing, explain why. If loan will be disbursed in more than one disbursement, explain amounts, condition, and expected timing. If the applicant was a XYZ borrower in the past explain that history.*

For example: A loan of \$57,000 from XYZ with a five year term with a three month principal moratorium. Interest rate fixed at 9.0%. First lien on business assets, personal guarantees of OWNER and HUSBAND OF OWNER. Assignment of a steady contract with monthly sales equal or more than the monthly payment for the loan.

**Collateral:** *Brief explanation of the collateral, including personal guarantees. For example, first lien on all business equipment, second lien on 2003 Ford F150 Truck and personal guarantees of all of the owners and spouses.*



Asset	Book Value	Discount	Collateral Value	Valuation Source
AR / Inventory		50%		
Existing Equipment		75%		
New Equipment		80%		
Vehicles				
Real Estate		80%		
Livestock				
Personal Asset(s) (describe)				
Collateral Value				
Collateral Coverage				

#### Sources and Uses of Loan

# Credit Memo Components

- Loan Recommendation
- Collateral Valuation
- Sources and Uses Table
- Loan Conditions
- Social Impact
- Business Description
- Ownership/Management Description
- Market/Industry Description
- Financial Information
- Business Financial Analysis
- Business Owner Personal Financial Analysis
- Debt Service Coverage Analysis
- Summary/Discussion

# Sample Loan Risk Rating Sheet

Rating	1(Doubtful)	2 (Substandard)	3 ( Adequate)-C	4 (Sound)-C	5 (Strong)-B	6(Exceptional)-A
Interest Rate			9%	8%	7%	6%
Cashflow (Debt/Income)	>75%	60 - 75%	50 - 59%	40 - 49%	29 - 39%	<28%
Capital (Project equity)	0	1 - 5%	6 - 10%	11 - 20%	21 - 30%	>31%
Credit  (Beacon score)	Late pmts. Several collection items. Bankruptcy in/out good explanation. <500	Late pmts. Several collection items. Maybe explainable bankruptcy. 501 - 559	Some late pmts. A few collection items. 560-619	A few late pmts. No collection items. 620-689	Great credit - always pay bills, no collection items or bankruptcy  690-749	Exceptional Credit >750
Collateral (Loan/Value)		>100%	90 - 99%	75 - 89%	76 - 61%	<60%
Capability (Mgmt./ Experience)	No experience working in industry or owning a business	Worked in industry but no mgmt. & ownership	Somewhat experience in business	Maybe some ownership experience. Strong mgmt. experience in business.	Existing business. Has owned a business before has 5 yrs. Experience in industry	Business more than 5 yrs old. Good business financials. Strong managerial competence
Commitment	No big plan. Didn't keep appts. or follow through	Weak business plan, not much follow through	Modest business plan-needs work. Kept most appts./follow through	Adequate business plan needs a little work, kept commitments/appts. Completed Financial Literacy	Completed biz plan course. Followed through on commitments w/ strong business plan	Well-rounded business plan, with marketing, financial, operating, and long-range profitability goals.

# From Loan Ratings to Loan Loss Reserves

<b>Loan Rating</b>	<b>Total Points on Loan Rating Sheet</b>	<b>Loan Loss Reserve</b>
A	23-31	5%
B	19 – 22	10%
C	15 – 18	15%

# Commitment, Closing, & Disbursal

- Provide commitment letter
- Review all documents with legal counsel (Commitment Letter, Loan Agreement, Promissory Note)
- File liens
- Make disbursement
- Collect baseline impact data

# Loan Conditions and Closing

- Pre-Closing
  - Follow-up with borrower as soon as possible after loan decision
  - Clearly explain any conditions of closing (or re-application)
  - Make sure all conditions are met and prepare all loan docs
- Closing
  - Explain key areas of loan docs (collateral, payment, terms, reporting, etc.)
- Put steps in a checklist (see handout)

# Questions?

- OFFICE HOURS SCHEDULED: **THURSDAY, JANUARY 9, 2020, 1PM-2PM ET**
- Open forum for more individualized questions and/or questions related to collections that were not covered in this webinar
- Registration reminder will be sent