KNOWING THE RULES OF THE FINANCE GAME

The Five C's of Credit: Capacity, Capital, Collateral, Conditions & Character

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The purpose of this article is to provide you with a brief overview of some of the financial analysis tools used by lenders during the underwriting process. As you might expect, the depth of analysis will vary depending on the size and type of loan. However, in general the framework for the analysis will follow the well-known five C's of credit: *Capacity, Capital, Collateral, Conditions* and *Character*. Of these five important components of the lending decision - Capacity, Capital and Collateral form the basis for quantitative financial analysis. The following is an overview of some of the simple analytical tools a lender will use to analyze these components.

Capacity refers to the company's ability to generate sufficient cash flow from normal operations to meet future obligations. To the lender, this represents the primary source of repayment for a loan and is the most critical of the five C's of credit. It is important to understand that the liquidation of collateral, which will be discussed briefly later, is never considered a primary source of repayment.

In its most basic form, cash flow is defined as earnings before interest, taxes, depreciation and amortization (EBITDA). The first step in the analysis of EBITDA is an examination of each of the components. Some of the questions a lender may attempt to answer are: What has been the historical trend in earnings? Are there extraordinary expenses that may have affected earnings performance? What are the trends in sales and gross profit margin and are those numbers sustainable? What is the trend in operating expenses? How does the depreciation and amortization expense relate to the need for capital purchases (in other words should depreciation be considered a real expense)?

Once the lender is satisfied with the EBITDA calculation, it will be compared to the company's current obligations (debt service). Debt service is simply the anticipated principal and interest payments on all debt. The key ratio then used to measure the capacity is called the debt service coverage ratio (DSCR). The DSCR is simply EBITDA/fixed obligations. In most cases, the lender will want cash flow from operations to exceed debt service by 20 percent. Therefore the DSCR should be greater than 1.20.

The analysis of capacity gets somewhat more complicated for working capital and seasonal lines of credit. For those types of loans not only will the bank examine EBITDA and the DSCR but they will also include an analysis of the company's ability to properly manage the conversion of working assets to cash. Essentially, this involves an analysis of short-term liquidity. As with EBITDA, the first step in the analysis of liquidity is an examination of the components. Often, some modifications to current assets and current liabilities may be required. Once the lender is satisfied with the composition of the current assets and current liabilities, an analysis can be performed.

The most widely used measures of liquidity are net working capital (current assets – current liabilities) and the current ratio (current assets/current liabilities). To gain more insight, the analysis must always be done on a comparative basis over time. As a general rule of thumb the lender is looking for a current ratio in excess of 2.0. In addition to these static measures of liquidity, it is necessary to analyze the degree of liquidity of the components of working capital. In order to further analyze liquidity, the lender may examine the company's Cash Conversion Cycle. The Cash Conversion Cycle is calculated as follows:

Days in Inventory + Days in Account Receivable - Days in Accounts Payable = Cash Conversion Cycle

The trends in these "turnover" ratios and a comparison to industry averages may give the lender some insight into the company's ability to convert working assets to cash.

One final tool the lender may use to analyze liquidity and cash flow is the statement of changes in financial position statement, also known as the flow of funds or cash flow statement. This statement gives insight into what assets have changed from period to period and where the funds came from or went.

Capital (aka Equity) represents the funds retained in the company to provide a cushion against unexpected losses. A strong equity position will provide financial resiliency to help a firm weather periods of operational adversity. Minimal or non-existent equity makes a business susceptible to miscalculation and thereby increases the risk of default. A strong equity position also ensures that the owners will remain committed to the business.

There is generally a careful examination of the debt-to-worth ratio of the company to understand how much money the lender is being asked to lend (debt) in relation to how much the owners have invested (worth). As a rule of thumb the maximum a lender is generally willing to contribute to the operation of a company is 75 percent compared to the owners 25 percent. Therefore, a good rule of thumb is a debt-to-worth ratio of 3-to-1.

Collateral is considered a secondary source of repayment for a loan. However, its importance to the structure of the loan should not be under estimated. There are two considerations to the loan structure that are affected by the collateral used to support the request: (1) the term of the loan and (2) the loan amount.

A lender will normally want the term of the loan to match the useful life of the asset used as collateral. Current assets are normally financed with lines of credit that are reviewed annually. Equipment may be financed over three, five or seven years, and commercial real estate is normally financed up to 25 years.

The amount of the loan is typically limited by the lenders perceived liquidation value. Some standard advance rates are shown below.

- **Accounts Receivable –** Up to 80% of eligible receivables
- **Inventory –** Up to 50% of raw materials and finished goods
- **Equipment –** Up to 80% of purchase price or orderly liquidation value
- **Real Estate –** Up to 75% of the lesser of purchase price or appraisal

It is important to remember that collateral is not the primary source of repayment and is only one of the five C's of credit. Exceptional capacity, capital or any of the other components of the five C's may allow for exceptions to the standard terms and advance rates listed above.

Character is the willingness of the borrower to repay the loan. For the most part, there is not a quantifiable measure to judge character. However, a lender will investigate your past payment experience and review a credit bureau report.

Conditions refer to the national and local economy, the industry and the bank itself. This is often difficult to quantify but your lender will be sensitive to the following:

- General economic measures
- Interest rates
- Local economy
- Trends within your industry
- The financial institutions current level of losses and problem credits

Summary

To quantify the financials of any business loan proposal your lender will be relying on the five C's of credit. Of the five C's the most important is the ability to show historic and recurring earnings otherwise known as "Capacity." This gives the lender the comfort in seeing how the loan will be repaid. Capital runs a close second to the Capacity of a business. The Capital injected into the business from its owners shows their commitment and a cushion to keep the company financially sound.

Gryphon Growth Group has assisted a wide variety of companies in successfully raising capital by utilizing resources ranging from growth capital to commercial debt financing to sub-debt, factoring and ABL financing. Working with **Gryphon Growth Group** enables you to achieve three important objectives: (1) you remain focused on day-to-day execution; (2) you gain access to and credibility with a broad range of funding sources and (3) you obtain better terms and a better fit with the right capital provider to meet long-term company objectives.

If you are looking to raise capital, we invite you to contact us today:

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