Five C’s of Credit:

A summary on the merit of a typical loan application.

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Grice, Pope and Associates
Commercial and Healthcare Finance
Education Series

1. Character

BUILD CHARACTER
BUILD SUCCESS

Most people immediately assume it must be collateral. However, character is the most important criteria for lenders because there are many wealthy people that constantly “slow-pay” their debt. But then there are those who, regardless of life’s ups and downs and periods of tight cash flow, always find a way to pay on-time. **These are the highly sought-after borrowers**.

2. Capacity

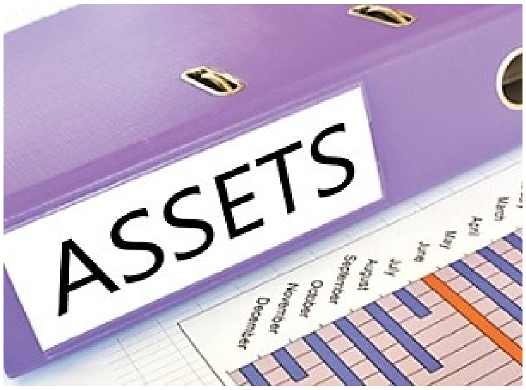
I'm not so much interested in
the return ON my money as I
am in the return OF my money.
Will Rogers

“Capacity to repay” refers to the actual ability the borrower possesses to repay a loan. If the funds are not available, regardless of character or reputation, you or your business cannot pay back loan.

Keeping with Will Rogers axiom regarding this, once a bank is comfortable with the fact that you have the character to return their capital, they analyze the borrower's revenue.

By comparing income against recurring debt and assessing the borrower's CADS (Cash Available for Debt Service) to Debt Service, the DSCR (Debt Service Coverage Ratio) must hit certain percentages for approval. For a small business loan, the majority shareholders will also have their personal debt analyzed as well. This is known as the Global DSCR (combining all personal and corporate income related to debt obligations.) You will need to demonstrate your historic earnings and then future earning will be derived by extrapolating this trend and projecting against your current and future business plan.

3. Collateral



Do you have assets that can be used as security? Collateral will never be looked at as primary source of payback - only as recourse source should the primary source fail. It assures them you're in it for the long haul.

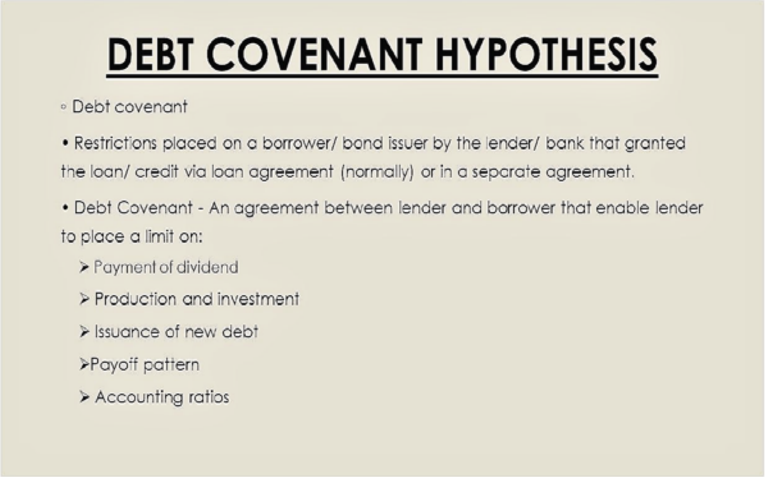
Below are some relevant issues associated with each type of collateral that you should consider before approaching a bank for a loan.

- Real Property, particularly those assets with a strong positive cash flow.
- Business Inventory and Accounts Receivable
- Cash Savings or Deposits: "Cash is always king" (but never great for your flexibility.

4. Capital

Investors never want to head into a slow pay or default situation, even if there is plenty of collateral. Not only do they want to see that you have financial resources invested in the business, but that you have "reserves" in case something doesn't go as planned. Depending on the size of the loan, lenders want to see what financial resources you already have and, at times, you must work hard so they don't put a "blanket lien" on them. **Note:** "sweat equity" can be considered in response to "what does the borrower have in the deal?"

5. Conditions



DEBT COVENANT HYPOTHESIS

◦ Debt covenant

- Restrictions placed on a borrower/ bond issuer by the lender/ bank that granted the loan/ credit via loan agreement (normally) or in a separate agreement.
- Debt Covenant - An agreement between lender and borrower that enable lender to place a limit on:
  - ➤ Payment of dividend
  - ➤ Production and investment
  - ➤ Issuance of new debt
  - ➤ Payoff pattern
  - ➤ Accounting ratios

Typically, the borrower is presented with 31 pages of closing documents to sign at closing. Are you really going to read all this while everyone around the table is watching you? By lending to you, they're investing in your business. The lender/investor will want to monitor your financial condition. There are the terms and conditions of the loan which can make or break your cash flow (such as rate, amortization, maturity, cross-collateralization).

In short, they want to be in control of "your" finances - but don't understand your business.

Example: CPA's often take large deductions for their clients to help them avoid excess taxes. However, when the bank is analyzing your tax returns, they can't reconcile your "book loss" to your actual cash flow and demand payment in full (technical default). See number 9 below

Bonus Edition. *When I taught aspiring bankers the fundamentals of lending, I challenged my students to look beyond the "5 C's of Lending" and challenge them to find additional "C's." Here are an extra 5 for you to consider.*

6. Cross-collateralization

FORECLOSURE
FOR SALE

If you've ever read the signature card of a checking/ savings account when you open it, it says that if there is a deficit in any part of the bank or bank's accounts that the bank can use these funds to cover said deficit.

Similarly, when you read the fine print of a collateral agreement, many times you are signing away free and clear title to your other assets rather than the specific asset for which you are currently borrowing. In other words, if you are not careful, you wind up tying up all your assets when you thought you were only borrowing on one asset.

7. Cross-Default Clause

CREDIT
CREDIT
CREDIT
CREDIT
CREDIT

This one is particularly painful: “a default on one debt constitutes a default on all other debts owed by subject borrower”! The reason you strive for liquidity and cash flow is to smooth out the operational ups and downs of owning any business - as well as preparing for anything unforeseen. Otherwise, when you hit a bump and attempt to work out of one situation, every other lender you have may panic and even unused lines of credit get “called” or sold to collection companies. You must avoid this at all costs. And, if you cannot avoid it, develop a hedge against it.

8. Cosigner vs Guarantor

KNOW THE
RULES

Before you either request a guarantor or cosigner (or become one yourself), know the differences.

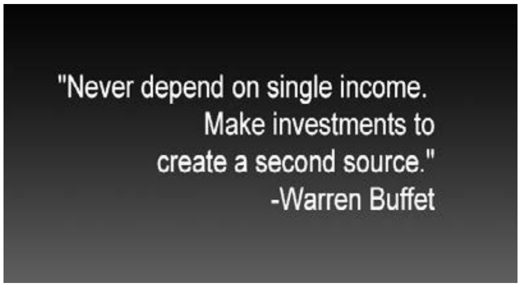
A cosigner is, in every way, part of the transaction. Credit is pulled, reported, you sign the note and will be the immediate target of any necessary collection activing. When borrowing money, you will have to calculate this payment into your global debt service coverage ratio. A guarantor is one stepped removed. Usually not reported on your credit report, will not be dinged month after month if the payment is late and you will not have to pay if the debt goes bad until every effort is made by the lender to collect from the primary borrower. Usually you will get a copy of the collection notices and will ultimately be named in any litigation however. You are the bank’s Tertiary Source of repayment.

9. Cash Flow

Although this could be # 1 (Character) and sounds like # 2 (Capacity to repay), Cash Flow has to do with knowing your budget, planning and creating alternative plans should plans A, B or even C not go as planned. Know what is a cash expense and what is not. Prepare a variable, anticipatory budget with a solid set of assumptions. Measure everything so you know where you always are. Remember, ***"Cash Flow is the Life-Blood of Every Business"*** and this is what will give you the capacity not only to repay your loan but for growth. You will identify the future expenses and planned acquisitions and reserve these moneys out of your weekly and monthly cash flow. Believe it or not, your budget is your best friend!

Budget
Annual Budget by Month

10. Continuity and Diversity of Revenue


"Never depend on single income.
Make investments to
create a second source."
-Warren Buffet

You must be aware of all the verticals and revenue enhancements that are available to you. No matter what business you are in, there are always related sources of revenue that one should look at. This is particularly true in healthcare. Instead of giving away potential patient revenue, the healthcare provider should look at services performed by others. If these can be pulled in-house without disruption of workflow or adding additional expenses they should be explored. The lender simply musty see the results and have some assurance that the diversity of income will have continuity.

About the author. Charles Pope has over 40 years of finance and management. His "hands-on" approach, coupled with vast experience in the most adverse financial climates, offers an extraordinary talent.