Underwriting in Times of Economic Uncertainty

Grow America

RLF Community of Practice

This presentation was prepared by Grow America using Federal funds under award ED22HDQ3070190 from the Economic Development Administration, U.S. Department of Commerce. The statements, findings, conclusions, and recommendations are those of the author(s) and do not necessarily reflect the views of the Economic Development Administration or the U.S. Department of Commerce.

RLF CoP Objectives

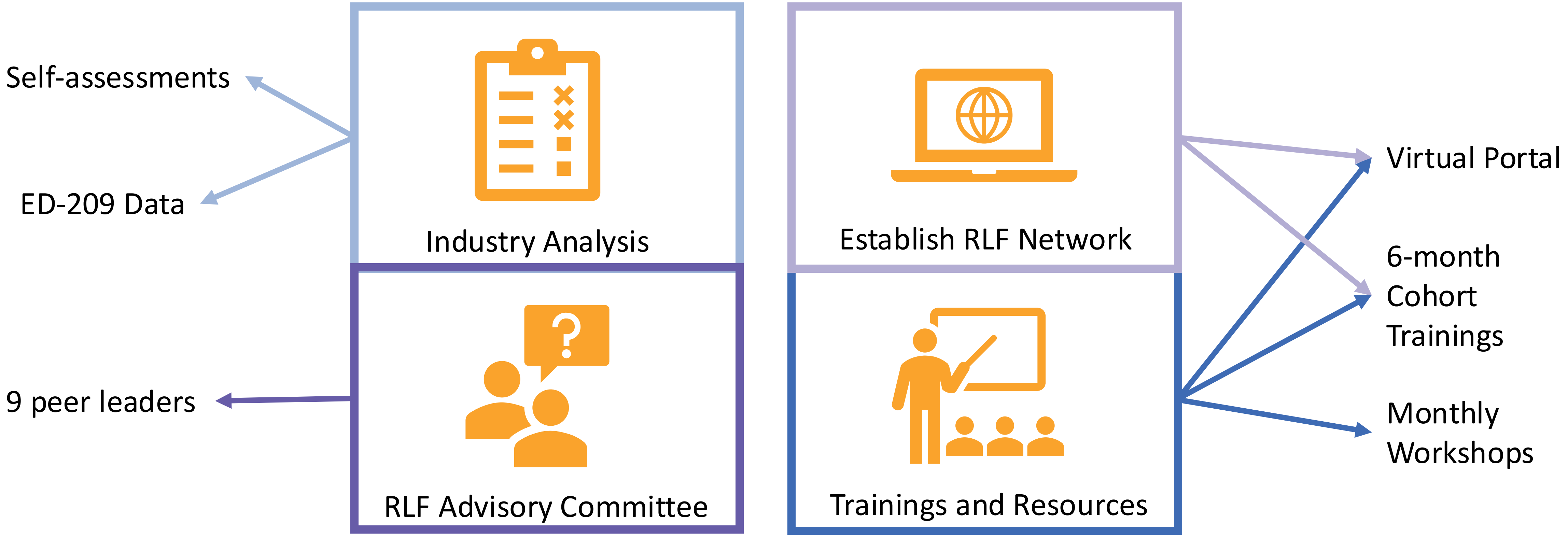
Increase the capacity of RLFs to meet the needs of their local economic develop strategies.

1. Increase organizational capacity.
2. Increase the volume of loans and loan capital.
3. Establish a peer-to-peer group of RLFs to collaborate on needs, strategies, capacities, and program impact.
4. Increase understanding of broader economic development strategies through training and curriculum.

Grow America

RLF Community of Practice

RLF CoP Activities



Stay Connected!

You can scan these QR codes to stay up to date about the RLF Community of Practice.

Scan this to subscribe to our listserv

Scan this to create a FREE profile on the RLF Portal

Agenda

- Why are We Talking about Economic Uncertainty
- Underwriting in Economic Uncertainty
- Underwriting Tips
- Industry Comparisons
- Suggestions to Mitigate Risk
- Loan Committee Management

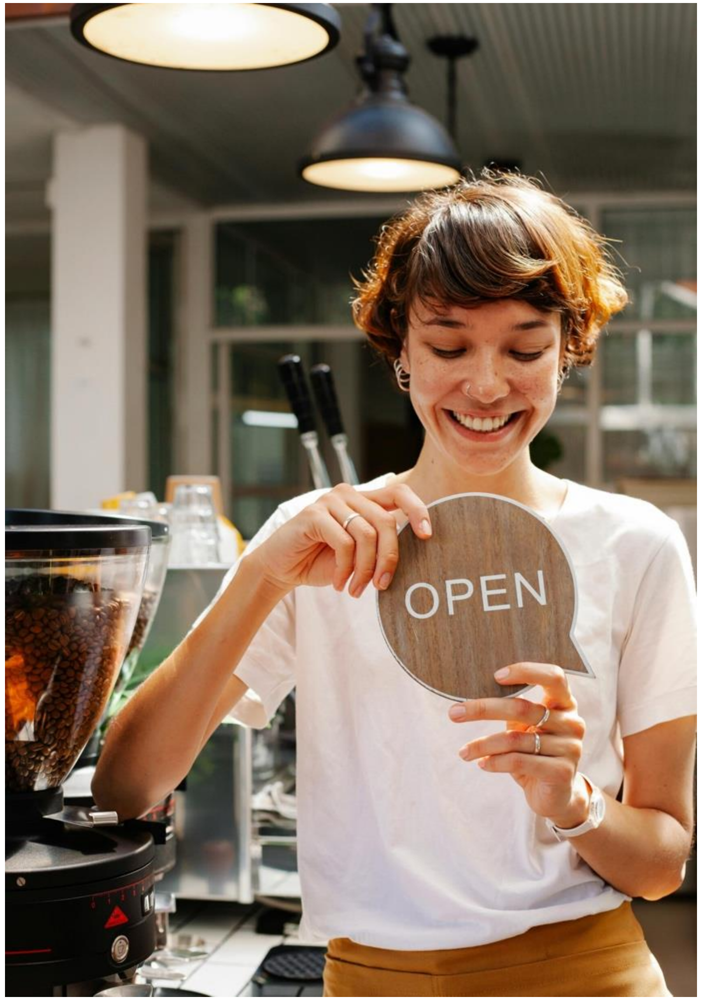
Why Are We Talking About This?

- Underwriting is an art, not science.
  - As the environment changes underwriting needs to adapt
  - These can be micro- or macro-level changes
- Loan Committees tend to get VERY conservative in their thinking during these times.
- Risk tolerance and performance for the portfolio should be evaluated regularly - not just during unstable times.

Why Are We Talking About This?

Uncertainty is **not** a reason to:

1. Stop lending
2. Require more complicated deal structures
3. Abandon the mission of the fund/organization



Grow America

Underwriting during Economic Uncertainty

Many businesses will be affected by tariffs and/or inflation/ decreased consumer spending

Items to think about including in your underwriting and analysis:

1. Do they have enough cash on hand to cover tariffs?
2. How does/will this affect their working capital?
3. Are they able to raise prices immediately or in contracts that will need to be amended?
4. Do they have other options for suppliers/brand of supplies?

Grow America

RLF Community of Practice

Underwriting during Economic Uncertainty

- Clients will tell you they can raise their prices to cover tariffs or inflation. **<u>BUT</u>** will their customers continue to spend (or spend at the same level) for their product/service?

- There is an equilibrium point of how much you can raise prices before customers stop spending.
  - You can read more about consumers' "Willingness to Pay" in this article by Harvard Business School: https://online.hbs.edu/blog/post/willingness-to-pay

Grow America

RLF Community of Practice

Underwriting during Economic Uncertainty

Breakeven Analysis is going to be more important then ever.

- Run several different scenarios - decreasing sales, increasing costs.
- It may take a discussion with the business owner to understand fixed costs and variable costs.
    - Remember variable costs include direct hourly labor, COGS (Raw Materials, inventory etc), royalty fees, shipping fees, etc.
- You can download an Excel Breakeven Analysis template on the RLF Portal: https://rlf-cop.growamerica.org/resource-library/

Underwriting Tips

Additional documents that can help with underwriting:

- ❑ Bank Statements
- ❑ Full business plan with 2-5 year projections
- ❑ Any additional market research that has been done
- ❑ Personal financial statement with accompanying backup documents for significant assets
- ❑ Resumes for ownership and key staff
- ❑ Year-to-date and prior year-to-date financial statements

Underwriting Tips

- Read the business plan/projections.
- Evaluate the assumptions.
- Find the gaps.
- Ask if professionals assisted in the preparation of the business plan/projections.
- Understand and analyze the local environment.

Grow America

RLF Community of Practice

Underwriting Tips

- All projections should be evaluated with a critical eye.
  - Review assumptions in depth
- Cash cycle calculations should be done to ensure adequate working capital.

Grow America

RLF Community of Practice

Underwriting Tips

- Do the spreads with the business plan projections first.
  - Additional spreads to stress them down to a breakeven (or your preferred) debt service coverage ratio (DSCR).
  - You can do as many scenarios as you feel is applicable, but at a <u>minimum</u> you should have spreads on the provided and breakeven scenarios.
- Multiple scenarios allow you to see how much “give” the projections have.
  - If the projections can only be off by 5% of sales/expenses before deal is at 1:1, it is a riskier deal.
  - If the projections can be off by 10-15%, there is more room if the business doesn’t perform.

Underwriting Tips

- If it's a variable rate loan you should do a stress analysis to analyze rate risk – *especially* in a rising rate environment.
  - Look at what happens to DSCR if WSJP increase 1-2%.
  - Depending on the reset timeframe, this may be done at annual review time as well.

Grow America

Underwriting Tips – Stress Test Examples

Results from Financial Statements

- Revenue $1,500,543
- Variable Costs 41.5%
- Fixed Costs $802,133
- Net Income $75,684
- Annual Debt Payments:$38,886
- DSCR 1.95x

Scenario 1

- Same Variable and Fixed Costs
- Revenue needs to be $1,383,798 for breakeven
- 8% difference from projections
- This is a tight margin. Little room for error.

Underwriting Tips – Stress Test Examples

Results from Financial Statements

- Revenue $1,500,543
- Variable Costs 41.5%
- Fixed Costs $802,133
- Net Income $75,684
- Annual Debt Payments:$38,886
- DSCR 1.95x

Scenario 2

- Variable Costs increasing 10% and Fixed Costs 2%
- Revenue needs to be $1,702,193 for breakeven
- 13% INCREASE in sales to support 1:1 DSCR

Industry Comparisons

- Industry reports can give you more knowledge but have limitations.
  - They are based on a variety of sizes of companies across the country.
- IBIS World – includes industry analysis and forecasts.
  - https://www.ibisworld.com/
- Risk Management Association (RMA) – member organization focused on risk management tools and education.
  - https://www.rmahq.org/

*EDA doesn't require use of a specific service

Screenshot from IBISWorld's recent publication, *Snack Food Production in the US*

Industry Comparisons

- Projections should be compared to RMA standards, your own portfolio, IBIS, etc.
- Compare NI, GP, and COGS margins of projections against the averages.
  - There are many ratios provided in the reports - use what is applicable to your deal.
- If the projections are out of line from industry averages, you need to discuss with the clients and find out why they believe their business will operate differently.
- Bring the projections in line with industry averages to analyze how the business will fare.

Suggestions to Mitigate Risk

- Outside income of guarantor's/owner operators
  - Provides security for household expenditures other than the business.
- Make sure the business has the professional advisors it needs.
  - Accountants, lawyers, marketing, etc.
  - Consider requiring TA for the first two years.
  - They have to be open to receiving assistance.

Suggestions to Mitigate Risk

- Collateral = Cooperation
  - Take all available collateral but don’t overcollateralize.
  - Make sure collateral can be found and liquidated.

- Require an equity injection, even on requests you may not typically do so

Grow America

Loan Committee Management

- When the economy stumbles, banks become more conservative. → If your LC consists of all bankers, you are going to have a hard time getting approvals.

- Comments heard at loan committee:
  - “My credit officer wouldn’t approve this.”
  - “This isn’t a deal we would do at the bank, I’m voting no.”
  - “I don’t like this industry because I had a deal go bad, we shouldn’t lend to them.”

Grow America

RLF Community of Practice

Loan Committee Management

- Members should have a strong understanding of the mission of the organization <u>and</u> why the organization's lending is different than regulated lenders.
  - Remind them that the banks' job is to protect the assets of clients and investors. They cannot take risks.
  - Our organizations/funds were designed to fill that gap.

Grow America

RLF Community of Practice

Loan Committee Management

- Have risk tolerance discussions BEFORE loan presentations.
  - Defaults WILL happen. Decide as an organization how much risk can be taken.
- If the full board agrees on risk tolerance when you are presenting, bring that into the discussion.
- Start your presentation with how the loan meets the mission of the fund/organization.
- Be upfront about the risks but always have mitigants to explain why you want to move forward.
- Don’t make simple mistakes on the loan package.

Thank you!
Questions?

RLF Community of Practice

Grow America

Mary Louk: mlouk@growamerica.org