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The '5 Cs of Credit' – Insider Tips for Your Business from a Former Banker

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You've worked hard to build your business to the point where it needs more money to meet customer demand. You now need financing to support the need for more inventory, for hiring new employees and for the purchase of much-needed equipment to support the growth.

The natural next step would be to approach your bank and request a loan. However, this is not necessarily the case. It is important to first understand the loan approval process and the factors a bank considers before making this move. How does a bank justify and quantify a loan request to approve or decline the deal? And if the loan request is outside a bank's normal criteria, should a non-bank lender be considered?

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Many of the scoring models used to determine loan approval are based on traditional criteria known in the banking industry as the '5 Cs of Credit' (5 Cs). These are used during the loan interview and are summarized below (I will explain risk factors and interest rates in a future article).

The '5 Cs of Credit' are:

- **Character** – Has the business borrowed money before and did it repay the loan in accordance with the terms outlined in the loan agreement? Is the credit score on the company's credit bureau satisfactory or are there any legal actions noted or negative ratings from suppliers or other lenders? Does the business owner have good motive and integrity for the loan, and are they an existing or new customer to the bank?

- **Capital** – How much equity is in the business? Lenders typically look at the amount of debt a business takes on relative to the owner's equity, commonly called the Debt to Equity ratio (D/E ratio). They generally consider lending up to a specific ratio; for example, a 2:1 debt/equity, where a lender would lend $2 for every $1 of the business's equity (assets-liabilities=equity). Some industries, such as manufacturing, will allow for higher D/E ratios where there is a higher need for equipment. A business owner's personal net worth is also considered. Generally, the more equity and net worth is demonstrated, the more comfortable a bank is in lending.

- **Capacity** – This refers to the amount of net income or free cash flow a business can generate to enable it to make the loan repayments. More income allows for greater availability of cash for payments to be made. Ratios are closely looked at based on historical repayment data. Many banks use a formula called EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). EBITDA is a cash flow and profitability calculation that is used to determine the company's ability to afford the new loan payments, along with its existing financial obligations.

- **Collateral** – Lenders typically want some form of tangible collateral to be able to rely upon if ultimately the business cannot make the loan repayments. For businesses, the most common types of collateral include accounts receivable (AR), inventory, plant, and equipment as well as many types of real estate. The more collateral a company can provide, the lower the risk to the bank, making for an easier loan approval. Personal guarantees of the business owner are also an integral part of the collateral banks seek.

- **Conditions** – What is currently happening in the economy may affect a company's ability to repay the loan. An economic downturn, recession, or companies operating in high risk industries would increase the loan risk. These factors would increase the borrowing cost or could even result in the bank declining the loan application.

The application will appear strong when most or all Cs fall within the bank's guidelines, which can vary. Banks will lend when there is a low risk of default, and high probability the loan will be paid as agreed. As the risk lowers, often the interest rate and borrowing costs will be reduced, making the loan more attractive for the business owner and more competitive to the lender.

But what if your business does not meet the bank's minimum requirements in one or more of the Cs? One alternative is to talk to different banks. Loan approval thresholds differ from bank to bank. However, if it's too far outside-of-the-box, there is a growing market of non-bank lenders who are willing to make loans on less stringent conditions. This is the market of alternative financing and is a viable option for many mainstream businesses.

Every bank or alternative lender is different, and many factors go into the credit decision. If you understand the 5 Cs, speaking with a lender is easier.

There is also a 6th C of credit, which I will explain in my next article. Understanding how all of these factors work together will maximize the chance of getting a "yes" to your bank loan request.

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