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Underwriting Criteria for Ulster County Loan Funds

1. Loan Origination and Credit Policies

The UCEDA will approve each loan Ulster County makes. The basic underlying proposition on which all lending theory rests is that there must be "two ways out" of every deal. That is, each loan must be repayable from two different sources - so that if one source or "way out" fails to materialize, a second source or "way out" is available to repay the loan. If *cash flow* fails to retire an obligation in an orderly fashion, the second escape route is called upon. Normally, the second way out is the collateral, which secures the loan.

A. Cash Flow Policies: The First Way Out

The cash flow or credit test, thus, is the primary indicator of the first way out, the primary indicator of whether or not a company is "bankable," that is, whether or not the company can repay its loan.

The UCEDA's preferred credit test is very straightforward. They want a borrower's existing cash flow from operations (after certain adjustments) to be adequate to repay the proposed debt service. The credit test can be stated as the following:

Cash Flow Test (Classified as "I" Loans)

ADJUSTED EXISTING CASH FLOW > PROPOSED DEBT SERVICE

The "Adjusted Existing Cash Flow" is determined by adding-in or subtracting-out certain items which are impacted by the proposed financing. It is determined as follows:

ADJUSTED EXISTING CASH FLOW

Last year's Earnings Before Taxes

\+ Depreciation (from Income Statement)

\+ Interest payments (from Income Statement)

\+ Savings in Rent, Officer Compensation (if applicable), or "Other"

\- Increased Occupancy Costs (occurring as a result of the project being financed)

\- Increased Real Estate Taxes (occurring as a result of the project being financed)

\- Other project related expenses (if any)

= Adjusted Existing Cash Flow

In order to determine the amount of "surplus" cash, or the Cash Flow Margin, from the Adjusted Existing Cash flow, all debt service obligations are subtracted.

Cash Flow Margin

Adjusted Existing Cash Flow

- Last Year's Interest and Principal Payments

- Proposed (Ulster County Funded) Project Debt Service (Principal and Interest)

= Cash Flow Margin/(Cash Flow Shortfall)

The Existing Cash Flow **Coverage Ratio** is defined as the adjusted existing cash flow divided by the proposed debt service (*principal and interest on both existing and (Ulster County funded) project debt*). If the adjusted existing cash flow is greater than the proposed [total] debt service, the coverage ratio will be greater than or equal to one, and the borrower and the proposed project will "pass" the cash flow test (and be Classified as a **Class I** deal;

Existing Cash Flow Coverage

$$\frac{\text{Adjusted Existing Cash Flow}}{\text{All Proposed Debt Service (p+i)}} \geq 1:1$$

If the adjusted existing cash flow exceeds the proposed debt service and all the evidence and trends suggest that cash flow will continue to exceed the proposed debt service, in all likelihood, the company is "bankable" and Ulster County should approve the deal. In a nutshell, the company will have demonstrated that its existing operations throw-off sufficient cash flow to repay the proposed borrowings. The company will not have to rely on any growth or outside sources to repay the proposed obligation. We will give this type borrower a "Class I" classification.

If an applicant fails to achieve a "Class I" classification, it does not mean that the borrower is un-creditworthy. Instead, it means that in order to repay the proposed obligation, the company' sales must grow, and profits must increase. Failure to grow will mean that the borrower might have difficulty repaying the loan with cash flow from operations in a timely fashion.

To assess the ability of the company to grow and increase profits, the Ulster County Loan Committee will look to the company's projections and to the company's principals. The projected cash flow, based upon a reasonable and achievable projected P&L, must be adequate to repay the proposed debt service. Notationally, the credit test for these type companies will be the following:

Credit Test (Classified as "II" Loans)

PROJECTED CASH FLOW > PROPOSED DEBT SERVICE

The projected cash flow will be adjusted in a manner similar to the adjustments in the existing cash flow as described above:

PROJECTED EXISTING CASH FLOW

Projected Earnings Before Taxes

+ Projected Depreciation (from projected Income Statement)

+ Projected Interest payments: on both existing and project loans (from projected Income Statement)

= Projected Cash Flow

The Projected Cash Flow must be greater than all of the proposed debt service (principal and interest on both existing and Ulster County loan project).

Cash Flow Margin

Projected Cash Flow

- Last Year's Interest and Principal Payments

- Proposed (Ulster County Funded) Project Debt Service (Principal and Interest)

= Cash Flow Margin/(Cash Flow Shortfall)

And the projected cash flow coverage ratio must be greater than or equal to one:

Projected Cash Flow Coverage

$$\frac{\text{Projected Cash Flow}}{\text{All Proposed Debt Service (p+i)}} \geq 1:1$$

These deals will be assigned a Class II classification.

In applications where, existing cash flow is not adequate to repay the proposed debt, in addition to closely assessing the reasonableness and achievability of the projected cash flow, the Ulster County Loan Committee will more closely scrutinize the capability of the company's principals. The principals must demonstrate adequate organizational skills to be able to generate and manage the necessary growth and to increase the profits to the level at which cash flow will be sufficient to repay the proposed debt. Obviously, in situations where existing cash flow is not adequate to repay the proposed debt, the evaluation of the credit will be more subjective and less objective.

A borrower who fails to achieve a Class I classification but satisfies the Ulster County Loan Committee that its projections are reasonable and its principals are solid, and its projected cash flow is reasonable and achievable will receive a Class II designation. Potentially, a company, which falls into a Class II, can be upgraded to a Class I by

restructuring the proposed financing (i.e. by reducing the project size, changing the maturity of the debt, increasing the equity portion, etc.) so that the existing cash flow becomes sufficient to repay the proposed debt service.

If a company fails to receive a Class I or a Class II designation, it will receive a Class III classification. By definition, in Class III companies, existing cash flow or cash flow based upon a reasonable projection will not be sufficient to repay the proposed debt in an orderly fashion. In other words, there is no "first way out." These are very tough deals to finance. We, however, should not automatically decline these deals. Instead, the Ulster County Loan Committee will look for a surrogate or "alternative" first way out. A proposed surrogate first way out must be a tangible and identifiable source of repayment with a high degree of reliability. Potential sources of repayment could be standby letters of credit from third parties, outside guarantees, outside income streams, or outside collateral. The collateral of the project and the company cannot serve as an alternate first way out, because it is already being relied upon as the second way out. UCEDA/Ulster County will permit 10% of its portfolio to be in loans to Class III companies.

As is abundantly clear from the above discussion, UCEDA will have a three-tier cash flow Classification system as follows:

CASH FLOW CLASSIFICATION SYSTEM

CLASSIFICATION	CREDIT TEST
I	Adjusted Existing Cash Flow > Proposed Debt Service Adjusted existing cash flow is sufficient to pay the proposed debt service in an orderly fashion. In all likelihood, this deal will be approved.
II	Projected Cash Flow > Proposed Debt Service Projected cash flow based upon reasonable projections, is sufficient to repay the proposed debt service. Management appears capable and sound. It is likely that the company will be able to grow sufficiently to meet its obligations. To approve this deal, a more subjective credit evaluation must occur.
III	Surrogate First Way Out The deal does not have a first way out and can be approved only by finding an alternative or surrogate first way out. No more than 10% of the Ulster County portfolio may be in loans to companies designated as Class III.

Note that in *all* instances, Cash Flow Classifications on existing companies will be made only based on the last available FULL YEAR Financial Statements (or tax returns) provided. Interim statements will not be used in this assessment, as they do not reflect the impact of a full year's cycle of operations.

B. Collateral Policies: The Second Way Out

Every loan must have two ways out. The first way out is cash flow. The second way out is collateral. Within reason, the stronger the first way out, the less concerned we need to be about the second way out. In all cases, however, collateral must be adequate to secure the obligation. While the UCEDA is primarily a cash flow lender, they normally will require the Ulster County Loan Fund to secure a loan with a general security agreement, a perfected lien on all assets, and the personal guarantees of all principals who own 20% or more of the stock or play a key role in management, few absolute statements can be made regarding collateral. UCEDA has no desire or need to be more stringent than the local Ulster County Committee and will work with the committee officers to comply with their policies.

Regardless of how strong or weak a company's cash flow appears, the Ulster County Loan Committee must assess the adequacy of the second way out, that is, the collateral being offered to secure the loan. Collateral value is not the same as the fair market value of the real or personal property offered as collateral because the time and cost of liquidating the collateral will cause the net proceeds to be less than the hypothetical fair market value of the collateral. For example, real estate is the least liquid of all collateral and generates the greatest amount of expenses to hold. If UCEDA or the Ulster County were to foreclose on a piece of real estate, UCEDA or the Ulster County would be responsible for insuring the property, paying the utilities, property taxes and operating expenses during the holding period, and paying a broker or liquidator a commission for disposing of the property. Attorneys would also have to be paid. In all likelihood, the net proceeds from the sale of the property will be less than the appraised fair market value.

In the case of machinery and equipment (M&E), foreclosure on M&E normally involves an auction or liquidator who sells the collateral for a price far below fair market value in order to liquidate the collateral quickly and to allow for the cost of removal from one site and the installation at another site.

Finally, regarding receivables and inventory, the collateral value of these assets are far less than their cost or face amount because when a company is in trouble, inventory "disappears" and receivables are either used by the entrepreneur to fund losses or to pay other, more pressing creditors, such as a short-tempered IRS. For these reasons, determining collateral value is more involved than simply adding up the cost or appraised value of a group of assets.

UCEDA will look for at least a 1:1 collateral coverage of the loan amount based upon the criteria described below:

Collateral Value Coverage

$$\frac{\text{Collateral Value}}{\text{Loan Amount}} \geq 1:1$$

Needless to say, the Ulster County Loan Committee should not be inflexible in its interpretation of collateral value nor rigid in its insistence on a 1:1 coverage. In much the same process as with the evaluation of cash flow, UCEDA utilizes a three tier Classification system based on a "discounted" valuation of collateral.

The following are the guidelines, which the Ulster County Loan Committee should use in assessing collateral value:

COMMERCIAL REAL ESTATE: 80% of Value

If UCEDA receives a first lien on a piece of commercial property, the collateral value of the property will be 80% of the fair market value of the property as determined by objective, outside appraisal. If UCEDA takes a mortgage on a piece of property on which there is or are a preceding lien or liens, the collateral value of the property will be 80% of the fair market value of the property, less the amount of preceding lien provided the preceding lien encumbers less than 40% of the fair market value of the property.

If the preceding lien(s) encumbers more than 40% of the fair market value of the property, the collateral value of that piece of property will be assumed to be zero. The collateral value will be assumed to be zero in these situations because to realize the value of the subordinated mortgage, UCEDA would have to make a substantial payment to the first mortgage holder to satisfy that lien. UCEDA may not have the resources at the time of foreclosure to satisfy a substantial first mortgage lien, and thus is unable to count the unencumbered portion of the property's value when the preceding lien is significant (i.e. over 40%). In these situations, it may make sense to repay (refinance) the first mortgage with Ulster County loan proceeds in order to secure a first lien position.

RESIDENTIAL REAL ESTATE: 90% of Value

If UCEDA receives a first lien on a piece of residential property, the collateral value of that piece of property will be 90% of the fair market value of that piece of property as determined by an independent, outside appraisal. If UCEDA takes a mortgage on a piece of residential property on which there is a preceding lien, the collateral value of the property will be 90% of the fair market value of the property, less the amount of the preceding lien, provided the preceding lien encumbers less than 60% of the fair market value of the property. If the preceding lien encumbers more than 60% of the fair market value of the property, the collateral value of that piece of property will be assumed to be zero for the same reasons described above under commercial real estate.

MACHINERY AND EQUIPMENT: 50% of Value

If UCEDA receives a first lien on a piece of machinery and equipment (M&E), the collateral value of that piece of M&E will be 50% of the fair market value of the M&E. Fair market value can be determined either through independent appraisal or through an estimate from a reputable equipment dealer who opines as to the economic life of the asset, the cost new, and the value of the specific piece of equipment being offered as collateral. If the M&E has a preceding lien, the collateral value of the M&E is assumed to be zero. In situations where there is a preceding lien on a piece of M&E, it may make sense to satisfy (refinance) the preceding lien with Ulster County loan proceeds in order to obtain a first lien position.

INVENTORY AND RECEIVABLES: 20% of Value

From a collateral value perspective, term loans for working capital are completely different than asset-based lending. Asset based lenders normally accord receivables as collateral value equal to 80% of the face amount of the receivables (less than 90 days old) and inventory as collateral value equal to 50% of cost. Asset based lenders are able to

accord such high collateral values to inventory and receivables because they monitor receivables and inventory on a monthly basis, tracking receivables on an invoice by invoice basis and counting inventory, piece by piece. Term lenders on the other hand, secure inventory and receivables by perfecting a lien through a general security agreement. Should a borrower get into trouble, the entrepreneur retains full control of the inventory and receivables and uses them in the manner he/she sees fit until foreclosure proceedings are begun. Not surprisingly, inventory and receivables "disappear." In reality, inventory is simply sold, and receivables are collected and used to fund losses or satisfy more pressing creditors (e.g. the inventory supplier who is threatening to stop shipments, an insurance company who is threatening to cancel necessary coverage, the IRS who is threatening seizure, or employees who have to be paid at the end of the week). Thus, the collateral value of inventory and receivables to a term lender like UCEDA is highly suspect. In spite of this fact, UCEDA will accord to inventory and receivables, a collateral value equal to 20% of the face amount of unliened inventory and receivables.

The discounted value of all of the collateral being pledged to secure the loan will be added together, and then classified as follows:

Adequate Collateral Value Coverage (Class A)

$$\frac{\text{Collateral Value}}{\text{Loan Amount}} \geq 1.15:1$$

In the instance of a Class A deal, the Collateral Coverage ratio exceeds or equals 1.15:1.

Marginal Collateral Value Coverage (Class B)

$$.90:1 \leq \frac{\text{Collateral Value}}{\text{Loan Amount}} < 1.15:1$$

In the instance of a Class B deal, the Collateral Coverage ratio equals or exceeds .90:1, but is less than 1.15:1.

Thin Collateral Value Coverage (Class C)

$$\frac{\text{Collateral Value}}{\text{Loan Amount}} < .90:1$$

In the instance of a Class C deal, the Collateral Coverage ratio is less than 0.90:1, and there is no strong "second" way out.

C. Personal Guarantee Policies: The Third Way Out

All UCEDA/Ulster County loans require the personal guarantees of every owner of 20% or more of the company stock. In some instances, the guarantees of non-owner key management are also required. In general, the guarantees are "unlimited" (i.e. guaranteeing full repayment of the loan, irrespective of percentage of ownership or personal net worth).

The third component of the Classification System relates to the net worth of the principals who are pledging their personal guarantee to repay the Ulster County loan. Based on the information provided by the guarantors (on executed UCEDA Personal Financial Statement), UCEDA "discounts" the assessment of assets in order to reach an "Adjusted Net Worth" figure. Those discounts are as follows:

PERSONAL ASSET	DISCOUNTED %
Cash and Savings Accounts	0%
IRA or other Retirement Accounts	50%
Unqualified A/R and N/R	100%
Life Insurance CSV	0%
Real Estate	20-25%
Automobile and Other Personal Property	80%
Unqualified "Other Assets"	100%

From the discounted value of the personal assets, the face amount of *all* existing and contingent liabilities is subtracted in order to calculate an Adjusted Net Worth.

Adequate Adjusted Net Worth ("+" Class)

Adjusted Net Worth > Ulster County Loan Amount

In those instances where the combined Adjusted Net Worth of the guarantors is greater than the Ulster County loan amount, that loan will be accorded a "+" classification.

Insubstantial Adjusted Net Worth ("-" Class)

Adjusted Net Worth < Ulster County Loan Amount

In those instances where the combined Adjusted Net Worth of the guarantors is less than the Ulster County loan amount, that loan will be accorded a "-" classification.