Lending to Contractors

2019 Rocky Mountain Regional CFMA Conference

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Sunflower Bank

Notable Quote

Money is governed today by the same laws which controlled it when prosperous men thronged the streets of Babylon, six thousand years ago.

– George Clason (The Richest Man in Babylon)

Contractor Statistics

- Construction unemployment double national average last down cycle
- Many sub failures 2009-2012
- 50% of contractors fail no matter how long in business
- Contractors fail 15% more than all other businesses
- Current environment unsustainable?

  - Bankers, CPAs, CFMA

Average Company Lifespan

1920 = 90 years

1950 = 60 years

2018 = 17 years

Loan Default Rates by Industry

TABLE 1: HISTORICAL AND FORECASTED DEFAULTS

INDUSTRY SEGMENT	HISTORICAL DEFAULT RATES	FORECASTED DEFAULT RATES	
	2017	2018	2019
Transportation	4.1%	3.1%	3.7%
Information	3.1%	3.4%	3.1%
Mining	2.7%	2.1%	2.1%
Accommodation & Food	2.3%	2.7%	3.0%
Agriculture	2.1%	1.9%	1.7%
Construction	2.1%	2.2%	2.5%
Health Care	2.0%	2.1%	2.3%
Administrative Services	1.9%	2.0%	2.3%
Retail	1.9%	1.7%	2.3%
Manufacturing	1.8%	1.8%	2.0%
Professional Services	1.7%	1.7%	1.9%
Finance	1.6%	1.4%	1.8%
Other Services	1.5%	1.6%	1.9%
Wholesale	1.5%	1.6%	1.8%
Real Estate	1.5%	1.6%	2.1%
Entertainment	1.1%	1.1%	1.6%
Education	1.0%	1.1%	1.8%
Public Administration	0.7%	1.2%	2.2%
All Industries	**1.8%**	**1.9%**	**2.2%**

Notable Quote

If you don’t have time to do it right, when will you have time to do it over?

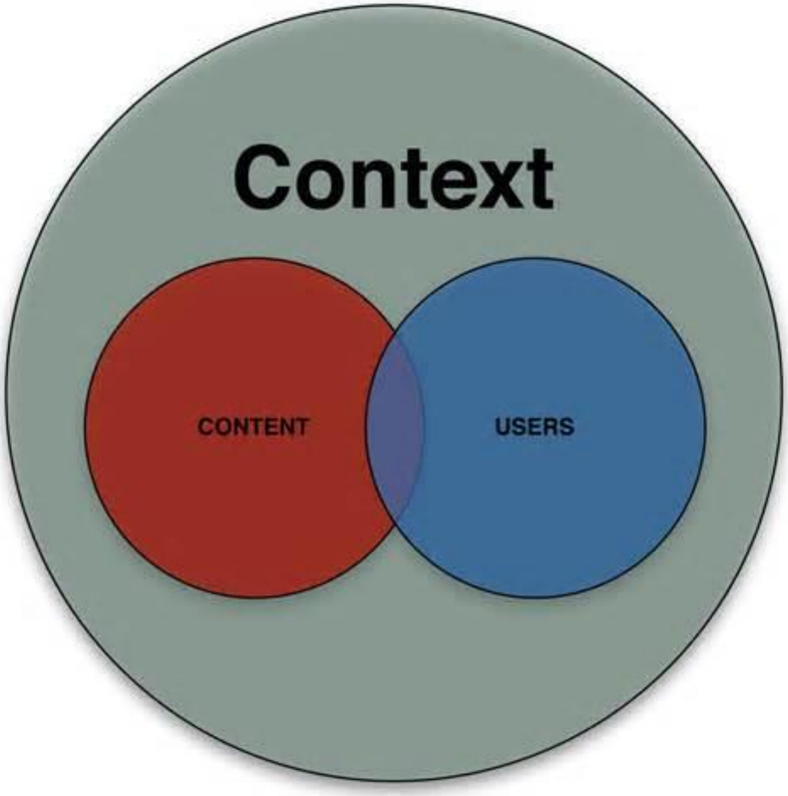
– John Wooden, retired UCLA basketball coach

Bank (n):

1. a long pile or heap; a mass; a bank of earth or clouds
2. an institution for receiving, lending, exchanging, and safeguarding money

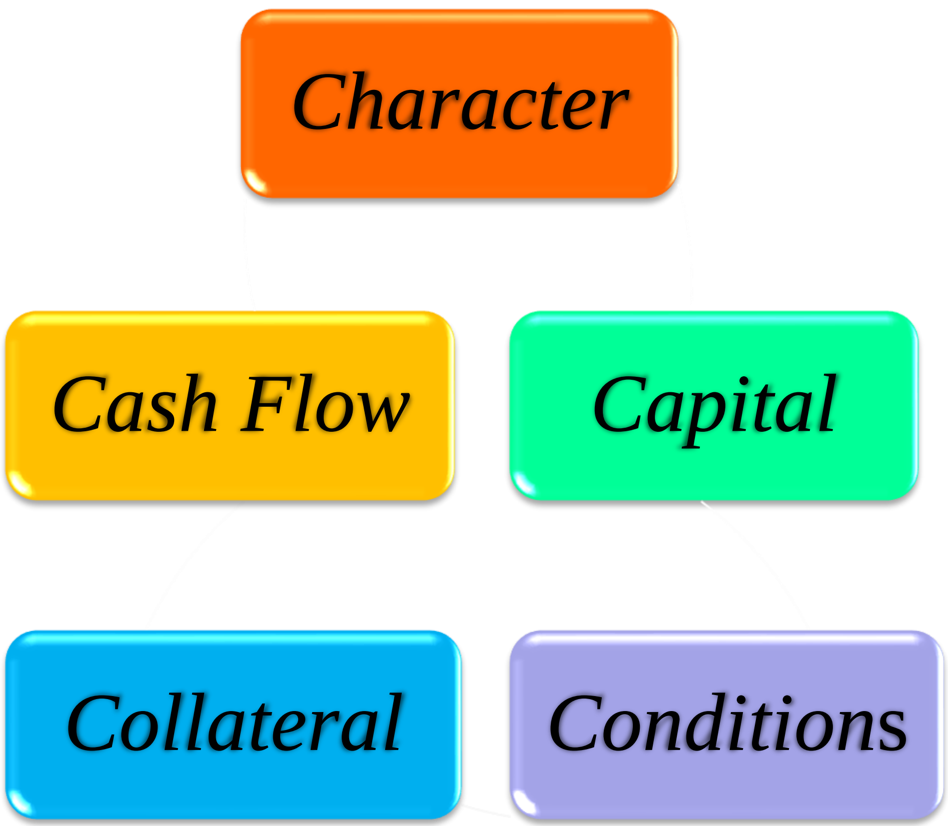

Loans

Context



- Traditional Commercial Lending vs. Construction
- Revolving Lines, Equipment & Owner/User RE Debt
- Traditional Credit Analysis
- Additional analysis: WIP, projections, backlog, etc.

5 C's of Credit & Contractors



The 5 C's

1. Character
2. Cash Flow
3. Capital
4. Collateral
5. Conditions

5 C’s Continued

- Character: extremely important
  - More than just “good” character, proven abilities
  - Stress a significant factor with contractors
  - Transitioning to the next generation a key risk
- Cash Flow / Capacity: must be able to repay debt
  - Financial analysis, B/S & I/S
  - Debt coverage = 1.2x (EBITDA ÷ Debt Service)
  - Operating & project cash flow
  - Line of credit revolving? Trade debt OK?

5 C's Continued

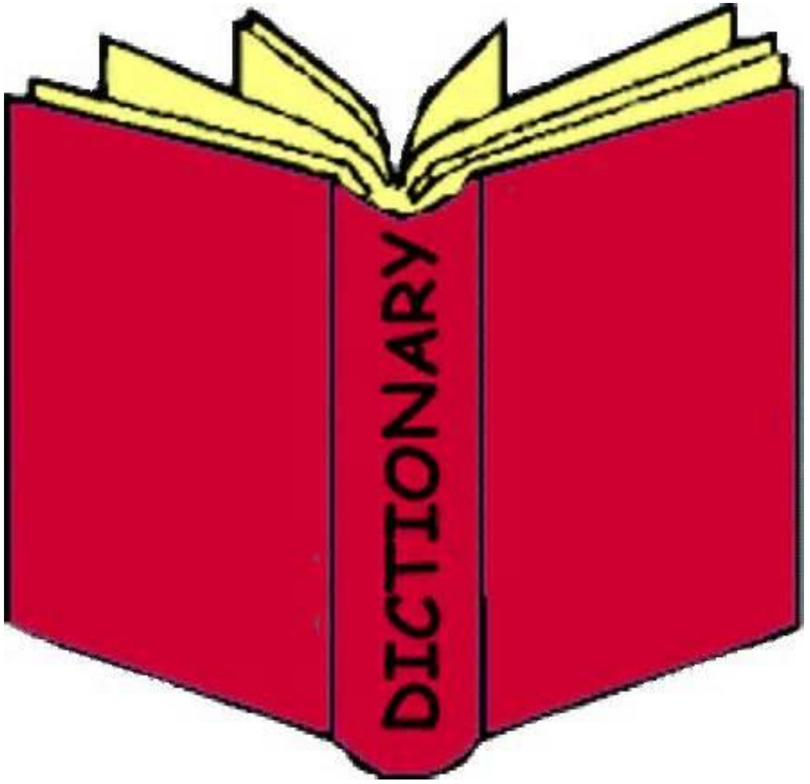
- Capital: B/S equity (A=L-OE)
  - Cushion for down times
  - Personal net worth
- Collateral: we don't want it but we'll take it if we must
  - Heavily discounted, borrowing base compliance
  - Contractor A/R collections by banks: 5%
- Conditions: other risk profiles
  - Sub/labor conditions, material pricing, tariffs, legal & economic environment, weather, natural disasters, etc.
- Strong contractors have > options than weaker

Character Defined

Honesty, courage, integrity, moral, ethical

A person's reputation

The sum of the complex mental & ethical traits that mark an individual, group or nation



Character

- Character DOES repay debt
- More than just honesty & integrity
- Management depth & proven abilities over time
- Time in business, succession
- Experience in downturns
- Relationships & reputation
- Personal net worth

Character continued

Contractor Considerations

- Time in business & experience in up & down cycles
- Management & succession
- New or untested ventures
- GC v. Sub & specialization
- Surety & banker relationships
- Financial reporting sophistication
- Personal net worth
- Golf & fun …

Character continued

- Environmental Factors
  - 2009 to 2012: Severe stress
  - Current: labor & sub shortages, volume of work, financial & overall stress
    - “Most mistakes made in up part of cycle” - GC
  - Lifestyle & other stresses
    - Hobbies, toys, real estate & other investments

Character continued

- Environment continued
  - Management depth, talent, morale, etc.
    - Poor talent recruitment & retention
    - Management by time & tenure vs. talent
    - Ability to perform in field & office, accountability
  - Company culture & reputation
    - What is it - good, bad, or otherwise?
    - Has it changed?
    - Observe employees at their place of business

Character continued

- Environment continued
  - Company culture continued
    - Bonding, banking & other relationships
    - Current reputation, not just time in business
  - Desire to please customers
    - Change order & project management “culture”
    - Afraid to say no or stop working
    - Documentation, documentation, documentation

Character continued

- Current environment continued
  - Succession planning:
    - Often lacking or unrealistic
    - Business tied to 1 or only a few key people
    - Family members or staff tenured?
    - Too small to transition or not financially viable
    - No way out, limited M&A potential
  - Bottoming out & high growth potential?
    - Both scenarios scary to bankers *("we'll make it up in volume")*

Character continued

- Financial Reporting
  - CFO / Controller position(s)
    - Does it exist, should it?
    - Revolving door or poorly qualified person?
  - Outside CPA relationship
    - Does it exist, taxes only, real advisor, revolving?
  - Budget & forecasting abilities
    - B/S & I/S, sales forecasting, what if scenarios?
    - Project cash flow forecasting?

Character continued

- Financial reporting continued
  - Overly complicated accounting or frequent FYE adjustments?
  - Poor vs. good quality & timely internal reporting are key to lenders & sureties
  - Does client communicate good & bad news early?
    - Sleuthing: good bankers never stop asking ?s
    - Clients often withhold bad news, afraid to share

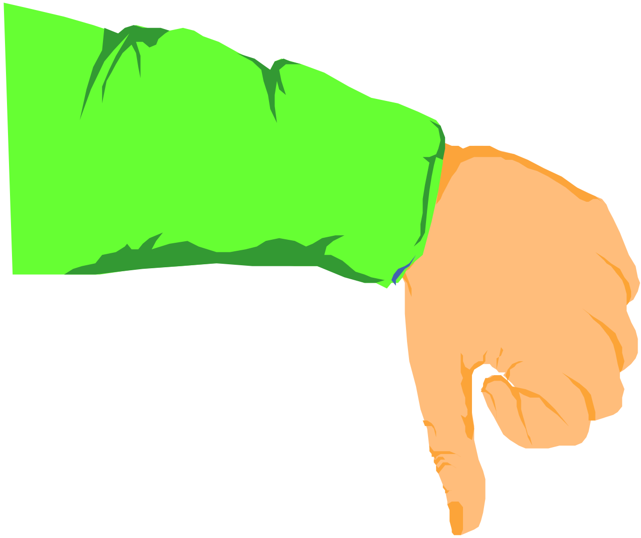
Character continued

- When difficulties arise
  - Head in the sand / reactionary / emotional?
    - Vs - Hands on, proactive, pragmatic planning
  - Outside assistance
    - Time to bring in reinforcements?
    - CPAs, consultants, turnaround specialists
    - When is it time to “pull the plug?”
    - Call in reinforcements, never act alone, consult legal

Character continued

- Lender’s Actions / Reactions
  - Bankers are imperfect, easy to lend too much in good times, not as objective as you might think
  - Stagnant lines, missed covenants, tight or negative borrowing bases create stress for us
  - Banker vs. underwriter vs. SAG departments
  - Bank culture, behavior in difficult times
  - Relationship & history are critical

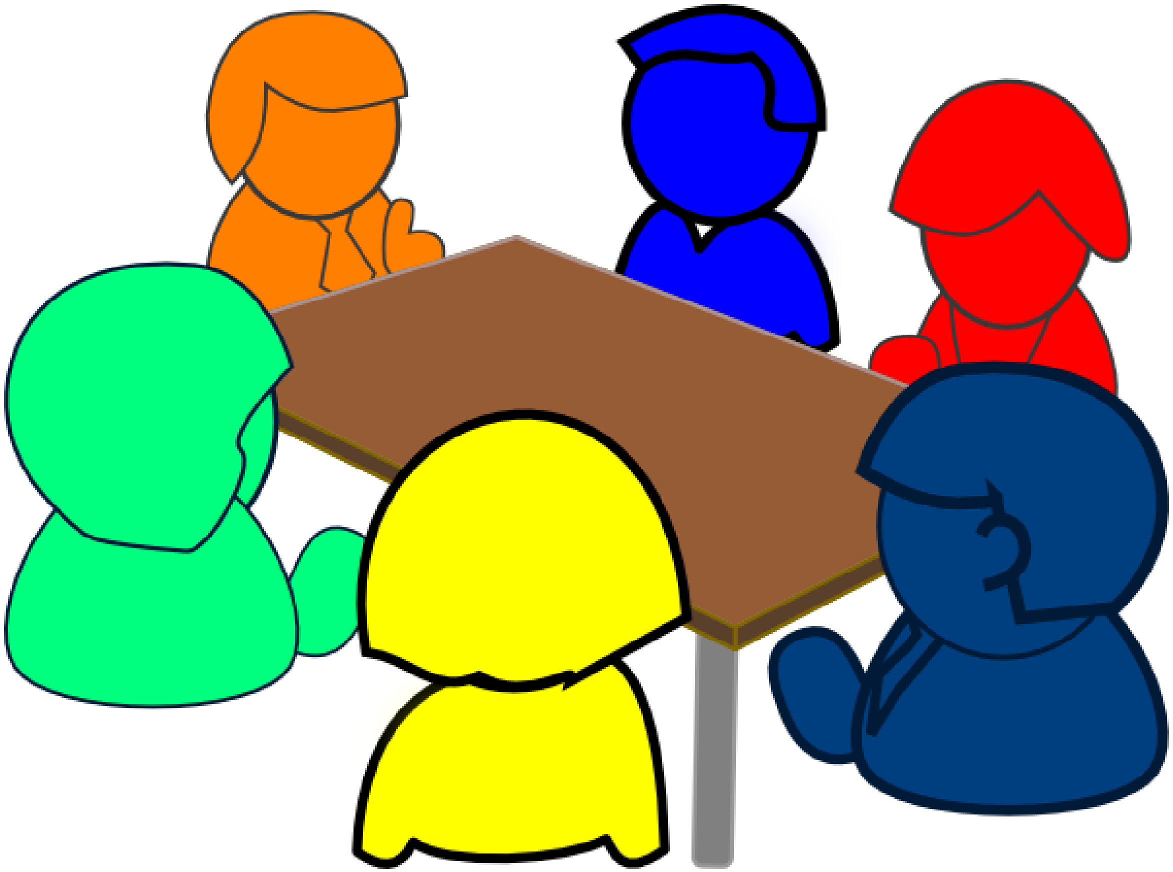
Character concluded



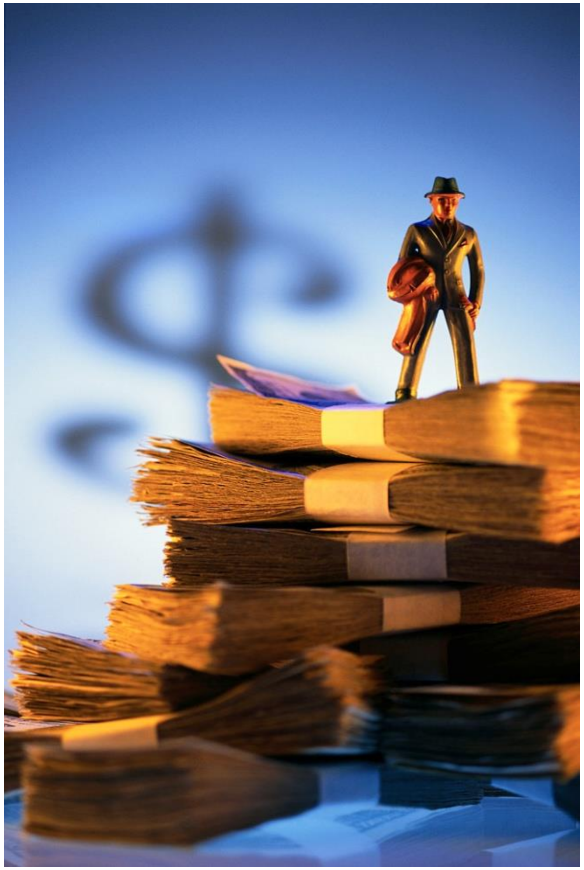
Reasons for Concern

- Lack of trust or confidence
- Radio silence or poor answers
- Unrealistic business plans
- Dissention / turnover
- New venture / lack of experience
- Lack of successful track record
- Poor project & CO management
- Poor personal credit / BK
- Lender fatigue

Group Discussion - Character



Cash Flow / Capacity



- Cash is King!
- Most relied upon underwriting method
- Annualized analysis
- Business & Personal
- EBITDA & DSCR vs. Other cash flow models
- F/S & WIP analysis

Cash Flow continued

Contractor Considerations

- B/S health, ratios, equity, etc.
- Revenue, GPM, OH & profit trends
- Internal vs. FYE reporting
- PCM vs. CCM vs. accrual
- WIP, backlog, projections
- A/R collection trends
- Industry comparisons

Cash Flow continued

- Bank Analysis process:
  - 3 to 5 years of FYE plus interims, projections, current WIP, A/R & A/P
  - High level, annualized effort using condensed financial spreading models is common
    - B/S, I/S & SOC (examples & banker versions)
  - Interim period compared to prior year period
    - Inconsistencies, unusual trends, good vs. bad?
  - Projections available & realistic?

Cash Flow continued

- Bank Analysis continued:
  - End point: borrowing base perimeters, cash flow/debt coverage, debt repayment, & covenants
  - Covenants: DSCR, TNW, D/W, W/C, current, line rest requirements, subordinated debt, etc.
  - Most underwriting models are industry agnostic
    - Narrative, WIP & other analytics specific to contr.
    - WIP: frequency and accuracy, fade (+/-), backlog, problem projects, type of projects

Cash Flow continued

- Financial Reporting Considerations
  - Banks requiring more, not less information
  - Monthly vs. quarterly reporting = line size & overall credit exposure
  - CPLTD and other GAAP items missing?
  - Projections: B/S & I/S?
    - Not just for down cycles, particularly important now
  - Interim reporting reliable & consistent with FYE CPA efforts, specifically WIP?

Cash Flow continued

- Financial Reporting continued
  - Over/under, accruals, job costing accurate & timely, significant swings (i.e. end of project)?
  - L/T vs. S/T classifications
    - W/C calculation: bankers & sureties adjust these to be conservative / more realistic
    - N/R to/from shareholders or clients
    - Investments, other irregular asset holdings
    - Non-revolving portion of lines

Cash Flow continued

- Financial Reporting continued
  - Borrowing base & monitoring
    - Monthly vs. quarterly = line size & usage
    - Contractor vs. traditional BBRs
    - Bonded, concentrations, RP, other ineligibles
  - Cash flow & project forecasting
    - I/S projections at a minimum, B/S & by project ideal
    - Critical as companies grow and as lines increase
    - Is information reliable and does client meet them?

Cash Flow continued

- Financial Reporting & the CPA:
  - Known to construction industry?
  - Delays & frequent rotation, large FYE WIP adjustments, going concern issues?
  - Audit vs. review vs. comp vs. nothing
    - Depends on outstanding commitments, bank culture, bonding/3rd parties, etc.
    - Greater borrowing = greater the requirements
    - Tax returns useless

Cash Flow continued

- CPAs continued
  - FIN 46 issues:
    - CPAs inconsistent in this regard
    - Banks don’t like this, muddies up the B/S and I/S and covenants apply to legal entities, not combined
  - Revenue recognition & leases:
    - Bankers are lost on RR & frustrated on leases, TBD
    - Interim vs. FYE adjustments?
    - GAAP exceptions, modified opinions, FRF?

Cash Flow continued

- General underwriting issues
  - Very robust underwriting environment
  - > Work for bankers & greater internal scrutiny
  - Strong companies > options, weaker not as much
  - Good & timely financial reporting
  - Debt coverage ratio: must be >1.2x
    - Heart of loan grading policies
    - Not an indicator for ability to revolve lines

Cash Flow continued

- Underwriting continued
  - Lines of credit
    - Stagnant, non-revolving lines a significant issue
    - Term outs common, SBA 7a sometimes an option
    - Profits & equity must be there to support lines
    - Bank & clients often “stuck” w/ annual renewals
    - Borrowing base reporting closely monitored
    - A/R testing, asset based lenders, etc.
    - Funding losses, excessive growth? Both bad

Cash Flow continued

- Cash Flow: Underwriting Methods
  - EBITDA & DCR Analysis
    - Generically used by bankers to underwrite lines & term debt, basis for grading & regulatory scrutiny
    - Misses other areas of cash flow, i.e. A/P & vendors, off-balance sheet investments (personal), loans to shareholders, distributions, non-cash items, etc.
    - Stagnant portion of lines often termed out (3-5 yrs)
    - Stress testing - don’t ignore negative results, i.e. increasing term debt or vendor pressure? (example)

EBITDA/DCR Example

$000's	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	2014 proj
Annual Revenues	**$ 26,406**	**$20,556**	**$19,829**	**$18,590**	**$13,644**	**$17,092**	**$20,559**
GM%	**22.1%**	**21.6%**	**18.0%**	**10.2%**	**18.9%**	**15.5%**	**16.8%**
Net Income	**$266**	**$1,147**	**$540**	**($1,077)**	**($36)**	**$189**	**$517**
+Deprec & Amort	188	252	273	258	206	147	133
+Interest Expense	95	135	150	148	121	96	119
-Distributions (tax & other)	(20)	(531)	(458)	(277)	(25)	0	(114)
-Stockholder Buyout	0	0	0	0	0	(20)	(27)
+/-Notes Receivable effect	$ 40	$ (672)	$ (75)	$ (43)	$ (284)	$ (120)	$ (193)
+/- Other Adjustments	0	0	0	0	300	35	0
Gross Cash Flow	**$569**	**$331**	**$430**	**($991)**	**$282**	**$327**	**$435**
Interest Expense	95	135	150	148	121	96	119
CPLTD	301	527	246	235	134	134	108
Total Bus Debt Service	**$396**	**$662**	**$396**	**$383**	**$255**	**$230**	**$227**
DCR - Business Only	**1.2**	**0.5**	**1.1**	**(2.6)**	**1.1**	**1.4**	**1.9**
+Rent Expense	110	210	336	310	289	272	135
-R/E Cash Expenses		(46)	(151)	(155)	(157)	(160)	(65)
Total RE Cash Flow		**164**	**185**	**155**	**132**	**112**	**70**
Bldg 1 P&I	49	49	49	49	49	49	40
Bldg 2 P&I	90	90	90	90	90	90	90
Total CRE Debt Svc	**$140**	**$140**	**$140**	**$140**	**$140**	**$140**	**$130**
DCR including CRE	**1.1**	**0.6**	**1.1**	**(1.6)**	**1.0**	**1.2**	**1.4**
Net Cash Flow after D.S.	**$33**	**($307)**	**$79**	**($1,359)**	**$19**	**$69**	**$148**

Cash Flow continued

- Cash flow underwriting continued
  - Other cash flow models
    - SCF & UCA: point in time vs. weekly/monthly
    - Weekly & monthly cash flow models by project or for the company as a whole
    - Break-even cash flow models – not just GP & OH driven, need to include all fixed cost obligations (i.e. debt service)
      - Forward looking, but historical results can be enlightening

Break Even Cash Flow Example

BREAK-EVEN CASH FLOW PROJECTION		**2013 Historical**			**2014 Projected**	
Total Operating Expenses (overhead only)			$ 2,687			$ 2,756
	- Interest	$ 96			$ 119	
	- Depreciation	147			133	
	- Rent	175			135	
	- Non-cash S/H write off	35			-	
	Total Add Backs		453			387
	Total Cash Operating Expenses		$ 2,234			$ 2,369
Debt Service & Distributions						
	Line of Credit - Int only	$ 60			$ 60	
	Term Loan - P & I	134			134	
	Third Party Term Loans - P & I	33			33	
	Related R/E PITI	165			165	
	Unrelated R/E Investment PITI	166			330	
	Department of Labor - P & I	-			160	
	Vendor Note Payable - P & I	-			208	
	Life Insurance Loans	-			25	
	Retired S/H Note Payable - P & I	30			30	
	Income Tax Distributions	-			114	
	Total Debt Service & Distributions		$ 588			$ 1,259
Total Cash Expenses and Debt Obligations			$ 2,822			$ 3,628
	Gross Profit Margin	16.5%			17.0%	
Gross Revenues Needed to Break-Even			$ 17,103			$ 21,341
Net Profits Needed to Break-Even			$ 135			$ 765

Cash Flow continued

- Personal & Global Cash flow underwriting
  - Personal spending & credit, other needs
  - Age, health & retirement & transitions
  - Owner or other RE investments
  - Should add strength not be a weakness
  - Global cash flow
    - Banks formerly relied upon heavily, but getting away from; not reliable, inconsistent

Global Cash Flow Example

	2010	2011	2012	2013	04/30/14
Operating Company + Rents from Owner Occupied CRE					
Gross Cash Flow	146,925	(122,603)	736,865	(196,326)	208,211
Business & RE P&I	101,338	103,370	105,419	100,764	33,588
Net Cash Flow	45,587	(225,973)	631,446	(297,090)	174,623
DCR	**1.4**	**(1.2)**	**7.0**	**(1.9)**	**6.2**
Rental Entity (Investment Properties)					
Gross Cash Flow	(80,616)	84,987	93,878	103,865	51,933
RE P&I	96,784	116,509	132,669	123,612	41,204
Net Cash Flow	(177,400)	(31,522)	(38,791)	(19,747)	10,729
DCR	**(0.8)**	**0.7**	**0.7**	**0.8**	**1.3**
Personal Cash Flow Recap (excludes all investment RE)					
Gross Cash Flow	130,352	135,428	240,848	205,133	68,500
P&I Personal Only (current)	67,167	67,167	67,167	67,167	22,389
Net Cash Flow	63,185	68,261	173,681	137,966	46,111
D/I Ratio	**52%**	**50%**	**28%**	**33%**	**33%**
DCR	**1.9**	**2.0**	**3.6**	**3.1**	**3.1**
Global Cash Flow Summary (all sources)					
Gross Cash Flow	196,661	(122,603)	736,865	(196,326)	208,211
Business & RE P&I	265,289	103,370	105,419	100,764	49,238
Net Cash Flow	(68,628)	(225,973)	631,446	(297,090)	158,973
DCR	**0.7**	**(1.2)**	**7.0**	**(1.9)**	**4.2**

Cash Flow continued

Reasons for Concern

- Loss trends or major swings
- Excessive growth
- Unexplained or recurring adjustments and addbacks
- Unrealistic projections
- Increasing debt load, cannot revolve line, vendor pressure
- Excessive personal spending & distributions

Capital

- Capital = Cushion
- B/S: A-L=OE
- NBV, not FMV of assets, more realistic
- Conservative, but good leverage indicator & ability to sustain losses
- Significant emphasis

Capital continued

Contractor Considerations

- Capital should match RLOC
- D/W < 4:1, 2:1 ideal
- Losses occur, but controlled?
- Excessive distributions?
- Aggressive tax planning?
- Excessive growth & leverage?
- Sub debt & treasury stock
- Personal net worth

Capital continued

- Underwriting considerations for Contractors
  - Capital / cushion is a good benchmark of a company's ability to withstand down cycles
  - Recent regulatory contractor stress test:
    - Revenues @ 50%, 25% lower margins, same OH; losses divided into remaining capital = x years
  - GAAP issues
    - FIN 46, leases, revenue recognition, leases, goodwill – all non-performance related debt/equity changes

Capital continued

- Underwriting continued
  - Low vs. high leverage was a significant survival factor during crisis (stress test example)
  - Tangible or “real” net worth
    - Goodwill, patents, related party items *MUST* be removed from equity, are not “real” assets
    - Subordinated debt: be careful, is it truly subordinated, could you exercise your rights as lender, does creditor expect to be repaid ?

Capital continued

- Underwriting continued
  - Personal Net Worth:
    - Strength or weakness, building or eroding?
    - Can mitigate losses – $ runs out eventually
    - Can erode quickly if heavily reliant on business
    - Lifestyle, divorce, illness, death, etc.
    - Life insurance?
    - Transition to next generation / employees?

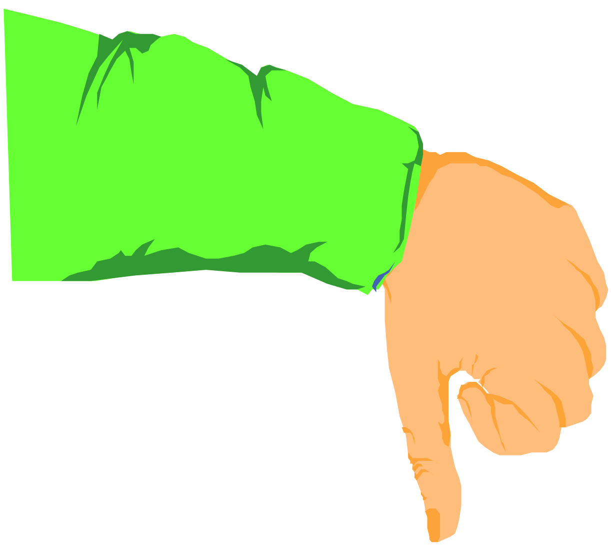
Capital continued

- Underwriting continued
  – Understanding capital requires in depth balance sheet analysis
  – Working capital *IS* capital
    - Adjusting W/C to remove "fluff"
    - Analyze related party, intangibles, etc.
    - Stale A/P & vendors?
    - W/C & Capital should match line commitment
  – Aged fleet, deferred borrowing needs?

Capital & W/C Example

$000's	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	2014 proj
Financials as Stated from CPA & Client						
Current Assets	$ 6,237	$ 5,705	$ 4,192	$ 3,169	$ 5,660	$ 5,810
Related Party N/R	$ 100	$ 855	$ 930	$ 973	$ 1,235	$ 1,507
Total Assets	$ 8,291	$ 7,614	$ 5,864	$ 4,890	$ 7,576	$ 7,714
Current Liabilities	$ 5,121	$ 4,324	$ 4,162	$ 2,517	$ 4,747	$ 4,047
Total Liabilities	$ 5,496	$ 4,737	$ 4,341	$ 3,166	$ 5,729	$ 5,043
Net Worth (stated)	$ 2,795	$ 2,877	$ 1,523	$ 1,724	$ 1,847	$ 2,671
Working Capital	$ 1,116	$ 1,381	$ 30	$ 652	$ 913	$ 1,763
Current Ratio	1.2	1.3	1.0	1.3	1.2	1.4
Debt to Worth	2.0	1.6	2.9	1.8	3.1	1.9
Restated Ratios (excluding related party items from CA & Equity)						
Working Capital	$ 1,016	$ 526	$ (900)	$ (321)	$ (322)	$ 256
Current Ratio	1.2	1.1	0.8	0.9	0.9	1.1
Debt to Worth	2.0	2.3	7.3	4.2	9.4	4.3

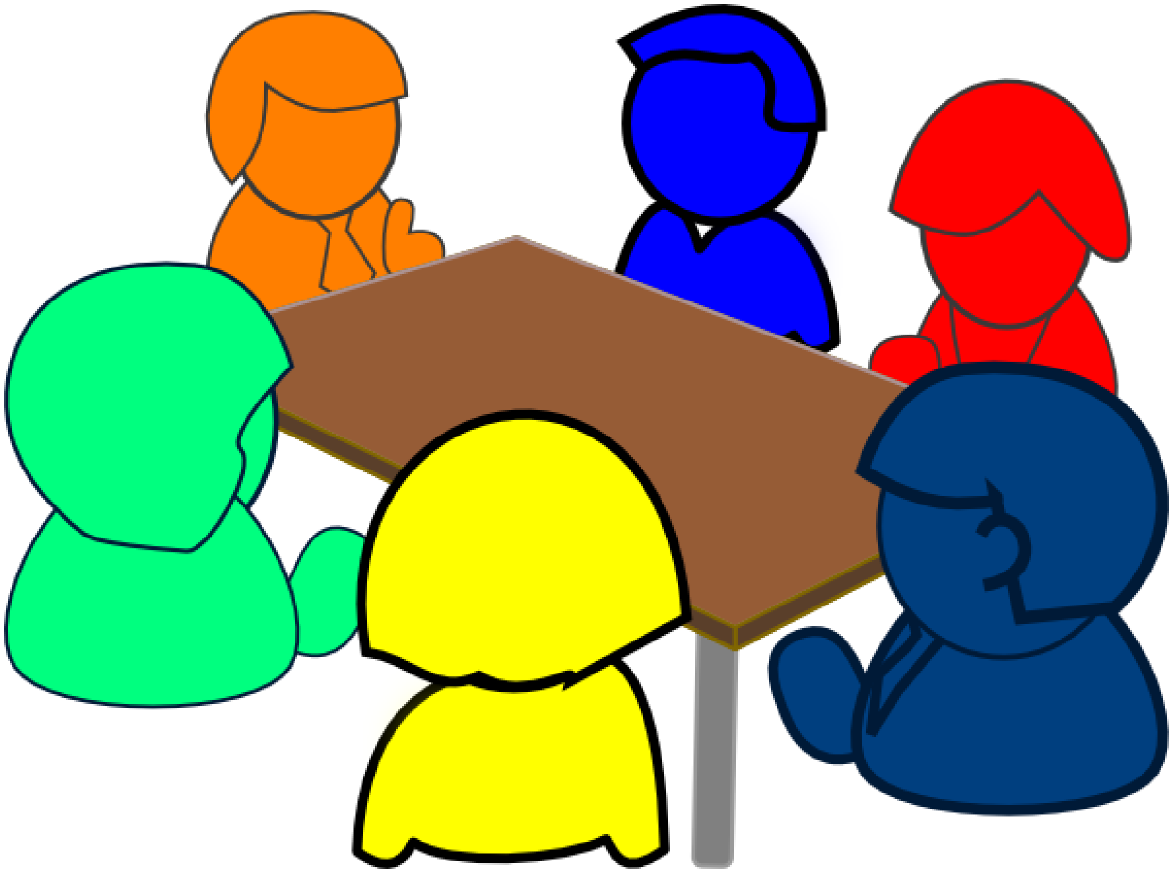
Capital continued



Reasons for Concern

- Lack of or negative equity
- Cannot or will not maintain NW or D/W covenants
- Poor reporting, unexplained equity adjustments, aggressive tax planning, etc.
- Losses & significant distributions
- Sudden or large project losses
- D/W ratio > 5:1, personal NW

Group Discussion – Cash Flow / Financial Analysis & Capital



Collateral

- We don’t want your stuff, but we’ll take it if we must!
- Collateral = security
- Collateral ≠ repayment
- Can mitigate risk
- Significant area of scrutiny by regulators during downturn
- Substantial discounting

Collateral continued

Contractor Considerations

- A/R exclusions: >90, WIP, retainage, bonded, foreign, etc. – some exceptions …
- Discounting rules
- Lien rights, surety priorities
- Seasonality & cyclicality
- Aging equipment & debt
- Collateral vs. cash flow
- Term debt vs. asset mix

Collateral continued

- Contractor Receivables
  - Difficult to collect, performance & collections easily disputed when contractor fails
    - Bank collection rate on contractor A/Rs = 5%
    - >90 accounts: > 25% is a concern, entire A/R could be excluded (taint rule)
    - Concentrations are common, some banks remove >20-25% balances
    - Bonded: many banks exclude, some are ok or discount them further (i.e. 50%)

Collateral continued

- Close monitoring & Borrowing Bases (examples)

- Other Short-term Considerations
  - Inventory becoming more commonplace as contractors bringing fabrication & manufacturing in-house
    - Discounted @ 25 to 50%, no WIP, RM & FG generally ok
  - Equipment equity can be used in BBR calculation to offset stale lines or if contractor is growing
  - Terming out stale portion of line is usually preferred
    - Very short-terms, 3-5 yrs, SBA provides longer options

Collateral continued

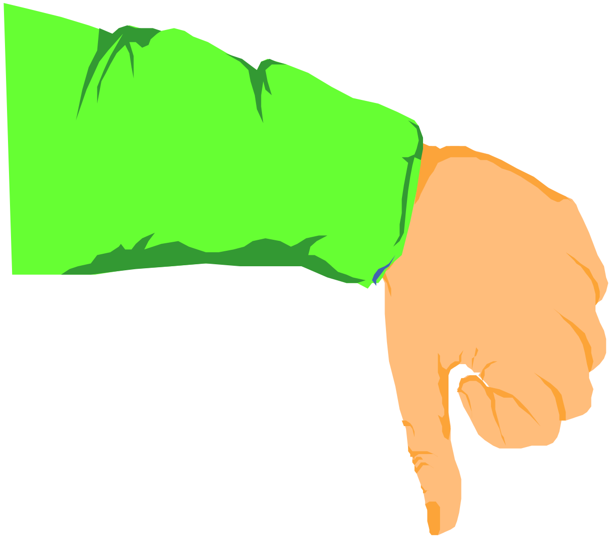
- Equipment & Other Assets
  - Aging or poor performing equipment, glut, specialized, cycles
    - Auction process & results inconsistent
  - RE: effective if clients willing & appraisals support values (cycles sway values dramatically)
  - Other assets: value, marketability? – i.e. stocks, bonds, art, collectibles, etc.
  - M&A & Goodwill = depends, SBA an option

Collateral continued

Collection Realities: Heavy discounting

Asset Class	**Typical Adv %**	**Liquidation %**
Receivables <90 days	50-80%	5%
Retainage	0-80%	0-50%
Bonded A/R	0-50%	0-5%
Inventory	25-50%	5-25%
Equipment	50-80% of FMV	45-60% of liquid.
Vacant Land	50%	10-50%
Residential Property	80%	25-90%
Commercial Property	65-80%	25-80%

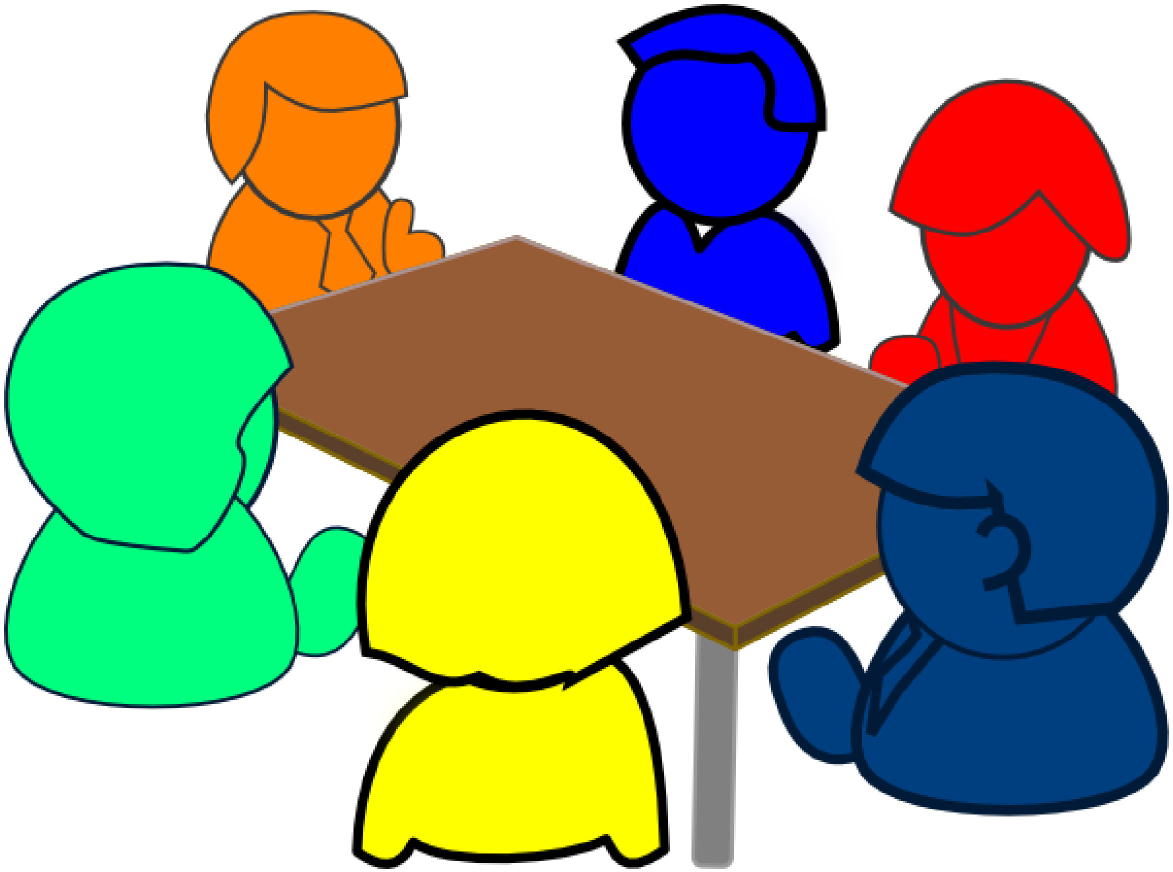
Collateral continued



Reasons for Concern

- Inadequate or tight coverage
- Good collateral coverage but lack of cash flow & debt coverage
- A/R concentrations
- Excessively aged A/R, high retention or bonded $
- S-T assets used for L-T loans
- Poor quality or old FF&E
- Top-end or no R/E equity

Group Discussion - Collateral



Conditions

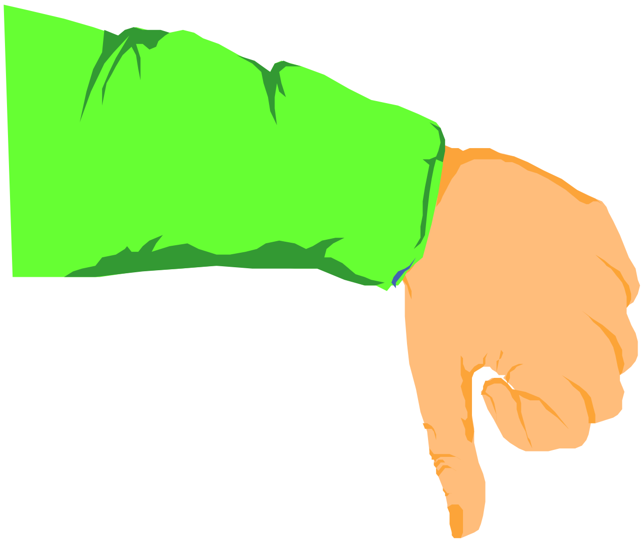
- Catchall category
- Includes any other strength or weakness that affects the credit decision
- Economic & industry cycles, global issues, client specific risks, weather, etc.

Conditions continued

Contractor Considerations

- GC vs. Subs & Niches
- Economic, seasonal, weather & other cycles
- Competition & bidding
- Sub & supplier conditions
- Warranty & legal risk
- Innovation, patents, IT, etc.
- Experience with the above

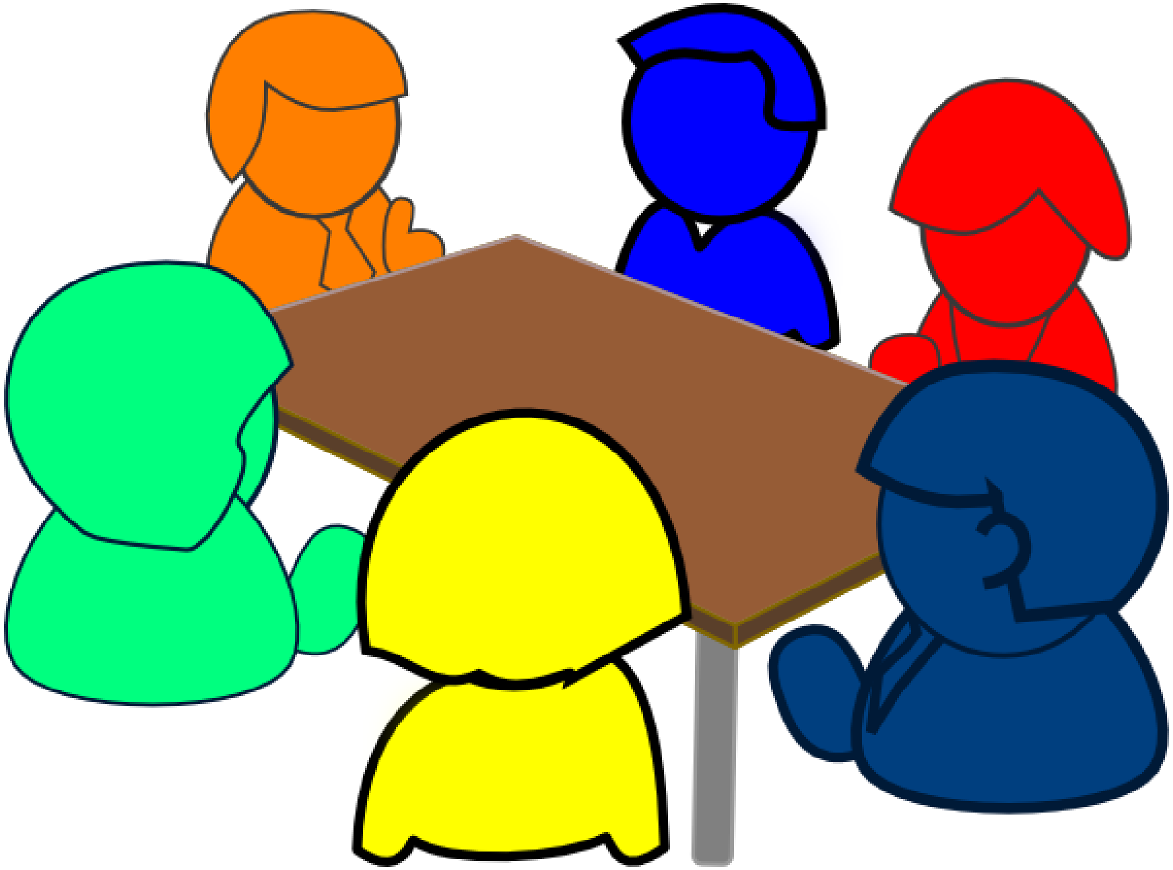
Conditions continued



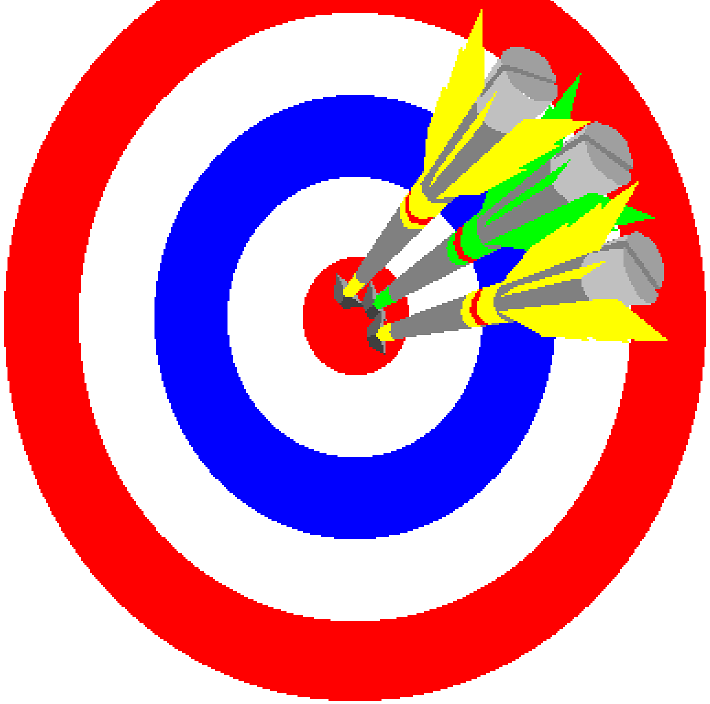
Reasons for Concern

– Excessive economic, political, environmental or other risks
– Sub vs. GC, unique niches
– Issues with prior Bank or surety
– Strained customer or vendor relationships
– Legal & technology challenges
– Weather & natural disasters
– Anything else we don’t like!

Group Discussion – Final Decision!



Conclusion



- Banks competing for good contractors but must perform & be profitable
- Some banks are quick to exit the industry
- Tighter covenants
- Relationships matter


SIGH
http://weblogs.newsday.com/sports/watchdog/blog/sigh.jpg

Questions?

Thank you!

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