The “Five Cs” of Credit Analysis

Capacity to repay is the most critical of the five factors. The prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan. Payment history of existing credit relationships — personal or commercial — is considered an indicator of future payment performance. Prospective lenders also will want to know about your contingent sources of repayment.

Capital is the money you have personally invested in the business and is an indication of how much you have at risk should the business fail. Prospective lenders and investors will expect you to have contributed from your own assets and taken on personal financial risk to establish the business before asking them to commit any funding.

Collateral or guarantees are additional forms of security you can provide the lender. Giving a lender collateral means that you pledge an asset you own, such as your home, to the lender with the agreement that it will be the repayment source in case you can’t repay the loan. A guarantee, on the other hand, is just that — someone else signs a guarantee document promising to repay the loan if you can’t. Some lenders may require such a guarantee in addition to collateral as security for a loan.

Conditions focus on the intended purpose of the loan. Will the money be used for working capital, additional equipment, or inventory? The lender also will consider the local economic climate and conditions both within your industry and in other industries that could affect your business.

Character is the general impression you make on the potential lender or investor. The lender will form a subjective opinion as to whether you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your company. Your educational background and experience in business and in your industry will be reviewed. The quality of your references and the background and experience of your employees also will be taken into consideration.

What do the 5 Cs of Credit mean to a small business?

One of the most common questions among small business owners seeking financing is, “What will the bank be looking for from me and my business?” While each lending situation is unique, many banks utilize some variation of evaluating the five Cs of credit when making credit decisions: character, capacity, capital, conditions and collateral.

1. **Character.** What is the character of the company’s management? What is management’s reputation in the industry and the community? Lenders want to put their money with those who have impeccable credentials and references. The way the

owner/manager treats employees and customers, the way he or she takes responsibility, timeliness in fulfilling obligations are all part of the character question. This is really about the owner or manager and his/her personal leadership. How the owner or manager conducts business and personal life gives the lender a clue about how he/she is likely to handle leadership as a manager. It's a banker's responsibility to look at the downside of making a loan. The owner/manager's character immediately comes into play if there is a business crisis, for example. Small business owners place their personal stamp on everything that affects their companies. Often, banks do not differentiate between the owner and the business. This is one of the reasons why the credit scoring process evolved, with a large component being personal credit history.

2. **Capacity.** What is the company's borrowing history and record of repayment? How much debt can the company handle? Will it be able to honor the obligation and repay the debt? There are numerous financial benchmarks, such as debt and liquidity ratios, that lenders evaluate before advancing funds. Become familiar with the expected pattern in the particular industry. Some industries can take a higher debt load; others may operate with less liquidity.

3. **Capital.** How well capitalized is the company? How much money has been invested in the business? Lenders often want to see that the owner has a financial commitment and has taken on risk for the company. Both the company's financial statements and the personal credit are keys to the capital question. If the company is operating with a negative net worth, for example, will the owner be prepared to add more of his or her own money? How far will his or her personal resources support both the owner and the business as it is growing? If the company has not yet made profits, this may be offset by an excellent customer list and payment history. All of these issues intertwine.

4. **Conditions.** What are the current economic conditions, and how do they affect the company? If the business is sensitive to economic downturns, for example, the bank wants to feel comfortable with the fact that the business is managing productivity and expenses. What are the trends for the industry, and how does the company fit within them? Are there any economic or political hot potatoes that could negatively affect the growth of the business?

5. **Collateral.** While cash flow will nearly always be the primary source of loan repayment, bankers should look closely at the secondary source of repayment. Collateral represents assets that the company pledges as an alternate repayment source for the loan. Most collateral is in the form of hard assets, such as real estate and office or manufacturing equipment. Alternatively, accounts receivable and inventory can be pledged as collateral, though in some countries, these "movable assets" are not well supported by the legal framework. The collateral issue is a bigger challenge for service businesses, as they have fewer hard assets to pledge. Until the business is proven, a loan should nearly always have collateral. If it doesn't come from the business, the bank should look to

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personal assets. Keep in mind that, in evaluating the five C's of credit, lenders don't give equal weight to each area. Lenders are cautious, and one weak area could offset all the other strengths. For example, if the industry is sensitive to economic swings, the company may have difficulty getting a loan during an economic downturn — even if all other factors are strong. And if the owner is not perceived as a person of character and integrity, there's little likelihood he or she will receive a loan, no matter how good the financial statements may be. Lenders evaluate the company as a total package, which is often more than the sum of the parts. The biggest element, however, will always be the owner.