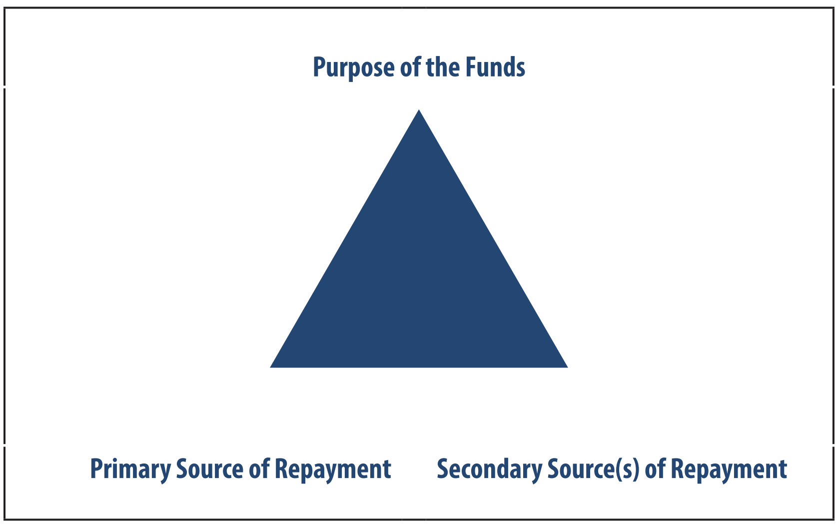
How a Business Loan is Underwritten

NOTE: This information is provided for reference purposes only. Should you have any specific questions about business loans, please contact Citadel's Business Lending Department at (800) 666-0191, BusinessLending@CitadelBanking.com or visit us online at CitadelBanking.com/BusinessLoans.

No matter which financial institution or funding source is used, the steps to underwriting a business loan request are fairly consistent. The lender's objective is to help the borrower in meeting their financing needs while minimizing the risk of loss associated with repayment. To this end, due diligence is completed by the lender in proportion with the amount and type of the request.

The first of these due diligence steps is to understand the request; that is, to understand the purpose of the funds along with identifying the primary & secondary sources of repayment.

Step #1 – Understanding the Request



Purpose of the Funds

The purpose of the funds may represent the financing of real estate or purchasing of equipment. Perhaps the reasons are for working capital, property improvements, or re-structuring of existing debt.

Clarifying the purpose of the monies being requested helps both the borrower and the lender determine the best loan product for that purpose. Matching the purpose of the funds to the loan product minimizes long-term risk and strengthens the borrower's balance sheet by more closely matching assets and liabilities.

Primary Source of Repayment

Most of the time, the primary source of repayment of a loan will be the cash flow generated by the operations of the business. When the request is for an owner-occupied commercial mortgage, equipment loan or line of credit, the lender will analyze the company's tax returns or financial statements to determine if the cash flow is sufficient to support the additional monthly payments.

If the loan is to finance an investment property then repayment will come from the rents generated by the commercial or residential tenants and the lender will review the net operating income (NOI) of the property to determine if it is self-sustaining relative to the monthly debt payments.

Secondary Source(s) of Repayment

Secondary sources of repayment represent the options the lender has to collect on the loan should the primary source of repayment prove insufficient or unsustainable to repay the loan. The most common of these secondary sources are collateral and guarantees of the company owners. As with the primary source of repayment, the lender will analyze the strengths and weaknesses to determine if the secondary sources are acceptable. With an unsecured loan, the lender is basically forgoing the need for an additional source of repayment for the loan request.

Analyzing Risk

After obtaining an understanding of the loan request and defining the sources of repayment, the lender will need to complete a due diligence process whereby the risks are identified, analyzed, and mitigated. It is at this stage that the borrower will be asked to provide documentation to support the request. Generally, the amount of information requested is proportionate to the amount of the credit exposure which the lender will have with the borrower. For example, if the loan request is less than $50,000 and the total amount of business credit extended to the borrower (including other business loans) is less than $100,000, the documentation needed for the due diligence would generally include the corporate or personal tax return for one year as well as a personal financial statement. If the credit exposure will be higher than these amounts, the documentation requirement may be expanded to two or three years of corporate and personal tax returns. If there are questions or concerns, additional information may be requested.

There are a number of factors which impact a loan decision. While the strength of the cash flow and the collateral coverage are the most important, other factors may include:

- Purpose of the funds being requested.
- Length of time in business.
- Strength of the historic financial performance.
- Acceptability of the collateral securing the loan.
- Risk associated with the borrower's industry.
- Personal financial position of the owner(s) and guarantor(s).
- Personal credit scores & debt levels of the owner(s) and guarantor(s).
- Future trends or company performance projections.

Step #2 - Calculating a Debt Service Coverage Ratio

The next step involves the analysis of the cash flow. This is accomplished largely through calculation of a debt service coverage ratio or DSCR. The DSCR is the ratio of cash available to service a company's debt relative to the principal & interest payments on that debt. It is a tool used by lenders to determine the strength (or weakness) of the primary source of repayment. The higher the ratio, the easier it is to obtain a loan.

While the calculation of a debt service coverage ratio may vary slightly between lenders depending upon their loan policies, it is generally is used in two separate ways:

Company-specific / Property-specific DSC Ratio – This ratio is calculated using only the financial results of the company or the NOI of the investment property. It does not take into account any monies paid to the owners in compensation or as management fees nor does it include any sources of income or debt on the personal side unrelated to the company or property. It is meant to show the strength of the cash flow on a "stand-alone" basis.

Global DSC Ratio – A global DSC ratio expands the company-specific or property-specific ratio to include the personal cash flow as well as the debt service of the owners and guarantors. It provides a comprehensive analysis of the financial position of the company and its owners.

Why are two ratios used? Many times small business owners find it advantageous to maximize owner's compensation in order to minimize net profit. There may also be tax advantages to expensing some items through the business which serve for both personal and company use. If the company-specific DSC ratio were solely used in analyzing the loan, it would present an unfair or inaccurate assessment of the total cash flow coverage. By also calculating a global DSC ratio, the lender is able to give consideration to all of the cash flow sources and make the best informed lending decision.

The lender will summarize the cash flows in a chart similar to the one below (the figures represent annual amounts):

Sources of Funds	2014 Tax Returns	2015 Tax Returns
Business Cash Flow (net income + depreciation + interest expense - taxes)	$75,450	$84,690
Net Personal Cash Flow (salaries + other personal income - taxes)	$65,980	$71,870
Total Combined Cash Flow	**$141,430**	**$156,560**
Application of Funds		
Business Debt Service (existing business debt + new loan request)	$53,990	$53,990
Personal Debt Service (mortgages + installment loans + revolving debt)	$37,855	$37,855
Total Combined Debt Service	**$91,845**	**$91,845**
Combined Excess Funds	$49,585	$64,715
Global Debt Service Coverage Ratio	**1.54x**	**1.70x**

Generally, lenders are looking for a minimum debt service coverage ratio of 1.20x to 1.30x depending upon their underwriting standards.

Step #3 – Analyzing the Collateral

Loan requests will need to be secured by acceptable collateral as a secondary source of repayment. While it is possible to request an unsecured loan such approvals are not the norm. At a minimum, smaller loan requests for general working capital will be secured by a UCC lien filed against the company's assets.

The type of collateral will usually correspond to the loan product being requested. For example, if the request is for a commercial or investment mortgage, the collateral will be a mortgage on the real estate being financed. Equipment loans will be secured by a UCC lien on the equipment and business vehicle loans will be secured by the title to the vehicle.

As a general rule, the borrower will need to put down 20% of the purchase price while the lender finances 80%. The value of the collateral will be determined based upon the lower of the purchase price or appraised value. There are some instances where a lender may allow for an appraised value higher than the purchase price to serve as the collateral value, but such instances will need to be justified by an acceptable explanation for the difference between the two amounts. Such exceptions are not common. The rule of thumb is that something is worth what someone is willing to pay for it. When the borrower is asking for the lender to refinance existing company debt, the value of the collateral is determined by real estate appraisals or equipment valuations (estimates).

While the typical loan-to-value ratio is 80%, there are circumstances where this ratio may be higher or lower. Such decisions by the lender are based upon the acceptability, type, and risk of the collateral as well as the strength of the primary source of repayment. Generally, financing for equipment or vehicles will be able to offer higher ratios up to 100%. Financing for vacant land, specialized-purpose buildings or some types of inventory financing will be limited to lower ratios of 50% to 70%.

Useful Life of the Asset

It is in the best interest of both the borrower and lender to match the term (aka maturity) of the loan with the expected useful life of the asset being financed. For example, if a business vehicle will be used as daily transportation to visit customers (i.e. a florist using her van for deliveries) it will incur higher mileage during the year. For this reason, it makes sense to limit the loan to 36 or 48 months. A shorter term will make sure the company is not still paying for assets after they have deteriorated and are no longer useful. It will also keep the company's balance sheet strong and help build equity for the owners. The same rule applies to equipment, working capital or building improvements.

Conclusion

Gaining an understanding of how business loans are underwritten and structured allows a small business owner to determine the most appropriate balance between asset growth and liability management. Working with the lender and with your accountant, it is possible to maximize your company's cash flow while obtaining the financing you need to grow your business.

We invite you to visit Citadel's website for more information on our business loans or stop by any Citadel office.