PIPSO
Pacific Islands Private Sector Organisation

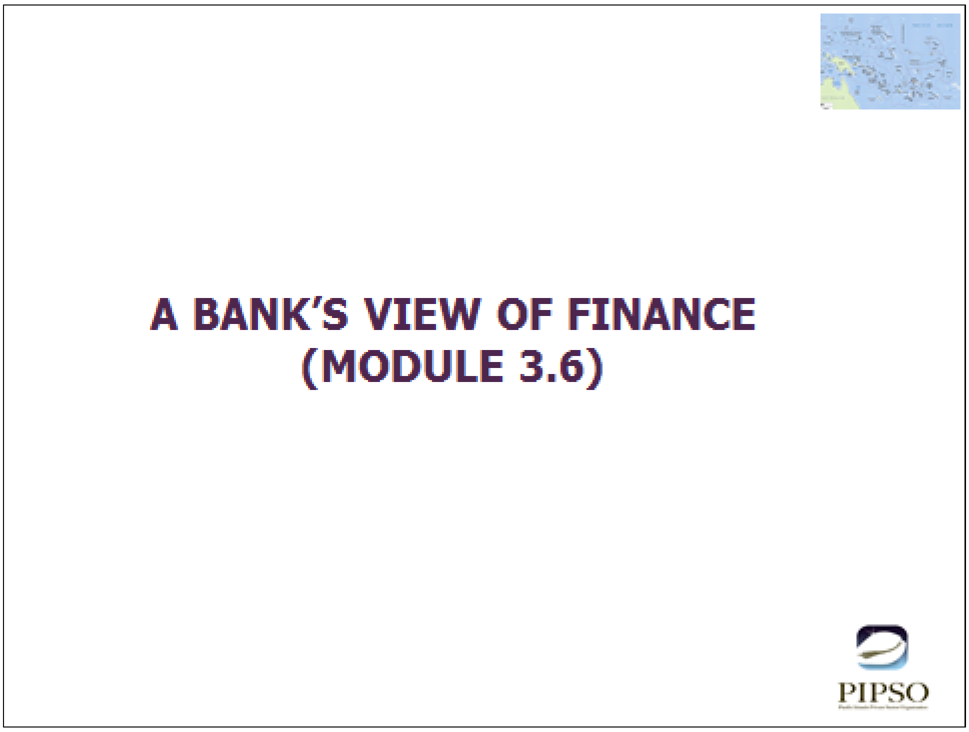
January 1

A BANK'S VIEW OF FINANCE

2014

This Module looks at lending from a bank's point of view; what it expects from a borrower before it will lend. It specifies some requirements of a bank, looks at several ratios used by banks to measure capacity to repay & the security expected. Lastly it provides a brief list of what a borrower must provide in order to obtain a loan.

MODULE 3.6



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PURPOSE

This Module aims to give prospective borrowers an insight into the expectations & requirements of a bank before it will provide funds to a business.

We begin by looking at how a retail commercial bank earns its revenues. Not surprisingly, interest & fees figure highly on the sources of revenue.

This leads to the consideration of what a bank wants from a borrower before it provides financial accommodation to the business. Participants are reminded that a bank does not wish to take entrepreneurial risk, the domain of the business owner(s), just commercial risk based on its credit assessment.

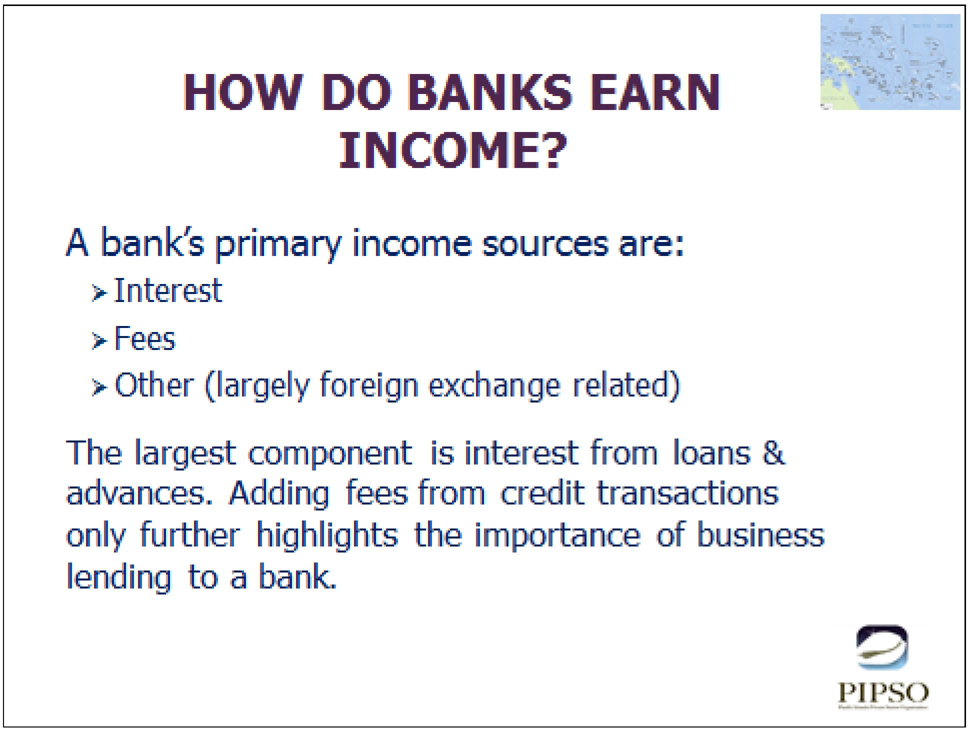
We look separately at the three components:

1. Business purpose
2. Capacity to repay
3. Protection against loss

After a short quiz, participants are provided with a check list for a loan application.

On completion of this Module participants should have a better understanding of what banks require from borrowers & why?

BANK EARNINGS



Retail or commercial banks earn the majority of income from interest on loans the significant majority of which are directly to retail customers; businesses & individuals. They also earn fee income again largely from the same customers & depositors.

A large part of a bank's net income represents the difference between what it receives in revenues for borrowers & pays depositors plus the fees it charges for services provided.

If a business is to borrow from a bank, surely it is helpful to know how a bank views its borrowers, i.e. its business customers, from micro to large, & what it wants before the business approaches the bank.

In this way, we can see what risk a bank will find acceptable & why a bank accepts & rejects lending proposals.

WHY DOES A BANK LEND?

A bank lends to earn:

- Interest
- Fees

A bank does not lend to foreclose on a customer or to send in a liquidator.

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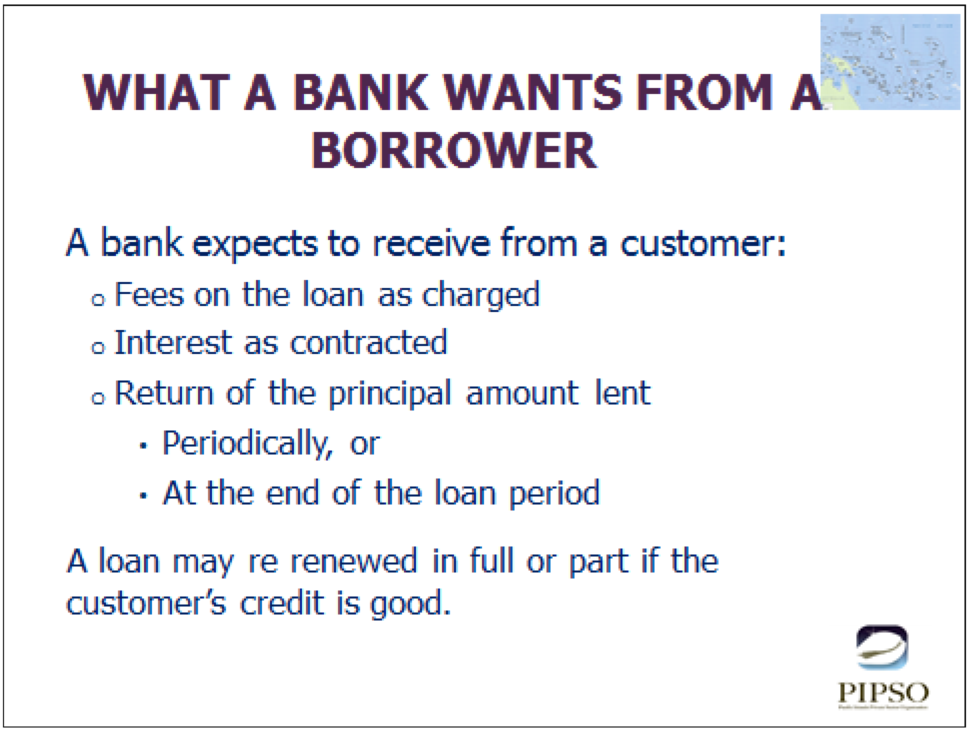
When assessing whether to lend, or not, a bank wants to be satisfied that the customer has the capacity to meet any obligations to the bank & other creditors.

A bank will not lend simply because it can recover any outstanding debt from the security it receives. It will consider the total debt obligations of a borrower, not just its own debt, even though it will seek to achieve priority in debt repayment over others.

WHAT A BANK WANTS FROM A BORROWER



Lending to retail, individual & business, customers is the largest earner of revenues for commercial banks. Banks lend to generate interest & fees. They want also repayment of the principal amount lent, either as a part of the monthly payments or on the due date.

A bank does not wish to:

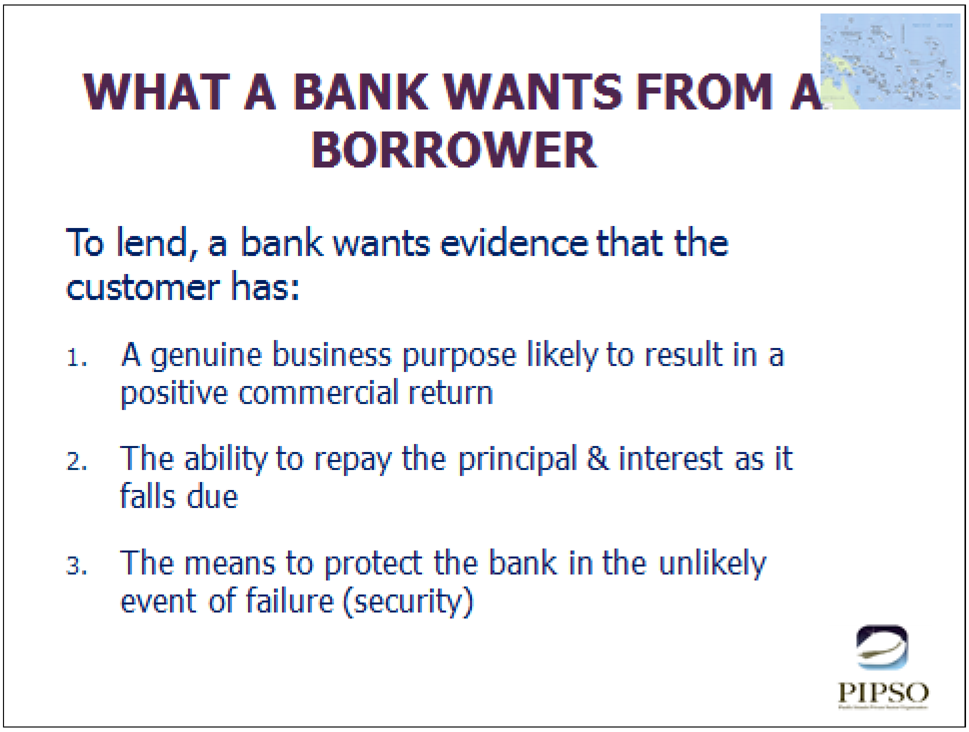
- Take entrepreneurial, equity or shareholder risk
- Foreclose on the security provided by a borrower
- Put in a receiver or liquidator to recover unsecured debt
- Lend where there is little or no prospect that a loan can be repaid on the due date

This does not mean that a bank will not renew or extend a loan. A growing business, or even a stable one, may carry some debt as a part of its business strategy to maximise owner wealth & a bank will provide accommodation so long as it is protected &has the option to review its position on a regular basis.

For a small business, the requirements of a bank may seem onerous, but to a larger business what they seek is nothing more than evidence of sound management practices & reporting. Small businesses often lack the level of proprietor discipline & planning sought by a bank, but these are the same traits required for a small business to successfully grow. It is necessary for the business to adopt better management & planning practices as they grow, for its own good, not just to borrow.

The bank has its credit criteria & these may not appear to be very flexible. However, banks are making greater effort to bridge the gap & find ways to assess small businesses albeit using conservative criteria.

So, what does a bank want?



Essentially for a borrower to be successful a bank requires that the borrower pass three tests:

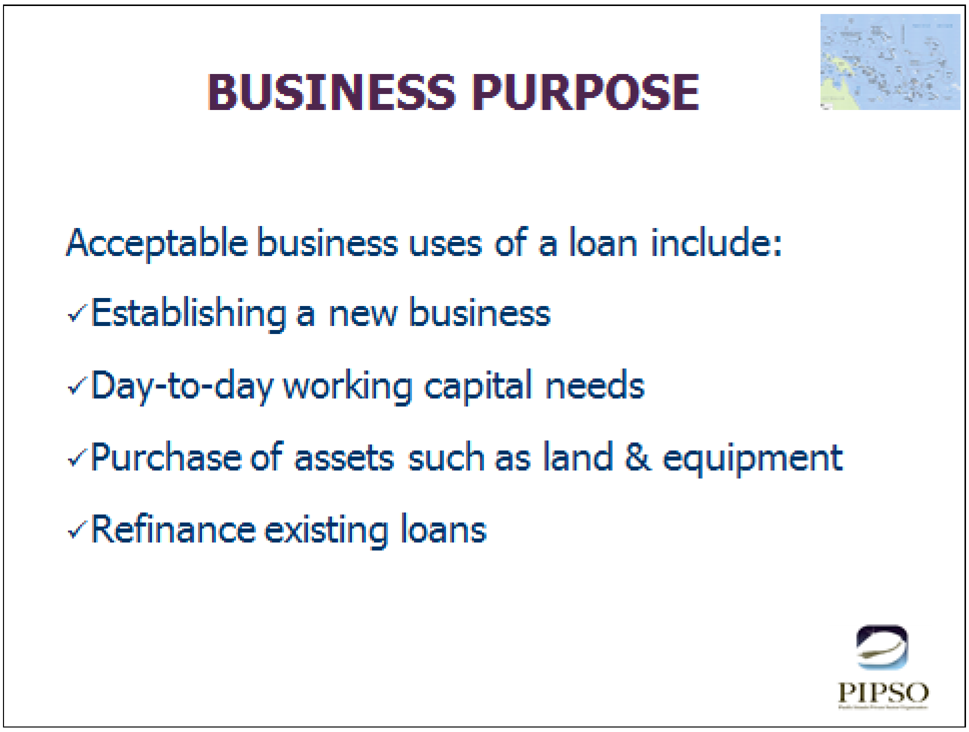
1. Have a business, not private, purpose
2. Demonstrate the capacity to meet interest payments & repay the loan as & when due
3. Provide the bank with sufficient security as protection in the event of a default

Remember the business owner takes the greater riskas the owner receives the greater return on equity. If a business is not generating profits in excess of the interest rate charged by the bank, why would a smart business person borrow?

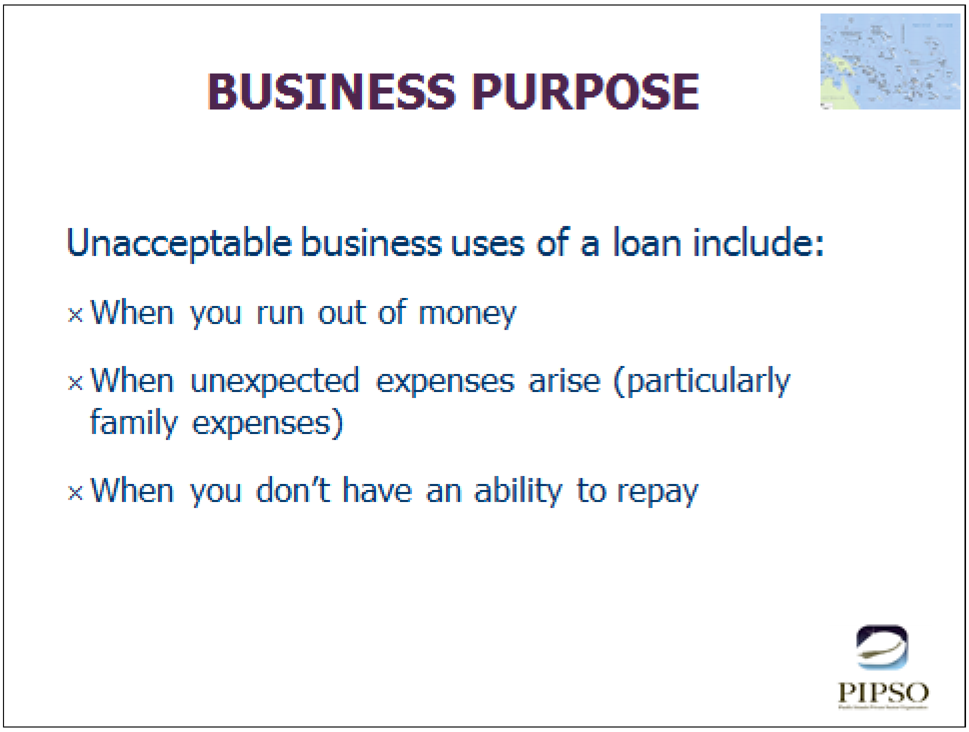
A bank will accept commercial risk, but no more, as its return is fixed. There is no extra benefit for good performance. Is this unreasonable?

We will now look at each of these tests in turn.

BUSINESS PURPOSE



If the purpose is a private purpose (e.g. to buy a recreational boat for the family), not a business purpose, the borrower should not be a business. It should be the individual. This is hardly a surprising or novel idea.

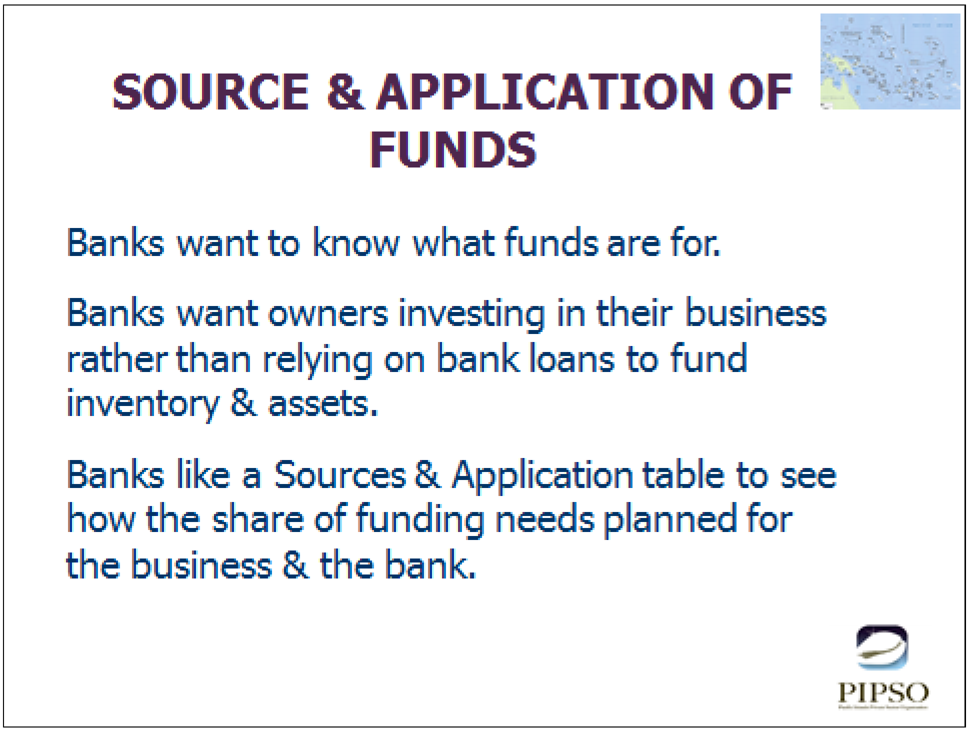


It is important to understand that banking is not a hand to mouth activity. If a bank is not to take entrepreneurial risk then it is not in the “bail-out” business. The “bail-out” business is high risk. There is a much higher price to pay due to the higher risk of failure. Remember that a bank is a commercial lender not an investor.

If a customer can show the bank a forecast for the next 12 months based on historical performance or reasonable assumptions& that 4 months ahead there is aprofitable seasonal opportunity, but to take advantage of it requires some short-term support it has a good chance of acceptance. If it has assets to offer as security during the period of the loan, it has an excellent chance of acceptance.

Let’s assume that the same business doesn’tforecast so it waits for three months unit the need is upon it as it seeks to stock up for the sale period. It is now running short of cash so it approaches a bank for funds, it has a much lower likelihood of success. It could, in fact, fail to take the opportunity or, worse still, doom itself to business failure as it cannot meet its creditor obligations in a timely manner, cannot stock up as it wishes &cannot generate the sales hoped for.

A little advance planning& preparation would have made all the difference.

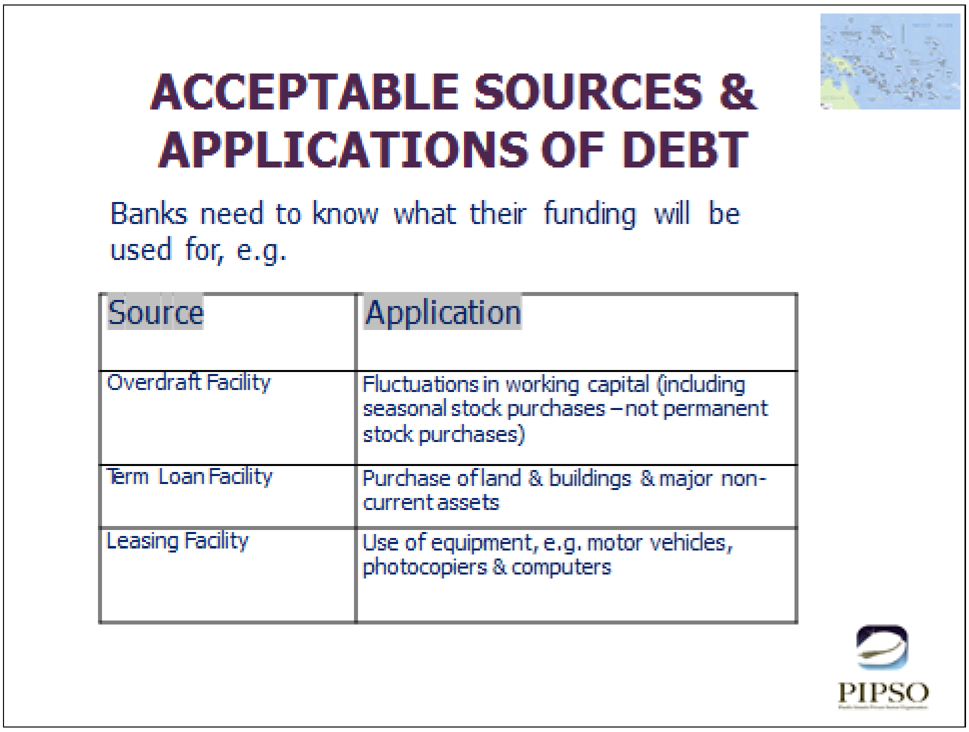


A bank will provide short-term loans if the application is presented well, but don’t wait until it’s a crisis. A bank wants to know that it is not taking entrepreneurial risk. That is what the business owner is doing.

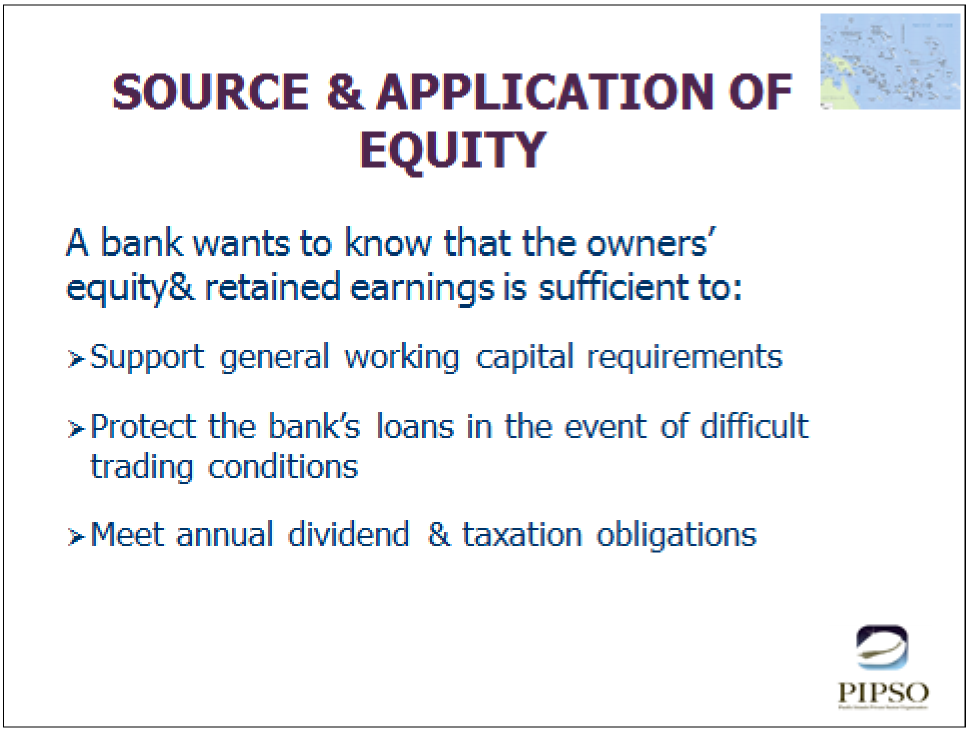
A bank does not mind a business making a profit on the funds provided by it. Surprise! Surprise! That is exactly what a bank does want. That way it gets paid its interest, fees & is paid its principal back. Everyone’s a winner.

On inspection of the business records & budget, what a bank does not want is to find is that the business seeking the loan willnot havesufficient earnings to repay the loan.

A budget, cash flow forecast or source & application of funds will show what the business is putting into the opportunity & what is being requested from the bank. The business owners put their money in first & take it out last.



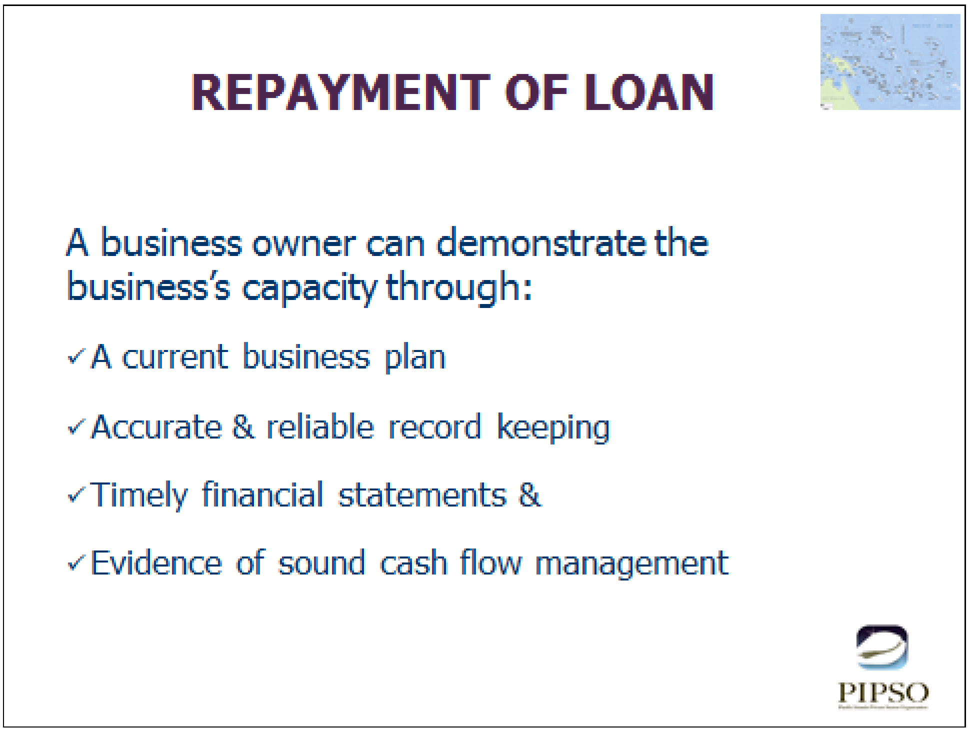
Remember that anyforecast must include the business's contribution towards the purpose. Its contribution must always be included. This may already be in place or be a new injection of funds.



EXAMPLE: A bank will look unfavourably on lending to a business so it can pay its taxes as due or a company dividend to shareholders. In this event the business is asking the bank to put funds in so it can take them out. It also demonstrates a clear lack of planning, because a business should generate earnings & cash from which it pays tax & dividends. If the business is profitable, but needs funds to pay taxes & dividends,what happened to the cash?

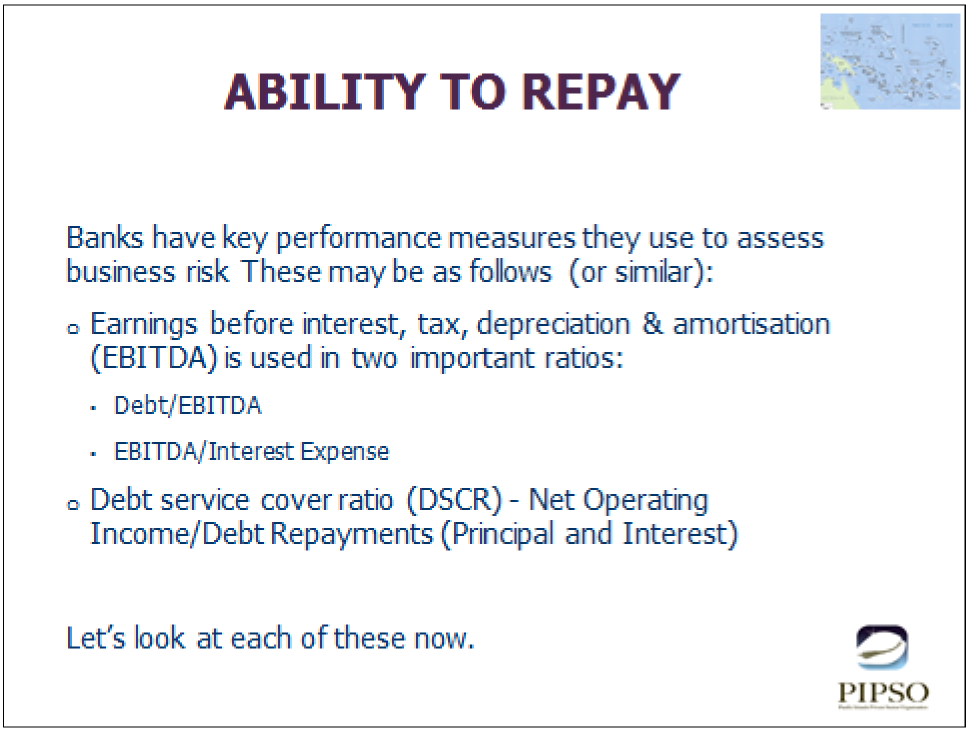
The bank may want to understand the business profitability & cash flow, but don't the business owners also, before they approach a bank for funds? How does a business owner know what to ask for if the owner has not done their own assessment &forecast?

CAPACITY TO REPAY



Having established an acceptable business purpose& understanding of business performance, the second hurdle is to demonstrate an ability to meet all interest & fee obligations & repay the debt.

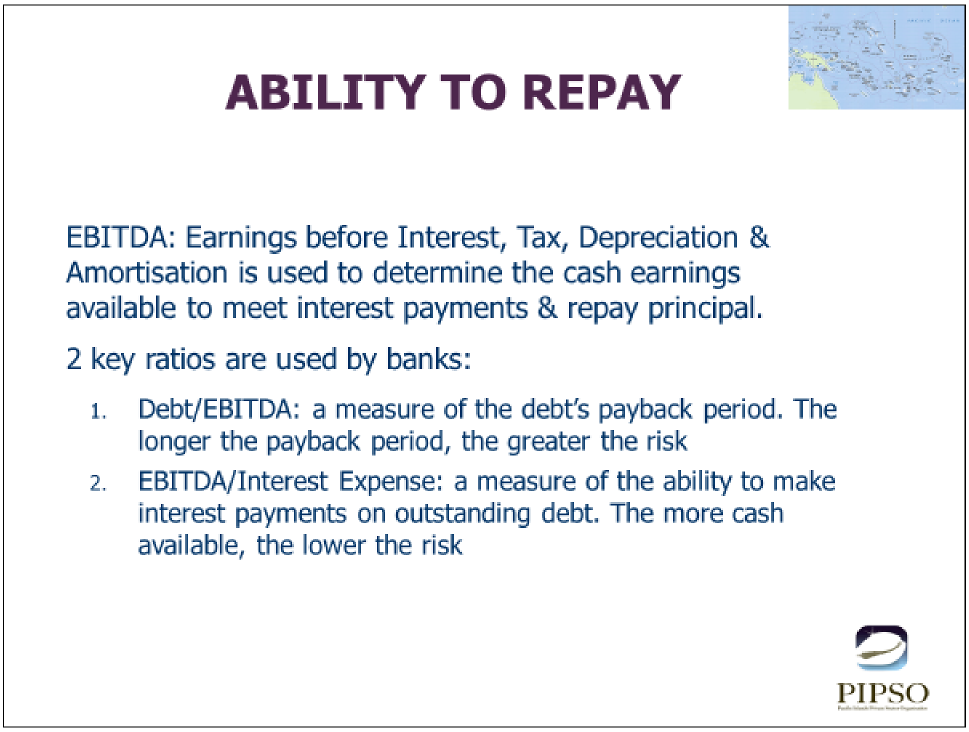
How can a business do this without a plan or forecast& good records of the past so that the bank or lender can have some confidence in the business forecast? A track record of cash management via a bank account is also highly desirable in this regard as evidence of sound management.



A bank will look at a variety of performance measures. The measures considered here are important ones, indicative of business health, but they are not the only relevant ones. While EBITDA may not be the measure used by all banks, a similar measureas a proxy for cash generation, will be used.

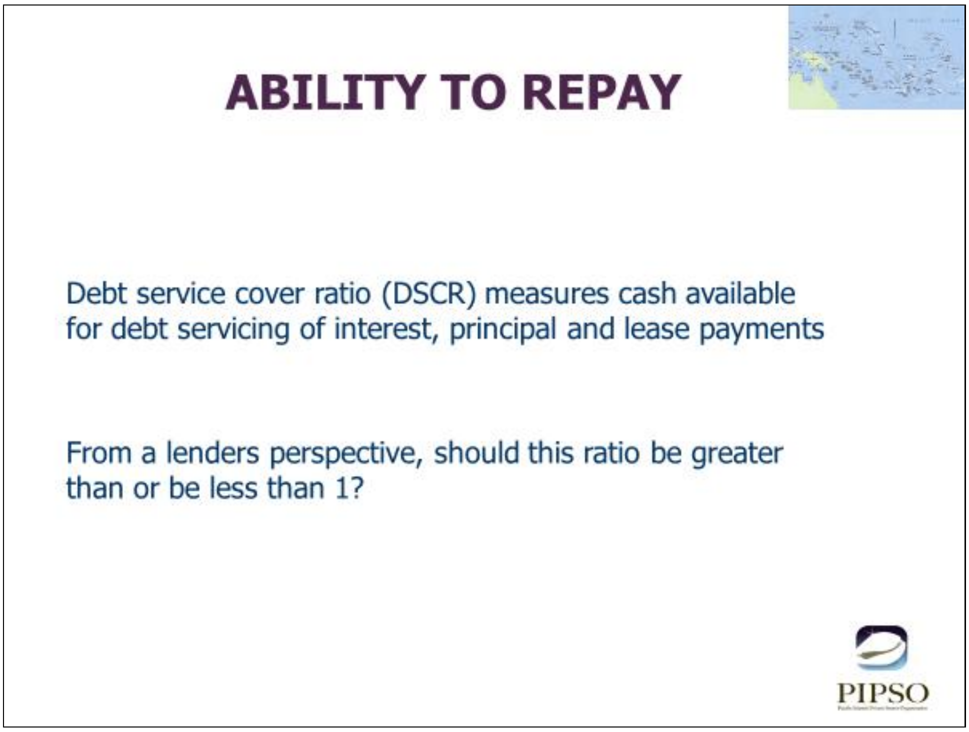
The full range of performance measures as outlined in Module 2.6, Financial Statements, may be used& others, but we will use the three measures detailed as they are directly linked to capacity to repay debt.

EBITDA is used hereafter for simplicity but is indicative only, remembering that a bank's business risk is ultimately determined by a customer's ability to repay monies as they fall due.

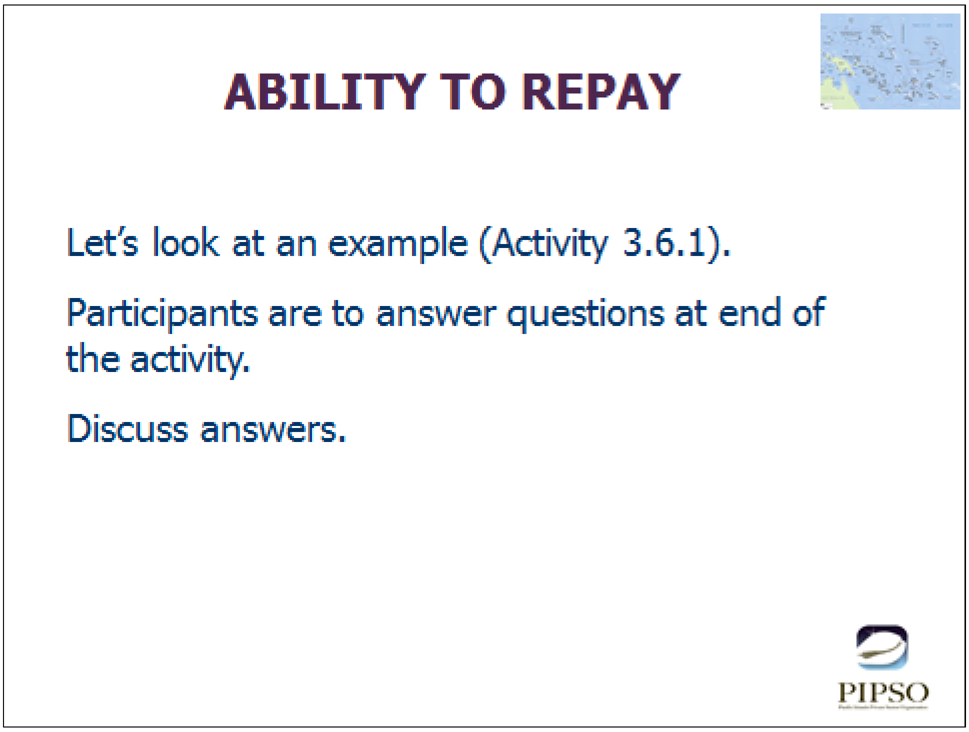


Why use EBITDA?Tax is added back to profit because interest is paid before tax not after. Interest is added back to net profit before tax so that it is not double counted. Depreciation & amortisation are added back because they are not cash expenses & the measure should be a cash one.

The objective is to determine how much cash a business has available to meet all its interest obligations, not just to the bank if there is more than one lender.



A debt service ratio of less than 1 would indicate that the ability of a business to meet its debt obligations is seriously in doubt. This is a very bad sign. Therefore, a ratio in excess of 1 at all times is desirable. The one exception to this rule may be during a start-up period when losses are incurred as forecast prior to profit growth.



ACTIVITY 3.6.1

PART 1				
Considering the capacity to repay debt of a business, tick the box below that is better for each measure.				
	Ratio	High	Low	
	Debt/EBITDA			
	EBITDA/Interest Expense			
	Operating Net Income/Debt Repayments			

NOTE FOR FACILITATOR

This part of the Activity should be used to launch a discussion on what represents good or bad results for the calculations of these ratios.

Ask those who complete the Activity to answer the additional question: "What is a good ratio for each of the three?"

Food for thought.

PART 2

Tane commenced a new business, Amazing Interiors, 12 months ago. He operates as a sole trader.

He borrowed $30,000 from his bank at the time at 12% p.a. interest based on his business plan. Repayment of the loan was agreed to be $6,000 annually on 31 December each year. Tane made the first repayment on 31 December 2013. He used his private residence as security for the loan.

Tane purchased a new vehicle for private purposes towards the end of the year & withdrew funds from the business as its cash flow was sufficiently positive despite the profit performance.

Tane's business plan forecast profits for his first 3 years of operation were as follows:

	$
2013	-
2014	30,000
2015	55,000

The financial statements for the new business as at 31 December 2013 were as follows:

Income Statement of Amazing Interiors for the 12 months ended 31 December 2013

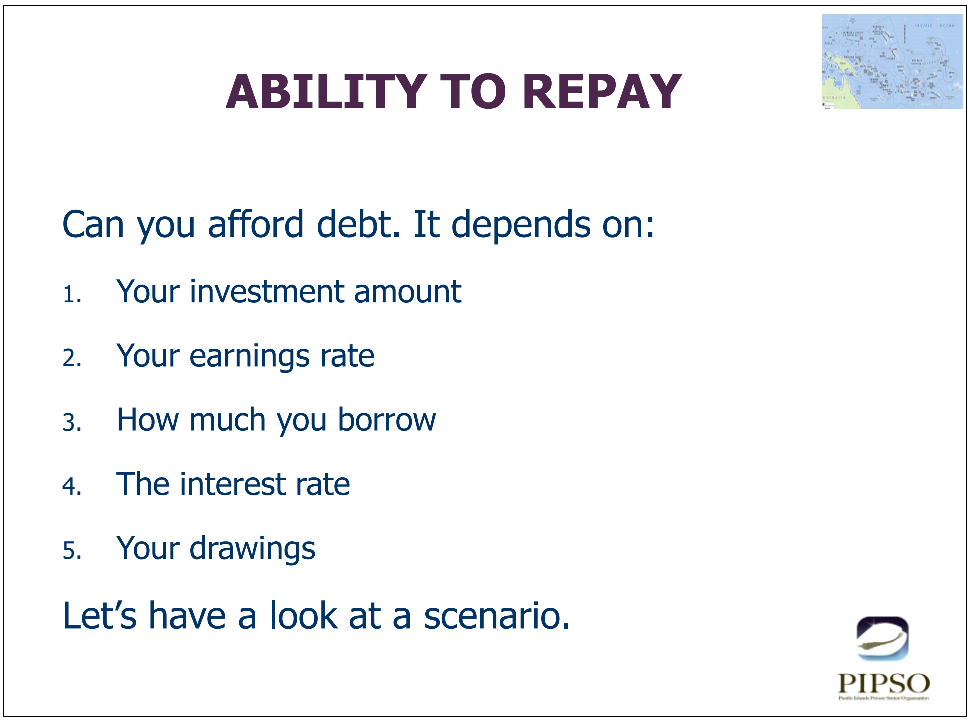
	$	$	$
Sales			127,000
Less Cost of Goods Sold			
Purchases		80,000	
Cartage		5,055	
Cost of Goods Available		85,055	
Less Inventories		35,500	49,555
Gross Profit			77,445
Add other Operating revenue			2,650
			80,095
Less other Operating Expenses			
Selling and Distribution Expenses			
Depreciation motor vehicle	7,788		
Advertising	20,000		
Sales salaries	17,025		
Freight on sales	5,100	49,913	
General and Administrative Expenses			
Depreciation office equipment	1,218		
Amortisation of establishment expenses	1,200		
Insurance	6,450		
Office wages	21,000	28,668	
Finance Expenses			
Interest on loan	3,600		
Discount expense	170	3,770	82,351
Net Loss			(2,256)

Balance Sheet of Amazing Interiors at 31 December 2013				
		$	$	$
Current Assets				
Bank			38,550	
Inventories			35,500	
Accounts Receivable			43,185	
Prepaid Expenses			6,950	124,185
Non- Current Assets				
Motor Vehicle		44,405		
Accumulated depreciation of motor vehicle		7,788	36,617	
Office Equipment		16,900		
Accumulated depreciation of office equipment		1,218	15,682	52,299
Intangibles				
Establishment expenses			12,000	
Accumulated amortisation of establishment expenses			1,200	10,800
Total Assets				176,484
Current Liabilities				
Accounts payable		11,150		
GST payable		5,600		
Accrued expenses		2,990	19,740	
Non-Current Liabilities				
Bank loan		24,000	24,000	
Total Liabilities				43,740
Net Assets				132,744
Owner's Equity				
Capital				175,000
Less Net Loss			2,256	
Drawings			40,000	42,256
Owners Equity				132,744
Questions				
1	Calculate the following:			
	a. Debt/EBITDA			
	b. EBITDA/Interest paid			
	c. Debt service cover ratio			
2	Tane is about to provide his bank with an annual review of the business. What does he need to explain? Do you expect the bank to have any concerns?			

This demonstrates the Bank's interest in a business, but what about the owner's interest?

When business owners are assessing a new or expansion proposal or an asset purchase, they need to consider their available source of funds &the ability& timingof the repayment of any funds required to be borrowed by the business. Given the owners closeness to the business, should they not know more, rather than less, about the business than the bank.

Are not the questions a bank asks good ones for the owners of a business to ask themselves before they approach a bank or any lender?



Let's look at a scenario.

Our investment	$50,000
Our earnings rate (return on investment or profit)	20% per annum
Amount to be borrowed	$20,000
Interest rate required by lender	15% per annum
Amount we require for personal use (drawings)	$5,000

In this scenario it takes nine (9) years to generate the amount required to repay the debt in full out of additional profits.

What is the primary driver of the generation of cash to repay the debt? **The ability to repay is** largely, but not entirely, **determined by the difference between the earnings rate & the interest rate payable on the debt**. Refer Module 3.5,Funding, Debt & Equity, for the rationale behind this.

The wider the differential between earnings & interest payable, the faster the debt can be repaid. If there is no difference when you repay the debt you have not generated anything for yourself or, if negative you are effectively earning less in order to pay bank. **Why would you do either of these things when, by doing a forecast, you can see that you earn at a lower rate of return than you must pay the bank to borrow the required funds. i.e. you will lose money?**

CALCULATION OF CASH FLOW UNDER DIFFERENT DEBT & SALARIES SCENARIOS

	Initial Investment	50,000		Earnings Rate	20%	
	Debt	20,000		Funding Cost	15%	$3,000
	Total Assets	70,000		Owner Salary	5,000	
	Calculation 1 - Cash generation no debt			Calculation 2 - Cash generation with debt		
Year	Cash In	Total Assets (No Debt)	Cumulative Increase in Cash	Cash In	Total Assets (Incl. Debt)	Cumulative Increase in Cash
1	5,000	55,000	5,000	6,000	76,000	6,000
2	6,000	61,000	11,000	7,200	83,200	13,200
3	7,200	68,200	18,200	8,640	91,840	21,840
4	8,640	76,840	26,840	10,368	102,208	32,208
5	10,368	87,208	37,208	12,442	114,650	44,650
6	12,442	99,650	49,650	14,930	129,580	59,580
7	14,930	114,580	64,580	17,916	147,495	77,495
8	17,916	132,495	82,495	21,499	168,995	98,995
9	21,499	153,995	103,995	25,799	194,793	124,793
10	25,799	179,793	129,793	30,959	225,752	155,752

The annual calculationsmade in tables above are as follows:

Total assets at the end of each year = total assets of the prior year + cash in during the year.

Cash in = (total assets of the prior year x the earnings rate) – owner's salary (or drawings) – interest paid of the loan.

Cumulative Increase in Cash = sum of the cash in to the end of that year.

When the cumulative increase in cash for the year under Calculation 2 - Total Assets (incl. Debt) is $20,000 is greater than Calculation 1 – Total Assets (No Debt)

In Year 9 cash flow is sufficient:

$124,793 – $103,995 = $20,768

Therefore, debt can be repaid in full by the end of year 9, but not before. However, if periodic payments were calculated to include principal & interest the period of the loan could be reduced.

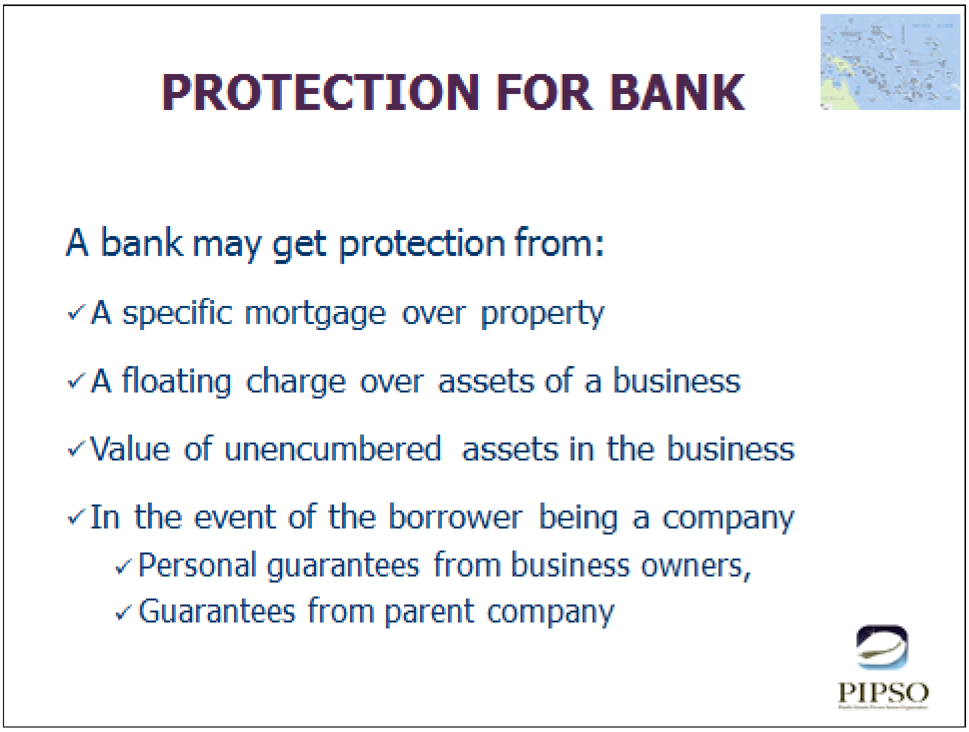
Try calculating other scenarios.

NOTE FOR FACILITATOR

Various outcomes can be demonstratedusing the cash flow calculator provided.

Higher borrowings with a positive gap between return & borrowing cost results in a shorter debt payback period, but also higher risk in the event of a downturn in business. These are decisions for owners to make.

PROTECTION



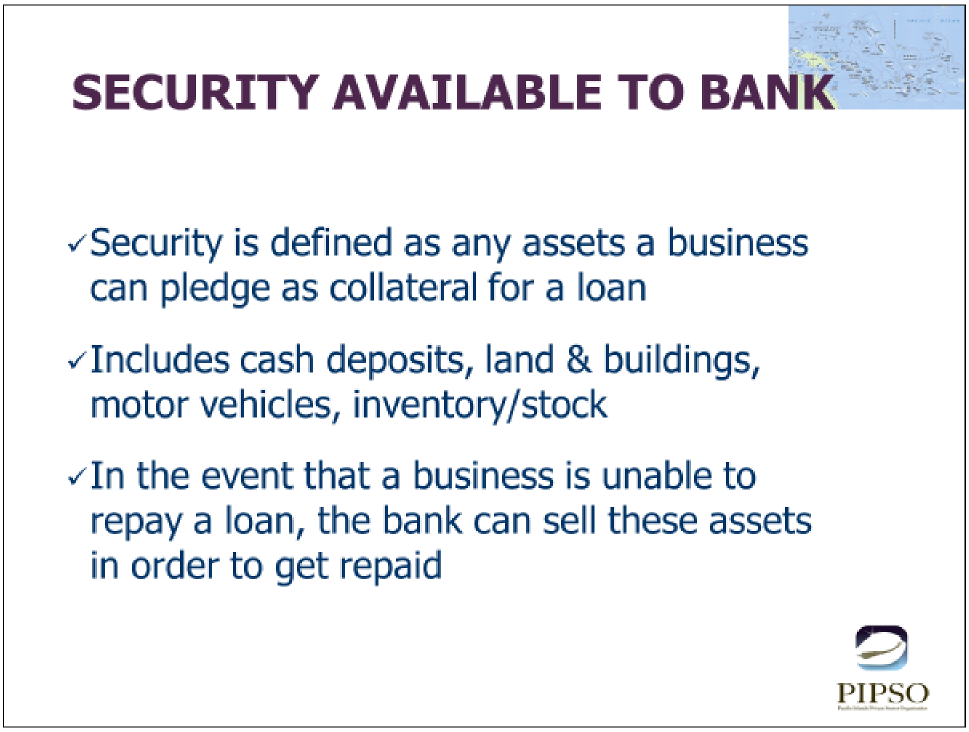
As has already been mentioned, a bank does not take entrepreneurial risk. A bank accepts that a percentage of businesses will fail & that, therefore, a small percentage of businesses that it lends to will also, notwithstanding the work put in to avoid this outcome. If you inspect a bank's financial statements, you will note reference to a provision for doubtful debts. It is usually adjusted from time to time based on broad economic circumstances, rising in tough time & decreasing in good times. It is a small proportion of loans, reflecting the conservative lending practices.

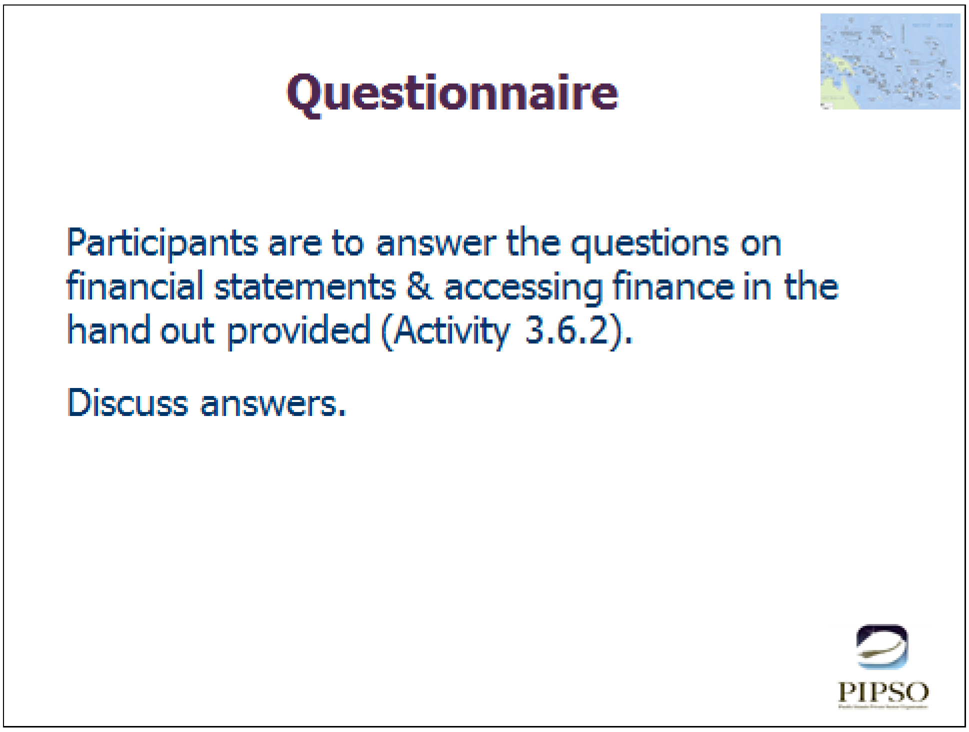
In the event of a receivership or liquidation, however, a bank endeavours to ensure that it receives its money back ahead of other general creditors, wherever possible,not just the business owners.

The likelihood is that the bank is the largest creditor in the event of a business failure. Protecting itself as much as possible is a natural response to the business risk perceived by the bank.

What security & how much is required by a bank will depend on availability of suitable assets &the financial strength of the business.

The terms of a loan are subject to negotiation. A business owner should read & understand their obligations under a loan agreement before it issigned & not wait until there is a problem or, even worse, a default.





ACTIVITY 3.6.2

Financial Statements & Accessing Finance

Q1. Which of the following does not appear on the balance sheet?

1. Accounts Payable
2. Cost of Goods Sold
3. Inventory
4. Overdraft

Q2. Which of the following is not an asset?

1. Accounts Receivable
2. Property
3. Motor Vehicle
4. Bank Loan

Q3. What is the definition of the accounting equation?

1. Assets + Liabilities = Owners Equity
2. Liabilities = Assets + Owners Equity
3. Assets = Liabilities + Owners Equity
4. Assets + Owners Equity = Liabilities

Q4. The income statement measures:

1. The liquidity of a business
2. The value of the company
3. The profitability of a business
4. The amount a business owes

Q5. Gross profit is equal to:

1. Assets – Liabilities
2. Revenue – Cost of Goods Sold
3. Cash at Bank
4. Profit After Tax

Q6. A debt incurred by selling goods or services to a customer on credit is:

1. Overdraft
2. Accounts Receivable
3. Accounts Payable
4. Revenue

Q7. Which of the following should you consider when applying for a bank loan?

1. Interest Rate
2. Fees and Charges
3. Your ability to service the loan
4. All of the above

Q8. Which of the following statements is incorrect?

1. You should use a deposit account to record all sales of your business
2. A term deposit account may be used for excess cash to earn additional interest
3. You should use an overdraft facility to finance the purchase of a new boat
4. You may use a trade loan to finance your cash conversion cycle

Q9. What are the consequences of issuing a cheque to a supplier if you don't have enoughfunds inyour account?

1. Your relationship with your supplier may be affected
2. Your bank may impose a penalty
3. Your bank may close your account
4. All of the above

Q10. Which of the following is not a form of security for a bank?

1. Accounts Payable
2. Property
3. Cash
4. Inventory

Q11. Which of the following is not a good reason to apply for a loan?

1. Refinance existing loan
2. Business has an immediate cash flow shortfall
3. Business is purchasing a new boat
4. Support day-to-day working capital needs

Q12. Which of the following is not a positive sign for a bank assessing the ability of a company to repay a loan?

1. Re-investment of earnings into the business
2. Debt/EBITDA ratio more than five times
3. Debt service ratio more than 5 times
4. Interest Cover ratio more than five times

LOAN APPLICATION

This slide ends this Module.

ANSWERS TO ACTIVITIES

ACTIVITY 3.6.1

Amazing Interiors

PART 1

Considering the capacity to repay debt of a business, tick the box below that is better for each measure.

Ratio	High	Low
Debt/EBITDA		✓
EBITDA/Interest Expense	✓	
Operating Net Income/Debt Repayments	✓	

PART 2

1	a. Debt/EBITDA =	$24,000 / (-$2,256 + $7,788 + $1,218 + $1,000)
		3.02
	b. EBITDA/Interest =	(-$2,256 + $7,788 + $1,218 + $1,000) / $3,600
		2.21
	c. Net Operating Income/Debt repayments	
	Actual DSCR =	-$2,256 / $9,600
		-0.24
	Forecast DSCR =	$30,000 / $8880
		3.38

2 Tane's annual review - Issues

1. Small loss against budget of break even, not large but needs advice.
2. Unforecast drawings for private purchase of vehicle.
3. Is forecast for 2014 still achievable? What is budget for 2014?

Bank concerns

1. Should not have material concerns
2. Might remind Tane of loan covenants, probable gearing constraint
3. Will seek confirmation of 2014 forecast & budget

ACTIVITY 3.6.2

Financial Statements & Accessing Finance

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c) Your bank may close your account
d) All of the above

Q10. Which of the following is not a form of security for a bank?

a) Accounts Payable
b) Property
c) Cash
d) Inventory

Q11. Which of the following is not a good reason to apply for a loan?

a) Refinance existing loan
b) Business has an immediate cash flow shortfall
c) Business is purchasing a new boat
d) Support day-to-day working capital needs

Q12. Which of the following is not a positive sign for a bank assessing the ability of a company to repay a loan?

a) Re-investment of earnings into the business
b) Debt/EBITDA ratio more than five times
c) Debt service ratio more than 5 times
d) Interest Cover ratio more than five times