TIPS FOR STRUCTURING PERMANENT WORKING CAPITAL LOANS

CONTENTS

WORKING CAPITAL LOANS VERSUS PERMANENT WORKING CAPITAL LOANS

Working capital simply refers to the layer of capital that is used exclusively for the day-to-day operations of the business. For example, money that is spent to purchase inventory, pay expenses, or finance credit all falls into the category of working capital.

Permanent working capital, or PWC, is the permanent layer of working capital that, month after month, year after year, never goes away. It should be regarded as part of the long-term capital structure of the company.

Permanent working capital loans are needed when the working capital cycle is continuous for a company over the entire fiscal year. This is unlike a seasonal business, where the working capital cycle is specific within a fiscal year. These needs can also be affected by certain events.

- One such event is rapid expansion in sales resulting from unexpected growth or expansion. New companies may also need permanent working capital loans as they make their initial investment in inventory or accounts receivable.
- Some companies need PWC loans because they have used existing short-term resources, like cash on hand or bank facilities, to meet long-term obligations, like capital expenditures, dividend payments, or long-term debt payments.
- The last event is the failed seasonal loan. Business events, such as the inability to sell all inventory during the peak seasonal period, could mean that the seasonal loan will not be repaid at the end of the season. The bank is left carrying the loan as a more permanent working capital loan over the close season until the next seasonal peak is reached.

No matter the industry, a company may need permanent working capital financing if it:

- Has a continuous working capital cycle.
- Experiences rapid sales growth.
- Is relatively new.
- Needs to replace working capital depleted through noncurrent asset purchases or losses.

TIPS TO IDENTIFY THE BORROWER NEED

1. One of the first steps in structuring a permanent capital loan is to identify the borrowing need. The purpose of a permanent working capital loan is to provide the borrower with the financing needed to purchase current assets or to pay current liabilities.

   The underlying need for permanent working capital loans is to finance the permanent level of assets and expenses associated with a continuous working capital cycle, but they can also start as seasonal loans that cannot be repaid because the borrower didn't make sales as planned, incurred losses, had rapid sales growth, or acquired noncurrent assets. Analysis of a permanent working capital loan shows that repayment is indefinite and ultimately depends on the borrower's long-term ability to generate enough cash flow to repay the loan.

2. An important step in identifying the borrowing need is to determine, as precisely as possible, how much the borrower really needs and how much the borrower can realistically repay. To establish the appropriate loan amount, you must first determine that there are acceptable current assets, which usually takes the form of receivables and inventory, to support the loan. Next, you need to identify the amount of permanent assets in the borrower's working capital—the amount of working capital below which the company cannot operate.

3. You need to assess the company's ability to generate long-term cash flow and set the amount of the loan to match that capacity. Remember, never offer more than what is needed or can be supported by the projected cash flow and the underlying collateral. And finally, address the permanent working capital element. There are several ways to do that. The owner might inject additional capital and self-finance or, if feasible, you could build in a term loan feature that allows for some reduction in the loan as equity increases through the retention of earnings.

GENERAL COLLATERAL CONSIDERATIONS: ADVANCE RATES TIPS

Collateral is the bank's way of sheltering itself from the inherent risks involved in lending. At an absolute minimum, the loan should be secured by a perfected security interest in accounts receivable and inventory. Plant and equipment might also be considered if reliance on inventory to repay the loan is high, especially if the inventory is perishable, trendy, or has other potential marketability issues.

Setting appropriate advance rates is essential when drafting collateral guidelines. Banks determine the advance rate for accounts receivable based on the quality of the receivable. This is generally within the range of 75 to 80%. Advances against receivables are more generous than against inventory because loan repayment depends only on the collection of a sale that's already been made—the sale itself is no longer in question. It's essential to monitor accounts receivable regularly, preferably monthly, verifying the accuracy of the information provided. Agings based on invoice dates rather than due dates provide a more reliable and conservative borrowing base.

Advance rates against inventory are almost always lower than against receivables, typically ranging from 40–50%. Work-in-process and certain raw materials may even be excluded prior to applying the advance rate. Inventory must first be sold and then collected in order to generate repayment funds. This makes lending against inventory much more uncertain, which is why advance rates against inventory are much more conservative than receivable advances. Because the quality of inventory may change over time and specific items of inventory may become unsalable, the bank should retain the right to change the eligibility of items of inventory included in the borrowing base at will. This prevents the bank from being required to lend against inventory that has lost its value.

GENERAL COLLATERAL CONSIDERATIONS: BORROWING BASE TIPS

A borrowing base is essential to good collateral considerations and has both benefits and limitations. It's important to carefully define the eligible components of inventory and receivables and set advance limits against the eligible collateral to reduce the risk that the bank lends against inventory that can't be sold and receivables that can't be collected.

BENEFITS

- A borrowing base:
  - Is a key element in providing the discipline needed to manage a permanent working capital loan.
  - Protects against the diversion of bank funds to support purchases on noncurrent assets.
  - Requires the borrower to be disciplined about managing working capital, turning inventory over quickly, and maximizing the use of trade credit without damaging relations with suppliers. Effective working capital management will reduce reliance on bank debt.

LIMITATIONS

- Requiring a borrowing base with advance rates means that inventory may not qualify for full funding. This control feature may limit a company's access to funds during times of high sales growth.
- Borrowing-base lending often does not meet the customer's need because of this limitation.
- A borrowing base is expensive for the bank to administer, and these expenses are commonly charged to the customer, which can be a competitive disadvantage. To minimize the administrative burden and expense, many banks apply borrowing base concepts informally, asking the borrower to self-report receivables and inventory without expensive bank field exams to monitor compliance. However, this approach can subject the bank to considerable risk.

STRUCTURING PWC LOANS: TERM LOAN TIPS

A term loan refers to a loan with a determined lifespan, an established interest rate, and the expectation that it will be repaid in full upon the maturity of the loan. The bank can issue a standalone term loan or combine it with a term facility used to support capital asset purchases. This is a good way to extract the permanent working capital level out of the working capital cycle. However, it should be noted that a regular revolver or line of credit will also be needed.

When using a term loan in this scenario, the bank will typically rely more on fixed assets than working capital assets as collateral, unless there is a carve out. The bank should, at a minimum, include accounts receivable and inventory as collateral. The advance rate for accounts receivable is generally 75–80% against eligible accounts receivable. Remember, advances against receivables are always going to be more generous than against inventory because loan repayment depends only on the collection of a sale that's already been made. The accounts receivable numbers will need to be monitored regularly. In terms of inventory, advance rates typically range from 40–50% because it must first be sold. Work-in-process and certain raw materials may be excluded from this figure.

Typically, when using a term loan to finance permanent working capital, the bank will set the term within five years. With regular amortization, the principal decreases over the life of the loan, resulting in a full and complete payoff by the time the loan matures. Typically, term loan covenants include restrictions on the use of proceeds to prohibit the borrower from using the proceeds for any reason other than the purposes intended. The lender may want to consider whether they want to allow or block the payment of dividends based on the company's leverage position. The bank might also restrict a company from other borrowings, and they might enforce a minimum interest or debt service coverage ratio as well as a maximum debt-to-equity ratio.

STRUCTURING PWC LOANS: REVOLVING CREDIT TIPS

Short-term revolving credits, such as seasonal lines and other lines of credit for general business purposes, generally have maturities of one year or less. Revolving loans with maturities over one year may revolve to maturity—sometimes called a bullet revolver—or may revolve for a specific time period, usually no more than three to four years, and then convert to a term loan. Such loans are typically referred to as revolver/term loans, and they typically do not have a final term longer than seven years and usually have a shorter revolving period than the term period. For example, the credit might revolve for three years and be termed out over four years. There may or may not be a larger final payment. Revolvers are often used by larger companies that want to show their debt as long-term debt on the balance sheet or are used in acquisition situations where working capital needs may be unknown at the outset.

As far as covenants go, the bank would enforce a borrowing base formula and definition of eligible receivables and inventory. The bank would require the reporting frequency for the borrowing base to be defined with monthly or quarterly reporting, or reporting at the time of every borrowing.

The bank would aslo enforce:

- The ability to change eligible collateral at the bank's discretion.
- Restrictions on use of proceeds.
- Restrictions on other borrowings.
- Minimum interest or debt service coverage ratio.
- Maximum debt-to-equity ratio.

The lender may want to consider whether they want to allow or block the payment of dividends based on the company's leverage position.

STRUCTURING PWC LOANS: SUBORDINATED DEBT TIPS

Subordinated debt simply refers to another type of loan a company can use as a source of capital. However, being a subordinated debt, it has a lower priority in terms of repayment, meaning that a lender with subordinated debt must wait until the borrower pays off its senior debt before the lender can expect principal payment on its subordinated debt. Because it occupies a lower priority on the repayment chain, subordinated debt often carries a higher interest rate to justify the greater risk.

Typically, any collateral associated with subordinated debt must remain available to the bank until the debt is paid in full. When using subordinated debt to finance permanent working capital, the bank will usually set the term based upon its comfort level and expectations. Generally, the subordination agreement itself serves to provide the guidelines, restrictions, and requirements of subordinated debt financing.

STRUCTURING PWC LOANS: ASSET-BASED LOANS TIPS

While not used as frequently with community banks, larger commercial banks might choose to issue an asset-based loan. An asset-based loan is a loan, often for a short term, secured by a company's assets. Interest rates on these loans may be less than interest rates on an unsecured loan or line of credit because if the borrower defaults on an asset-based loan, the bank has the ability to immediately seize the borrower's assets.

With an asset-based loan, the borrower would be required to put up its receivables and inventory as collateral. Other assets may be required as collateral as well. As mentioned, advances against receivables will be more generous than those against inventory because loan repayment depends only on the collection of a sale that's already been made. The bank may set the term of the loan at one to three years. It might also draft it as an on-demand loan, in which case they can call the loan due at any time.

The covenant options involved in an asset-based loan are extensive. A borrowing base formula may be imposed along with a definition of eligible receivables and inventory and the ability to redefine the eligible borrowing base at the bank's discretion. Daily reporting of receivables and frequent monitoring of inventory is required, along with an initial investigation by the bank's examiners followed by periodic—one to four times per year—examinations. Cash control through lockbox receipt of payments on receivables is often used. There may also be additional restrictions and covenants that are appropriate to longer term financings as discussed previously.

STRUCTURING PWC LOANS: EQUITY TIPS

Equity financing involves issuing stock in exchange for funds and is often a last resort for a company looking to borrow. If a company were to pursue equity financing, they would sell a partial interest in their company to the company's existing investors or third parties. In exchange for these funds, the investor receives equity, or an ownership position, in the form of stock in the company.

With equity financing, there is no collateral involved. The equity owners are at all times behind senior lenders in the event of bankruptcy. There are no set terms involved in equity financing, nor is there an obligation to repay. Equity financing is a permanent form of financing. There are no covenants involved in equity financing.

IMPLEMENTATION AND MONITORING: COVENANT CONSIDERATION TIPS

The loan agreement should define the relationship between the borrower and the lender, including agreed-upon covenants. Although tailored to specific circumstances, there are a few covenants that are typically included in a permanent working capital loan:

- Definitions of eligible inventory and receivables ensure that there is a clearly defined understanding between the bank and the borrower in regard to which components of the inventory and accounts receivable are to be used as collateral. The bank should have the ability to change the eligibility of collateral from time to time so that it is not required to lend against receivables or inventory that have lost their value due to bankruptcy, technological obsolescence, or poor condition.

- Advance rates to be applied identify the understanding between the borrower and banker regarding the amount of money that the bank is willing to lend against the borrower's inventory and receivables. This covenant helps to define the relationship between the borrower and the banker and creates clear expectations.
- When a PWC need is financed through asset-based lending, a common covenant is a requirement that collections be applied to loans outstanding through a lockbox. Lockbox banking simplifies the collection and processing of accounts receivable by having payments mailed directly to a location accessible by the bank.
- The bank will almost always include a covenant that restricts the use of the proceeds being distributed to the borrower. This ensures that the borrower is using the funds for their intended purposes—to purchase inventory, carry receivables, and pay trade creditors or other current liabilities.
- A covenant restricting other borrowings prohibits the borrower, to the degree specified in the agreement, from acquiring new debt without first receiving permission from the bank. This protects the bank and the borrower by keeping the borrower in a more financially secure position.
- The bank will usually also require the borrower to maintain minimum interest or debt service coverage ratios. This simply refers to the ratio of cash available for debt servicing to interest, principal, and lease payments. It's a common tool used in the measurement of a company's ability to produce enough cash to cover its debt payments.
- With a maximum debt-to-equity ratio covenant, the bank ensures that the borrower maintains an appropriate and strong debt-to-equity ratio, which can be determined by dividing a company's total liabilities by its stockholders' equity. The number you get indicates what proportion of equity and debt the company is using to finance its assets, which ultimately determines how highly leveraged a company is. In order to minimize its risk, the bank will enforce this covenant to ensure that the borrower maintains a strong balance sheet and remains in a position to repay its debts while also executing its business plan.

MONITORING TIPS

Because permanent working capital loans can be structured as either a term loan or a revolving loan, they should be monitored continuously. The following guidelines can be helpful in monitoring permanent working capital loans.

First, you should require that the bank has the right to perform regular inspections of inventory and audits of receivables.

- While this may not always be necessary or appropriate, the bank needs to at least have the right to perform inspections and audits.

The bank should also require the borrower to submit financial statements and agings of receivables and payables on a regular basis, often monthly.

- This helps the bank keep track of the monthly cash flow of the borrower, which allows it to respond to worrisome trends in a timelier manner. This benefits both the bank and the borrower.

Additionally, it is prudent to include language that requires the borrower to periodically submit a borrowing base certificate that identifies the eligible collateral against which the requested advances would be funded.

- Again, this is just another tool that helps the bank stay on top of the trends taking place within the company that could impact the borrower's ability to repay.

Finally, be prepared to cap the borrowing base or line of credit in order to control unrestrained growth.

- While this may sound counterintuitive—why would you want to slow a company's growth?—the reality is that unchecked growth can lead to disaster if the borrower finds itself in a position where its sales growth has completely outpaced its growth in equity and it can no longer afford the demands being placed on it by its newfound success.

Remember, all of these measures are a way for the bank to keep its finger on the pulse of the borrower, which is a benefit to the bank and the borrower. The bank might see some potential trouble in the future to which the borrower is oblivious. By putting these measures in place, the borrower has the advantage of another pair of eyes looking over its books.

PWC LOAN RISK TIPS

There is no such thing as a risk-free loan. No matter how well-structured the agreement might be, there is always an element of risk. However, one way of mitigating that risk is to meet it head-on by identifying the particular areas in which, historically, permanent working capital loans tend to go south. The following are examples of high-risk areas:

1. The bank undergoes a thorough review of the borrower's application and considers its projections and statements with care. If the borrower then uses the loan proceeds for purposes other than the purposes intended—usually the purchase of current assets or the payment of current liabilities—this throws the entire architecture of the deal into chaos and sets both the borrower and the bank up for failure. Losses may occur in the receivables portfolio related to mistakes on the part of the bank. For instance, higher than normal concentrations, which simply refer to the percentage of the outstanding accounts that each bank loan represents, can lead to losses in receivables. Similarly, inadequate credit screening of borrowers or poor collection practices can also lead to losses in receivables.

2. Inventory may not be sellable. When a PWC loan fails and the bank seizes the inventory that was put up as collateral, many issues may arise, such as storage costs, obsolescence, contingencies arising from warranties, and costs of disposing the inventory. That may prevent the bank from liquidating the inventory as a source of repayment.

3. Unexpected or uncontrolled growth in sales may lead to the continuing buildup of current assets. It seems strange to think that growth can be a bad thing, but when the growth is unplanned and affects the capacity of the business to carry out its day-to-day functions, it's a potential recipe for disaster. For a business to operate effectively, it requires that all resources are being properly allocated, and unplanned growth almost always means that resources must be redirected from other critical functions.

4. Working capital dynamics may change. Trade suppliers may change their terms of payment, competitive factors may dictate the need to extend longer terms to customers, or supply dynamics may change how much inventory is kept on hand.

5. Cash flow may be insufficient to carry debt. In the planning and reviewing stage, this risk is usually flagged, and the application is generally denied. But banks don't have a crystal ball to guarantee that the borrower will be successful. The harsh reality is that some businesses fail to meet their goals. And when a borrower's cash flow drops low enough, it will find itself unable to repay its debt.

6. Unfortunately, there have been instances in which a borrower, desperate to obtain more funding, will falsify records in order to enhance the appearance of its receivables and/or inventory. While these issues are generally weeded out during the initial application and review process, it is still a potential hazard.

NON-REPAYMENT TIPS

What options does a borrower have in case the loan does fail?

- If the loan is a traditional working capital loan, it may be possible to bring in a professional asset-based lender to take over the loan.
- If the loan is already amortizing, a payment restructure may be appropriate. Missed payments or loan covenant violations may signal that the loan repayment schedule was set too aggressively and just needs to be re-analyzed.
- Collateral liquidation may be the only viable option, either with the borrower's cooperation or through bankruptcy. In this unfortunate case, it's likely that collateral values may be depressed. Should that be the case, the bank should seek the expertise of a work-out specialist.

For more detailed information on this topic, delve into RMA's online course, *Structuring Commercial Loans.*

ABOUT RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country's banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 16,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

Phone: 800-677-7621
Fax: 215-446-4101
Website: www.rmahq.org

RMA UNIVERSITY

In today's rapidly changing financial services industry, you need practical, day-to-day knowledge that will help you excel in your profession. RMA provides quality education to advance sound risk principles in the financial services industry. Traditional classroom training and online learning resources are available as open enrollments or in-bank training. Visit http://www.rmahq.org/events-training/rma-university/rma-university to learn more.

ESTATEMENT STUDIES

RMA's eStatement Studies℠ is the only source of comparative data that comes directly from the financial statements of small and medium-size business customers of RMA's member institutions. Round-the-clock online access gives you the ease and flexibility to use this wealth of information at your convenience. Visit http://www.rmahq.org/tools-publications/tools/estatement-studies to learn more.

ARE YOU AN RMA MEMBER?

An RMA membership provides many benefits. In addition to a free subscription to The RMA Journal® and discounts on RMA events, products, services, and training, membership also provides countless networking opportunities and exposure to the industry's key decision makers and manager. RMA's local and national events keep you up to date on industry trends and issues while allowing you to meet new people and swap successes with peers. Visit http://www.rmahq.org/joinrma to learn more about membership.

JOIN. ENGAGE. LEAD.