FINANCIAL MODELING DOS & DON'TS

for debt transactions

[Contact Us](mailto:info@cerebrocapital.com)

info@cerebrocapital.com

www.cerebrocapital.com

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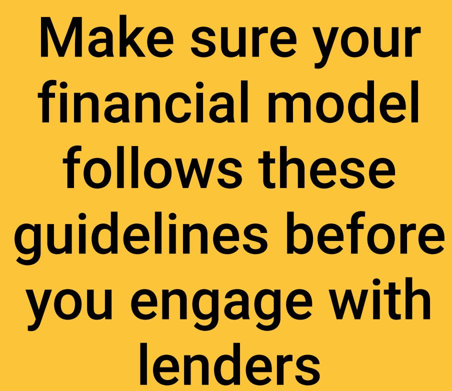
Make sure your financial model follows these guidelines before you engage with lenders

INTRODUCTION

Building a thoughtful financial model is one of the most important things you need to do before engaging with lenders for refinancing or sourcing new credit facilities. The work you put into your financial model will echo throughout the life of your deal because lenders use it to set loan structure and covenants. Additionally, your financial model helps give confidence to lenders that you understand your business and its future.

Spending time building a proper model now will ensure you find the right lending partner and receive the best terms for your needs. It will also save a lot of time when you are ready to negotiate terms for your credit facility. Below are a number of helpful guidelines of things you should and should not do in preparing your model for debt deals.

DOS & DON'TS

Model variances

Do include assumptions & explanations.

Include a tab of comments discussing the assumptions and large **variances** that are present in the model. Items affecting revenues, cash flows, profitability, liquid assets, and debt levels should be explicitly written out in a comment section or footnote area within the Excel model. This will prevent analysts, credit officers, and others who may not be familiar with the company's story from taking a negative first impression.

All other variances are things that should be able to be explained verbally.

Historical periods

Do include 3 to 5 years of statements.

Don’t include **monthly** increments, they are often overkill. Businesses with seasonality should break out quarters to show the seasonality. This will help lenders structure covenants that don’t accidentally get tripped during a normal business cycle. If the level of credit being sought is relatively small for the organization, then annual historicals should be sufficient.

Don’t leave out any **recent acquisitions** or dispositions. Lenders are going to want to understand the run rate operations of your business and they are going to want to tie your model back to your financial statements. In these cases it is best to prepare a model on an adjusted basis where you either remove acquisition related costs or the impact of dispositions on historical performance. In either case, any adjustments made should have a clear reconciliation so lenders can reverse engineer the calculations and match the historical periods to the financial statements after accounting for the adjustments.

Projection periods

Do project as far forward as the length of the loan.

Don’t include fewer forecast **periods** than the term. For example, if you’re seeking a five year term loan, your model should show least five years of forecasted periods.

Don’t vary the period **increments** from your historical reports. Ensure the the forecasted model mimics the same increments as the historical periods. However, if the business is not seasonal then lenders may be okay with annual forecasts so long as the credit facility is relatively small compared to the strength and size of the business.

Do show **growth** and a positive outlook in the long run. It is okay to show initial deterioration due to known factors, but the model should also show a recovery.

Do ensure the model shows that the **debt service** (principal and interest) can be covered by the cash flows generated by the business.

Bullish or bearish?

Don't be bearish. If the growth of a forecast in a model is discounted to err on the side of caution, then the discount will count against the business twice, because any lender reviewing models will be sure to dampen your expectations.

An overly bearish model could easily become too pessimistic and severely impact a lender's ability to provide compelling terms or even risk the lenders ability to move forward at all.

Don't be bullish. If the model is overly optimistic, then this could be equally hazardous to your business.

Lenders will often set covenants and structure based on the forecast. If the business fails to deliver on their forecast, then the lender will often have the ability to come in and restructure the debt, raise pricing, or even worse call the loan.

Do be accurate when forecasting your model.

Lender considerations

Do make sure your projected cash flows are able to service the projected new debt by at least **1.25x** to make lenders comfortable. Lenders do not want to see that their interest and principal is being paid out of the proceeds of their own debt.

Don't contact **lenders** if the model can't show improvement over time. No lender wants to lend into a sinking ship without hope of improvement. The company would be better off devising a more optimistic strategy that might include reasonable cost cutting initiatives, pricing increases, or new revenue streams.

Do ensure cash flows and balance sheet **strength** improves throughout the forecast to avoid lenders worrying about refinancing risk. Lenders do not want to be stuck in a company that can't attract other lenders to refinance them out.

Do include detailed projections.

The more detail the better, assuming the model can still remain fairly accurate.

At a minimum forecasted periods should show revenue breakouts, major expense line items, and a clear reconciliation of cash flows available to service debt.

This will help lenders make sense of the model and give them the information they need to underwrite your company's risk.

Ramifications of getting your model wrong:

If your model is wrong, lenders will fail to understand the proper **risk** associated with lending to your company. And since, lenders base pricing off of the perceived risk of the company, your rates could be unnecessarily higher and the terms could be more restrictive than you deserve.

If your model is overly optimistic, the lender will initially charge less for your facility, but there is a good chance you will fail to hit your targets and will default on your **covenants**. If this happens, the lender could charge you large fees, raise your rates or even call the loan entirely.

How do you keep track of your covenants?

Cerebro Capital offers the latest technology for managing loan compliance and tracking covenants. Typical credit agreements are up to 50 pages long and include a lot of fine print. Never miss another reporting deadline or forget about a trigger buried in your agreements. Let Cerebro digitize your agreement and create easy to track digital dashboards.

Learn more here.

CONCLUSION

Your financial model is your lender's litmus test to determine whether your company leadership has the sophistication to handle its debt financings. The details of the model serve as a road map for lenders to craft covenants and structure that fit your business model and expected performance.

Financial modeling for debt deals versus equity deals have different goals. Equity investors will want to see value creation in the business. In the case of debt transactions, the lender just needs to feel comfortable that the debt service and final repayment are comfortably within the company's reach.

Finding the best lending partner

If you are seeking to refinance or source corporate loans, contact us to learn more about our data-driven approach to finding the best lending partner. Our technology paired with our expert team, help get you the best rate and structure in the market.

Learn more here.