PROBLEMS IN HISTORICAL DATA
1. Borrower experiences cannot be simplistically extrapolated into the future
2. Loan covenants do not provide adequate protection against any significant deviation or deterioration
3. Optimistic or incorrect numbers are often provided to the lender by the borrower
4. All variables that affect the loan may not have been anticipated during credit analysis

CREDIT DECISION PROCESS
1. Developing a commercial lending philosophy & attitude toward calling on (marketing to) corporate customers
2. Preparing the credit request including appropriate documentation
3. Evaluating collateral in support of the loan
4. Determining whether the borrower has the potential for sufficient earnings to make periodic payments on the interest & principal borrowed
   - Review audited financial statements including ratio analysis & common-size financials
   - Construct cash flow statements showing operational, investment & financial sources & uses of cash
   - Work with the borrower to develop financial forecasts
5. Preparing loan covenants that require specified levels of borrower performance during the loan period
6. Presenting the loan package to the bank’s credit committee for approval
7. Drafting the formal loan agreement

THE FOLLY OF NUMBERS
Data alone not useful without context; even information is of limited value:
- Many examples of well-run companies failing to capture important changes in the market because of the metrics led them the wrong way
- Numbers can be comforting because of the illusion of diligence
- Christensen has written on the dangers of religiously following metrics

CREDIT DECISION “NUMBER” FOLLY
- Typical loan agreements are internal
  - Extrapolation of past results
  - Overreliance on ratios & protective covenants
- Credit decisions need better information that goes beyond company & industry comparisons
- Necessary to protect against loan losses
- Cases on credit decisions
  - Coldwater Creek
  - 3 Chemical Companies
  - Krispy Kreme
  - O’Reilly Automotive
  - 14 others

SCENARIO ANALYSIS
Business trapped in interrelated lifecycles
- Non-linear patterns driven by a variety of factors
- Scenario analysis applies probabilities to various future states
  - Borrower’s capacity to repay a loan should involve high & low performance thresholds
  - Calculation of a joint expected value
  - Used in finance for risk management & in structuring investment portfolios
  - Banks do not apply probabilities in the consideration of alternative (particularly worst case) borrower outcomes
Outcomes include:
- Most likely case
- Best case
- Worse case

BANKS DO NOT WANT TO LEND … SO WHAT’S A COMPANY TO DO?
- Asset-based lending with saleable assets as collateral
- Current assets are preferred as most readily converted to cash (loan as % of fair market value)
  - Inventory: 50-85%
  - Accounts receivable: 60-90%
  - Notes receivable
- Fixed asset loans: based on life of asset
- More expensive than bank lending
- Limits flexibility of business managers

FUTURE RESEARCH
Regression (or other statistical) analysis to determine the causal factors that effect loan repayment (with loan default as the dependent variable) & such independent variables as:
1. total receipts-to-cash flow
2. return-on-equity (ROE)
3. financial leverage (total debt-to-total assets)
4. inventory turnover (cost of goods sold ÷ inventory)
5. accounts receivable turnover (sales ÷ accounts receivable)
6. revenue growth (or decline)
7. competitive initiatives
8. technological changes
9. management of expenses
10. senior officer stability & experience

For additional information, see James Sagner and Herbert Jacobs, Handbook of Corporate Lending, Bank Credit Training Partners (2011)