insightpartners
advance your mission

(717) 576-5984
www.advanceyourmission.net

ADVISORY NOTES

June 2010

Effective Debt Financing Strategies

INTRODUCTION

Many nonprofit organizations planning a facilities project will need to secure long-term debt financing to fund some of the project's cost. This paper discusses crucial elements an effective debt financing strategy that, if followed, will ensure that an organization secures an optimal financing package.

THREE PHASES OF A SUCCESSFUL STRATEGY

An organization must effectively manage the following phases of the debt financing process:

1. **Foundational Phase**: Effective management of this phase will ensure that well-defined controls, processes, ***and people*** are in place to properly guide the debt acquisition process. ***The Foundational Phase is never-ending and should be periodically reviewed and revised as necessary, regardless of whether or not the organization is currently contemplating debt financing.***

2. **Analysis Phase:** This occurs once an organization has identified one or more projects for serious consideration and wishes to assess the economic viability of its dreams. In order to be successful, all key elements of the envisioned project must be identified and objectively analyzed.

3. **Application Phase:** In this phase**,** the organization formally seeks debt financing. If the prior two phases have been properly managed, the process should go relatively smoothly.

THE FOUNDATIONAL PHASE: A FUNDAMENTAL PREQUISITE

Because capital projects are major initiatives that must be thoroughly studied and analyzed, seeking debt financing will naturally require much time and effort. However before an organization embarks upon serious consideration of any project (and related debt), it should make sure that it has the following foundational components in place:

1. A strong management team and well-rounded board
2. Positive relations with area financial institutions
3. A board-approved long-term debt policy

Everything starts with effective leadership

Long before any loan is approved, a financial institution will most likely assess the character and competency of those persons who are the public face of the organization. It is important that the organization have both a strong management team and a diverse and highly engaged board. Persons from senior management should exhibit strong technical competencies and be able to clearly articulate how their roles and skills support and enhance the organization's mission. The board should demonstrate a diverse set of professional competencies and community perspectives. Ideally, it should be comprised of a mix of well-respected persons with legal, accounting, marketing, general business, and community relations skills.

Cultivate and maintain positive bank relations

The time to make sure that your organization has a sound relationship with community (and possibly regional) banks is not when it is time to borrow money, but long before those needs arise. Therefore an organization's key leaders must continuously cultivate and maintain positive bank relations by staying connected to and engaged with area bank officers.

A well-prepared long-term debt policy should guide and govern the process

Having a sound debt policy in place before a project is considered is a crucial element of the foundational phase. Dynamic leaders, by definition, should frequently dream about new programs and initiatives. Therefore, the existence of a effective long-term debt policy—one that has been crafted in a manner that is detached from the planning process—should act as a governor against the momentum of big and exciting dreams that may be just a bit too big and a bit too risky.

An effective debt policy should define:

- **The types of allowable debt**. For example, the policy should explicitly state that long-term debt is permitted only for the financing of capital projects of a defined scope and size. That is, it should not be used to fund a short-term cash squeeze or the financing of minor equipment and furnishings.

- **The required analysis and approvals for proceeding with a loan application.** The policy should specifically identify and define those financial analyses the organization must prepare in advance of formal consideration of a capital project. It should also identify board committees

that must review the project before the project is voted on by the full board.

- **Targeted key financial indicators and ratios that must be achieved and maintained.** A crucial analysis will be a financial forecast that most likely extends five or more years out. An effective long-term debt policy should: a) specifically define targeted financial indicators that cannot be breached during the forecast period using expected ***and stress test-based*** modeling assumptions (the term "stress test" is defined below); and b) state that all modeling assumptions must be reasonable. For example, if a board requires that an organization maintain operating reserves equal to one year's projected cash outflows, then an effective debt policy should require that in forecasted outcomes, these minimal reserves must be maintained *even in projection scenarios where future economic condition are presumed to deteriorate by a reasonable magnitude*.

  Using financial indicators and ratio constraints will not only enforce discipline on the front end of the debt financing process, but well-prepared analyses should aid the loan application process, as discussed later.

- **Process for reviewing and approving proposed loans.** Once a financial institution approves the organization for debt financing, it may offer multiple loan packages with varying degrees of fixed- and variable-rate components. There may even be a bridge financing component to cover pledges receivable. Obviously management should carefully review all loan proposals, but ultimate approval should occur at the board level. Therefore, the policy should mandate that any proposed loan package be approved by at least the finance committee of the board, if not the full board.

Additionally, the policy should provide authority for the organization to engage persons with specialized skills in financial analysis and/or knowledge of the debt financing process. This is a good proactive measure, as an organization may believe at the outset of the analysis phase that it possess adequate internal skills, but as the process unfolds, it may determine that it would be prudent to tap external skills and expertise.

ANALYSIS PHASE: IS THE PROJECT VIABLE?

Financial projections should encompass multiple modeling scenarios, ranging from a best-case scenario to a worst-case (or stress test) scenario that envisions a credible level of adverse economic conditions. **<u>Don't purposely use only the most favorable scenarios</u>; a loan officer (and I believe an alert board member doing his/her job) will see through it.**

Effective financial analysis should serve as a healthy reality check on an organization's dreams, and if performed properly, will enhance the credibility of the organization's loan application. Such due diligence should ultimately enable a loan officer to review the application with relatively little difficulty.

A banker's insight

Following is a valuable perspective from Jim Tatnall, Senior Vice President for Corporate Banking at Fulton Bank in Harrisburg, Pennsylvania, who does lending to nonprofit organizations. Much of what he says correlates with some of the key points made above.

According to Mr. Tatnall, "We look for well-thought and well-articulated forecasts. Everybody's forecast will show the desired results, so we look closely at the modeling assumptions. Furthermore, we like to see that the forecast is prepared by a highly skilled and knowledgeable financial officer or professional." And he goes on to state that while a professionally prepared forecast is crucial, it is just half the story: "The organization should have a competent CFO or board member that can speak to the financial aspect of the project and its underlying analyses. If you've engaged an advisor or consultant to prepare the analyses, bring that person to any meetings with us. And, an executive director that can speak effectively about the project and its financial aspects can be a huge plus."

If there is a request for bridge financing, a bank will want to focus closely on that element. According to Mr. Tatnall, "We'll want to see a listing of major pledges and the timeline for expected payments of those pledges.

APPLICATION PHASE: IDEALLY NO SURPRISES

As noted at the outset, if an organization effectively manages the first two phases, the loan application and review process should go relatively smoothly. According to Mr. Tatnall, one factor that can optimize outcomes is proactive engagement of the lending bank—which in many ways harkens back to the importance of the foundational phase—as reflected in this simple but crucial advice he offers to prospective borrowers: "Talk with us while you're still in the planning and fundraising process. We have advice to give and can offer valuable assistance if you simply contact us well in advance and allow us to work with you. Don't knock on our door 60 days before you're scheduled to break ground. Often that's just not enough time for us to be able to provide all that we are capable of providing"

OTHER RELEVANT FACTORS

Following are some other points to note.

- **Understand the board's philosophy about debt**. In theory, this philosophy should be reflected in the organization's long-term debt policy. However there can be a disconnect between the theoretical exercise of drafting a long-term debt policy and the very real possibility of adding a substantial debt to an organization's balance sheet. Therefore, organizations should have an in-depth discussion with its finance committee about envisioned projects' debt load long before embarking upon serious planning and analysis.

- **Audits will be required**. This should not be an issue if an organization already has an annual audit by an independent CPA firm, although a major project may result in a greater audit scope that translates to a larger audit fee. For those organizations that would need a first-ever audit, be sure to understand the range of fees that will become ongoing operating costs.

- **Loan terms are not the same as conventional household mortgages.** Typically, the maximum loan term is 20 years, with only the first five years committed to a fixed rate.

- **An appraisal will be required.** Most likely the bank from which an organization is seeking financing will require an appraisal, at cost of at least a few thousand dollars. Also, periodic appraisals may be needed in the future in order to satisfy insurance or independent auditor needs. The organization will need to be aware of any such requirements for budgeting purposes.

- **Banks are looking for a full relationship.** In today's environment most banks will be looking to lock the organization into a full commercial banking relationship, thus enabling them to stay close with the creditors and capture the added revenue that goes with these relationships.

CONCLUSION

Two crucial themes that are present throughout this document are ***proper planning and analysis***, and ***managing proactively***. If an organization properly plans and analyzes a proposed project, and if management takes appropriate proactive measures—both well in advance of any identified needs for debt financing and throughout the capital project planning process— it will most likely secure an optimal loan package.

ABOUT THE AUTHOR

John W. Packer, CPA, founder of Insight Partners, provides consulting services to small business and nonprofit organizations, with a focus on accounting, tax, internal controls, and operational matters. He can be contacted at: jwpackercpa@comcast.net