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E·D·A
U.S. ECONOMIC DEVELOPMENT ADMINISTRATION

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Introduction To the COP & Grow America

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Introduction To the COP & Grow America

- Grow America (fka NDC, National Development Counsel) acts as partner, teacher, advisor, investor, developer and lender, bringing together technical know-how and capital for community and economic investment.
- We work with local and state governments and community-based organizations to help them create and implement their own unique economic and community development strategies.

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Introduction To the COP & Grow America

- Awarded to Grow America in 2022 to help increase the organizational capacity and volume of loans of EDA RLF's across the country
- First Cohort of RLF's started in August of 2023
- COP expected to last into 2025 with several cohorts
- In the process of issuing a Self-Assessment to better understand the needs and challenges of RLF's

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Introduction To the COP & Grow America

- Created a online community to help connect RLF's with peers and provide resources
- As of 11/2023 portal had 113 registered users
- You do not need to be a member of the Cohort to register!
- https://rlf-cop.growamerica.org/

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Agenda

- Why a credit process is important
- Designing a credit process/policy
- Credit Analysis
- Collateral Analysis
- Credit Memo Development
- Preparing for Loan Committee

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Housekeeping

- Break-10 mins at the halfway point
- Feel free to ask questions as we go
- Interact! We want to hear your stories, your experiences and challenges

What do we need in our Toolkit?

- A credit to a process that works
- Ways to make that process more efficient
- Knowledge to avoid the most common mistakes
- An eye towards fraud

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Why is a Credit Process important

- Repetition is a great way to find efficiencies
- Having a documented process will help eliminate mistakes
- It will help when adding new members of your staff

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Why is a Credit Process important

- Loans that go bad are more then just a loan loss
  - Staff cost
  - Attorney costs
  - Community cost
  - Borrower cost

- Having a credit process that ensures you are taking an accurate look at risks and benefits can help protect everyone involved

Designing a Credit Process that works

- It starts with your loan policy

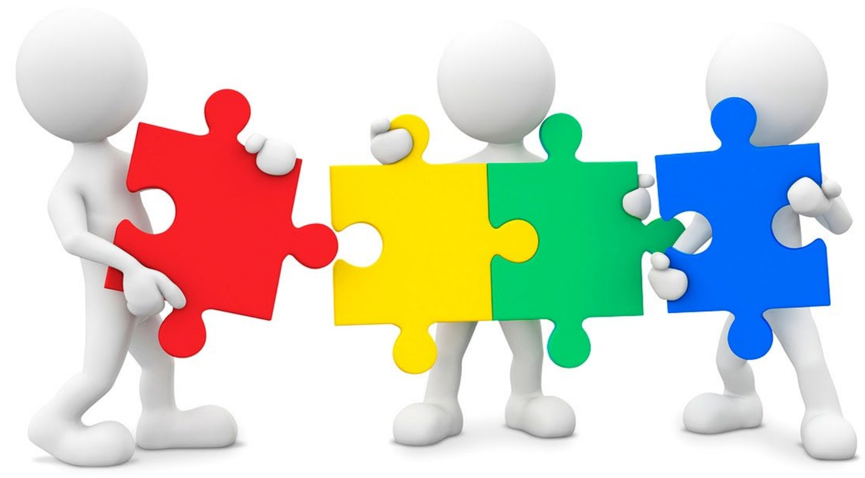
- Loan policy and your admin plan need to be reviewed and updated regularly.
  - When was the last time your organization updated either document?

- Discussion Point: Have you updated your confidentiality policy with the advent of electronic meetings?

Designing a Credit Process that works

- This is the living document that will make staff turnover, hiring new staff and help current staff in their daily duties

- All Staff should be involved in the process



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Suggestions to consider for credit process

- Have a standard list of documents that every borrower needs
  - BUT make sure that list has documents that you analyze for every deal
  - Don’t ask for documents if you are not going to review them in your underwriting process
- Don’t require that the borrower provide every single document upfront before underwriting begins
  - Ask for most recent BTR & PTR, credit authorization, run a quick cash flow

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Suggestions to consider for credit process

- If you decide the deal has merit then ask for the additional information. If it doesn't then the client hasn't spent a huge amount of time gathering documents only to be told no.
- Regardless of when you are declining, make sure to have a list of resources available to them
- Additionally have a short document/video explaining the process. It helps the client know what to expect

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Suggestions to consider for credit process

- Check out “What to Expect When Applying for a Business Loan” https://vimeo.com/794191520

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Credit Analysis

- Cash Flow is King
  - It must be right. Simple mistakes can cause long term issues

- While all parts of the credit memo are important the cash flow analysis is the bedrock of the deal.

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Credit Analysis

- Underwriting is an art not a science
  - The analysis is not the same for every business
  - Don’t let emotions overrule common sense

- Make sure its accurate. Garbage in = loan that goes bad.
  - Cash flow is KING when it comes to judging if the loan can be repaid or not. It has to be right
  - Even if projections come from an accountant or SBDC gut check them. Does it make sense?

Credit Analysis

- Financial analysis is not regurgitating numbers from the tax return
    - Sales went up 20% YOY versus The 20% increase in sales YOY was due to the company adding an additional product along with increasing market share of existing products
    - Talk to your borrower. Ask the how's and why's behind the numbers.
- Make sure it is right
    - Always review documents critically. You should ask WHY on anything that looks out of line.

Credit Analysis

- Every deal is not the same. Make sure you are analyzing the right information
  - Some ratios are more appropriate for a real estate deal then a retail business deal
  - Make sure you are comparing apples to apples
    - If you are underwriting a coffee shop don't use full-service restaurant industry statistics.

Credit Analysis

- Financial statements (Compiled, Audit etc) are prepared to present the numerical story of the business according to GAAP
  - This provides investors/owners etc with an accurate view of the company's financial position
- Purpose of tax returns is to provide the IRS with information needed to determine tax liability
- Terminology is not the same between the two
  - Loss/gain on tax return and loss/income on a financial statement are not the same

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Credit Analysis

M1 and ordinary business income are not always the same.
Banks always start with M1 and work backwards
You have to understand what the differences are to come up with the correct cash flow

Dedu	19	Other deductions (attach statement) SEE STMT 1		19	616,349
	20	**Total deductions.** Add lines 7 through 19 ▶		20	1,529,978
	21	**Ordinary business income (loss).** Subtract line 20 from line 6		21	-7,597
	22a	Excess net passive income or LIFO recapture tax (see instructions)	22a		

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income (Loss) per Return**

Note: The corporation may be required to file Schedule M-3. See instructions.

1	Net income (loss) per books	337,433	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize): a Tax-exempt interest $ STMT 5 345,025	345,025
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize)		6	Deductions included on Schedule K, lines 1 through 12 and 14p, not charged against book income this year (itemize): a Depreciation $	
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14p (itemize): a Depreciation $ b Travel and entertainment $		7	Add lines 5 and 6	345,025
4	Add lines 1 through 3	337,433	8	Income (loss) (Schedule K, line 18). Subtract line 7 from line 4	-7,592

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Credit Analysis

- Net Income per the books (M-1 line 1) is the number in most cases you would find as the bottom line number if you had a reviewed statement from the accountant
- Why are they different?
  - Example: Line 3B Travel and entertainment. For the IRS only some of this is able to be included for tax purposes but for the financial position of the company it was expended in full.

  - Example 2: Depreciation for tax purposes is different then GAAP

Credit Analysis

- Best Practices:
- Before you start inputting numbers review the tax return/fs COMPLETELY
  - Look at all statement and notes
  - Look at who prepared it - this is important for several reasons
  - Look at the ownership on the tax return versus what they put on the app
  - Look for things you would expect to see based on the industry/business
    - Its not always about what's there, its about what’s not

Income Statement-Quick Tips

- Cost of goods sold-review the breakout and the statement notes
- Is rent listed? If not, is it buried in a note?
- Is there debt associated with the building or is it free and clear?
  - Don’t forget to add back rent if they are purchasing

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Income Statement-Quick Tips

- Depreciation and interest listed?
  - Interest indicates other debt. Make sure its on the debt schedule
  - Make sure you catch Section 179 Depreciation

- “Other Deductions – See statement #”
  - Always review the statement and see what is there. Its typically where amortization hides

Income Statement

Caution: Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

	Line	Description			Line	Amount
Income	1a	Gross receipts or sales	1a	2,881,762		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	2,881,762
	2	Cost of goods sold (attach Form 1125-A)			2	1,359,381
	3	Gross profit. Subtract line 2 from line 1c			3	1,522,381
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)			4	
	5	Other income (loss) (see instructions—attach statement)			5	
	6	**Total income (loss).** Add lines 3 through 5 ▶			6	1,522,381
Deductions (see instructions for limitations)	7	Compensation of officers (see instructions–attach Form 1125-E)			7	74,200
	8	Salaries and wages (less employment credits)			8	570,423
	9	Repairs and maintenance			9	31,047
	10	Bad debts			10	
	11	Rents			11	
	12	Taxes and licenses			12	129,265
	13	Interest (see instructions)			13	28,453
	14	Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			14	51,814
	15	Depletion **(Do not deduct oil and gas depletion.)**			15	
	16	Advertising			16	1,116
	17	Pension, profit-sharing, etc., plans			17	27,311
	18	Employee benefit programs			18	
	19	Other deductions (attach statement) SEE STMT 1			19	616,349
	20	**Total deductions.** Add lines 7 through 19 ▶			20	1,529,978
	21	**Ordinary business income (loss).** Subtract line 20 from line 6			21	-7,597

Statement 1 - Form 1120-S, Page 1, Line 19 - Other Deductions

Description	Amount
INSURANCE	$ 238,432
TRAINING & EDUCATION	138,377
OFFICE EXPENSE	80,743
UTILITIES & TELEPHONE	70,004
LEGAL AND ACCOUNTING	47,650
TRAVEL EXPENSES	21,148
COMPUTER IT	5,136
BANK SERVICE CHARGES	2,677
VEHICLE EXPENSE	793
AMORTIZATION	11,389
TOTAL	$ 616,349

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Income Statement

1	Inventory at beginning of year	1	402,500
2	Purchases	2	655,724
3	Cost of labor	3	686,250
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule) STMT 7	5	445,042
6	**Total.** Add lines 1 through 5	6	2,189,516
7	Inventory at end of year	7	830,135
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return. See instructions	8	1,359,381

9a Check all methods used for valuing closing inventory:

- (i) ☐ Cost
- (ii) ☒ Lower of cost or market
- (iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO — 9d

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity? See instructions ☒ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No

Statement 7 - Form 1125-A, Line 5 - Other Costs

Description	Amount
SUBCONTRACTING	$ 196,212
SUPPLIES	132,126
RENT	86,174
DELIVERY COSTS	30,530
TOTAL	$ 445,042

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Credit Analysis

- Common Mistakes on Cash Flow spreads
  - Expenses categorized differently year over year
  - One-time expenses/income not excluded from analysis
  - Amortization in the notes missed as an add back
    - Net effect
  - Rent is not added back when appropriate
  - Distributions not subtracted from business

Credit Analysis

- Make sure to understand what is driving sales growth
  - An annual increase is great…But WHY is it going up?
  - If they are irregular (huge increase then a huge drop) you will need to dig in to their sales cycle
- It's the how's and why's that matter
  - You have to understand what is behind the numbers
- AVOID THE ELEVATOR ANALYSIS

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Credit Analysis

- Profitability is needed to service the debt.

- What is driving changes in the profitability of the company?
  - Materials cost increase?
  - Labor?
  - Inflation ?
  - Change in accounting?

Credit Analysis

INCOME STATEMENT	12/31/19		12/31/2020		12/31/2021		8/31/2022	
Sales	$3,935,725	100%	$2,881,762	100%	$3,854,538	100%	$2,614,346	100%
-COGS	$2,094,337	53%	$1,359,381	47%	$1,151,143	30%	$936,181	36%
= Gross Profit	$1,841,388	47%	$1,522,381	53%	$2,703,395	70%	$1,678,165	64%
-SG & A	$1,375,909	35%	$1,352,733	47%	$2,195,304	57%	$983,657	38%
=Oper. Profit	$465,479	12%	$169,648	6%	$508,091	13%	$694,508	27%
-Officer Salary	$340,658	9%	$74,200	3%	$0	0%	$126,055	5%
-Deprec. exp./Amort	$63,423	2%	$63,203	2%	$17,398	0%	$0	0%
-Interest exp.	$26,372	1%	$39,842	1%	$48,277	1%	$2,531	0%
-rent	$0	0%	$0	0%	$0	0%	$0	0%
+Other Income	$0	0%	$0	0%	$0	0%	$0	0%
= EBT	$35,026	1%	($7,597)	0%	$442,416	11%	$565,922	22%
-Income taxes	$0	0%	$0	0%	$0	0%	$0	0%
PAT	$35,026	1%	($7,597)	0%	$442,416	11%	$565,922	22%

What would you ask the borrower about?

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Credit Analysis

- Debt Analysis
  - Make sure all debt is accounted for
  - Look at term and remaining payments
  - Understand what the debt was used for & what secures it

Business Debt Schedule

The schedule should include loans for contracts/notes payable and lines of credit, not accounts payable or accrued liabilities.

Company Name ______________________ Date __________

CREDITOR Name/Address	Original Date	Original Amount	Term or Maturity Date	Present Balance	Interest Rate	Monthly Payment	Collateral or Security	WHAT WAS LOAN FOR?

Credit Analysis

- Expiring debt
  - Different methods
    - Some exclude any debt maturing in under 12 months
    - Some include the balance of the debt maturing in 12 months
    - Fairly common to EXCLUDE debt maturing within 90 days
    - On interim analysis-match the number of months to the debt service
      - If 8 months of income include only 8 months of debt service

Credit Analysis

- Cash Flow Analysis:
- Adjustments that are commonly incorrect
  - Rent only added back if moving from renting to purchase
  - VERIFIABLE one-time non-recurring expenses
    - Don’t add back just to make the deal work
    - PPP/Grants etc. shouldn’t be included in most cases

Credit Analysis

- Balance Sheet:
- The balance sheet can clue you into many trends
  - But it is only a snapshot in time
  - It can help with questions to ask
- Check for big changes. If the change is dramatic in either direction it warrants a question (common size)
    - If you are requiring equity for the project make sure there is adequate cash (60-120 days WC depends conversion cycle)
    - Can not be 100% of the cash. They will have no operating cash

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Credit Analysis

- Watch for large writes off of A/R and ask questions
- Inventory reports may or may not be helpful depending on how they are put together-Make sure you understand what is Raw Materials, WIP and Finished Goods
- A/P-Changes are indications of the company's health

Credit Analysis

- Loans to/from Shareholders-This ALWAYS needs an explanation in the credit memo
  - Prohibit repayment of shareholder debt without lender approval

- Intangibles gross value should not change year over year
  - Net will go down annually due to amortization

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Credit Analysis

- Personal Cash Flow Analysis
  - If the individual can't meet their personal obligations, they may pull from the business and vice versa
- Common Misses:
  - Living expenses
    - This is usually a standard %
      - If adjustments are made on a certain deal you must explain why
      - BE REALISTIC
  - Spousal Income –To include or not to include

Credit Analysis

- K1 Distributions can be included in personal income IF you have the K1

- If there is Schedule C/E/F income (not your borrower), make sure to look for interest expense and include any debt.

Credit Analysis

- Personal Credit Report:
- Score isn't everything
  - Past behavior can be a predictor of future behavior but not always
- Scores can widely vary by credit agency

712	Experian	Primary
740	TransUnion	
791	Equifax	

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Credit Analysis

- Best Practices for Credit Report reviews:
- Read Everything-check credit report versus application
  - Name
  - Address
  - DOB
  - Social Security Number
- Any differences should be noted and explained in the credit memo

Personal Cash Flow Analysis –Credit Report

- Look at what makes up the credit profile
  - High revolving debt balances
  - Late pays
    - When? Was it the pandemic? Is there an explanation?
  - Lack of credit history
  - If no mortgage listed on credit report ask how about rent
    - Some landlords are now reporting to credit agencies
  - Do not double count if a debt that shows on the personal credit report but is listed on the business debt schedule

Credit Analysis

- Personal Credit Report Alerts:
- Fraud Alert
  - Must be cleared
  - Initial or Extended
    - <u>Initial</u> are valid for 90 days and can be renewed for 90-day terms
    - <u>Extended</u> are valid for 7 years
- Other types of alerts
  - <u>Active Duty Alert</u> indicates that the applicant is on active duty in the military
    - Take the extra step to verify identity and note this in your credit memo
- Credit report locked/frozen
  - If a report is frozen it must be noted in the credit memo and you should speak with the applicant and verify that a freeze was on, and that no fraud is occurring

Credit Analysis

- Every credit report must be reviewed for any alerts/notes
  - This is a fraud risk if you miss this step

ALERT
1 - EXPERIAN ID SECURITY ALERT ON FILE. DO NOT EXTEND CREDIT WITHOUT VERIFYING CONSUMER INFORMATION.
1 - [redacted] YOB: 1967 EXPERIAN OFAC NAME MATCHING SERVICE: NO MATCH FOUND UNLESS OTHERWISE INDICATED
2 - TRANSUNION FRAUD ALERT: INITIAL FRAUD ALERT ON FILE. VERIFY CONSUMER IDENTITY BEFORE ISSUING CREDIT.
3 - EQUIFAX FRAUD ALERT: POSSIBLE ID THEFT VICTIM - INITIAL ALERT ON FILE. DO NOT GRANT CREDIT WITHOUT VERIFYING THE CONSUMER'S IDENTITY.

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Credit Analysis

- The REMARKS section tells you what you need to do:
  - You must call the number listed. You can not use the number in the application
  - You should note in the credit memo there was a fraud alert, that you called the number listed on the credit report, spoke to the applicant, and verified that the applicant submitted the application.

REMARKS

1 - EXPERIAN MESSAGE: SSN MATCHES

1 - CONSUMER STATEMENT: 27& 08-26-22 2499947 ID SECURITY ALERT: FRAUDULENT APPLICATIONS MAY BE SUBMITTED IN MY NAME OR MY IDENTITY MAY HAVE BEEN USED WITHOUT MY CONSENT TO FRAUDULENTLY OBTAIN GOODS OR SERVICES. DO NOT EXTEND CREDIT WITHOUT FIRST VERIFYING THE IDENTITY OF THE APPLICANT. I CAN BE REACHED AT 347-357-2973. THIS SECURITY ALERT WILL BE MAINTAINED FOR 1 YEAR BEGINNING 08-26-22.

2 - CONSUMER STATEMENT: #HK#IFCRA INITIAL FRAUD ALERT: ACTION MAY BE REQUIRED UNDER FCRA BEFORE OPENING OR MODIFYING AN ACCOUNT. CONTACT CONSUMER AT (347) 357-2973

3 - CONSUMER STATEMENT: FRAUD VICTIM. "INITIAL ALERT". CONSUMER HAS REQUESTED AN ALERT BE PLACED ON THEIR CREDIT FILE.

Credit Analysis

- A Global Cash Flow Analysis is important to see the overall health of the relationship, you must consider certain factors:
  - If the business can not support the debt should you make the loan?
  - How long will the principal support cash flow for the business?
  - If the principal's cash flow is short how long can the business support that shortage?

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Credit Analysis

- Projection based approvals/analysis is a very high risk credit decision
- Common Miss: You should (must) stress the projections that are provided to you
  - You should understand the assumptions behind the projections
  - Does it make sense?
    - It's a gut check-Is a Coffee shop that estimates an average ticket of $12 going to be able to do $3M in sales in a year ?
  - Compare to industry standards
    - RMA
    - Franchise history
    - Seller returns
    - Your Portfolio

Credit Analysis

- You can use secondary income as a strength, but how long? Will they eventually work for the business? Does it work without the secondary income?
- Pay careful attention to working capital availability
  - This can be the downfall of many rapid growth and start-up businesses
  - Business needs adequate cash to work through ramp up period

Other situations to think about

- PPP
- Employee Retention Tax Credits
- Business Grants
- Covid
- Inflation
- Employee Compensation Increases
- Student Loans

Collateral Analysis

- **Collateral is only beneficial if it can be liquidated (and found).**
- Check your filings annually
  - UCC, Mortgage etc.
  - Have ticklers and back up to your ticklers
  - Double check filings at closing even if your attorney closed and filed
- Don’t over collateralize
  - Can also cause heavy administrative burden along with a nightmare during liquidation

Collateral Analysis

- Common misses:
  - Changing the advance rate to eliminate a shortage. Use your standard rate, show a shortfall and mitigate why you support approval
  - However, lower advance rate if the collateral is lower quality, has issues etc0
  - Beware of concentration issues that show up on A/R reports
  - Beware of the type of inventory (perishable, restricted by licensing etc.)
  - PMSI filing versus a blanket filing

Credit Memo

- Simple credits, straightforward analysis. Complicated credits, more in depth analysis. NOT $ driven
- Common issues:
  - Narrative is ambiguous
  - Quality over quantity. If you can say it in 5 words don't use 15.
  - Don't assume the reader knows what you mean. Explain everything
- Avoid at all costs the ELEVATOR ANALYSIS
  - Focus on trends and the WHY's behind those trends

Credit Memo

- Pro tip: Have someone else read your credit memo before you submit for loan committee
  - Presenter should review with fresh brainpower before submitting

- Don’t minimize the risks
  - Explain the deal objectively and mitigate the risks

Credit Memo

- Small errors can cause your Loan Committee to lose faith in your knowledge of the deal
- Make sure multiple people review your credit memo
  - If you are a one person shop, ask a board member if possible
- Make sure the presenter is well prepared
  - Learn from each meeting

Wrapping Up

- Know your deal
- Ask questions (not just of borrower but partners etc)
- Avoid common mistakes
- Cash flow is king.

Wrapping Up

- Properly Collateralize
- Have a useable policy that is updated regularly
- Phone a friend-ask others in the industry

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