US Department of Housing and Urban Development

Office of Community Planning and Development

Underwriting Guidelines

for

Business Loans

For Section 108 Loan Guarantee Recipients

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I. INTRODUCTION

A. Program Overview

The **Section 108 Program** (hereafter referred to as "Section 108") provides state and local government grantees the ability to leverage their Community Development Block Grant (CDBG) Program funds into federally guaranteed loans large enough to spur economic growth and jump-start community revitalization efforts. It provides CDBG grantees with a source of financing for economic development, housing rehabilitation, public facilities, and other large-scale physical development projects. Section 108 is one of the most potent and important public investment tools that HUD offers to states and local governments.

The loans are made by investors who purchase "debt obligations" that are guaranteed by HUD. The debt obligations are promissory notes issued by states and local governments, or public agencies (such as redevelopment agencies and housing authorities) designated by a state or local government to be the issuer. Each issuer receives a loan guarantee from HUD and is referred to in this guide as a "**Recipient**[1]**.**"

A state or local government that receives a loan guarantee under the Section 108 program must pledge its current and future CDBG allocations as security for the guaranteed loan. This pledge of grant funds will not impact how the state or local government receives or uses its grant funds, but instead it allows HUD to use those grant funds to pay debt service if the Recipient misses a payment. Although HUD relies on this pledge of CDBG funds as security for its guarantee, it cannot assume that CDBG funds will always be available. **Thus, in order to receive a Section 108 loan guarantee, the Recipient must furnish additional collateral to ensure that the loan guaranteed by HUD is an acceptable credit risk**. Examples of additional collateral include liens on real property and pledges of tax increment revenue and other revenue sources identified by the Recipient and approved by HUD. This guide, however, focuses on another category of additional collateral: ***business loans***.

A **business loan** is originated when the Recipient chooses to use the Section 108 guaranteed loan funds to make a loan to another entity (i.e., a **business**). A typical example is a loan made by a Recipient to a for-profit business pursuant to 24 CFR 570.203(b), where the loan funds will be used to carry out an economic development project. Business loans made with Section 108 guaranteed loan funds may also be used to finance other project types including, but not limited to: housing rehabilitation, public facilities and improvements and mixed-use development. HUD uses the term "**Business Borrower**" to refer to a third party (such as a for-profit business) that receives a loan from the Recipient.

Together with the pledge of CDBG funds, a business loan may, in addition to serving as the source of repayment for the Section 108 funds, be sufficient to satisfy HUD's additional

[1] **Recipient** is a state or local government that receives CDBG funds from HUD, also known as "grantee." As noted above, they participate in either the Entitlement Program (for cities in metropolitan areas over 50,000 in population, designated principal cities of metropolitan statistical areas or urban counties with more than 200,000 people). Under the States and Small Cities Program, states receive funding directly from HUD and provide it to smaller cities (non-entitled communities), also referred to as units of general local government.

collateral requirements for the related Section 108 guaranteed loan. Consequently, proper underwriting of business loans by the Recipient, as well as following programmatic requirements, can substantially reduce the risk that CDBG or general funds will have to be used for repayment of the loan.

B. Purpose of This Underwriting Guide

HUD is providing the following guidelines to assist Section 108 Recipients in underwriting loans that support business enterprises. Although compliance with these guidelines is not mandatory, HUD's acceptance of business loans as collateral for Section 108 guaranteed loans will be facilitated if they meet these guidelines. Furthermore, while this document is meant to provide general guidance for underwriting, it is not meant to include all criteria a Recipient may use when evaluating the risk of making a loan to a Business Borrower.

HUD has a companion document, "HUD Section 108 Underwriting Guidelines for Income-Producing Projects Including: Residential, Office, Retail, Industrial, and Mixed-Use Real Estate Projects." This is a resource for Recipients to use when a business provides real estate as collateral for a loan and/or when acquisition and/or improvement of real estate is part of the package of business assistance in the proposed HUD 108 financing.

These guidelines, and those in the companion document, are meant to serve as resource for assessing the financial risk and viability of projects. All projects and activities that utilize Section 108 must also comply with eligible activity requirements, national objectives criteria and public benefit standards (if applicable).[2]

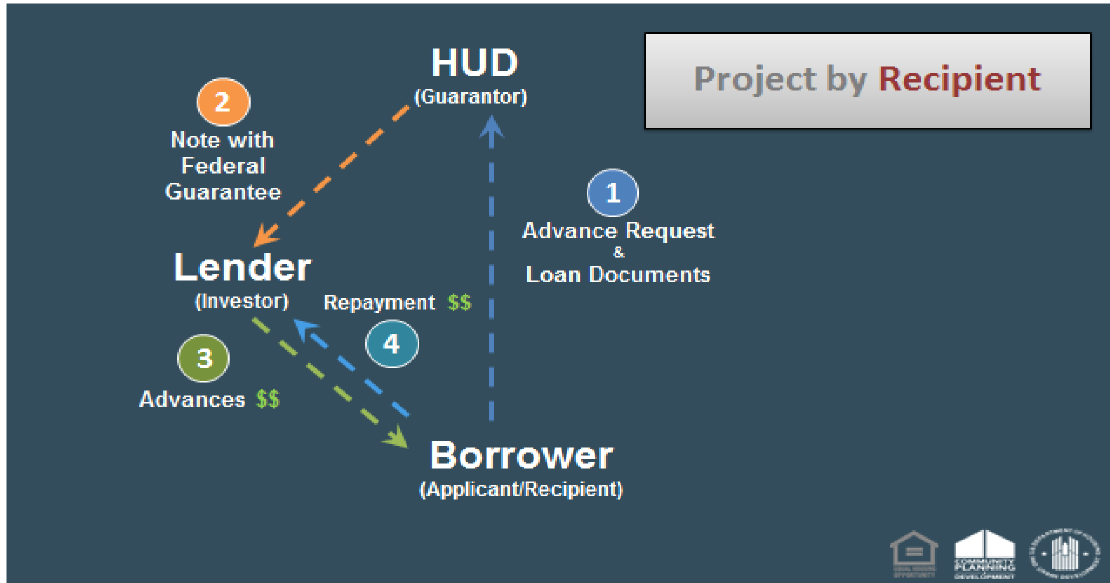
C. Section 108 Project Financing Structures

There are two ways a Recipient can use Section 108 guaranteed loan proceeds—either directly or through a third party.

1. Project Undertaken by Recipient

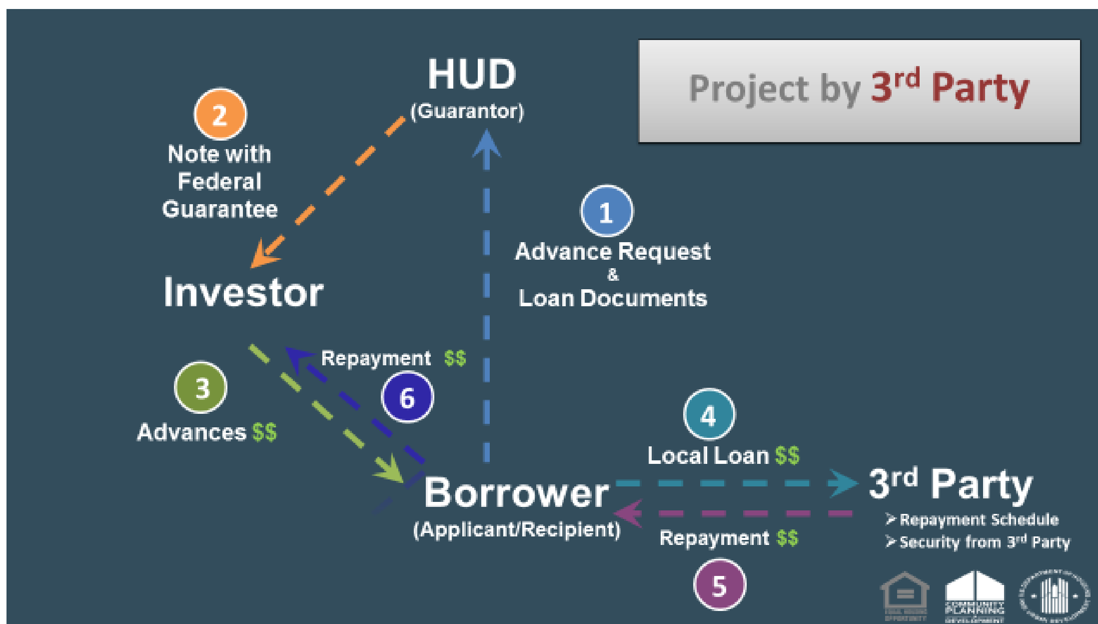
The Recipient can directly use proceeds from a Section 108 guaranteed loan to undertake eligible housing or community and economic development activities. For example, the Recipient may use Section 108 loan funds to construct a public facility. Under this structure, the Recipient is directly responsible for all repayment and guarantee obligations. (See graphic below.)

[2] This document does not provide detailed guidance on Section 108 program requirements. To assess a project or activity's compliance with program requirements, refer to 24 CFR subpart M (beginning at 24 CFR 570.700 and the Guide to Eligible Activities and National Objectives.



2. Project Undertaken by a Third Party

In many instances, however, the Recipient re-lends the Section 108 guaranteed loan funds to a business or to multiple businesses (for example, if the Recipient established a loan fund with Section 108 financing). Under this structure, the Recipient must use the repayment from the business loan(s) to repay the Section 108 note. (See graphic below)



II. CONTEXT FOR UNDERWRITING SECTION 108-FUNDED BUSINESS LOANS

The first step in making a business loan is to evaluate the proposed project for compliance with Section 108 program and cross cutting Federal requirements. A business loan may meet the underwriting guidelines described below but may still be ineligible for funding under Section 108 because it does not meet Section 108 program eligibility requirements such as compliance with CDBG national objectives criteria.[3] The Recipient must therefore treat compliance with the program requirements as an initial threshold step in the underwriting process or determine compliance prior to the underwriting stage.

Additionally, the Recipient must incorporate guidance from "**24 CFR Part 570, Appendix A to Part 570 - Guidelines and Objectives for Evaluating Project Costs and Financial Requirements**" when using guaranteed loan funds to carry out economic development projects. The guidance in 24 CFR Part 570, Appendix A incorporates the following factors:

(1) that project costs are reasonable;

(2) that all sources of project financing are committed;

(3) that to the extent practicable, CDBG funds are not substituted for non-Federal financial support;

(4) that the project is financially feasible;

(5) that to the extent practicable, the return on the owner's equity investment will not be unreasonably high; and

(6) that to the extent practicable, CDBG funds are disbursed on a pro rata basis with other finances provided to the project

While this underwriting guide does not explicitly cover each of these factors, it details strategies that can be used to address each point. Please refer to Exhibit II of this document for a checklist to assist with compliance with the Appendix A factors.

Business Loan Underwriting is the process of evaluating the risk of providing financing to a specific borrower for a specific project. The underwriting process evaluates the risks of making a loan to a business. The objectives of these underwriting guidelines are to ensure:

1. The Business Borrower has the experience and capacity (e.g., qualified/experienced staff) to undertake the project or activities (including managing a loan fund) starting with the financing phase and continuing through to development and then to implementation
2. The Business Borrower has a successful accomplishment record of developing and operating similar projects or activities
3. The Business Borrower's business model and market conditions support the growth and profitability projections

[3]See the Guide to National Objectives and Eligible Activities for CDBG Entitlement Communities.

4. Project/activity costs are accurately projected
5. Cash flow will be adequate to cover the debt service on the loan with a reasonable cushion
6. Collateral value and source of guarantee(s) are sufficient to cover debt service in the case of non-payment

III. EXECUTION OF UNDERWRITING FUNCTION

The term "**Underwriter**" refers to the person or entity that acts on behalf of the Recipient and is responsible for determining the financial feasibility of, and assessing the risk associated with, making a business loan. Section 108 Recipients may elect to carry out the underwriting function in a variety of ways, including:

- In-house staff underwriting
- Underwriting services under a contract with an outside entity
- Combination of in-house and contracted underwriting services

If the Recipient plans to operate one or more loan programs with a significant loan volume, it may make sense to develop internal staff capacity. If the Recipient plans to make only a small number of loans or just a single loan, it may be more cost-effective to use outside expertise.

Recipients that do not have the in-house capacity to underwrite loans may pursue a variety of options, including:

- Use the expertise of another department or agency such as an economic development department, public housing authority, or an economic development corporation.
- Work with a qualified outside source such as a Community Development Financial Institution (CDFI), a Community Development Entity (CDE), a credit union, or a firm that specializes in underwriting commercial real estate and business loans
- Engage a banker, former banker or other finance expert as an underwriting consultant

Some communities employ a hybrid model where staff members review the loan applications against certain criteria while outside experts also prepare a credit analysis report or serve on a loan review committee. In some cases, outside assistance could be used to set-up systems, policies, and procedures to assist staff through the first few loans while training them to take over the function. In the case of particularly large and/or complex Section 108 projects, even when the community has staff members capable of conducting the underwriting, it may be wise to obtain outside assistance for an additional review.

The duties of the loan Underwriter typically include, but are not limited to:

- Assess creditworthiness of prospective borrowers by completing review of company and personal financial statements

- Evaluate historical trends, financial statements, cash flow projections, management performance, market and industry conditions, capital structure and collateral analysis
- Order and analyze reports (credit, environmental, and market analysis)
- Prepare Credit Memo which provides a summary of underwriting, risks and mitigating factors, and proposed loan terms and conditions for a Credit Committee[4]

The loan underwriting guidance that follows will be helpful to the community regardless of whether the underwriting will be conducted by in-house staff or by engaging outside professional assistance.

IV. BUSINESS LOANS

The following underwriting guidelines are intended for use in connection with loans where the Business Borrower utilizes the loan proceeds for:

- ✓ Acquisition of machinery and equipment
- ✓ Working capital for the expansion of a business enterprise
- ✓ Acquisition of commercial property that the business uses for production and/or some connected form of business operations that results in products, goods, and/or services

For Section 108 business loans, the Recipient/Lender provides financing to individual businesses. In some instances, the business may offer real estate as collateral for a business loan, which must be included as part of the underwriting process. If real estate property is acquired and/or improved and/or is offered as part of the collateral for HUD Section 108 financing, then the Underwriter must engage in a review of real estate in addition to the business enterprise. The Recipient/Lender has an obligation to expand the review to include compliance and real estate project feasibility underwriting in addition to business enterprise underwriting. However, the primary focus of the loan is to provide capital to grow the business rather than as financing for a real estate venture.

Typically, Section 108 business loans are secured primarily by a security interest in business assets such as machinery and equipment, inventory and accounts receivable. Recipient/Lenders may also require a Business Borrower to provide a personal and/or corporate guarantee as a condition to receiving Section 108 financing.

Business loan underwriting requires evaluation of the characteristics of collateral and financial performance that make a prospective loan customer desirable or undesirable. The Underwriter must understand in a practical sense the quality, validity, and the collateral securing the loan is collectable. Additionally, the Underwriter should focus on performance issues as reflected in

[4] These guidelines assume that business loan applications will be reviewed by a committee or a panel before financing.

the Business Borrower's historical financial statements that may affect the viability of the borrower as an ongoing entity.

A. Business Borrower Evaluation

A borrower's reputation, credit history and its business experience in the community and for the project must be weighed as part of the underwriting process. Specifically, the Underwriter should focus on reviewing all ownership structures, purpose of legal entities, and capacity to own and operate similar type of businesses in accordance with Section 108 program requirements and loan terms. The Underwriter must also review the Business Borrower's ownership structure, credit histories and capacity to operate its business in accordance with Section 108 program requirements and loan terms.

B. Ownership Type

The Business Borrower must provide the Underwriter with the identity of all parties/counterparties and entities or individuals involved in the organizational structure in order for the Underwriter to be able to determine ownership, financial strength and creditworthiness of each **Key Principal**. An individual(s) or entity owning or controlling twenty-five percent (25%) or greater interest in the project must:

- Be legally authorized to do business in the United States
- Not appear on the HUD list of debarred contractors

The Recipient often requires the Key Principals guarantee the loan by offering additional sources of collateral to reduce their exposure to risk of default. In this case, the Underwriter must confirm that the owners and/or the business entity has the financial capacity to guarantee 100% of the loan's principal balance, either individually and/or jointly through combined sources of collateral such as machinery and equipment and a loan loss reserve. This guarantee from the Business Borrower does not cancel the obligations of the Recipient/Lender should the project or activities fail, it is instead, added security to mitigate risk.

The following illustrates various ownership structures and principals that may participate in Section 108 financing:

Business Borrower(s)	Key Principal(s)
General or Limited Partnership	General Partner(s)
Limited Liability Company- LLC	Managing Member(s)
Corporation	Controlling Shareholder(s)
Trust	Controlling Party(ies)
Individual(s)	Individual(s)

C. Business Borrower Experience

The Underwriter should complete thorough review of the Business Borrower's management capacity. The narrative should detail the history of the Business Borrower and include the following components:

Business Borrower Information	Note
Business Borrower Legal Identity	Date and place of formation/incorporation
List of Key Principals	Include name, role and contact information
List of Principals	Include name, role and contact information
Key Staff	Resumes, Qualifications
Organization Chart	Key Principals and Staff Roles and Responsibilities
Staff Qualifications	Resumes, Qualifications
Subcontractors and Affiliates	Resumes, Qualifications
Annual Operating Budget	At least two years
Pending Litigation, Foreclosures, Liens	If applicable
Contingent Liabilities	If applicable

V. BUSINESSS BORROWER FINANCIAL CAPACITY

For Business Borrowers and Key Principals, the Underwriter must consider overall financial strength as well as their history in owning and successfully operating similar types of businesses. The Underwriter must review and deem as satisfactory financial statements, tax returns, and credit reports.

There are three levels of Certified Public Accountant (CPA) prepared financial statements—audited, reviewed, and compiled. Audited financial statements are preferable for underwriting, followed by reviewed, then compiled.

Audited. Audited financial statements have been prepared and certified by a CPA that the financial statements meet the requirements of Generally Accepted Accounting Principles (GAAP). An unqualified opinion is an independent auditor's judgment that a company's financial records and statements are fairly and appropriately presented, and in accordance with GAAP.

A qualified opinion is typically given due to a limitation of scope in which the auditor was not able to gather sufficient evidence to verify one or more aspects of the financial statements. A qualified opinion is also issued when accounting procedures used do not conform to GAAP. A business with a qualified opinion presents a higher credit risk than one with an unqualified opinion. If the opinion is qualified, the Underwriter must discuss the situation with the Business Borrower and include an explanation in the credit memo.

Reviewed. The CPA reviews information provided by the business and provides limited verification, along with doing some key tests to validate levels of inventory and receivables.

Compiled. The CPA uses the information provided by the business and puts it in the proper form. The accountant does no evaluation as to the correctness or completeness of information.

A. Required Financial Statements

To conduct a comprehensive credit analysis of the prospective borrower for HUD Section 108 business assistance financing, the Business Borrower should submit copies of the following for the recent three (3) years of business:

- Balance sheets
- Income statements
- Statement of cash flows
- Tax returns

In addition, the borrower should provide:

- Contingent liabilities and a statement concerning their amount, nature and path towards resolution
- Bank statements (for the past 6 months)
- Any notes from the Borrower that can provide explanation and/or rationale for any information that Underwriter may perceive as a credit and/or capacity issue
- Authorization to pull credit reports, as specified by the Lender

B. Balance Sheet

The balance sheet presents a company's financial position at a specified date. It shows the Underwriter what a company ***owns*** as well as what it ***owes*** to other parties. The following ratios are used to evaluate the condition of a borrower's balance sheet.

1. Current Ratio

Current Ratio = Current Assets ÷ Current Liabilities

The Current Ratio answers the following question:

"If the Business Borrower can collect all of its receivables and turn its entire inventory into a product and sell that product and collect the receivables from that sale, will it generate enough cash to pay its suppliers, employees and its lenders?"

A Current Ratio of 1:1 means that the Business Borrower has $1.00 in current assets for every $1.00 in current liabilities. A Current Ratio of less than 1:1 means that the Business Borrower requires additional working capital to cover its cash needs. Current ratios vary from industry to industry, a generally accepted range is from 2:1 to 3:1.

2. Quick Ratio (Acid Test Ratio)

Quick Ratio = (Cash + Receivables) ÷ Current Liabilities

The Quick Ratio answers the following question:

"If the Business Borrower had only its cash and was able to collect its receivables, could it make payments to suppliers, employees and debt service to the lender?"

A Quick Ratio of 1:1 means that the Business Borrower has $1.00 in "quick" assets (cash and receivables) for every $1.00 in current liabilities (supplier, employees, lenders). A quick ratio of less than 1:1 means that the Business Borrower requires additional working capital to cover its current liabilities.

A Business Borrower that has a Current Ratio of 1:1 and a Quick Ratio of less than 1:1 has a heavy reliance on inventory as its current assets. In these instances, the Underwriter must determine if, and how efficiently, the company can convert that inventory into cash.

The Quick Ratio assumes that all receivables can be collected. Therefore, the quality of a Business Borrower's accounts receivable needs to be considered when analyzing the quick ratio. Receivables with extended terms or that may not be collected could allow an acceptable quick ratio to mask forthcoming problems. While varying from industry to industry, a quick ratio of 1 or higher is generally considered acceptable.

3. Debt to Equity Ratio

Debt to Equity Ratio = Debt ÷ Equity

The Debt to Equity ratio answers the following question*:*

> *"What amount of debt and equity has the Business Borrower used to finance its operations?"*

A Debt to Equity ratio of 2:1 means that the Business Borrower has $2.00 in debt for every $1.00 in equity.

A Debt-to-Equity ratio of 0.40:1 means that the Business Borrower has 40 cents in debt for every $1.00 in equity.

On a company's balance sheet, equity represents the combination of the amount of capital invested by the owners plus the accumulated retained earnings (or losses). The higher the amount of debt, the greater the Business Borrower is vulnerable to changes in interest rates, banking climates, and market conditions. Over time, the Debt-to-Equity ratio should be declining. The Business Borrower should be able to place less reliance on debt and more reliance on growth in cash flow from retained earnings.

A company with a higher Debt-to-Equity Ratio presents a greater risk of being considered "over-extended" in debt obligations than those with a lower ratio.

A high Debt-to-Equity Ratio can indicate that there may be issues related to the business model and/or execution of management because there is more debt than equity investment and working capital. The Underwriter should require the applicant to address what factors lead to a high Debt-to-Equity Ratio.

C. Other Balance Sheet Indicators

In addition to the above ratios, the Business Borrower should have a positive net worth. Receivables, inventory, and accounts payable should be consistent with the level of sales. Accounts receivable and/or inventory should be sufficient to support the debt service on the financing request.

1. Income Statement

The income statement is also referred to as the profit and loss statement (P & L) statement of income, or the statement of operations. It reports the revenues, gains, expenses, losses, net income and other totals for the period of time shown in the heading of the statement. The income and expense statement should show that:

- The company is making money
- Earnings from year to year are steadily increasing
- Healthy, consistent gross profit margin and operating expenses

The company's management must provide an explanation for any dramatic changes from year to year in earnings or operating expenses. The following review tool could be used to determine important trends. Use at least three previous years of data.

Income Statement Review tool			
Income Statement			**Comments**
Are sales increasing?	Yes	No	
Are Cost of Goods Sold (COGS) / Sales as a % stable or declining over time?	Yes	No	
Industry/RMA COGS[5] / Sales : ____%			
Are operating Expenses / Sales as a % stable or consistent over time?	Yes	No	
Are Operating Expenses / Sales as a % consistent or better than industry?	Yes	No	
Industry/RMA Sales General Admin. / Sales: ____%			
Are profits increasing?	Yes	No	
Is the profit margin (Earnings Before Taxes / Sales as a %) increasing?	Yes	No	
Is the profit margin consistent or better than the industry?	Yes	No	
Industry Earnings Before Taxes / Sales _____%			

[5] "RMA" - Risk Management Association provides industry standard comparative statistics. Other sources for industry data can be used for comparable analysis such as Dun & Bradstreet (D&B), industry associations, or trade publications.

2. Statement of Cash Flows

The cash flow statement reports the *cash* generated and used during the time interval specified in its heading. The period that the statement covers is chosen by the company.

The cash flow statement answers the question:

How well do the Key Principals manage cash to meet the financial obligations of the firm?

The cash flow statement reports cash generated and used in the following categories:

- Operating activities within the income statement
- Investing activities such as purchase or sale of assets such as real estate and equipment
- Financing activities such as incurring and/or paying off debt as a borrower or providing debt as a lender

3. Cash Flow Analysis

A Business Borrower's historical financial statements reflect how well management has deployed the company's resources and present a picture of its financial health.

Utilizing the Business Borrower's historical financial statements, the Underwriter evaluates the following:

- Are the Business Borrower's projections logical and reasonable? Are they consistent with historical numbers and ratios?
- Do projected sales appear to be attainable?
- Has management accounted for increases in operating costs? Are increases in wages sufficient to support job creation projections?

The Underwriter should ask for explanations for major differences the projections and the historical numbers. Such discrepancies may include

- Large sales increases
- Changes in operating cycle ratios
- Reduction in operating costs

The Underwriter must review the assumptions for financing to assure they are accurate and current.

Accurate and realistic projections can be helpful in determining a Business Borrower's need for working capital in the future, as well as their ability to repay.

4. Contingent Liabilities Statement

A contingent liability is a potential liability that may occur, depending on the outcome of an uncertain future event. A contingent liability is recorded in the accounting records if the contingency is probable and the amount of the liability can be reasonably estimated. The contingent liabilities statement should detail the amount, their nature and the path toward resolution.

Contingent liabilities can include:

- Outstanding lawsuits
- Claims against the company not acknowledged as debts
- Legal liability
- Liquidated damages
- Torts
- Unliquidated damages
- Destruction by disaster such as storm or flood
- Product warranty
- Disputed taxes
- Financial guarantees given

Assessing risks of contingent liabilities requires the Underwriter to see how well the applicant:

- Provides transparency and detail as to the nature of the contingent liability
- Quantifies the financial risk
- Specifies what material factors will determine when the contingent liability becomes a current and material liability.

D. Tax Returns

If applicable, Federal income tax returns for the previous three (3) years may be required from the Business Borrower and/or identified Key Principal(s). Information in the financial statements should be consistent with the information stated in the tax returns. If not, then the Business Borrower needs to provide an explanation to satisfy the discrepancies.

E. Bank Statements

The Underwriter must review the Business Borrower's bank statements for the most recent six (6) months. The bank statements must verify cash on hand as stated in the most recent financial statements. Any discrepancies must be explained.

F. Creditworthiness

In addition to financial statements and verification of bank accounts, the Underwriter must determine a recommendation of "creditworthiness" based on an evaluation of credit reports, credit scores and any past bankruptcies. There are two types of credit reports.

1. Personal Credit Reports

Personal credit reports are required for the Business Borrower and Key Principal(s). It is an industry standard that credit reports be no more than 60 days old at the time of application and no older than 120 days from funding.

The Underwriter must order all credit reports directly after the borrower signs an authorization and release.

2. Business Credit Reports

A report from an established business credit-reporting agency (such as the Dun & Bradstreet "Business Information Report") or other acceptable commercial credit report for business entities is required. An acceptable commercial credit report must include the following:

- Public filings that include suits, liens, judgments, bankruptcies, and federal debt
- Uniform Commercial Code (UCC) filings
- Credit payment history
- Industry standards showing how the facility compares in the areas of financial stress and payment trends
- A credit payment delinquency risk score over a 12-month period

It is an industry standard that credit reports be no more than 60 days old at the time of Application and no older than 120 days from funding.

The Underwriter must order all credit reports directly after the borrower signs an authorization and release.

3. Credit Scores

The Underwriter is responsible for obtaining credit scores for each individual Business Borrower(s) and Key Principal(s). The credit score primarily referred to in this document is FICO® Score developed by the Fair Isaac Corporation (FICO).

If the Underwriter identifies issues related to credit scores and/or credit reports, the Underwriter may consider requesting from the Business Borrower a Credit Explanation Statement that addresses each issue identified in the credit report. A satisfactory Credit Explanation Statement should include:

- Clarity that the Business Borrower understands and takes responsibility for each negative event
- The steps the Business Borrower took and/or is taking to remedy the negative credit event and resolve the issue

The Underwriter is looking specifically for a pattern of proactive responsibility and accountability for meeting all financial obligations.

4. Minimum Credit Score Requirement

All credit-scoring models rank individual consumers by their relative credit risk. That is, a score represents a borrower's likelihood of becoming delinquent on a loan. It is a general industry standard that a personal credit score of 700 or above positions the Business Borrower as a positive credit risk. A credit score below 700 may require a credit explanation statement from the Business Borrower so that the Underwriter can evaluate compensating factors.

5. Past Bankruptcies

The Underwriter must evaluate such applications on a case-by-case basis. The Business Borrower and any Key Principal(s) in a limited partnership must sign a detailed Credit Explanation Letter, Certified Ownership, and Loan History Statement. The explanation must describe the following:

- Pending or current litigation, judgments, or public records
- Any delinquencies, defaults, foreclosures, or deeds-in-lieu of foreclosure, which occurred during the last seven (7) year
- Bankruptcy that occurred within the last ten (10) years

The Underwriter can require the Business Borrower to include in their Credit Explanation Statement an explanation concerning low credit scores and/or bankruptcy.

VI. EQUITY

For business loans, especially working capital loans, the Underwriter must evaluate the amount of equity in the overall business. This can be accomplished through the analysis of the balance sheet ratios of Business Borrower equity or cash compared to debt.

Some Recipients will make Asset-Based loans, whereby the Section 108 loan helps the business purchase equipment, machinery, license, and/or other asset that has a market value. The Business Borrower offers the asset as some portion of the collateral to the loan. For Asset-Based loans, the Recipient may require the Business Borrower to contribute cash equity equal to some percentage (e.g., 10% to 25%) of the total project cost and/or market value of the asset as an added protection against risk.

See recommended Section 108 collateral ratios in Section VII.

VII. EVALUATING THE BUSINESS OF THE BORROWER

In addition to the financial statements, the Underwriter must also evaluate the operations of the Business Borrower's business. This analysis must include sales growth potential, the operating cycle, a reconciliation of net worth, a review of capital expenditures, and a comparison of the Business Borrower's business to similar firms.

A. Sales Growth

Ideally, the Business Borrower should experience steady sales growth over time.

Sales Growth = Most Recent Year's Sales - (Previous Year Sales ÷ Previous Year Sale)

The Underwriter must answer the following questions when analyzing sales growth:

- What is the long-term growth pattern?
- Has there been an increase in the actual number of products sold?

- What is the history of price increases over time?
- Is the sales growth in a single particular product or service or is it from a range of products and services?
- Is the sales growth from one-time only increases?
- If there have been decreases in sales, what are the cause(s) for such decreases?
- Are the decreases one-time due to extraordinary circumstances?
- Does any major growth or decline come from the business of one major customer?

As noted above, sales should be increasing evenly over time. Steady sales decreases should be investigated further.

The Underwriter needs to gain a level of understanding that the Business Borrower knows the nature of their business. The business needs to clearly articulate and show evidence for what factors lead to sales increases and/or decreases, and their plan to increase sales and profits.

B. The Operating Cycle

The operating cycle is a representation of the uses and sources of cash in the Business Borrower's business operations. In short, it is the amount of time a company spends between spending money on operating activities and collecting money from the same operating activity. To analyze the operating cycle, it is necessary to look at the following in terms of the average number of days it takes to convert these items to cash:

- Accounts receivables
- Inventory
- Accounts payable
- Accruals

The Operating Cycle is also called the "Cash to Cash" cycle. It focuses on the Business Borrower's use of cash in Receivables and Inventory and its source of cash from Payables.

The Operating Cycle analysis answers the question:

> *"How long does the Business Borrower have cash tied up in operations from the first investment in inventory to collecting the sale from the customer?"*

The longer the operating cycle, the greater the Business Borrower's need for working capital. The Operating Cycle should be stable or declining over time and be consistent with or better than the standards for the business's market or industry.

Operating cycles determine cash flow. If a Business Borrower is able to keep a short operating cycle, current assets are being turned into cash quickly, providing the company with revenue to pay current liabilities. Conversely, a long operating cycle means that current assets are not being turned into cash very quickly, increasing the likelihood that the Business Borrower will have to borrow money to pay short term liabilities. The cost of this debt can make the company less profitable.

Operating Cycle = Days Receivable + Days Inventory – Days Payable

A. Where:

- "**Days Receivable**" is the average number of days it takes the Business Borrower's customers to pay their bills after a sale.
- "**Days Inventory**" is the average number of days' worth of the inventory on hand.
- "**Days Payable**" is the average number of days it takes the Business Borrower to pay its suppliers.

1. Days Receivables

Days Receivable	**=**	**÷**	**Total Accounts Receivables** / **Net Credit Sales × Number of Days in Statement Period**

Accounts Receivables are shown on a company's balance sheet as a current asset, which means they should be paid in a relatively short period. If a company has both credit and cash sales, the net credit sales should be separated from gross sales on the income statement because it is important to identify cash separate from credit.

In analyzing Days Receivable:

- A Days Receivable of 30 days means that, on average, a Business Borrower takes 30 days to collect from its customers.
- Days Receivable should be consistent with terms offered to customers. When days receivables are longer than terms offered customers it is an indication of poor collection procedures and customers who are unable or unwilling to pay for their purchases.
- A high Days Receivable may lead to cash flow problems because of the long duration between the time of a sale and the time the company receives payment.
- Days Receivable should be consistent or better than the Business Borrower's industry and stable or declining over time.

2. Days Inventory

A. The Days Inventory is calculated by dividing inventory by cost of goods sold and multiplying by the number of days in the statement period, usually one year.

Days Inventory = (Inventory / Cost of Goods Sold) x 365 [days in statement period]

B. Ending inventory is reported on the balance sheet and the cost of goods sold is listed on the income statement.

C. In analyzing a day's inventory:

- The longer the days inventory, the more cash that the Business Borrower has tied up in production which is not available to pay bills.
- This is particularly important for manufacturing businesses, who must always focus on reducing their manufacturing time and how much they must warehouse. It costs

money for a company to keep, maintain, and store inventory. Companies also have to be worried about protecting inventory from theft and obsolescence.

- Days Inventory should be generally consistent with the production cycle.
- Over time, Days Inventory should be stable or declining.
- Days Inventory should be consistent or better than the industry.

3. Days Payable

Days Payable is the average number of days it takes the Business Borrower to pay its suppliers. The ability to pay suppliers is determined by the Business Borrower's ability to generate cash from its receivables and to turnover its inventory.

Days Payable is calculated by dividing Average Accounts Payables by Cost of Goods Sold (COGS) multiplied by the number of days in the statement period.

Days Payable = Average Payables / COGS) x 365 [days in the statement period]

The Average Payables is used because payables are not consistent throughout the year. The Average Payables is calculated by taking the sum of the beginning and ending accounts payable and dividing by 2.

The Business Borrower's Days Payable should be:

- Consistent with the terms offered by suppliers
- Consistent or better than the industry
- Stable or declining over time

A shorter Operating Cycle means that a Business Borrower has a lesser need for working capital. A longer Operating Cycle means that a Business Borrower has a greater need for working capital.

VIII. MARKET/INDUSTRY ANALYSIS

A thorough analysis by the Business Borrower of the need for their goods or services is a fundamental part of the loan application and underwriting process. The Business Borrower must be able to show that a market exists for the products and services offered, that it operates in a stable industry and is in a favorable competitive position.

The Underwriter should review the market information and analysis provided by the Business Borrower to answer the following questions:

- Who are the customers of the business?
- Is there a demonstrated market demand for the product or service, and what is the extent of the total demand?
- What are the trends and outlook for the industry and the market to be served?

- What are the trends in the economy of the market area?
- How will the Business Borrower distinguish itself from its major competitors?
- What is the likelihood of other new competitors entering the field?
- Does the applicant's analysis seem reasonable considering what the Underwriter knows about the industry and market?
- Is the Business Borrower's market strategy clearly justified and reasonable based on its analysis of the market and competition?

IX. COLLATERAL

Once the Underwriter is comfortable with the project's prospective financial performance, it needs to look at the collateral for the Business Borrower Loan.

HUD recommends that the loan be fully secured (100 percent of the principal amount) by one or more of the following forms of collateral:

- A lien on real property, established through an appropriate and properly recorded mortgage
- Any and all rights, titles, and interests of the Business Borrower to any leases covering the Real Property
- A security interest in personal property (machinery and equipment, accounts receivable, inventory and other items of personal property). To ensure that the Business Borrower Loan is fully secured, the following LTV ratios are recommended:

A. Recommended Section 108 LTV Ratios

The principal amount of the Business Borrower Loan secured by real property shall not exceed an amount equal to 80 percent of the "as improved" appraised market value, less the outstanding balance on other indebtedness secured by a mortgage lien of senior or equal priority on the real property.

The principal amount of the Business Borrower Loan secured by personal property shall not exceed an amount determined as follows:

(A) in the case of used Machinery and Equipment (M&E), not more than 90 percent of the appraised net liquidation value, less the outstanding balance of other indebtedness secured by a senior security interest in such M&E; and

(B) in the case of new M&E, not more than 80 percent of the cost thereof (including installation), less the outstanding balance of other indebtedness secured by a senior security interest in such M&E; and

(C) in the case of accounts receivable, not more than 80 percent of the average of the ending balances of the last three (3) years of accounts receivable, less the outstanding balance of other indebtedness secured by a senior security interest in said accounts receivable; and

(D) in the case of inventory, not more than 50 percent of the average of the ending inventory balances of the last three (3) years, less the outstanding balance of other indebtedness secured by a senior security interest in said inventory.

The Recipient may optionally require the Business Borrower to establish a debt service reserve and/or furnish a personal or corporate guaranty to ensure timely payment of the Business Borrower Loan.

The Underwriter must require the Business Borrower to execute and deliver promissory notes, mortgages, deeds of trust, security agreements, financing statements, instruments, documents and other agreements as the Recipient or its attorneys may reasonably request to evidence and secure the Loans and to perfect all security interests.

A. <u>Evaluation of Guarantees</u>

Recipients may require a guarantee from a financially responsible guarantor to reduce the risk that it will have to pay back the Section 108 loan from CDBG or other Recipient funds. The attributes of a financially responsible guarantor include the following:

- Guarantor has both the financial capacity and willingness to provide support for the loan.
- The guarantee is adequate to provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term.
- The guarantee is written and legally enforceable.

The Underwriter must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. This assessment includes consideration of the total number and amount of guarantees currently extended by a guarantor in order to assess whether the guarantor has the financial capacity to pay contingent claims.

Sample Standard Section 108 Collateral Requirements (Add – Introduction of these standards)

X. LOAN SIZING AND DETERMINING DEBT CAPACITY

To determine the maximum loan amount, the Underwriter may want to calculate a minimum debt service coverage ratio (DSCR) and a maximum Loan to Value ratio (LTV). In general, loans with higher DSCRs and lower LTV Ratios should be evaluated more favorably than loans underwritten to minimum standards. HUD does not use DSCR and LTV to determine loan size but does use these ratios to evaluate acceptability of Business Loans as collateral for a Section 108 loan. The Recipient can utilize its own methodology for loan sizing as long as the loan is sufficiently secured.

A. Debt Service Coverage Ratio (DSCR) Method

The debt service coverage ratio measures the amount of cash flow a business has available to pay for debt. A minimum DSCR of 1.25, for instance, means that a business has $1.25 in cash

flow for every $1.00 in debt. Cash flow divided by the minimum DSCR equals the maximum amount available for debt service. The example below demonstrates how a maximum loan amount is calculated using the DSCR.

1. **DSCR Example -**

Calculate Net Cash Flow

Profit after Tax		$100,000
plus Depreciation	+	25,000
less Current Portion of Long-Term Debt Service Payments (CLTD)	-	10,000
equals Net Cash Flow:	=	$115,000

Calculate Maximum Debt based on Cash Flow by the DSCR Method

How much debt will the Cash Flow support at a 1.25 DSCR?

Maximum Amount of Cash Flow for Debt Service = Net Cash Flow ÷ DSC Ratio

$115,000 ÷ 1.25 = $92,000

In this example, $92,000 is the maximum annual debt service. Next use the Present Value (PV) formula in Excel (PV (rate, NPER, PMT)) to calculate the maximum loan amount based on the maximum annual debt service and the terms of the loan.

	Monthly	Annual
Rate:	.0375%	4.50%
Term:	120	10
Annual Amount for Debt Service:	$7,667	$92,000
Maximum Loan Amount Based on Cash Flow:	**$739,751**	

NOTE: To accurately calculate the loan amount, convert the rate, the term (NPER) and payment (PMT) into monthly amounts. For a loan at a 4.5% annual interest and a 10 year term: PV (.045/12,10*12,-92,000/12) = $739,751.48

B. Loan to Value (LTV) Method

The LTV is the ratio of a loan amount to the value of the collateral. For a loan secured by collateral that is worth $1,000,000, a LTV of 80% results in a maximum loan amount of $800,000.

LTV = Loan Amount/Value of Collateral

If other debt is secured with the same collateral, the Underwriter must calculate the combined loan to value (CLTV), The CLTV is the amount of the outstanding debt plus the amount of the new debt being added by the Section 108 loan, divided by the value of the collateral.

The maximum loan amount is the lesser of the maximum loan amount as determined by the DSCR method or the LTV method. Given that the two examples above are for the same borrower, the maximum loan amount for this borrower is $739,751, the lesser of the DSCR method and the LTV method.

C. Multiple Financing Sources

In business lending, there may be multiple sources of financing that go into a Business Borrower's project. Along with the Business Borrower loan, the other types of financing are debt financing, equity investments, or other types of financial assistance (local/state grants, charitable contributions, etc.).

If the Section 108 loan is providing most of the financing for the activity, the Recipient/Underwriter may require a lien position that is senior to all other financing sources. For a variety of reasons, the Recipient is likely to face pressure from the Business Borrower to agree to subordinate its security interest. At a minimum in this case, the Recipient should request a shared senior lien position with any other debt financing source.

In other instances, the Business Borrower's loan is utilized to fill a financing gap that is a relatively small share of the project's financing sources. In these cases, the Recipient/Underwriter may determine that the Section 108 loan must be subordinated to the loan from the other lender (e.g., a financing source that is providing most of the financing).

1. Inter-creditor Agreements

In cases where there are multiple lenders, it may be necessary for the Recipient to enter into an Inter-creditor Agreement (or the equivalent thereof). To ensure that its collateral is not compromised, the ***Recipient*** should carefully review the Inter-creditor Agreement ("ICA") for the following:

- "Standstill" Provisions: circumstances under which a senior lien holder can limit or block payments that would otherwise be due to the Recipient. Standstill Provisions should be negotiated that limit this type of provision to payment defaults.
- A firm definition of what constitutes Section 108 debt as well as what constitutes senior lender debt, i.e., the ICA must not allow a senior lender to amend the terms of its loan without the Recipient's consent.

- Recourse strategies in the event a Business Borrower becomes delinquent on its debt service payments to any loan. Some ICAs may contain complex provisions that could hinder, or even block, a lender from pursuing remedies to cure the Business Borrower's debt. The Recipient will want to be firm in ensuring that adequate recourse provisions are included in any ICA.
- The Recipient should require provisions in the ICA that clarify when, and it what form, advanced notifications are given in the event of default. This advanced notification timetable by the senior lender should allow the Recipient sufficient time to develop strategies for curing such a default.

It is important to remember that, while ICA's generally contain standard language, but the language can be amended and the Recipient is encouraged to insist upon certain terms prior to the Business Borrower closing on its loan with other lenders. Doing so will make it easier to negotiate should a senior lender require the execution of an ICA, thus protecting the Recipient in the event of default.

EXHIBIT I

SAMPLE CREDIT MEMO

The Underwriter should submit a report to either the credit committee and/or designated decision-makers of the Recipient that summarizes the factors affecting the proposed transaction and include the relevant underwriting documentation outlined above. The Credit Memo is the primary deliverable of the Underwriter and record of analysis and recommendation for how to proceed with the HUD 108 financing request. Credit Memo should include:

COVER SHEET	
Applicant:	
Project Name:	
Requested Loan Amount:	
Project Description:	
Location:	
Collateral:	
Target Closing Date:	

ANALYSIS

A. Project Description

1. Section 108 Program Compliance
   - a). Section 108 eligible activity under 24 CFR 570.703
   - b). National objectives criteria under 24 CFR 570.208
   - c). Public benefit standard as required for projects qualifying under 570.703(i) and 570.203 or 570.204 activities.
   - d). Environmental review
2. Evaluation of Compliance with Underwriting Guidelines
   - a). Project Feasibility and Readiness
   - b). Experience and Management Capacity
   - c). Borrower Financial Capacity and Creditworthiness
   - d). Project Financial Analysis
   - e). Collateral (including any Loan Repayment Guarantees)

3. Risks and Mitigating Factors

CONCLUSION AND RECOMMENDATION

1. Recommendation and rationale for approval/disapproval. If recommendation is approval, provide the following information:
   a. Loan Amount
   b. Primary & Secondary Collateral
   c. Recommended Conditions:
      1. Receipt of commitment approval documentation from other funding sources
      2. Satisfaction of insurance requirements, General Liability, Builder's Risk and Property
      3. Receipt of an updated lender's Title Policy in favor of the Recipient
      4. HUD release of funds from environmental condition
      5. Approval and execution of construction contract
      6. Confirmation of lien and judgment-free status (search) prior to closing
      7. Receipt of approval from HUD
      8. Receipt and execution of loan documents from HUD
      9. Receipt of updated documents from the Business Borrower (budgets, contracts, other documents) as requested
      10. Schedule for Repayment of Section 108 Loan
   d. Business Loan Terms:
      1. Interest rate: (should be pegged to rate on Section 108 loan)
      2. Term:
      3. Payment frequency (monthly or quarterly):
      4. Special provisions: (e.g., principal amortization deferral, balloon payment)

CREDIT MEMO EXHIBITS:

A. Detailed Sources & Uses and Analysis of Cash Flow
B. Property Appraisal – Executive Summary
C. Site Plan & Schematics
D. Other documentation as required

EXHIBIT II

Checklist for 24 CFR Part 570 Appendix A:
Guidelines and Objectives for Evaluating Project Costs and Financial Requirements

HUD has developed the guidelines at 24 CFR Part 570 Appendix A to provide CDBG Recipients and/or the parties assisting with underwriting with a framework for financially underwriting and selecting CDBG-assisted economic development projects which are financially viable and will make the most effective use of the CDBG funds. The use of these underwriting guidelines is now mandatory.

Where appropriate, HUD's underwriting guidelines recognize that different levels of review are appropriate to address differences in the size and scope of a proposed project, and in the case of a microenterprise or other small businesses, to take into account the differences in the capacity and level of sophistication among businesses of differing sizes.

Recipients and/or their underwriters, are encouraged to develop their own underwriting criteria that is relevant to their specific types of projects and activities, though all underwriting criteria should consider the factors in Appendix A. The checklist below is provided as an aid to ensure compliance with the guidelines at Appendix A but it is not meant to be inclusive of all the underwriting criteria necessary for every economic development project.

	Appendix A Factor	Guidance
☐	Project costs are reasonable	Recipients/Underwriters should obtain a breakdown of all project costs to ensure the reasonableness of each cost element making up the project. For more expensive costs elements or for less experience underwriters it may be more appropriate for the Underwriter to compare the cost element with a third-party, fair-market price quotation for that cost element.
☐	All project financing sources are committed	To the extent practicable, prior to the commitment of CDBG funds to the project, the Recipients/Underwriter should verify that: sufficient sources of funds have been identified to finance the project; all participating parties providing those funds have affirmed their intention to make the funds available; and the participating parties have the financial capacity to provide the funds.
☐	CDBG funds are not substituted for non-federal funds	Recipients/Underwriters should review the economic development project to ensure that, to the extent practicable, CDBG funds will not be used to substantially reduce the amount of non-Federal financial support for the activity. To determine this, the Recipient/Underwriter would conduct a financial underwriting analysis of the project, including reviews of appropriate projections of revenues, expenses, debt service and returns on equity investments in the project.

☐	Project is financially feasible	A project would be considered financially viable if all of the assumptions about the project's market share, sales levels, growth potential, projections of revenue, project expenses and debt service (including repayment of the CDBG assistance if appropriate) were determined to be realistic and met the project's break-even point (which is generally the point at which all revenues are equal to all expenses). In addition to the financial underwriting, the Recipient/Underwriter should evaluate the experience and capacity of the assisted business owners to manage an assisted business to achieve the projections.
☐	Owner's equity return is reasonable	The amount, type, and terms of the CDBG assistance should be adjusted to allow the owner a reasonable return on his/her investment given industry rates of return for that investment, local conditions, and the risk of the project.
☐	CDBG funds are disbursed on a pro rate basis	Recipients/Underwriters should not place CDBG funds at significantly greater risk than non-CDBG funds by distributing the funds first. This will help avoid the situation where it is learned that a problem has developed that will prevent the completion of the project, even though all or most of the CDBG funds going into the project have already been expended. When the Recipient determines that it is not practicable to disburse CDBG funds on a pro rata basis, the Recipient should consider taking other steps to safeguard CDBG funds in the event of a default, such as insisting on securitizing assets of the project.

EXHIBIT III

ACRONYMS AND TERMS

Acronyms

Section 108: HUD's Section 108 Loan Guarantee Program

CDBG: Community Development Block Grant

HUD: Housing and Urban Development

UCC: Uniform Commercial Code

ICA: Inter-creditor Agreement

Terms

Business loans: loans originated when the Recipient chooses to use the Section 108 guaranteed loan funds to make a loan to another entity (i.e., a business). A typical example is a loan made by a Recipient to a for-profit business pursuant to 24 CFR 570.203(b), where the loan funds will be used to carry out an economic development project.

Balance Sheet: presents a company's financial position at a specified date. It shows the Underwriter what a company ***owns*** as well as what it ***owes*** to other parties.

Contingent liability: a potential liability that may occur, depending on the outcome of an uncertain future event.

Debt obligations: promissory notes issued by states and local governments, or public agencies (such as redevelopment agencies and housing authorities) designated by a state or local government to be the issuer.

Income statement: also referred to as the profit and loss statement (P & L) statement of income, or the statement of operations. The income statement reports the revenues, gains, expenses, losses, net income and other totals for the period of time shown in the heading of the statement.

Key Principals: an individual(s) or entity owning or controlling twenty-five percent (25%) or greater interest in the project.

Recipient: states and local governments, or public agencies (such as redevelopment agencies and housing authorities) designated by a state or local government to be the issuer of a note guaranteed by HUD.

Standstill Provisions: circumstances under which a senior lien holder can limit or block payments that would otherwise be due to the Recipient.

Underwriter: The person or entity that acts on behalf of the Recipient and is responsible for determining the financial feasibility of, and assessing the risk associated with, making a business loan.