



U.S. Small Business
Administration

Underwriting and Cash Flow

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Underwriting and Cash Flow

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We would like to thank Mary, Ray and Chuck for their time and providing information regarding their experience on SBA lending programs from their perspective.

All opinions, conclusions, and/or recommendations expressed herein are those of the presenters and do not necessarily reflect the views of the SBA.

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SBA Underwriting Requirements

The SBA SOP 50 10 5(K) states:

“Lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. The cash flow of the Small Business Applicant is the primary source of repayment, not the liquidation of collateral. Thus, if the lender’s financial analysis demonstrates that the Small Business Applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available or outside sources of cash.”

SBA U/W Requirements - Three Categories

1. 7(a) Small Loans - \$350,000 or under (except Express) – Credit Score (SOP 50 10 5(K), pages 182 to 185)
2. 7(a) Loans \$350,000 to \$5 million – (SOP 50 10 5(K) pages 178 to 182) Calculate the Debt Service Coverage (DSC), SBA has a 1.15X rule
3. SBA Express (SOP 50 10 5(K) pages 187 and 190)

Underwriting Requirements-Analyzing Credit

- Detail Sources & Uses
- Collateral Discussion
- Discuss and verify Equity Injection
- Balance Sheet Analysis (pro forma or existing)
 - Adequacy of Working Capital
 - Ratio Analysis (compared to industry – Current Ratio; Debt to TNW; etc.)
- Reasonable assurance of repayment through analysis of historic or projected cash flow (acceptable credit score for loans up to \$350,000 is sufficient to meet this requirement)

Underwriting Requirements Standards to Follow

- History of Business
- Description of management team
- Owner/Guarantor Analysis
 - Life Insurance discussion
- Affect of any affiliates
- Lender rationale for recommending loan for approval

SBA Specific Credit Memo Requirements

- Eligibility of Borrower
- Eligibility of Use of Proceeds
- Credit Elsewhere Test
- Verification of tax returns (tax transcripts)
- Discussion of Previous Government Debt (SBA, FHA, VA, Student loans, etc.)

Use of Proceeds

The SBA requires the Lender outline in detail what the loan funds will be used for:

Use	Bank Loan	Borrower Equity*	Other Equity Sources	Total	Eligible Maturity
Land Purchase	\$0	\$0	\$0	\$0	25
Real Estate Purchase	\$0	\$0	\$0	\$0	25
Real Estate Construction	\$0	\$0	\$0	\$0	25
Construction Contingency (10%)	\$0	\$0	\$0	\$0	25
Interim Interest	\$0	\$0	\$0	\$0	10
Equipment Purchase	\$0	\$0	\$0	\$0	10
Leasehold Improvements	\$0	\$0	\$0	\$0	10
Business Acquisition	\$0	\$0	\$0	\$0	10
Refinance debt	\$0	\$0	\$0	\$0	10
Included Misc. Costs detailed below:	\$0	\$0	\$0	\$0	10
Guaranty Fee	\$0	\$0	\$0	\$0	10
Total	\$0	\$0	\$0	\$0	

Collateral

- SBA considers a loan as “fully-secured” if the lender has taken security interests in all available fixed assets with a combined “net book value” as adjusted below up to the loan amount. For 7(a) loans, the term “fixed assets” means real estate, including land and structures, machinery and equipment owned by the business or an EPC.
 - Equipment (75% New; 50% Used or 80% of the Orderly Liquidation Value)
 - Commercial Real Estate (85%)
 - Residential Real Estate (85%) – SBA does not require a lien on a personal real estate if there is not at least 25% equity.
 - All Business Assets (10% Furniture, Fixtures, A/R, Inventory, etc.)
 - For Lines of Credit (up to 85% of A/R and 50% of Inventory)

Equity Injection/Capital

- Start-Up Business – At a minimum, SBA considers an equity injection of at least ten (10) percent of the total project costs necessary to operate on a sound financial basis. SBA considers a start-up to be a business that has been operating for less than 12 months.
- Change of Ownership – SBA considered equity injection of at least ten (10) percent of the total project costs necessary for a complete change of ownership transaction. Seller may contribute up to five (5) percent of the required ten (10) percent. The seller note must be in full standby for the life of the loan.
- With a change of ownership between existing owners, 10% equity injection is not required if: (i) the remaining owner has been actively involved in the business for at least 24 months prior to the change of ownership (lender must obtain borrower certificate to this effect and note it in the credit memo); and (ii) balance sheet reflects debt to worth ratio of not >9:1 prior to the change of ownership (otherwise, 10% equity is required).

Balance Sheet & Ratio Analysis

- Pro Forma Balance Sheet (after loan has been made) or,
 - Current balance sheet adjusted for all changes in assets and liabilities as a result of the loan, other debt, required equity and use of proceeds
- Ratio Calculations (based on Pro Forma Balance Sheet and historic and projected income statement)
 - Current Ratio
 - Debt/Tangible Net Worth
 - A/R, Inventory and A/P Turnover
 - Any other ratios lender considers significant

Working Capital

Positive Working capital is essential for the company to meet its continuous operational needs. (**Current assets** are the most liquid of the assets, meaning they are cash or can be quickly converted to cash. **Current liabilities** are any obligations due within one year)

The lender must address the adequacy of the Small Business applicants working capital position.

If the lender's analysis shows the working capital is inadequate, the lender must

1. Ask the Small Business applicant to provide an explanation of where the working capital will come from, or
2. The lender should provide sufficient funds in the SBA loan to support adequate working capital

Debt Service Coverage Ratios

- Applicant's debt service coverage ratio (OCF/DS) must be equal to or greater than 1.15 on a historical and/or projected cash flow basis and 1:1 on a global basis.
- OFC Operating Cash Flow = EBITDA
- DS Debt Service = the future required principal and interest payments on all business debt inclusive of new SBA loan proceeds.

Tools Required to determine Cash Flow

- Most recent three years complete Tax Returns for the subject business and all affiliates
- Most recent three years financial statements if the tax returns are not reflective of the business being financed (acquisition of a division or territory of a larger company)
- Financial statements from the most recent quarter end of the subject business, includes P&L and Balance Sheet and all affiliates
- Business Debt Schedule of the subject business and all affiliates
- Projections for the subject business, if applicable
- Personal Financial Statement of all guarantors
- Personal credit Reports of all guarantors
- Last two years of personal tax returns for all guarantors

Build the Foundation – Business Analysis

Before you can perform a Global Debt Service Analysis, you must perform Debt Service Analysis on the individual businesses associated with the deal.

- Spread each affiliate and the subject company separately using their respective financial information and debt schedules
- Make standard adjustments to OCF
 - Non-recurring rent payments in real estate purchases
 - Owner’s salary addback and/or owner’s draw
- Explain any non-standard adjustments to your analysis
 - Other non-recurring or one-time expenses
 - Unfunded Capital Expenditures
 - Non-recurring income

Build the foundation – Personal Analysis

Before you can perform a Global Debt Service Analysis, you must perform Debt Service Analysis on the individual businesses associated with the deal.

Your next step is to determine the personal income sources and expense. There are no specific rules in how you determine the personal cash needs of the individual guarantors, but it needs to be reasonable and explained.

- Compare the PFS to the Personal Credit Report to determine all household debt
- Review Personal Tax Returns for
 - any rental income and expenses
 - Schedule C for sole proprietorship income
 - Schedule E for potential affiliates
- Review Personal Credit Report for all debt and repayment terms

Personal Budget Analysis

Below is the analysis Radar Lender Services uses to determine how much draw is required from the subject business. You do not have to use this analysis, but you need to show and explain how you determined your draw requirement.

Personal Budget Analysis:				Borrower Name: _____		
	Monthly	Annual			Monthly	Annual
Income				Expenses		
Required Draw	\$0	\$0		Personal Mortgage (P&I)	\$0	\$0
Gross Salary-Principal	\$0	\$0		Rental Property Mortgage (P&I)	\$0	\$0
Gross Salary-Spouse	\$0	\$0		Rental Property Expenses	\$0	\$0
Gross Rental Income	\$0	\$0		Auto/Installment Loans	\$0	\$0
Interest Income	\$0	\$0		Revolving Credit	\$0	\$0
Alimony	\$0	\$0		Child Support/Alimony	\$0	\$0
Other Income	\$0	\$0		Living Expenses (\$400/person) ¹	\$0	\$0
Total Income	\$0	\$0		Property Taxes (last actual)	\$0	\$0
				Income Taxes	\$0	\$0
				Misc. (5% of Total Income)	\$0	\$0
				Total Expenses	\$0	\$0
				Net Discretionary Income	\$0	\$0

Personal Financial Needs

- Eliminate debts from your analysis that will payoff within the next 6-12 months (excluding balloon notes)
- Estimate personal taxes based on draw requirements
- Ask about alimony and/or child support payments
- Assume student loans will need to be paid off and won't be on deferment forever

DSCR Chart

Type	Tax Return	Tax Return	Tax Return	Interim	Projection
Period Ending	12/31/2016	12/31/2017	12/31/2018	3/31/2019	Year 1
Months	12	12	12	3	12
Revenue	\$0	\$0	\$0	\$0	\$0
Net Income	\$0	\$0	\$0	\$0	\$0
+ Rent	\$0	\$0	\$0	\$0	\$0
+ Interest	\$0	\$0	\$0	\$0	\$0
+ Depreciation/Amortization	\$0	\$0	\$0	\$0	\$0
+ Officer's Salary	\$0	\$0	\$0	\$0	\$0
+Other Addback:	\$0	\$0	\$0	\$0	\$0
+Other Addback:	\$0	\$0	\$0	\$0	\$0
+Other Addback:	\$0	\$0	\$0	\$0	\$0
+Other Addback:	\$0	\$0	\$0	\$0	\$0
- Officer Draw/New Owner Comp.	\$0	\$0	\$0	\$0	\$0
CF Available to Service Debt	\$0	\$0	\$0	\$0	\$0
Projected Debt Service (see Table Above)	\$0	\$0	\$0	\$0	\$0
Excess Cash Flow	\$0	\$0	\$0	\$0	\$0
Debt Service Coverage Ratio	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!

Other Addbacks/Expenses

In addition to a departed owner, here are some other typical addbacks that may be allowed. You must be able to verify these amounts from the financial data collected.

Addbacks:

- Other salaries being replaced or eliminated, management fees that are being eliminated
- Equipment Rental being eliminated
- Extraordinary Repairs & Maintenance or Legal Fees
- Automobile expenses for businesses that do not require autos for the business operations

Expenses:

- In real estate deals adjust for property taxes and expenses
- CapEx – if the business has to replace equipment in quick succession, you need to account for these expenses

Projections

If:

- your business has not generated revenue for at least 12 months it is considered a start-up and requires projections
- your analysis does not reflect debt service in the most recent full fiscal year we suggest you obtain projections
- your loan is for a complete change in ownership, the SBA considers this a new business and you must obtain projections

Projections are to be for two full fiscal years with the first year being on a month-to-month basis.

Recast vs. Addbacks

Originators and brokers have a tendency to want you to use their recasted numbers as your historical analysis. This is not the way the SBA will analyze the loan and we do not recommend you analyze the credit in this manner. Recasted financials display how the business could have been managed to generate better profitability. This can serve as support to the incoming owner's projections, but is not a historical analysis of the subject business.

Global Debt Service Coverage

Global Cash Flow	12/31/2016	12/31/2017	12/31/2018	3/31/2019
Personal Cash Flow - Guarantor	\$0	\$0	\$0	\$0
Cash available for Debt Service - Borrower	\$0	\$0	\$0	\$0
Cash available for Debt Service - Affiliate #1	\$0	\$0	\$0	\$0
Cash available for Debt Service - Affiliate #2	\$0	\$0	\$0	\$0
Total Existing Cash Flow	\$0	\$0	\$0	\$0
Personal Expenses - Guarantor	\$0	\$0	\$0	\$0
Existing Debt: Borrower	\$0	\$0	\$0	\$0
Existing Debt: Affiliate #1	\$0	\$0	\$0	\$0
Existing Debt: Affiliate #2	\$0	\$0	\$0	\$0
Proposed SBA 7(a)	\$0	\$0	\$0	\$0
Total Debt	\$0	\$0	\$0	\$0
Global Debt Service Coverage	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!

Suggestions

- Don't force your deal to look better on paper.
- Ask as many questions of the applicant as needed to get comfortable with the deal.
- Get support for addbacks – paystubs, W-2s, receipts, etc...
- Dig in on the assumptions that support to projections. Start-ups or turnarounds are higher risk and you may be required to defend those projections to the SBA at the approval stage or worse yet, if the loan goes bad early.

Questions?



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