SERVING ASSET-BASED LENDING DECISION MAKERS

Just the Tip of the Iceberg

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The recent news announcing the relationship between the largest bank in the United States and a new age Fintech is just the tip of a looming iceberg that will eventually displace much of what is considered the "tried and true lending standards" that have developed slowly over at least the preceding six decades. I originally planned on using the metaphor "a tsunami washing over the shores of commercial finance," but a tsunami can be seen coming, and I'm not sure many of my contemporaries felt this day would come, or if it was going to come, definitely not this soon. However, all you have to do is look at the building blocks of today's commercial lending practices and you'll clearly see that what lies beneath the surface of the Fintech revolution is bigger, and more importantly, better than how things were done in the past.

The 5 C's of Commercial Lending

Like most things in life, there is no "one thing" that magically determines a successful outcome for a lending transaction. Rather, it is the overall combination of certain attributes that help a lender ascertain whether or not a borrower can be relied upon to fully repay its loan, with interest. These attributes are coined "The Five C's"; Capital, Collateral, Credit, Character and Capacity.

Capital, or as I like to call it, "skin in the game," is defined as the amount of personal capital at risk of the borrower/owners/decision makers. The more the borrower has to lose vis-à-vis the lender, the more one can count on the borrower to do all that is humanly possible to ensure a successful outcome. The most common measurement of this is the debt-to-equity ratio. Companies that have debt levels less than three times their equity capital are considered good risks, those with three to four times their invested capital are rated as fair risks and those in excess of four are considered high risk. The further above four the business gets, the riskier it is perceived.

Collateral is the unencumbered assets of a borrower that can be pledged to a lender as a secondary source of repayment if the business cannot repay from cash flow. The market value of the collateral has to exceed the amount of the loan by an amount sufficient to cover the costs of foreclosure, possession and sale of the assets. Lenders usually specialize in certain forms of collateral so that they can become experts at estimating the "excess value" needed to recover a loan "gone bad."

Credit refers to the borrower's history of repaying creditors, including lenders, vendors and taxing authorities. The longer the history of the borrower, the more reliable the payment pattern is to the decision maker. Low risk loans typically imply clear credit histories. Medium risk loans can have minor defects, usually in the form of some periodic slow/late payments. Higher risk loans will have more serious signs of cash flow problems, such as law suits from suppliers or tax liens.

Character is considered by many to be the least quantifiable, but personally, I think its capacity. Regardless, character refers to the integrity of the owners and decision makers of the borrower. Lenders want to know that the people involved feel a moral obligation to repay the loan and will not take undue risk. Many lenders require personal guarantees to backstop the business loan. This absolutely helps to reinforce the personal obligation of those involved at the borrower to repay the loan. Most lenders use the FICO scores of the people involved as an indication of their past financial dealings.

Lastly, capacity is an attempt to measure the ability of the borrower to execute on its business plan. This considers the company's position within the competitive marketplace, its physical ability to fulfill sales orders and management's experience. This is, in my opinion, the hardest of the C's to quantify. This also explains why private equity-backed firms tend to succeed at a rate higher than average. Most PE firms can augment (or replace) management if the business falls short of plan. Further, they can inject additional capital or make an acquisition to expand production. They are also adept at repositioning the enterprise within the market, which requires different management expertise, additional capital or both. Many lenders specifically target PE-backed borrowers to eliminate the question of capacity altogether.

Measurement and Monitoring

While commercial lending can be as much an art as it is a science, the better the science, the less art required. In addition, some of the necessary art can be quantified when the science is developed by the artists. The availability of data today was unimaginable even as recently as a decade ago. So there are new variables that the data scientists have uncovered that have taken the art to a whole different level. To illustrate why the Fintech approach is a major improvement over the old methods, and will no doubt replace what exists today, let's examine the two critical elements for measuring and monitoring the five C's.

Sound commercial finance underwriting and portfolio management relies on timely and accurate information. The increasing use of financial software by borrowers has improved these areas greatly. The software used by the lenders themselves has also improved. But heretofore, the two were separate. Lenders wait for borrowers to prepare and submit information. Then the lenders enter the data into their systems to process it before an experienced person can analyze it. On the other hand, Fintech is all about extracting data, real time, and having it processed and analyzed automatically. I don't have to convince you that this is a tremendous enhancement to existing methods. And as to accuracy, pulling data directly from the source minimizes borrower compilation errors (and manipulation) while automatic processing removes lender errors and omissions. To be sure, computers and programs have their glitches, but problems are far less frequent than human error. Now we'll look at how more timely and accurate information effect the five C's.

Like all of these elements, capital is fluid. It rises and falls with profits, losses, capital injections and stock dividends. Its measurement is easy as it is the borrower's total equity plus any subordinated debt. Its accuracy should also be easy as there are only a few accounts that make up this figure, absent of course, fraud. Presently, monitoring (usually of debt-to-equity ratios) is only done on a monthly basis as the financial statement is submitted. Capital movements within a period should be picked up during field exams when they are performed, but even then it would be long after they occurred. On the other hand, Fintechs will strive for direct access to the financial accounting software which would allow for the uploading of the daily transactions and covenant testing automatically. Therefore, a covenant violation would get picked up the day it occurred, not many weeks or months later.

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Collateral comes in two primary forms, fixed collateral (like real estate, equipment and intellectual property) and working capital collateral (A/R and inventory). The working capital collateral changes every day. Today, it takes considerable time to review the changes in the working capital assets from one period to the next. Here again, Fintechs will be accessing the borrower's systems directly to balance the assets to the penny in real time. This data can be tested to examine profit margins, obsolescence, dilution, etc. and so forth, right down to each customer and SKU on a daily basis. The shipping data can also help validate weights and timing. All this happens without taking up a single minute of a person's time. As for the fixed assets, the biggest issue with these is the change in values over time. Data scientists will monitor the most popular sites where fixed asset sales occur to get up-to-the-minute values right down to the model number and year made. So they will be able to understand their LTV as it evolves rather than waiting for the next appraisal, which is usually at least a year away.

The borrower's credit is reflected in its ability to meet its obligations in a timely manner. Today, this is a backward looking science as a delinquency usually doesn't get noticed until long after it occurs. With daily data feeds, Fintechs can see delinquency the day it occurs. Even better, there is a direct link between production and cost-of-goods sold. So with proper financial modeling, they can even pick up fraud should the borrower try hiding obligations by not entering them into the system. Add to that daily feeds of the borrower's bank activity, and held checks can be discovered. So rather than waiting for a credit reporting bureau or a lien to discover deterioration, the Fintechs will know before anyone else.

As pointed out earlier, "true" character can be tough to quantify. But personal credit reports, combined with personal financial statements and tax returns, can be a pretty good proxy. The problem here is, most lenders obtain these during the underwriting process and then annually thereafter … and a lot can happen in the interim. Fintechs can not only view them at a point in time, but they can compare the three to validate income figures and debt service, something that is a painstaking practice today (for the very few lenders that even try to do this). Then they can, like the credit card companies, monitor the guarantor's changes in their personal credit on a daily basis. Throw in real-time payroll and capital account data, and the Fintechs can detect when a guarantor is leaning on the business to support personal issues almost the second it starts to occur.

Finally, there's capacity. While tough to quantify, it can be easy to monitor if you have the data. Currently, lenders can validate management's ability to perform budgeting and then execute according to plan only as monthly budget-to-actual financials are prepared (and this is for the few lenders that require projections ongoing and the even fewer that take the time to review them monthly). Fintechs can not only do this automatically, but they can uncover root causes as they happen, such as dropping margins, lower sales of key products, increases in expenses by ledger account number, etc. And all of this discover can happen without involving a single person's time.

Conclusion

I haven't even scratched the surface of what the Fintech's can do and are doing with data. I've only focused on the five C's. However, they are also extracting data to compare how their borrowers are performing relative to key industry standards and competitors. They are monitoring business licenses to see if the borrower's competition is growing in their geographic area, suggesting future problems. They can monitor trucking licenses and insurance to know the day an issue arises. And by getting daily uploads of both general ledger data and banking data, the ability to detect fraud goes way up. And all this without paying for a portfolio manager, account executive or field examiner. If you aren't already planning on joining the Fintech revolution, no worries. This iceberg will displace you soon enough anyway.