The "Five Cs" of Credit

(and other things your banker expects from you)

Lenders want to be sure that your company can and will repay any loans they grant your company. Not only that, many lenders want assurances that any additional debt repayments won't cripple your company's cash flow so to cause financial stress. To assess your company's creditworthiness, many bankers start with the "Five Cs of Credit" approach as the basis for initially determining whether to commence a lending relationship with most borrowers.

Simply stated, the "Five Cs" of credit are (i) **capital**, (ii) **collateral**, (iii) **capacity** (to repay), (iv) **conditions**, and (v) **character**.

Capital. How much money do you have invested in your business? If you want a lender to invest in your business via a loan, then you need to supply ample equity capital for your company's long-term money needs. Does your company have adequate cash reserves to weather economic downturns? Lenders expect existing businesses to have 10% to 30% invested in any loan amount requested. For businesses less than three years old, the percentage equity investment required can be 30% or more. Lenders also monitor the debt-to-equity ratio over the life of any loan. The borrower must maintain a debt-to-equity ratio within an acceptable range, which the lender determines.

Collateral. Collateral provides a secondary source of repayment for the lender should the borrower fail to timely repay the loan. Does the fair market value of the collateral cover the outstanding loan? Does the collateral meet the standards for good collateral, such as:

- ✓ Can you easily transfer title?
- ✓ Is the collateral easy to maintain and cost little to service?
- ✓ Does the collateral increase in value over time?
- ✓ Is there a ready and liquid market to covert the collateral into cash?

These asset traits provide assurances to the lender that the bank can rely upon the collateral should the need arise. Listed next are asset types and the percentage banks rely upon them as collateral:

- ✓ Certificate of deposit (100%)
- ✓ Real Estate (75-80%)
- ✓ Publicly Traded Stock (75%)
- ✓ Vehicles (75-85%)
- ✓ Equipment (50-75%)
- ✓ Accounts Receivable (50-71%)
- ✓ Inventory (0-50%)

Capacity (to repay). Capacity to repay examines your business's ability to generate profits and cash flow from operations to repay the loan. Does your business generate enough cash from operations to timely pay its obligations including the proposed loan? Some banks require net profits to exceed the debt service by more than two times. Are the projected monthly minimum cash balances sufficient to meet your company's debt obligations? Are your sales and profit projections consistent with your industry's experience?

Conditions. Your company's ability to repay its loan depends, in part, on the conditions in your industry and the economy. What is the current health of the economy? Is consumer spending expanding or contracting? What growth do economists predict for domestic gross national product? Are overseas economies expanding or contracting? How do these exogenous factors affect your industry? Will slower industry growth intensify rivalry within your industry? Also, what is the nature of competition in your industry? Is it cooperative or cut-throat? Where does your company fit within the industry? What marketing strategy does your company employ? Does your company employ a market differentiation strategy, a cost leadership strategy, a focus strategy, or some hybrid of these strategies? How your business positions itself will give your banker clues on your company's ability to survive (and thrive) in varying economic times.

Character. Character is the fifth "C." Here, the focus is on the managers of your company. Bankers look closely at the character traits of the business's leaders. What has been the company's track record in managing its finances? Are bills paid when due? Are trade receivables collected promptly? Do the business and its managers (personally) have strong credit ratings? Do the managers have the moral character, professionalism, and ethics to work through financial problems should they arise? Will the management team cooperate with the lender should the bank require repossession or other remedies for repayment? Simply put, does your management team have integrity?

The Five "Cs" of Credit is an overview; it is only a starting point of what a lender expects from a borrower. Every borrower must support its request for money with a sound, thoughtful, and well written business plan. A top-notch business plan embeds the principles of the Five "Cs" of Credit. The financial analysis portion of the business plan should address capital, collateral, and capacity to repay. The marketing and sales plan should examine the conditions in the marketplace. And the management section should discuss the management's style, attributes, and prior successes. As you embrace the concepts of the Five "Cs" of Credit in your business plan, you will find your lender more acceptable to your lending proposals.

About the Author.

Nathaniel ("Nat") James is real estate broker-in-charge and lead business broker of Crimson Cardinal Realty LLC. He is a graduate of Univ. of Pennsylvania - Wharton (BS in Finance), Harvard University (MBA), and The Univ. of Virginia School of Law. He worked in finance at Morgan Chase, IBM, AVX, and with a nationwide SBA-preferred lender. Mr. James is also a NC-licensed attorney and serves the Charlotte – Mecklenburg, Triad, Research Triangle Park, and Wilmington, NC areas.