



Small Business Lending 101

■ Strategic Consulting and Financing | June 2012



Agenda

- Introduction
- Lending Lifecycle
- Portfolio Management
- Questions



Who is new to Small Business Lending?

CDFIs with expertise in other areas

- Housing
- Community Facilities
- Commercial Real Estate
- Microfinance

CDCs

504 Lenders

Technical Assistance Providers

Business Incubators

Community Development/Economic Development organizations

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Small Business Lending Comparison

| Primary Financing Sector | Borrowed Funds Average Interest Rate % | Average Interest Rate Charged (%) | Average Term (# of months) | 90+ Delinquency Ratio | Net Charge off Ratio |
|--------------------------|--|-----------------------------------|----------------------------|-----------------------|----------------------|
| Business | 3.0% | 6.8% | 88 | 6.0% | 4.1% |
| Commercial Real Estate | 3.7% | 6.8% | 66 | 4.0% | 3.0% |
| Community Facilities | 2.4% | 6.3% | 70 | 5.8% | 1.5% |
| Housing to Individuals | 2.7% | 6.0% | 206 | 4.5% | 1.9% |
| Housing to Organizations | 2.5% | 5.5% | 87 | 3.4% | 1.5% |
| Microenterprise | 2.0% | 9.3% | 51 | 4.5% | 10.3% |
| Totals | 2.7% | 6.4% | 91 | 4.0% | 3.2% |

•Riskier lending than most sectors

•About the same spread as the average

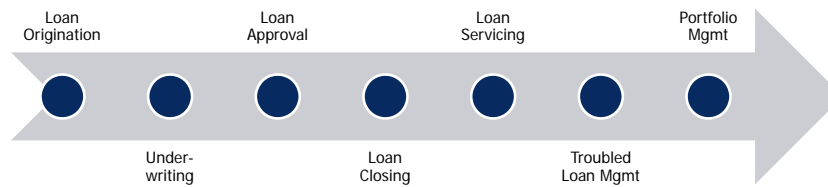
•**Execution is critical to success**

Source: OFN 2010 Member Data

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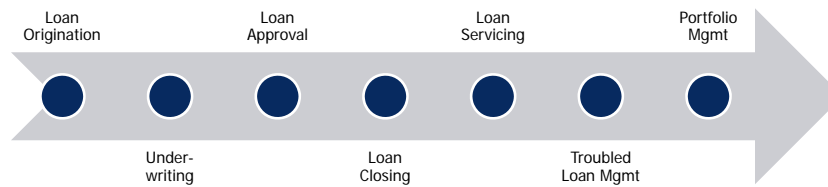
Look at the Lending Lifecycle



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Support Functions of Lending



| |
|--|
| MIS and Technology |
| Organizational Structure/ Staffing/ Professional Development |
| Reporting |
| Quality Control |
| Productivity |

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Before you start lending.....

- How does Small Business Lending fit with your mission?
- Who is your target market?
- Who are eligible borrowers?
- What are eligible uses (and ineligible)?
- What loan products will you offer?
- Establish clear staff roles & responsibilities

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Loan Origination

- Variety of sales channels
- Vetting checklist or pre-application:
 - Industry
 - Eligibility
 - Underwriting criteria
 - Fit for loan program or source of funding
- Meet borrower and visit the business
- **Expect only 20-30% of inquiries to result in completed applications**
- Recommend appropriate Technical Assistance

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Underwriting

Decentralized or centralized underwriting

Credit analysis to evaluate/rate risk:

- Earnings
- Cash Flow
- Asset Quality
- Leverage
- Management
- Guarantors
- Collateral
- Industry/Market/Competition
- Financial Reporting

Determine how to work with borrowers with challenges

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Underwriting – Risk Rating Scorecard

See recent TA memo on Risk Rating for Small Business CDFIs

| | Weight | 4 | 5 | 6 |
|--|--------|---|--|---|
| Operating Margins/Cash Flow Debt service coverage (DSC) calculations are based on 12 months of historical financial information or projections that include our loan using EBITDA and 12 months of full loan payments | 20.0% | Historic DSC 1.1x to 1.29x. (Based on the most recent FYE) | Historic DSC 1.09x to .80x. (Based on either the most recent FYE or the projected, stabilized year) | Historic DSC .79x to .50x. (Based on either the most recent FYE or the projected, stabilized year) |
| | | 4 | 5 | 6 |
| Balance Sheet: Tangible Net Worth (Based on the proforma after our loan closes) | 12.5% | Equity to Assets .17 > .19 (Debt:Tangible Worth 5:1) | Equity to Assets .13 > .16 (Debt:Tangible Worth 7:1) | Equity to Assets .10 > .12 (Debt:Tangible Worth 9:1) |
| Balance Sheet: Working Capital (Based on the proforma after our loan closes) | 12.5% | Current Ratio 1:1 to 1.49:1 | Current Ratio .9:1 to .99:1 | Current Ratio .75:1 to .89:1 |
| | | 4 | 5 | 6 |
| Management/Credit History- Highest Score of principal(s) | 10.0% | FICO 749 > 725 | FICO 724 > 660 | FICO 659 > 620 |
| Management (To choose rating – all of descriptor must be true) | 15.0% | <ul style="list-style-type: none">• Proven experience, but perhaps in a different business.• The company provides employee training and benefits.• CEO has good financial systems and can and does submit required financials, sometimes with prompting from us.• Financial trends are stable. | <ul style="list-style-type: none">• CEO's ability to manage firms of this type is unproven.• CEO has demonstrated he/she understands the need for good financial systems and required financials are submitted, but are sometimes late.• Financial trends may be negative, but CEO has demonstrated that he/she understands what it takes to realize better financial results. | <ul style="list-style-type: none">• CEO has not demonstrated adequate knowledge or acquired adequate resources to help the company become more profitable or the company is a start up.• CEO's financial systems are not adequate, financials not reliable or required financials are not submitted regularly. |
| | | 4 | 5 | 6 |
| Collateral/Secondary Source of Repayment Collateral analysis Loan to Value (LTV) = Total loans (including our loan)/Collateral Value. Collateral Coverage Ratio (CCR) = Collateral Value/Total Loans (including our loan) | 15.0% | LTV is 76% to 100% CCR 1.29 < 1.0 | LTV is 100.1% to 120% CCR .9 < .8 | LTV is 120.01% to 150% CCR .79 < .7 |

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Loan Approval/Closing

- Internal Loan Committee/Board Loan Committee
- **Expect 75-90% approval rates due to prior vetting**
- Ensuring the guarantee is critical – quality control and compliance are core competencies
- 10-15% of approvals may fail to close due to changing circumstances of borrower

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Loan Servicing

- Must balance three critical components:
 - Is the borrower meeting their obligations?
 - Is the viability of their business on track?
 - Are we maintaining our collateral/guarantee?
- Important administrative function
 - Staff and technology
- Relationship with the borrower
 - On-going support, with Technical Assistance

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Loan Servicing – ongoing risk rating

- Risk rate annually, at a minimum
- Evaluate more frequently for riskier credits
- Monitor larger trends related to:
 - Industries
 - Geographies
 - Loan types
 - Originators
 - Borrowers with more than one loan

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Troubled Loan Management

- Clear delinquency processes
- Defined non-accrual/watch/write-off policies
- Troubled Loans/Watch List reviewed by management and board
- Write-off according to policy, but keep engaging the borrower
- Know how and when to exercise applicable guarantees

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Portfolio Management

- Essential tool of risk management
 - Concentration risk; Migration of risk in the portfolio
 - Board and senior management priority
- Customize concentration analysis to size, complexity, mission, and investor restrictions of the lender

| Industry | Geography |
|------------------------|---------------------|
| Market Served | Lending Product |
| Security | Family of Borrowers |
| Asset Size of Borrower | Loan Size |

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Sample Portfolio Management Report

| Portfolio by Loan Product | | | | | | | | | | | |
|---------------------------|----------------------|--------------------------|-----------------------|---------------------------|------------------|-----------------------------------|----------------------|---------------------------------------|-------------------------|-------------------------|-------------------------|
| | # of Nonprofit Loans | Nonprofit \$ Outstanding | # of For-profit Loans | For-profit \$ Outstanding | Total # of Loans | % of Portfolio (using # of loans) | Total \$ Outstanding | % of Portfolio (using \$ Outstanding) | 30 Day Delinquency Rate | 60 Day Delinquency Rate | 90 Day Delinquency Rate |
| <= \$50,000 | | | | | | | | | | | |
| \$50,001 - \$100,000 | | | | | | | | | | | |
| \$100,001 - \$250,000 | | | | | | | | | | | |
| \$250,001 - \$500,000 | | | | | | | | | | | |
| >\$500,000 | | | | | | | | | | | |
| Total | | | | | | | | | | | |
| Portfolio by Industry | | | | | | | | | | | |
| | # of Nonprofit Loans | Nonprofit \$ Outstanding | # of For-profit Loans | For-profit \$ Outstanding | Total # of Loans | % of Portfolio (using # of loans) | Total \$ Outstanding | % of Portfolio (using \$ Outstanding) | 30 Day Delinquency Rate | 60 Day Delinquency Rate | 90 Day Delinquency Rate |
| Industry 1 | | | | | | | | | | | |
| Industry 2 | | | | | | | | | | | |
| Industry 3 | | | | | | | | | | | |
| Total | | | | | | | | | | | |
| Portfolio by Geography | | | | | | | | | | | |
| | # of Nonprofit Loans | Nonprofit \$ Outstanding | # of For-profit Loans | For-profit \$ Outstanding | Total # of Loans | % of Portfolio (using # of loans) | Total \$ Outstanding | % of Portfolio (using \$ Outstanding) | 30 Day Delinquency Rate | 60 Day Delinquency Rate | 90 Day Delinquency Rate |
| Location 1 | | | | | | | | | | | |
| Location 2 | | | | | | | | | | | |
| Location 3 | | | | | | | | | | | |
| Total | | | | | | | | | | | |

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Conclusion

Questions

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