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GETTING THE CREDIT YOU DESERVE

Dairy Girl Conference
November 2, 2016

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Role of Financial Institutions

- Fulfill Dreams!

- Products/Services (Money/Information)
 - Facilitate Payments
 - Wealth Management
 - Build (Investments)
 - Protect (Insurance)
 - Credit

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Role of Financial Institutions

- Act as Risk Intermediaries
 - Every financial product involves RISK!
 - Have Processes/Procedures to manage risk according to institutions risk appetite
- Key Credit Concepts
 - No one ever makes a loan decision; they make a *portfolio decision*.
 - Yesterday's loan repaid with today's cash; today's loan repaid with *tomorrow's cash*.
 - You aren't paid to make loan decisions; you're paid to *manage credit risk*.

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Risk Assessment

- *Commercial Credit* → Financing of borrower's *cash shortfall*
 - Where did they run out of own cash? [Cause]
 - Can they replenish cash shortfall? [Repayment]
- *Commercial Loan* → *Self-liquidation* of asset being financed
- Financial Institutions are unique →

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Focus of Credit Risk

GET THE CASH BACK!!

***“You Aren’t Paid to Make Loan
Decisions; You’re Paid to
Manage Credit Risk!”***

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Cash Pays the Bills!

- *Cash is the key ingredient to business success*
 - Used to acquire the “*Resources*” needed to do the business of the business
 - Needed to repay “*Financing*” of business resources
 - Debt → Creditors
 - Equity → Owners
- *Assessment of Risk Needs to Focus on Cash Outcomes*
 - *Sources*
 - *Uses*

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Cash Outcomes

- **Cash *Uses*** (*Cause of Cash Shortfall*)
 - *Increase Assets* → *Growth*
 - *Decrease Liabilities* → *Debt Repayment*
 - *Decrease Equity* → *Lifestyle*

- **Cash *Sources*** (*Source of Repayment*)
 - *Debt* → *Creditors*
 - *Equity* → *Ongoing Profits/Capital Injection*

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Cash Sources/Uses

	INCREASE	DECREASE
ASSETS	U (Inv)	S (AR)
LIABILITIES	S (LOC)	U (AP)
EQUITY	S (Ret Earn)	U (Div)

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Credit Risk Management

- ***Credit Risk = P x C***
 - ***Probabilities*** → Events That Will Impact Repayment →
Identify Risks → ***Perform Analysis***
 - ***Consequences*** → Events Don't Occur as Intended →
Mitigate Risks → ***Structure***
- ***Risk Generators***
 - ***Marketplace Factors Impacting Borrower's Business***
 - ***Borrower's Response to the Marketplace Factors***

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Risk Assessment Focus

Marketplace Factors Impacting Business

PLUS

Borrower's Response to Marketplace

EQUALS

Financial Statements

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Risk Assessment

- **Financial Analysis → Quantitative Analysis**
 - Involves “Numbers” (Obtain Multi-year Data → 3-5 years)
 - Generates “Questions” (Perform Trending)
 - Used to Identify Change (Start Point for Credit Analysis)
 - **Key Tool to Perform Credit Analysis**
- **Credit Analysis → Qualitative Analysis**
 - Involves “Events” (Issues Creating “Numbers”)
 - Generates “Explanation” of Reason/Impact of Change (“Risks”)
 - Used to Understand Issues Impacting Repayment (Borrower’s Response to Marketplace Factors Impacting Business)
 - **Key Tool to ANTICIPATING THE FUTURE**

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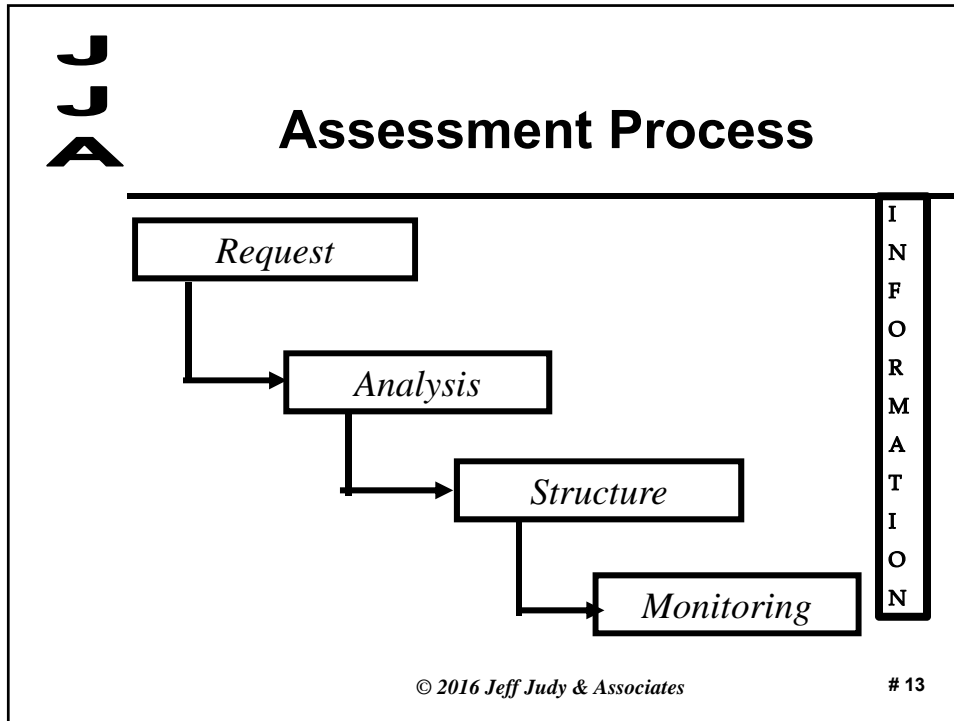
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Risk Assessment

- **Financial Statements**
 - Used to generate questions → What Changed?
 - Involves Numbers
 - Financial Analysis
- **Risk Factors**
 - Used to explain Numbers
 - Involves Marketplace/Borrower Response
 - Credit Analysis

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- ## Information
- *Preliminary Analysis—Qualify for Risk Assessment*
 - *Site Visit—Observation of Risk Potential*
 - *Decision-making—Risk Assessment of Request*
 - Understand “Risks”
 - Understand “Cash Outcomes”
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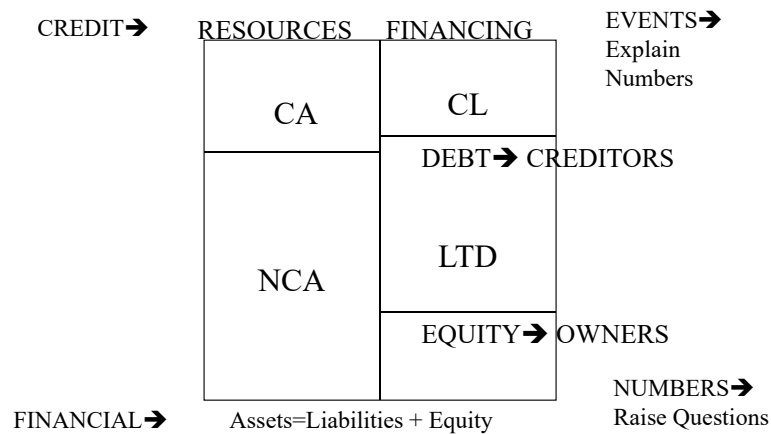
Financial Assessment Information

- *Gather Necessary Information* to understand and identify “**Risk**” and “**Cash Outcomes**”
- Core Financial Information
 - **BUSINESS PLAN**
 - *Financial Statements*
 - *Balance Sheet/Personal Financial Statement*
 - *Income Statement/Tax Return*
 - *Aging*
 - *AR (Concentrations/Collectability)*
 - *AP (Concentrations/Payment Behavior)*
 - *Schedules*
 - *Inventory*
 - *Fixed Asset (versus Depreciation)*
 - *Operating Expense (Cost of Doing Business)*
 - *Debt Service (Payment Risk/Cash Flow)*

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Balance Sheet Analysis



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Income Statement Analysis

Financial → Numbers	Credit → Events
Sales	CUSTOMERS
COGS	SUPPLIERS
Operating Expense/SGA	“EMPLOYEES”
Interest Expense	FINANCE COST—CREDITORS
Taxes	GOVERNMENT
Net Income/Loss	MINE → OWNER
Dividends	FINANCE COST—OWNERS

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Financial Analysis Process

- *Comparisons* *APPLICATION*
[Common Size Financial Statements]
- *Ratios* *ANALYSIS*
[Inter-relationship of 2 numbers]
- *Cash Flow* *ASSESSMENT*
[Ability to Fund Ongoing Operations]

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Credit Analysis Process

- *Marketplace Factors*
- *Industry Risk*
- *Management Strategy Risk*
- *Business Risk*
- *Management Risk*

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Cash and the Business

- *Focus of Banker is the Understanding of Cash Activities of Business*
- *Key Assessment Tools*
 - *Cash Drivers*
 - *Cash-to-Cash Cycle*
 - *Cash Cycle*
 - *Cash Flow Analysis*

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Cash Drivers

- Account for 80%-90% of cash being consumed/generated
- Reflection of management response to Marketplace Factors
- Indicates Borrower Behaviors (CASH)

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Cash Drivers

<i>Cash Driver</i>	<i>Financial Outcome</i>	<i>Credit Outcome</i>
(IS) Sales [<i>Ultimate Driver</i>]	Impacts Other 6 Drivers	Insight into Borrowing Cause
(BS) Inventory DOH	Short Term Cash Skills	Direct Influence
(BS) AR DOH	Short Term Cash Skills	Direct Influence
(BS) AP DOH	Short Term Cash Skills	Direct Influence
(IS) Gross Margin		
(IS) Op Exp as % of Sales		
(BS) Capital Expenditures		

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Cash-to-Cash Cycle

 - *Understand the Business of the Business → Determine EXPECTATIONS for Normal Behavior*

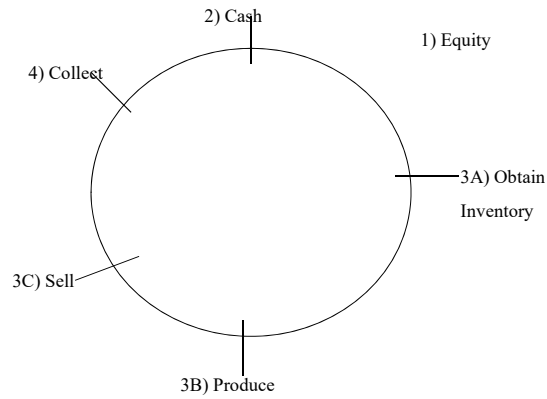
 - *Determine Borrowing Cause → Creation of Cash Shortfall*

 - *Appropriate Credit Structure → Alignment of Repayment with the Cause*

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Cash-to-Cash Cycle



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Know the Business

- Manufacturing
- Wholesale/Distribution
- Retailing
- Service (People/Fixed Asset)

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Cash Outcome—Focus

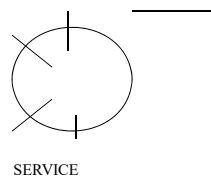
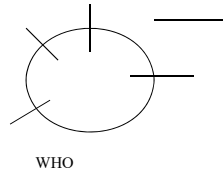
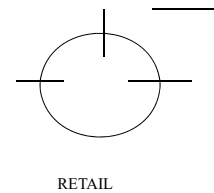
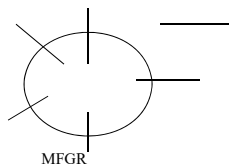
- Referred to as Working or Earning Assets
 - Inventory
 - Fixed Assets
 - Accounts Receivable
- Used to match Expectations with Actual financial performance
 - Appropriate Cash Generation
 - Appropriate Cash Consumption

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Know the Business



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Borrowing Cause

- Finance *“Inadequate Equity”*
 - NO:
 - YES:
- Finance *Inventory*
- Finance *Fixed Assets*
- Finance *Expenses Associated with the Cycle*
- Finance *Accounts Receivable*
- Finance *Changes in Owner’s Equity*

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Cash Cycle

- Determine appropriateness of line of credit request
- Assess maximum for line of credit
- Assess borrower’s ability to finance their share of business activity

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Cash Cycle

Accounts Receivable DOH
PLUS
Inventory DOH
MINUS
Accounts Payable DOH

100% minus Advance Rate=Borrowers Share

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Cash Flow Assessment

- *Must Understand Generation/Timing of Cash Flows [Cause/Repayment Source]*
- *Focus on CASH*
 - *Timing of Financing Need (Short/Long)*
 - *Frequency of Financing Need (Single/Rekurs)*
- *Apply Appropriate Assessment Tool*

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CASH FLOW—APPROACHES

- Specialty
 - Ag
 - Personal
 - Global

- Business Specific
 - Traditional
 - EBIT (DAD)
 - FASB95
 - UCA

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Cash Flow Types

<i>TYPE</i>	<i>INFO NEEDED</i>	<i>MECHANICS</i>	<i>TYPICAL USE</i>
Ag	<ul style="list-style-type: none"> • 1040-F • Balance Sheet • Accrual Adj 	1040-F + BS + Accrual Adj = ACCRUAL F/S	Ag Production <ul style="list-style-type: none"> • Cost to Market • Earned Equity
Personal	Personal F/S 1040	Calculate “CASH AVAILABLE”	Sole Proprietor Guarantor
Global	Personal CF Business CF(s)	Consolidate Shared Cash	Guarantor Multi-Entities

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Cash Flow Types

<i>TYPE</i>	<i>INFO NEEDED</i>	<i>MECHANICS</i>	<i>TYPICAL USE</i>
Traditional (Oldest/Easiest)	Income Statement	Net Income/Loss + Non-Cash Charges (DAD)	Long Term Asset Financing
EBIT (DAD)	Income Statement	Earnings Before Interest and Tax	Measure Cash Outcome of Ops
FASB95 (Management)	Balance Sheet Income Stmt	Calculate How Much Cash is in the Income Stmt	Rapid Growth
UCA (Banker)	Balance Sheet Income Stmt	Recast Accrual I/S back to Cash	Explain Borrower Behavior

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Cash—Use In Assessment

- *Cash and the Business (Cash-to-Cash Cycle)*
- *Cash Need Analysis (Cash Cycle)*
- *Cash Behavior Outcome (Cash Drivers)*
- *Cash Outcome Assessment (Cash Flow Analysis)*

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Credit Risk Focus

- ***Future Marketplace Situation***
 - *Borrower's ability to identify potential changes and plan for responding*
 - *Borrower's ability to manage through future events*
- ***Borrower's Future Response***
 - *Ability to understand and manage to future marketplace conditions*
 - *Ability to willingness/ability to adapt to change*

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Future Cash Assessment

- ***Proforma (Borrower View)***
 - Reasonable
 - Appropriate
- ***Projections (Banker View)***
 - *Apply Bankers Assessment of Marketplace/Response*
 - ***Answer Question— "What If?"***

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Getting It Back.....

***“YESTERDAY’S LOAN
REPAID WITH TODAY’S
CASH; TODAY’S LOAN
WILL BE REPAID WITH
TOMORROW’S
CASH.....”***

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Risk Assessment Focus

FUTURE Marketplace Factors Impacting Business

PLUS

FUTURE Borrower’s Response to Marketplace

EQUALS

FUTURE Financial Statements

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Mitigate Risks

- Covenants
 - Set Expectations for Borrower Behavior
 - Bring Borrower Back to Negotiating Table
- Collateral
 - Asset Being Financed is Secured
 - Alternative Sources of Repayment
- Pricing

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Credit Decision

- Requires completion of document explaining bankers decision process
- Requires internal approval (Affirmation of Decision)
- Generates institutions credit management process

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Key to Success

- Communicate
 - Significant Changes
 - Be Open/Honest
- Provide Timely/Appropriate Information
- Ask Questions

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Resources—Personal

- www.annualcreditreport.com
- www.creditkarma.com
- www.myFICO.com
- www.phroogal.com
- www.truecredit.com (“Credit Educ Ctr”)
- www.ftc.gov (Consumer Rights/Disputes)

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Resources—Business

- www.inc.com
- www.crfonline.org
- www.creditworthy.com
- www.loanuniverse.com
- www.itssimple.biz
- www.allbusiness.com

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45



THANK YOU!!!!

www.jeffjudy.com: Home of “Jeff’s Thoughts”—A bi-weekly newsletter regarding credit risk management issues

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46