

DP03

Principles of Lending

6 OCTOBER 2004

1. Time allowed : Three (3) hours
2. Total number of questions : Four (4) questions
3. Number of questions to be answered : All four (4) questions
4. Show details of workings where appropriate. Silent, non-programmable calculators may be used.
5. Begin each answer to a new question on a fresh page.
6. Answer **all** questions in **English**.
7. Blank pages are provided at the end of the question paper for rough work.

ANSWER ALL FOUR (4) QUESTIONS

1. Outline and describe the processes of credit evaluation in commercial lending. Use a process diagram to support your answer. (Total:20 marks)

2. (a) In the course of financing working capital, it is a common practice for banks to protect their interests with a fixed and floating charge over the borrower's assets.
 - (i) Explain what a "floating charge" is. [5]
 - (ii) Under what circumstances will a floating charge crystallise into a fixed charge? [5](b) Explain **five** key factors that a bank must evaluate prior to an appointment of a receiver and manager under a debenture. [10]
(Total:20 marks)

3. You have several new trainees assigned to you in the credit evaluation and processing department. Your first task is to coach them on how to write credit memos for business loans.

Prepare an instructional guide on the areas of coverage expected in a credit memo. You should describe the relevance of each area of coverage in the assessment process.

(Total:20 marks)

4. Palmstead Sdn Bhd, a wholly owned subsidiary of Palmstead Group Bhd, operates an integrated palm oil refinery. Palmstead Sdn Bhd also owns 50,000 hectares of oil palm plantation in Johor. The company has over 1,000 workers in its plantation to harvest the fresh fruit bunches (FFB) as well as to replant and maintain the plantation.

The process of an integrated palm oil mill begins with the crushing of FFB to produce crude palm oil (CPO). The CPO is then processed in the refinery by various distillation processes to produce RDB Olein (known as commercial cooking oil). In this process, the CPO is refined and bleached to change colour from dark orange to light golden yellow, and finally deodorised to remove the pungent smell of CPO. Palmstead Sdn Bhd then sells its RDB Olein to independent traders who pack them under their own brand of cooking oil and thereafter, retails them in supermarkets and grocery outlets.

The following financial statements are of Palmstead Group Bhd, the investment holding company:

BALANCE SHEET AS AT 31 DECEMBER

Item	2001 RM'000	2002 RM'000	2003 RM'000
Current assets:			
Cash	15,204	34,103	85,908
Time deposits	39,389	58,870	46,724
	54,593	92,973	132,632
Accounts/notes receivables - trade	436,993	350,627	308,586
Bad debt reserve	(44,604)	(58,577)	(61,949)
Total accounts/receivables - net	392,389	292,050	246,637
Accounts/notes receivables - related companies	9,436	7,744	7,866
Accounts/notes receivables - others	107,814	77,257	78,326
Income tax receivable	32,218	44,647	57,268
Property development in progress	44,294	57,474	90,779
Inventory:			
- Raw materials	4,636	3,222	3,746
- Estate produce	5,638	2,762	2,200
- Finished goods	86,141	79,443	57,347
- Consumable stores	11,310	9,673	10,370
Total inventory	107,725	95,100	73,663
Dividends receivable	0	1,512	1,737
Total current assets	748,469	668,757	688,908

BALANCE SHEET AS AT 31 DECEMBER (cont'd)

Item	2001 RM'000	2002 RM'000	2003 RM'000
Non-current assets:			
Land	1,294,083	1,383,143	1,449,625
Buildings and improvements	105,993	102,634	115,492
Machinery and equipment	232,252	243,175	282,078
Gross fixed assets	1,632,328	1,728,952	1,847,195
Accumulated depreciation	(221,164)	(239,395)	(273,003)
Total fixed assets - net	1,411,164	1,489,557	1,574,192
Investment properties	257,000	257,000	453,745
Investment in associated companies	1,130,004	900,011	937,225
Other investments	18,546	293,706	290,407
Development of properties	368,022	380,420	329,526
Deferred tax assets	0	58,501	62,952
Intangibles - goodwill	0	0	4,226
Total non-current assets	3,184,736	3,379,195	3,652,273
Total assets	3,933,205	4,047,952	4,341,181
Current liabilities:			
Overdrafts (financing)	93,916	58,810	59,057
Short-term loans payable - bank	806,890	791,868	716,030
Current portion long-term debts - bank	125,679	190,876	256,146
Accounts payable - trade	128,881	160,103	146,749
Accounts payable - related companies	38,532	14,076	16,791
Accounts payable - others	99,362	83,765	113,746
Dividends payable	-	-	-
Taxation	53,119	33,015	32,770
Total current liabilities	1,346,379	1,332,513	1,341,289
Non-current liabilities:			
Long-term debts - bank	435,117	395,584	261,204
Bonds, medium-term notes and commercial papers	25,000	50,000	347,004
Block discounting loans	30,115	35,530	25,922
Deferred income tax - long-term portion	14,613	20,886	29,959
Total non-current liabilities	504,845	502,000	664,089
Total liabilities	1,851,224	1,834,513	2,005,378

BALANCE SHEET AS AT 31 DECEMBER (cont'd)

Item	2001 RM'000	2002 RM'000	2003 RM'000
Net worth:			
Minority interest-equity	725,771	773,081	464,754
Common stock	136,376	136,435	272,873
Share premium	283,734	283,897	364,269
Revaluation reserve	89,435	84,643	80,554
Statutory reserve	16,497	43,198	66,195
Other reserves	111,355	119,051	151,359
Retained earnings	698,982	766,706	807,999
Reserve on consolidation	19,831	6,428	127,800
Total net worth	2,081,981	2,213,439	2,335,803
Total liabilities and net worth	3,933,205	4,047,952	4,341,181
Working capital	(597,910)	(663,756)	(652,381)
Tangible net worth-actual	2,081,981	2,213,439	2,331,577

PROFIT AND LOSS STATEMENT FOR THE YEAR ENDED 31 DECEMBER

Item	2001 RM'000	2002 RM'000	2003 RM'000
Sales/revenues	1,024,251	983,214	1,081,496
Cost of sales/revenues	(733,546)	(659,803)	(687,621)
Gross profit	290,705	323,411	393,875
Other operating income	229	369	1,906
Defined contribution plans	-	(17,904)	(19,228)
Directors' remuneration	(1,085)	(1,147)	(1,441)
Lease/rent expense	(6,540)	(5,471)	(5,097)
Depreciation	(28,984)	(27,874)	(29,983)
Staff costs	(121,682)	(117,903)	(129,724)
Bad debt expense	(3,066)	(24,876)	(13,222)
Total operating expense	(161,357)	(195,175)	(198,695)
Net operating profit	129,577	128,605	197,086
Interest expense	(45,652)	(55,654)	(73,547)
Interest income	3,425	994	1,865
Net interest (expenses)	(42,227)	(54,660)	(71,682)
Income from subsidiary/joint ventures	(107,651)	84,971	75,426
Other investment income	3,134	523	9,250
Other investment loss	(207)	(6,050)	(4,376)
Gain (Loss) on asset sale	2,797	(1,223)	2,229
Total other income (expenses)	(144,154)	23,561	10,847
Profit before taxes	(14,577)	152,166	207,933
Current income tax	(57,825)	(43,526)	(59,827)
Minority interest	(39,173)	(39,610)	(35,594)
Net profit	(111,575)	69,030	112,512

- (a) Compute the following financial ratios for years 2001 to 2003, based on the given consolidated accounts of Palmstead Group Bhd:

Item	2001	2002	2003
(i) Current ratio			
(ii) Assets turnover ratio (ATO)			
(iii) Gearing (Total liabilities/total net worth)			

[10]

- (b) (i) What is the relevance of the ATO? [2]
(ii) Why is Palmstead Group Bhd's ATO low? Give reasons for your answer. [3]
- (c) Why is there a difference between the total net worth and the tangible net worth-actual for the financial year ending 2003? [3]
- (d) Identify another business sector that Palmstead Group Bhd has invested in, besides the plantation sector. [2]
- (e) As a credit officer, describe how you would analyse the business performance of Palmstead Sdn Bhd. [10]
- (f) (i) Explain **one** difference between long-term loans and short-term loans. [2]
(ii) Give **three** examples for each of the two loan categories above. [3]
- (g) Would you recommend the Group to move downstream into retailing cooking oil under their own brand name? Give reasons for your recommendation. [5]

(Total:40 marks)

OUTLINE ANSWERS

The comments given in the boxes below indicate the areas of weaknesses the examiners have identified and their advice to future candidates.

Question 1

Candidates produced the wrong process diagram to show the credit evaluation process.

1. Credit evaluation process generally begins with an assessment of the basic lending criteria to determine credit worthiness. The basic criteria comprises the 5Cs of credit and they are:

- **Character**
Character comprises those qualities which makes a borrower intend to pay a debt when due, or when the situation demands it. In the absence of the banker having confidence in the borrower who possesses this quality, it is preferable to decline the proposal no matter how good the security is. Character is human qualities that subsist in any person (e.g.: honesty, acumen, capability). If majority of the qualities were negative in the borrower, he would be a bad credit risk.

- **Capacity**
Income is universally accepted as a measure of capacity. For individuals earning a fixed income, repayment capacity is determined by matching income against existing and contracted commitment. For a business entity, studying their financial aspects over the past few years may indicate their financial strength. A forecast of the company's operations will assist in determining the future potential income and general confidence in the borrower.

Therefore, a high debt structure (gearing) could mean that the company's income is already committed to servicing existing debts and the capacity to further borrow is diminished.

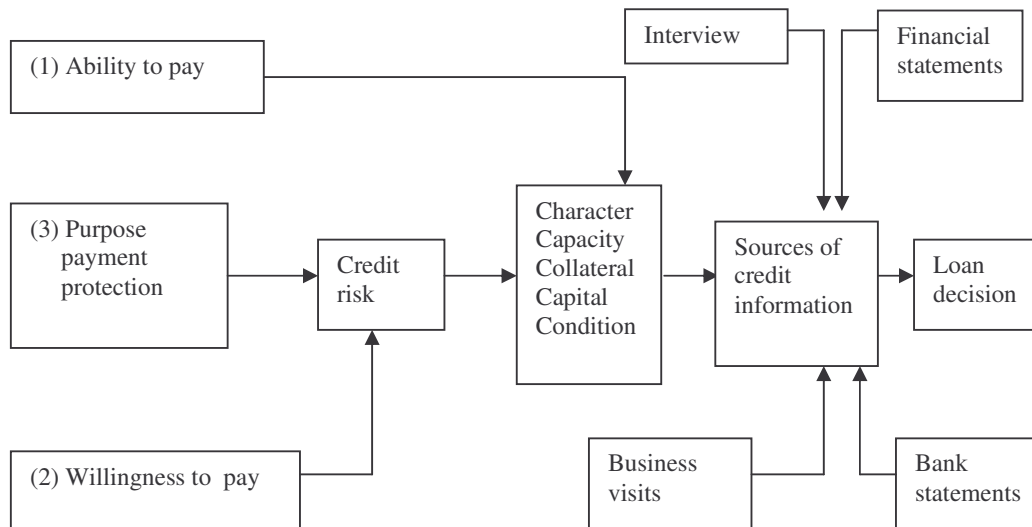
- **Capital**
Capital is a financial factor which provides the ability to absorb unanticipated losses. The amount of capital introduced denotes the financial strength and commitment of the owners towards their operations.

An increase in capital by ploughing back profits into the company should be distinguished from a capital increase arising from capitalisation of surplus realised from assets revaluation. A capital increase from capitalisation of surplus arising from assets revaluation is a non-cash increase, and does not in any way improve the business cash flow at the point of the exercise.

- **Condition**
A credit officer must ensure that the right economic conditions exist for the business venture, be it a new business or one that is undergoing expansion. Trade cycle, business environment, global economic condition and government policies must be taken into consideration to ensure a correct credit decision.

- **Collateral**
A lending decision should never be based solely on the collateral factor. Lenders should be looking at cash flows from operations as the take-out source. The main and primary source of loan repayment comes from revenue generated from business operations. Security risks refer to imperfect documentation, diminishing value of security and adverse publicity upon liquidation of the collateral. The realisation of security other than fixed deposits is a long, drawn-out legal process and causes the bank time, money and manpower.

Credit Evaluation Process



In analysing a loan, a credit officer is required to understand the importance of the following basic criterion:

- **Ability to pay**
The borrower must have fixed income to service the loan repayment. Besides, the loan amount must be of a reasonable sum matching his income.
- **Willingness to pay**
This means the borrower's preparedness to pay as opposed to his ability to repay. Lending to borrowers who have an ability to pay, but by nature, like to delay the repayment process, should be discouraged.
- **Purpose and payment protection**
The purpose of the loan must not be in conflict with the objective of the central bank and the country. Currently, under the Sixth Malaysia Plan, the main objective is to promote industrialisation and economic growth. All lending must be in line with this objective. The purpose must also meet the economic condition and market trends.

Payment protection refers to the security/collateral provided by the borrower to the bank. Should the borrower fail to pay, the bank will liquidate the security to recover the outstanding loan amount. Therefore, security/collateral is the second line of defence for the lender.

Information gathering pertaining to the relevant aspects of the potential borrower is very important. This can be done through the following methods:

- **Interview**
Forward any doubts or questions and to understand the person better.
- **Financial statements**
To study the company's cash flow and its ratio to determine its current financial position and past performance.
- **Business visits**
Pay a site visit to ensure the genuineness and viability of the business.
- **Bank statements**
Request for bank statements to check the conduct of his account, the frequency of inward/outward returned cheques and inflow/outflow of funds.

After examining all these criterion, a decision on the loan application can be derived. If the results are favourable, approval can be granted and the offer letter can be issued. Otherwise, the loan application should be rejected.

Question 2

- Candidates were confused with the word “charge”, referring it to the cost of banking business payable by customers.
- Candidates misunderstood floating charge as a legal documentation in loan collateral.
- Candidates were advised to read the question thoroughly and understand the requirement of the question before answering.

2. (a) (i) A floating charge is a particular form of debenture allowing a company to raise finance from banks in exchange for collateral over all or a specified class of the company’s assets, both present and future.
- (ii) A floating charge will crystallise into a fixed charge when a default condition is violated. These include payments default, a breach of covenants, borrower ceases or threatens to cease operations or other events expressly defined in the debenture.
- (b) The bank has to evaluate the following conditions and factors:
(Any five of the following:)
- The competence of the management.
 - The adequacy of accounting information.
 - The borrowers responsiveness to change.
 - Present and future level of trading, (e.g.: new contracts and sales order).
 - Pricing and costing policies.
 - Gearing, liquidity and profitability indicators.
 - Business hazards, (e.g.: strikes, fire and recession).
 - Non-financial symptoms, (e.g.: staff morale, staff turnover and working environment).

Question 3

3. The instructional guide should cover the following items:
- Purpose of the loan
 - Facility structure and rational
 - Background of operations
 - Financial analysis
 - Risks analysis
 - Security analysis
 - Conclusions and recommendations

With appendices to include:

- Term sheet
- Profile of key management and directors
- Financial spread sheet
- Cash flows with sensitivity analysis

Brief description on each area above is required.

Question 4

4. (a)

	2001	2002	2003
(i) Current ratio	0.56:1	0.50:1	0.51:1
(ii) Assets turnover ratio (ATO)	0.26:1	0.24x	0.25x
(iii) Gearing (Total liabilities /total net worth)	0.89:1	0.83:1	0.86:1

- (b) (i) To measure the operating efficiency in assets utilisation.
- (ii) Palmstead Bhd's ATO is low as it has very substantial assets in the form of investments in land and associate companies which may not be generating the revenue expected.
- (c) Caused by goodwill as an intangible asset of RM4,226,000.
- (d) Property development.
- (e) Palmstead Sdn Bhd is a plantation company and therefore analyses should be focused on yield per hectare, crop productivity, refining efficiency and management ability to optimise plantation output, as well as a detailed discussion on commodity prices.
- (f) (i) Short-term loans are less than 12 months and long-term loans' tenor exceed 12 months.
- (ii) Examples of short-term loans are overdraft, revolving credit and current portion long-term loans.
- Examples of long-term loans are bonds, term loans and medium term notes.
- (g) I would not recommend Palmstead Group Bhd to move down stream into retailing of cooking oil under their own brand name. Instead, advise them to remain focused on core businesses of plantations and refining.

To set up retailing, the company will face extra business problems in the following areas:

- Distribution
- Extra costs in warehousing and transportation
- Price wars from existing brands
- Higher costs in human resources
- Additional financial resources needed to enter into a new business area.