



Credit vs. Investment Decision

Don't mistake a lender's decision as an endorsement or criticism of an investment decision.

by Mark D. Working

Business owners and managers are often confused or disappointed with the underwriting decisions made by their lenders. From the manager's perspective, a loan request would not have been made if it had not already been determined that the investment was a good idea. However, management must resist the interpretation that approval of their loan request means that the bank, often a large "sophisticated" financial institution, has agreed with their analysis of the business opportunity. Alternatively, if the bank turns down the loan request, management should not conclude that the investment opportunity should not be pursued. Both lines of thinking are flawed.

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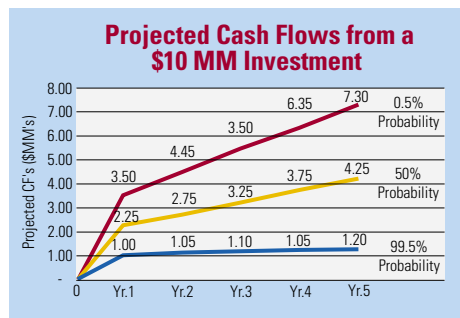
The investment decision must consider the full spectrum of risk and return, from losing everything to generating a handsome return. Alternatively, the credit decision is a subset of the investment analysis that considers only a limited range of risk and return possibilities.

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Credit and investment decisions are independent thought processes that are only tangentially connected. The investment decision must consider the full spectrum of risk and return, from losing everything to generating a handsome return. Alternatively, the credit decision is a subset of the investment analysis that considers only a limited range of risk and return possibilities.

THE INVESTMENT DECISION

Every asset has a value based on the sum of all future cash flows to be generated, discounted to the present by a rate that reflects the risk to the cash flows. The difficulty in analyzing business opportunities is that the future is not known. That is, there is no single



or certain outcome. The extent to which the possible outcomes vary is a measure of the risk of the opportunity. The above graph illustrates the possible cash flows for a hypothetical investment opportunity that would require an initial investment of \$10 million.

The investment analysis requires that the "expected", meaning the weighted average of all potential outcomes, cash flow stream be discounted to the present by a rate that reflects its risk. If the present value of the cash flows is greater than the initial investment, the opportunity will be expected to create value. In this example, the total cash flow expected from the \$10 million investment, discounted at 15%, yields a present value of \$10.43 million or a net present value of \$430,000. Given these expectations, the investment should be pursued as a value-creating opportunity.

CREDIT DECISION

A lender considers the same investment opportunity quite differently. The range of possible cash flows available to the lender is considerably different than to the investor.

Example Loan Economics	
Interest Rate (floating)	4.5%
Cost of Funds	2.0
Loan Spread	2.5
Operating Expenses	0.5
Loan Loss Reserve	0.5
Operating Profit	1.5%

The lender's upside is capped by the potential interest to be earned and the downside is a total loss of the monies lent. Since there is a ceiling on the upside return, only part of the risk can be borne.

Commercial banks for example typically earn only a 1.5% "profit" on a loan. As a result, banks can't afford to lose much and remain in business. For example, to make up for a loss of \$1.5 million in principal, the lender must make an additional \$100 million of no-risk loans to break even. It's a small wonder that, as banks experience losses, their focus on loan quality is sharpened.

Because of the low return, lenders must conclude that there is a very low probability of incurring a loss of principal. Accordingly, the cash flow stream must have a near certain probability of occurring and must be timed to amortize the loan.

The following table demonstrates the lender's analysis of our example investment.

Lender's Underwriting Analysis						
(\$ 000's)	Beginning	Yr.1	Yr.2	Yr.3	Yr.4	Yr.5
Loan Payment		1,000	1,000	1,000	1,000	1,000
Interest (7%)		287	237	184	127	65
Principal Outstanding	4,100	3,387	2,624	1,808	934	-

Because the range of possible returns is similar to the investor on the downside, but much less on the upside, the lender can only justify making a loan equal to 41% of the \$10 million required for the investment. We come to this conclusion by "sizing" the loan to the highest probability cash flow stream. In our example, approximately \$1 million is available for debt service. As shown in the above table, annual payments of \$1 million can retire \$4.1 million during the five-year period. In this example, that equates to a loan amount of nearly twice the expected \$2.25 million operating cash flow in the first year.

Of course, investors may induce the bank to increase the amount of the loan by offering

collateral that has a value independent from the performance of the investment. In that manner, the downside protection is improved, such that a shortfall in the investment's cash flow stream does not mean that the lender will lose the entire loan principal. Long-lived assets are particularly helpful for

extending the amortization and maturity of the loan. In this example, to the extent that the value of the collateral exceeds the amount supported by the cash flow (\$4.1 million), a larger loan can be justified.

The analysis and examples provided herein are for the purpose of explaining the prima-

ry differences in the investment and lending decisions. Obviously, many other details could bear on the result. Nevertheless, by better understanding the context of lenders' underwriting decisions, borrowers won't mistake the lender's conclusion as either confirmation or criticism of their investment decision. ♦



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