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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org

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CREDIT EVALUATION BY COMMERCIAL BANKS OF INDUSTRIAL FINANCING PROPOSALS

by

H. Clark Griswold
Chemical Bank New York Trust Company, New York

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CREDIT EVALUATION BY COMMERCIAL BANKS OF INDUSTRIAL FINANCING PROPOSALS[1]

I ECONOMIC

A commercial bank is both directly and indirectly concerned with the economic function of the industry in which the company applying for term credit is engaged. This is somewhat less important in a broad and deep economy such as in the United States where places can be found for many kinds of non-essential industries which might not survive in a less-developed economy. But whether a product can be considered a necessity, the demand for which will remain stable regardless of other short-term economic fluctuations, is a function of the economy's development. Public utility industries, such as electric or water companies, are assured of demand. An industry which satisfies changing fashions is not. In short, the bank will try to evaluate in a general way the elasticity of demand for the output of an industry.

In a more general way, the bank is concerned that any proposed increase in plant capacity, for which it is asked to provide term financing, actually contribute to the national economy an increase in efficiency or productive

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[1] Discussion of technical and legal evaluation of credits is outside the scope of this paper except as noted generally below.

capacity great enough to offset the corresponding increase in the money supply that will result from the loan.[2] If this improvement does not take place, the net effect will be inflationary, a trend no creditor likes to see.

Finally, the bank may be concerned with the balance-of-payments influence the industry has on its nation's economy[3]

II COMPETITION

The bank is naturally concerned with a prospective borrower's position within his own industry, especially as to both the company's absolute share of the market and whether this share is increasing. The bank must decide whether the projected increase in this share resulting from financing an expansion can reasonably be expected. If the company is introducing a new product, the bank must decide whether the company's inexperience will be sufficiently offset by other factors to enable it to compete effectively with companies already producing this product.

The general reputation of the company among its customers, suppliers, and competitors is of concern. The bank may conduct a "product check" to determine if the company's customers are satisfied with existing products.

III MANAGEMENT

The bank will have satisfied itself as to the integrity of management, perhaps by checking with other banks, before it even considers a financing proposal. If the loan will run for a longer term, the bank will be especially

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[2] W. F. K. Anders, Principles of Commercial Bank Term Lending, unpublished thesis, Chemical Bank New York Trust Co., May, 1966; mimeographed, pp. 1-2.

[3] Cf. Author, "Preparation of Manufacturing Data for Submission to Commercial Banks," p. 6.

concerned with the <u>depth</u> of management. Is the company encouraging and developing its middle management, and are these capable of assuming positions of greater responsibility should the need arise? Are they qualified to carry out the tasks assigned them and entailed by the proposed expansion? If the company is expanding into a new line of business, does management have the breadth to enter this line successfully?

These considerations apply equally to any other companies engaged in the expansion: designers, contractors, consultants, and customers under contract to purchase the new output.

<u>IV FINANCIAL STRENGTH</u>[4]

An appraisal of the financial strength of a company will reflect directly upon management, and may be the bank's best criteria for judgement of ability.

Banks make wide use of a number of ratios to summarize key balance sheet and income statement proportions. The most common of these are the current or working capital ratio (current assets to current liabilities), debt to tangible net worth ratios (variously computed), sales to accounts receivable ratios, sales to inventories ratios, and the profit to net worth (or to total assets) ratio. Expect for debt to worth, none of these ratios has much meaning in isolation. But if the financial statements and ratios are computed on a consistent basis from year to year, they can be very good indicators of <u>trends</u>, if not of absolute position.

The second major use of ratios is for external comparison, or the comparison of one company's ratios with the averages for the industry. This also has important limitations. To be meaningful, the companies compared must be engaged in the same operations, ideally in the same geographical area. They must prepare their financial statements similarly enough so that

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[4] Cf. Carlisle R. Davis and Edward F. Gee, <u>Analyzing Financial Statements</u>, rev. ed., New York: American Institute of Banking (American Bankers Association), 1956, esp. Chs. VI-XIII.

meaningful comparison can be made. But, hopefully *ceteris paribus*, a company with a higher sales to receivables ratio than average for its industry is in better shape than average.

Sources and Applications of Funds Statements for a number of years will show the bank the company's demonstrated ability to generate cash from the difference of earnings and non-cash charges minus dividends and capital expenditures. This is of primary importance in looking for repayment of a proposed loan. In accounting terms, it is quite possible for a company to generate high earnings without generating cash to repay debt.

It is particularly important to know about company lease obligations and other "off-the-balance-sheet debt" which, although not liabilities in the accounting sense, are nevertheless fixed obligations, and claims on company funds.

Two of the most important figures on the balance sheet are the tangible net worth total (capital and surplus less intangible assets such as goodwill, patents, and treasury stock), which provides an equity "cushion" for lenders; and the working capital (current assets less current liabilities), which provides an operating margin of safety. Both should be adequate, in the banker's judgement.

V EARNINGS

The income statement has assumed primary importance in the last few years, especially in term lending evaluations.

Sales trends are of self-evident importance. A large difference between gross and net sales[5] can indicate trouble to a banker if it is indicative of defective merchandise or poor shipping; a moderate difference coupled with a high sales to receivables ratio might simply indicate that customers were

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[5] I.e. Gross sales minus returns of defective, damaged, or unsold merchandise, and minus discounts taken for prompt payment.

taking advantage of discounts offered in sales terms, and this is an indication of strength.

Operating profit and margin trends are of particular importance when the company has large non-operating gains or losses. Operating figures indicate how well the company performs in the most stable component of its business, and, therefore, may be a better indication of future performance than net income.

Bankers would prefer, in most cases, to look for proposed debt repayment from the proven earnings of present operations, rather than from the projected earnings of the new expansion financed by the loan. Any new earnings arising from the loan might be applied to reduce the last maturities of a serial payback, or to reduce a balloon payment. Ideally, traditional earnings should be sufficient to repay the new debt, to provide a cushion against recession in the economy, and to provide funds for reinvestment in plant and equipment to stave off obsolescence.

If the bank is asked to finance the expansion of a particular product line or division, it will look especially closely at the contribution to total earnings of that particular product or division. The most secure loan is the one which finances the expansion of the most profitable part of the company's operations.

VI PROJECTIONS

In light of the marketing surveys conducted and the record of the company's past operations, the bank evaluates the realism of the financial projections the company has submitted to the bank. Of particular importance is the calculation of the "break-even point" which, for the bank's purpose, is the lowest sales, operating, and financial position the company can fall to and still be able to meet its debt obligations. Thus, if the company's plans call for the production and sale of [illegible] units in a given future year, the bank might calculate that the production and sale of only [illegible] units is necessary to service the debt and keep the company on an even keel. This break-even point would be much stronger than a situation in which break-even was [illegible] of projected production and sales, or [illegible] units.

The bank will try to decide if the projected working capital position of the company is sufficient to meet seasonal demands and unforeseen pressures.

VII PROPOSED REPAYMENT SCHEDULE

Proven earnings are the most dependable source of repayment, and bankers are often wary of plans to retire debt several years hence with the sale of fixed assets or the flotation of a new stock issue. It is difficult to predict what funds these might bring in the future, and they have often proved to be disappointing.

The payback schedule should be comfortable enough to provide safety margins against unforeseen events, and to allow some fluctuation in earnings. This becomes especially important in industries relying on fashion or producing luxury goods. A public utility, on the other hand can commit a higher proportion of earnings to repayment since its sales are more stable.

If arranging a comfortable schedule of maturities extends the term of the loan beyond the bank's normal limits, a balloon payment on the last maturity may be arranged, which could be refinanced when it came due.

Too heavy a reliance on depreciation charges as a source of loan repayment may serve as a warning to the bank that the company may not be planning for adequate replacement of equipment to keep the plant from deteriorating.

VIII PROPOSED SUPPORTS

If the loan request is supported by direct guarantees, performance covenants, collateral, or third parties, the bank will examine the soundness of these supports.

The most desirable support from the bank's point of view is the unqualified guarantee of a third party of unquestioned resources, such as a government, a bank, or a large corporation. This third party could be either a sponsor otherwise involved in the project, or a non-participant. If the third-party guarantor is a sponsor by virtue of having entered into purchasing, construction, or management and technical assistance contracts, the bank might hope that the sponsor would be willing to contribute equity funds to the project. This provides the bank with an additional cushion, and is indicative of the commitment of the sponsor to the project. If such a sponsor is unwilling to provide part of the required funds, the bank cannot rely on him to rescue the company should trouble develop.

The second best support is the "indirect guarantee," or performance covenant, by which the company obligates itself to maintain minimum net worth and working capital positions, and maximum dividend and salary levels, and, furthermore obligates itself not to contract any additional debt beyond certain levels and not to change its corporate structure.

The next type of support are contracts the company has with third parties. These might include a "take or pay" contract by which the third party agrees to buy a certain amount of output at a fixed price, or if it does not "take" the output, to pay the same amount of money in cash. The company is thus guaranteed a certain level of revenue. There are two major limitations on this: (1) the third party's obligation to take or pay is contingent on the company's output of the product (there is no obligation to take or pay for more output than is made available); and (2) the fixed price might turn out to be below actual manufacturing costs, in which case a steady loss is incurred.

Contracts of a third party to furnish other kinds of assistance may impose fixed obligations on the company. The banker must assure himself that the company will be able to bear these obligations regardless of what happens.

Mortgages on the plant to be built with the bank's funds also have limitations. Whereas the value of existing, profitably employed plant is assured, the value of new plant rests entirely on projections of assumed new earnings. In the event of default, the shut-down plant would have drastically reduced value. The plant's only value is as a going concern.

The weakest form of support is the "moral" responsibility of principals and sponsors. When a reputable third party corporation is involved, it has to be remembered that the directors, however anxious they are to preserve the corporate good reputation and image, have a primary responsibility to the stockholders and cannot, by law, squander corporate cash or impair equity by rescuing another company with which they have become associated.

Any guarantees, contracts, and agreements in connection with bank term lending are given careful scrutiny by the bank's counsel for legal evaluation.

IX THE LOAN AGREEMENT[6]

When the bank has completed its evaluation of the credit and its negotiations with the company, the loan agreement embodying the above is drawn up for final study by both the company's and the bank's legal counsel. The technical formulations in these agreements are beyond the scope of this paper, except as outlined above, but the prudent banker is aware that no amount of legal finesse can make an essentially marginal credit into a good one.

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[6] A typical term loan agreement can be found in K. K. White, Financing Company Expansion, New York: American Management Association, (A. M. A. Research Study # 64), 1964; Appendix A, "A Sample Term Loan Agreement," pp.113-120.

Cf. also The Hanover Bank (now, Manufacturers Hanover Trust Co.), Check List: Revolving Credits and Term Loan Agreements, New York: Author, 1959; and Anders, op. cit., pp.35-70.

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