

The 5 C's of Credit or How Do Lenders Evaluate the Borrower?

- 1. Capacity:** The most critical. How exactly do the borrower(s) intend to repay the loan? The lender considers cash flow (based on the 3 year profit and loss projections) as compared to similar or the same businesses. The borrower(s) previous payment history is a critical factor in the lenders decision to make the loan. Do the borrower(s) have any secondary sources to repay the loan if the business is not able to repay the loan?
 - ▶ Cash flow is more technical than comparing income and/or expenses. The lender attempts to determine both current cash flow and the creditability of the business plan projections as to future cash flows to repay the loan.
 - ▶ Lenders may use standard reference sources and/or their own experience with a particular industry to evaluate the reasonableness of cash flow projections.
 - ▶ Lenders like a second income source from a spouse or business partner so in the event the business has temporary cash flow problems the borrower has another source of cash to help the business or for living expenses.
- 2. Capital:** Do the borrower(s) have their own funds invested in the business and if so how much? Lenders want the business owners to have their personal assets at risk so that they are more motivated to make the business a success.
 - ▶ Equity, total debt, value of assets, and permanent working capital.
 - ▶ Lenders want to help you finance your business, not buy it for you, thus they want the borrowers' assets at risk so they remain dedicated to the business' success.
- 3. Collateral:** What is the market value of the collateral owned by the business and what is the potential value in a liquidation sale if the business cannot repay the loan? Do the borrower(s) have personal assets to repay that part of the loan that may not be repaid from the sale of the business collateral?
 - ▶ Collateral provides a lender with an alternative source to repay the loan if the business is not successful. Other than cash, the lender must make an educated guess at the value of most collateral.

- ▶ Common types of collateral include: accounts receivable, inventory, machinery and equipment, real estate, marketable securities (traded stocks/bonds), cash, and guarantees that may be collateralized [the guarantor has pledged assets to back part or all of the guaranty].
- ▶ Lenders assess the collateral by reviewing the accounts receivable (under 60 days are considered good), balance sheet, personal financial statements of guarantors, appraisals of equipment or real estate [if available], etc.

4. **Conditions:** What is the general economic environment for this type of business both nationally and locally? What conditions outside of the control of the owner(s) or manager(s) could negatively impact this business?

- ▶ Local competition, industry trends, general economic conditions, legal and regulatory restrictions, and liability concerns.
- ▶ Some conditions are outside of the borrower's control e.g. industry trends and general economic conditions – but they may affect the business' ability to succeed.

5. **Character:** The lenders personal impression of the borrower(s). The lenders subjective determination of the borrower(s) trustworthiness to repay the loan as agreed.

- ▶ Honesty, integrity, trustworthiness & managerial skills of key managers.
- ▶ Lenders make a character judgment based on the business plan, credit history, questioning of the Owners and Manager and their knowledge of the industry, niche and location.