CAVA RMA Commercial Lending School

Secured Lending

presented by

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Background

- 30 of 41 years in banking with BB&T/Truist (1983-2024)
- 11 years with 3 different community banks
- Prior roles (all at BB&T):

Commercial Finance President, Head of Specialized Lending Group, Chief Wholesale Credit Officer, Head of Middle Market Banking, Home Mortgage President

- Served in many different leadership roles with RMA, including national Chair 2015-16

Class Introductions

Who are you?

What do you do?

How do you do it?

How can I help you do it better?

What do you want to take away from today?

The Five C's of Credit

Five C's of Credit:

- Character
- Capacity
- Collateral
- Capital
- Conditions

Collateral

Collateral is a <u>secondary</u> source of repayment.

Collateral

Why would you take collateral?

- Reduce the risk profile of transaction;
- Transfers risk to customer;
- Gain control;
- Protect bank's interests.

Collateral

What are problems you face when you need to sell collateral?

- Time consuming
- Expensive
- Creates ill will

Guarantors can be your secondary source of repayment.

WHEN DO WE NOT TAKE SECURITY?

Normally <u>not</u> with certain types of loans:

- Self liquidating debt (conversion of assets);
- Certain term notes of very well capitalized companies with strong, consistent cash flow relative to size of maturing obligations.

WHEN DO WE TAKE SECURITY?

Normally <u>all</u> other times loans are secured!

Weigh borrower's cash flow, management, and collateral type / value.

WHEN DO WE TAKE SECURITY?

What trade-offs are possible or could collateral be a deal killer?

Collateral structure and creativity could differentiate from competition and be a deal maker!

WHEN DO WE TAKE SECURITY?

Collateral structure and creativity:

- Amount of loan dollars
- Terms and conditions
- Pricing options
- Repayment periods
- Guarantees

Taking Collateral

Know your customer's:

- Integrity
- Experience
- Future Prospects

Taking Collateral

Know your collateral:

- Personal visual verification / inspection
- Objective / Independent evaluation (i.e. Appraisal)

Taking Collateral

Know your market:

- Real estate appreciates and depreciates quickly.
- Other types of assets have specialized value in special markets.

Taking Collateral

Control your collateral:

- Reporting (aging, jobs in progress)
- Periodic verification
- Access to facilities (i.e. landlords waiver)
- Other needs – software / access

Taking Collateral

Reliance upon collateral in credit decision:

- Primary source (ABL, liquidation as source of repayment)
- Secondary source
- Control (little liquidation value, psychological)

Primary Types of Collateral

Accounts Receivable

- Careful review receivables aging report
- Quality of customer
- Types of customers
- Advance rates 75-90% of qualified

Primary Types of Collateral

Accounts Receivable

- Average length of collection;
- Credits / adjustments;
- Allowance for bad debts ;
- Concentration >20%;
- Cross aging, inter-company, foreign, etc.;
- Progress billings;

Primary Types of Collateral

Inventory

- Markets determine breadth and stability;
- Quality of customer controls;
- Seasonality or obsolescence;
- Valuing inventory;
- Inspections / monitoring;

Primary Types of Collateral

Inventory

- Advance rates usually 50-60% of cost;
- Finished or in process;
- Commodity price fluctuation;
- Buyback contract;
- Liquidation before another processing season.

Primary Types of Collateral

Equipment / Fixed Assets

Amortization should stay ahead of:

- physical depreciation;
- functional obsolescence of equipment.

Primary Types of Collateral

Equipment / Fixed Assets

- Heavy reliance on the add back of depreciation in the cash flow analysis.
- Maintenance?
- Does it move?

Primary Types of Collateral

Marketable Securities – Stocks / Bonds

- Diversification of portfolio;
- Marketability of stocks / bonds;
- Price volatility;
- Level I, II or III quotes;
- Reporting;
- Restrictions (rule 144 / trading volumes);

Primary Types of Collateral

Real Estate

- Property type;
- Zoning / permitted uses;
- Appraised value – sale or income;
- Alternative uses.

Primary Types of Collateral

Other types of collateral:

- CVLI
- Note Receivable
- Intangibles
- SBA Guarantees

Collateral Monitoring

Commitment Letter / Loan Agreement:

- Inspection rights, books, physical;
- Equipment lists with serial numbers;
- Insurance requirements;
- Maintenance requirement of equipment or real estate;
- Landlord's waiver.

Collateral Monitoring

Commitment Letter / Loan Agreement:

- Submission of receivables aging report;
- Borrowing base certificates;
- Field examinations;
- Financial reporting;

Collateral Monitoring

Commitment Letter / Loan Agreement:

Financial covenants:

- Advance rate
- Over advances
- DSCR
- LTV

Collateral Liquidation

- Account Receivables
- Equipment
  - equipment dealers
  - Auctioneers
- Real Estate
  - Deed in Lieu
  - Foreclosure

Perfection of Security Interest

Primary Document Types:

- Promissory Note
- Security Agreement
- Deed of Trust / Mortgage
- Pledge / Assignment

Perfection of Security Interest

Promissory Note:

A legal instrument (more particularly, a financial instrument), in which one party (the maker or issuer) promises in writing to pay a determinate sum of money to the other (the payee), either at a fixed or determinable future time or on demand of the payee, under specific terms.

Notice – nothing about collateral!

Perfection of Security Interest

Security Agreement:

Contract that governs the relationship between the parties in a secured transaction. Grantor (typically a borrower but possibly a guarantor or surety) assigns, grants and pledges to the grantee (typically the lender) a security interest in <u>personal property</u> which is referred to as the collateral.

Perfection of Security Interest

Security Agreement:

The security agreement sets out the various rights the grantee will have with respect to the collateral.

Perfection of Security Interest

Security Agreement:

Where the collateral remains in the physical possession of the borrower, or where the collateral is intangible (such as a patent, accounts receivable, or a promissory note), the security agreement must be in writing in order to satisfy the statute of frauds.

Perfection of Security Interest

Security Agreement:

- The security agreement must be authenticated by the debtor;
- Must bear the debtor's signature (physical or electronically marked);
- Must contain a reasonable description of the collateral;

Perfection of Security Interest

Security Agreement:

- Must use words showing an intent to create a security interest (the right to seek repayment of the loan by foreclosing on the collateral);
- For it to be valid, the borrower must usually have rights in the collateral at the time the agreement is executed.

Perfection of Security Interest

Security Agreement:

In order for a security interest to attach to the collateral in the possession of subsequent purchasers, it must be perfected.

Perfection of Security Interest

Security Agreement:

- Purchase Money Financing – perfection is automatic.
- Otherwise, the lender must record either the agreement itself, or a UCC-1 financing statement.

Perfection of Security Interest

Security Agreement:

- Perfecting the interest creates constructive notice;
- Deemed legally sufficient to inform the rest of the world of the lender's rights in the collateral;
- First lender to record the interest has the strongest claim to that property.

Perfection of Security Interest

Deed of Trust

A deed wherein legal title in real property is transferred to a trustee, which holds it as security for a loan (debt) between a borrower and lender. The equitable title remains with the borrower. The borrower is referred to as the trustor, while the lender is referred to as the beneficiary.

Perfection of Security Interest

Deed of Trust

- Deed of trust is normally recorded with the clerk of the court for the county where the property is located;
- Evidence of and security for the debt;
- Act of recording provides constructive notice to the world that the property has been encumbered.

Perfection of Security Interest

Deed of Trust

When the debt is fully paid, the beneficiary is required by law to promptly direct the trustee to transfer the property back to the trustor by re-conveyance, thus releasing the security for the debt.

Perfection of Security Interest

Mortgage

A mortgage is a security interest in real property held by a lender as a security for a debt, usually a loan of money.

Perfection of Security Interest

Mortgage

- A mortgage in itself is not a debt, it is the lender's security for a debt;
- Transfer of an interest in land from the owner to the mortgage lender;

Perfection of Security Interest

Mortgage

- Condition that this interest will be returned to the owner when the terms of the mortgage have been satisfied or performed.

- Mortgage is a security for the loan that the lender makes to the borrower.

Perfection of Security Interest

Marketable Securities

- Pledge of account;
- Acknowledgment by custodian / brokerage firm;
- Margin requirements;
- Monthly statements.

Working Capital

Working capital, *also known as net working capital*, is the difference between a company's current assets, like cash, accounts receivable (customers' unpaid bills) and inventories of raw materials and finished goods, and current liabilities, like accounts payable.

Working Capital

More simply:

Working Capital = Current Assets - Current Liabilities

Working Capital

- Measures both a company's operational efficiency and its short-term financial health.

- Indicates whether a company has enough short-term assets to cover its short-term debt.

Working Capital

Good ratio = 1.2x and 2.0x.

Above 2.0 might indicate that a company is not using its excess assets effectively to generate maximum possible revenue.

Checks for Industry norms.

Working Capital

Bad = less than 1.0

Negative working capital indicates potential liquidity problems – regardless of the industry.

Working Capital

By definition, working capital is the level of permanent financing available to support permanent (or core) current assets (accounts receivable and inventory).

Working capital is not a loan purpose!

Working Capital

- Company may be able to operate for a short period of time with a deficiency of working capital.
- Relying excessively on current liabilities (i.e. accounts payable, lines of credit, or other short term debt).
- Neither of these represents viable long-term strategies.
- Mismatch of financing will ultimately create a repayment problem that must be resolved.

Working Capital

- Find the true operating low point of the business.
- At operating low point, the inventory and accounts receivable represent core or permanent current assets and therefore should be financed with permanent financing or preferably equity.
- Equity is the major contributor to a strong working capital position.

Deficient Working Capital

What is causing the need for working capital:

- Rapid sales growth?
- Slowdown in the operating cycle?
- Losses or marginal profitability?
- Excessive distributions to owners?
- Excessive fixed asset purchases?

Deficient Working Capital

How did the company compensate and keep the doors open:

- Riding the trade payables?
- Increasing accruals?
- Relying on a seasonal line of credit and not paying it out as agreed?
- Using Overdrafts?
- Incurring officer debt?

Deficient Working Capital

Can the Company:

- Improve its working capital position?

- Does management have the ability and <u>mindset</u> to do so?

Deficient Working Capital

Can the company:

- Slow sales to reduce purchases?
- Become more selective with sales to improve profit margins?
- Improve the operating cycle?
- Control expenses to increase profitability?

Deficient Working Capital

Can the company:

- Inject some capital?
- Sell unnecessary fixed assets?
- Collect the officer receivables?
- Restructure short term financing?

Contact Information

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