BANKERS GUIDE TO SECURE LENDING

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## Lending Rationale

### Introduction

The major purpose of credit analysis is to:

- Identify risk in lending situations,
- Draw conclusions as to the likelihood of repayment, and
- Make recommendations as to the proper type and structure of the loan facility

Analysis of a loan proposition may involve three steps:

(i) Assessment to involve the following:

- The historical performance of the managers of the business,
- Determine the major risks factors, and
- Evaluate how well these risks have been mitigated in the past.

The past performance evidences factors influencing the firm's present condition and past performance that may foreshadow difficulties, or indicate the likelihood of success, in the borrower's ability to repay a bank loan at some future time.

(ii) Analysis of the loan proposition;

- To enable reasonable projection of the probable future financial condition of the company
- To estimate the company's ability to service proposed levels of debt.

(iii) Assessment of:

- The firm's creditworthiness and a proposal for structuring a loan facility that can be amortised given the firm's projected cash flows
- The 'offer' from the borrower of sufficient protection against loss and control of the lending relationship.

Financiers are always faced with three generic lending situations, or rationales, based on:

- The purpose of the loan,
- The source of repayment,
- The risk inherent in the situation,
- The structure of the loan.
These lending rationales are:

- Asset conversion
- Cash flow
- Asset Protection Lending

For each of the lending rationales, look out for the following identification factors:

- Source of cash used to repay a bank loan. The specific source of repayment is dependent on the purpose of the loan, or the use to which the proceeds of the loan are applied.
- The specific financing need elicits the nature of the risk to the lenders, who must be certain to evaluate carefully the factors that will mitigate that risk and protect them against loss.
- The repayment source, loan purpose, and risks dictate the form of protection, monitoring and control employed by the bank.
- ACE primary purpose in distinguishing these three lending rationales is to provide the Bank analyst with support for determining those areas or issues that might be of primary concern when evaluating a particular credit and to provide an approach to analysis.
- It is essential to recognise that lending rationales are used to characterise a type of loan proposition or credit facility and not a type of borrower.
- Thus, a company is not a "cash flow company" or an "asset Protection Lending Company". The same company may have several different loans with the bank; each made on the basis of a different lending rationale.
Asset Conversion Lending

- For most businesses the flow of funds from the completion of sales transactions or the rendering of services is the main source finance for the purchase of raw materials, wage / salary payments, and other expenses involved in conducting business operations.
- In many cases, this unevenness of the flow of funds is not of sufficient magnitude to create a need for outside financing, as the firm's normal cash position is large enough to absorb these short-term fluctuations.
- In other cases, particularly in seasonal businesses a temporarily builds up of inventory and then accounts receivable above normal levels, is expected at a given time of the year. There is then a significant difference between the inflows and outflows of funds for short periods of time, necessitating the use of short-term, temporary funds from outside sources.
- Where provided by, say, a bank such short-term temporary financing derives payback from the cash collected when the receivables arising from the sale of inventory are liquidated at the completion of the asset conversion cycle. This form of Asset conversion lending is a main stay of bank business lending to the commodity trade.
- Asset conversion loans are short-term, self-liquidating loans and are made to finance a temporary build-up of current assets - inventory and accounts receivable - above the permanent level the firm normally keeps on hand.
- The loans are generally unsecured, and the primary protection against loss is:
  (i) The bank's confidence in management's ability to complete the asset conversion cycle and
  (ii) The liquidity of the assets being financed.

Credit Analysis Features

Loan Purpose

- To finance seasonal working investment build up, i.e. the difference between working Investment at low point (the permanent level) and working investment at high point (the seasonal peak).

Primary Source of Repayment

- Cash received from the successful completion of the asset conversion cycle, i.e. the recovery of costs at the end of a major selling season.

Risks

- Inability to complete the asset conversion cycle successfully due to risks in the supply, production, sales, or collection segment of the asset conversion cycle.
PROTECTION

- The quality (liquidity) of the working assets in the asset conversion cycle and the ability of management to mitigate the risks inherent in cycle.

LOAN STRUCTURE AND CONTROL

- Use of a line of credit, with borrowings on demand or short-term notes, which allows the lender to review the financial condition of the company frequently during the cycle before renewing the notes or adding new borrowings.
- The series of notes should correspond to the length of the asset conversion cycle, that is, the expected time needed to convert the assets to cash and repay the loan.

CASH FLOW LENDING

- Cash flow lending is lending to finance a firm's permanent, i.e. long-term needs. Apart from seasonal needs, permanent needs are associated with:
  (i) Permanent level of working investment
  (ii) Capital expenditures
  (iii) Investment activities
- Cash flow lending by a bank is usually medium-term, with loan terms of up to seven or eight years in most cases
- The "support" assets such as plant and equipment that are being financed are expected to produce other, "working", assets which, when converted to cash through the successful completion of successive asset conversion cycles, will generate sufficient cash to repay the loan. For example new equipment, financed in anticipation of higher productivity to boost sales and profitability.
- In the case of permanent levels of working investment, an increase in sales volume will usually require an increase in the permanent level of working investment. It is expected that the increased level of sales will result in additional retained earnings that will repay the term loan.
- Cash flow lending, then, is essentially lending to repeated asset conversion cycles, and payback is dependent on the firm's ability to generate (and retain in the business) sufficient cash over a number of years of profitable operations to make required interest and principal payments on the loan.
- Assessing a firm's creditworthiness for a term loan to be repaid out of cash flow requires making reasonable projections of the firm's future sales prospects and cash flow and determining the amount of cash that will probably be available to service debt in the future.
- Long-term loans present greater risk to the lender than short-term loans since the longer into the future that payback is scheduled, the greater the chance of unforeseen events intervening and jeopardising the safety of the loan.
- The primary justification for a cash flow loan is the reasoned expectation of the firm's future ability to generate sufficient cash flow, not its historical ability to do so. Therefore, Covenants in the loan agreement are often included a 'trigger' to signal to the lender a deteriorating situation so that corrective action may be taken.

Credit Analysis Features
**Loan Purpose**

- To provide external financing for permanent needs, this will support or enhance the generation of internal net cash inflows from profitable operations.

**Primary Source of Repayment**

- Cash flow (primarily from additional profits) over time.

**Risks**

- Inability to generate and/or retain sufficient cash from operations to amortise debt because of, for example, selling problems arising from competition, product failure OR
- Obsolescence or inability of management to efficiently and prudently manage the sources and uses of cash.

**Protection**

- Primary protection against loss is the stability of profit generation and preservation of the strength of the firm’s financial position.
- Covenants in the loan agreement establish conditions necessary to preserve cash flow and financial strength and serve to signal deterioration in these areas that may threaten payback.
- Cash flow lending by a commercial bank is medium-term, up to 7 or 10 years (long-term loans of up to 40 years are made by insurance companies, pension funds, governments, and the public (through bond offerings).
- Lenders are often willing to refinance the individual debt issues, depending on the perceived ability of the firm to service the debt and, thus, a serviceable level of medium and long-term debt can be a "permanent" source of capital.
- Usually term loans will call for amortisation of a portion of the loan annually or quarterly, and each long-term debt issue will have a series of notes corresponding to the timing in the amortisation schedule.

**Form of Control**

- Covenants in the term loan agreement, which set parameters within which the borrower must work to assure strength in the overall financial condition.
ASSET PROTECTION LENDING

- Asset Based lending is a method of financing a relatively permanent need with a short-term vehicle. The permanent need normally consists of a stable, but revolving, level of current assets.
- The asset based loan thus combines features of the asset conversion loan (a short-term vehicle) and the cash flow, or term, loan (a permanent financing need), but is quite distinct from these forms of lending.

ASSET PROTECTION LENDING COMPARED WITH ASSET CONVERSION LENDING.

- Asset based lending differs from asset conversion lending, in which the financing need is temporary and payback is expected in full at the completion of the asset conversion cycle.
- The need financed by the asset protection loan is, by contrast, a permanent level of current assets, and the bank is essentially financing an on-going stream of asset conversion cycles.
- This position necessitates that the loan is continuously rolled over. The loan could not be paid back in full without reducing the normal level of the firm's current assets and thus seriously disrupting the firm's operations.
- The fundamental paradox of Asset Based Lending is that the repayment of a permanent level or principal is not expected as long as the business is a going concern, although individual transactions or promissory notes within that level are expected to be self-liquidating.

ASSET PROTECTION LENDING COMPARED WITH CASH FLOW LENDING

- Asset Based lending also differs from cash flow lending. Although both finance a permanent need, in an Asset Base situation, the company does not generate sufficient cash flow to amortise a substantial term loan.
- The bank, however, has confidence in the ability of the firm to repay the loan, if necessary, from the liquidation of the assets being financed, and, therefore, makes funds available through a short-term vehicle in order to exert greater control, similar to that inherent in asset conversion loans.
- It is therefore of critical importance that the creditworthiness of the Borrower company in relation to competence and integrity of the firm's management is not taken for granted.
- Ordinarily, the bank should lend only when it is assured of the firm's ability to successfully complete rapidly successive asset conversion cycles and to continue in the future as a viable concern.
- Asset based lending also requires that the bank be assured that the net realisable value (in a forced sale or liquidation) of the assets being financed is sufficient to fully satisfy the amount of the loan, given sufficient senior creditor status.
- This requirement of asset based loans is designed to protect the bank against loss in the event of bankruptcy or liquidation.
- Asset Based loans may be secured or unsecured depending on the strength of the borrower, the quality of the assets being financed, and the nature of the transaction cycle.
WHEN WOULD ASSET PROTECTION LENDING BE APPROPRIATE?

(i) Merchant businesses.
- Where the business acts as an intermediary between buyer and seller, supplier and manufacturer, saver and investor, etc. The Asset Based loan is then required to finance the permanent level of current assets requirement.
- In these businesses there is little value added during the asset conversion process and there is, therefore, low profit per transaction and low retained earnings and equity, with profits generated primarily by high volume. The high financial leverage that is characteristic of these businesses implies high risk to the lender.
- The lender, however, will advance under the Asset Based rationale if it is assured of the viability of the business as a going concern and if the quality of the assets is such that, if liquidated, the net realisable value would be sufficient to repay senior claims.

(ii) Uncertainty about the borrower’s ability to generate sufficient cash flow to amortise a term loan or, where the level of borrowing is so high that there is an unstable financial condition in the near term.
- Then the lender will take security in assets with a liquidation value adequate to repay the loan, if necessary. For example a personal mortgage, which is amortised primarily by the borrower's earnings but is also supported by the liquidation value of the home and property being financed (other forms of asset-based financing, such as leasing, would also fit this broad category).

(iii) Where the bank has reason to doubt the firm's cash flow potential.
- An example would be a start-up manufacturer, for which the bank might finance plant, equipment, or permanent working investment with a secured term loan, expecting sufficient profits over time to pay back the debt, but due to the uncertainty of the new enterprise, takes security in the company's assets to assure payback should the firm prove unprofitable.
- Another example might be a firm that had recently experienced cash flow problems that injected new uncertainty into its prospects for future profitability to an extent that disqualified if for consideration for an unsecured term loan.

Credit Analysis Features

LOAN PURPOSE
- To finance permanent level of current or readily marketable working assets.

SOURCE OF REPAYMENT
- On a going-concern basis, the successful completion of individual transactions in an amount equal to the stated value of the working assets.
- In a going concern, the loan is an evergreen one, in which payback in full of the principal is never really expected).
- In a distress situation, the liquidation of the assets being financed.

RISKS
- Risks that - due to price fluctuations or other factors - the value of the assets shrinks below the net realisable value necessary to pay out the bank as a senior creditor.
PROTECTION

- Value and liquidity of the assets financed. (This must be assumed in both secured and unsecured lending situations).

LOAN STRUCTURE AND CONTROL

- Short-term secured or unsecured notes with tenors dictated by the expected length of the financing need in the asset conversion cycle itself or in a specifically financed transaction.
- Control becomes extremely important in secured asset protection lending.

*See Table Below containing a Summary for lending rationale*

<table>
<thead>
<tr>
<th>Rationale</th>
<th>Purpose</th>
<th>Source of Payment</th>
<th>Banks</th>
<th>Protection</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Conversion</td>
<td>Financing short-term Seasonal build-ups of working assets Financing other temporary, transactional build-ups of current assets.</td>
<td>Cash received from the successful completion of the asset conversion cycle</td>
<td>Inability to recover costs through successful completion of the asset conversion cycle</td>
<td>Asset liquidity. Management’s ability to complete cycle. Short time factor.</td>
<td>Short-term notes. Frequent opportunity to review situation before renewal.</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>Financing of long-term assets or permanent working investment and support assets</td>
<td>Cash from profits generated and retained in the business over time</td>
<td>Inability to generate a stable level of profits over several years</td>
<td>Management’s ability to generate profits Adequate equity cushion Unused debt capacity</td>
<td>Covenants in the term-loan agreement to preserve or enhance the financial condition</td>
</tr>
<tr>
<td>Asset Based Lending</td>
<td>Evergreen financing of a permanent level of working assets. Financing other assets under temporary condition of increased risk, as a secondary lending rationale</td>
<td>If asset protection is primary rationale, no payback on an ongoing basis is expected. If it is the secondary rationale, payback is expected from asset conversion or cash flow. In both cases, liquidation of assets being financed will pay back the loan in a distress situation</td>
<td>Inability to recover costs by successful completion of asset conversion cycle; inability to generate profits fast enough to maintain a sound financial condition. Decline in the value of the assets below amount necessary to pay out senior creditors</td>
<td>Management’s ability to complete each transaction and to generate a satisfactory level of profits over a number of years. Asset liquidity and low shrinkage in a forced sale</td>
<td>Demand or short – term notes. Security and proper documentation. Debt limitations and covenants where applicable.</td>
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