The Five Cs of Credit

Many business owners do not fully grasp the challenge facing lenders. Virtually no lender, banker, sales person, business development officer, relationship manager, or the person a business owner would work with to begin the loan process can make a decision on your request for credit.

This hasn't always been the case. Back in the day, it was possible, in some cases, for a banker to make a lending decision. Today, banks have divided the business development function from the credit function (decision-making), a sort of separation of church and state. The person you meet with to apply for the loan, your lender, will need to demonstrate your creditworthiness to a credit officer (the decision maker,) who has not, and probably will not, ever meet you, let alone get to know you. The only thing the credit officer will have to base a decision on will be the paperwork evidence you have presented to the lender.

Understanding that the person you are dealing with cannot say yes makes it imperative to present your case in such a way as to meet the minimum standards established by the credit officer. These standards, which can be broken down into the 5 Cs of credit, will help demonstrate the creditworthiness of your business.

Character

Character is generally measured by a number of readily available reports that bankers will generally pull. These may include:

- A personal credit report from each of the reporting agencies, Experian (formerly TRW), TransUnion and Equifax will typically be pulled.
- A Dun & Bradstreet report is a common report that is obtained by the bank, but it deals with the business in question. These reports will generally include important information concerning public filings, i.e. UCC 1 filings, pending suits and any judgments against the business. Any discrepancies from what a perspective borrower would tell the

banker and what is found in the report would need to be explained and could have a negative impact on the character component of the application.

- A felony report is required by some lenders, though generally not local banks, as most lenders will not lend to a convicted felon.
- A LexisNexis report is another report generally not required by local commercial banks.

Within the reports pulled, the lender will look for trends in payment history as well as any derogatory information relating to the business and/or person.

Character is considered a vital element in the loan approval process. Borrowers who do not demonstrate good character or integrity in the way they have dealt with their past financial dealings will have a very difficult time getting a bank or any other reputable lender to provide a loan on any terms.

Keep in mind you will not be approved for a loan because of good character, but you can certainly be declined for a loan without it. Personal and business credit issues, including bankruptcy, may be explainable. Having documentation to support your explanation will be very important. Many lenders will look at a credit report to see what the credit history was like prior to the negative issue and then what it is like after the negative issue.

Collateral

The lender is looking for a borrower to share in the loan risk. If the loan request is for the purchase of property, the property purchased will be pledged as collateral to secure the loan. The same would hold true for equipment purchases. When banks make loans, they will generally look to advance a percentage of the asset cost or appraised value, whichever is less. There are no hard and fast rules concerning advance rates but generally speaking, banks will not lend 100 percent of the cost or value of the item that the borrower is looking to finance.

When banks provide a line of credit for working capital, they will generally rely on the accounts receivable and/ or inventory of the borrower to determine the amount of working capital that will be provided.

There are usual and customary advance rates for all the asset classes. For example, lenders will generally advance no more than 85 percent of the appraised value on real estate, 75 percent of the cost of equipment purchased, 50 percent of inventory, and 85 percent of accounts receivable. How these advance rates are determined is based on the lender's understanding of the asset and its value to the market should the lender have to liquidate the assets or foreclose on the real estate. In addition to the collateral securing the loan, personal guarantees are a usual and customary requirement for loans to privately held companies.

That being said, most banks will not make a loan to a company solely based on the strength of a guarantor. That was not always the case, as a guaranty secured by tangible personal property, a house or marketable securities, often was enough for a lender to say yes, whether the borrowing company had the ability to pay the loan back based on historical results. But lenders found out that guarantors were, with rare exception, not quite ready, willing and able to part with their personal assets, making the strength of their guarantee a bit shaky, at best. Add regulators to the mix and you have a situation where banks are required to look at the borrowing company's ability to pay back the loan, based on some level of historical results, in order to approve a loan request.

Banks will consider making unsecured and unguaranteed loans, however, borrowers that qualify for these loans tend to be very strong financially and have a long history of financial success. Even so, when the future is uncertain, how well a company has done in the past is no guarantee it will continue to have positive results going forward. Keep in mind that banks are not in the business to take risk, although they may market a more aggressive lending attitude.

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Conditions

The general economic- and company-specific factors that may influence the ultimate success or failure of the business are conditions. For example, during a recession, it would be difficult to argue that your company will be growing significantly due to a robust economy. Having evidence of pending sales, generally in the form of purchase orders or contracts, will demonstrate to the lender that your claim of increasing sales can be realized. It is very important to present evidence to support any claim you might make regarding the success of your business.

Seasonal businesses present unique challenges to lenders because of the obvious ups and downs associated with the business. The business that relies on Christmas to make or break its year, while common, is risky. Any business involved in agriculture is subject to weather conditions it cannot control. Businesses involved in landscaping or snow removal can be seriously impacted by the weather, both good and bad.

Concentration risk is a condition not often fully understood by lenders or borrowers. We often think of concentrations posing risks of payment, which is certainly true, but a bigger risk might be the loss of sales. When considering concentration risks, consider both outcomes. Many may contemplate the effects of a major customer decreasing sales, but what if that customer increases its sales exponentially?

Capital

Capital is the net worth of the business, which would include retained earnings and money you or others have invested in (capital stock or paid-in-capital) or loaned to (subordinated debt) the business. Leverage, the ratio of debt to equity (capital) is a key measurement taken by banks to assess the perceived level of risk inherent in a business. High leverage means more risk and low leverage means less risk. Leverage ratios above 4 to 1 are generally considered high.

It goes without saying, if you have too much debt relative to your overall size, if something goes wrong in the business, the leveraged business has less of a cushion to fall back on. Keeping in mind that lenders do not want to take a lot of risk, leverage is a balance sheet component that should not be overlooked.

While a business may itself be leveraged, there are assets that may be considered part of the business but

not be reported fully (or at all) on the financial statement of the business. The simplest example of this would be real estate assets owned by the business or the owner of the business and used exclusively by the business. A business may be leveraged, but because the real estate asset is either owned by something else, such as a real estate holding company owned by the owner of the business, or is reported on the balance sheet of the business at less than its market value (depreciated), the leverage of the business may be overstated. Assets, such as goodwill and other intangible assets, may also overstate the true value of the business.

Capacity

Capacity would be the demonstrated ability to service the loan (make the payments) you are requesting. Lenders typically require what they call the coverage ratio to be at least 1.10 times the minimum requirement of the loan you are requesting. The higher the coverage ratio, the easier it would be to qualify for a loan. Again, the lender is looking to protect their asset (the loan) and your ability to demonstrate, based on the financial information presented, that you can repay the loan should be the number one priority of the lender.

While collateral is important and used to be the most important factor, insufficient cash flow is the fastest way to be declined for a loan. Projections are helpful but will not be a basis for a loan approval. Banks make loans based on past history and understanding that concept will result in a more efficient loan approval process. If your company is not showing the ability to pay back the loan, obtaining favorable terms and conditions would be highly unlikely.

It is also important to understand what is meant by cash flow. Profit alone may not be adequate to demonstrate the ability to pay back a loan. Lenders will look at a combination of numbers reported on your financial statements, including interest expense, taxes, depreciation, amortization, other non-cash items expensed. Lenders will add these numbers up and report it as EBITDA.

Consider the 5 Cs

If you understand that lenders will be basing their credit decision on the five Cs, that is your character, the collateral, the conditions, your capital position and your capacity, you will have a better understanding of the rationale they will use in approving or declining your request for credit.

For questions, comments or concerns about the 5 Cs of credit, please contact:

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