Five "C"s of Financing

☐ ***C**haracter* ☐ ***C**apacity* ☐ ***C**ollateral* ☐ ***C**ash Flow* ☐ ***C**apital*

Each is important individually, but a lender looks at the overall risk to make a determination if you qualify for a loan.

***Character*:** **Do you have a demonstrated desire to repay debts? Do you have an ability to do what you say you are going to achieve?**

Personal credit bureaus are pulled on each owner who owns 20% or more of the business; if the loan is supported by a SBA guarantee any 20% or more owner must guarantee loan.

Recommend reviewing credit report from TRW, Equifax, Experian, and TransUnion to get problems corrected prior to going to the banks. Problems include collections, past due payments, and bankruptcies.

If there are slow pays you should either:

Pay off the debt, or
Pay as agreed for about 12-18 months.

If there is a bankruptcy:

If any federal debt was discharged, you are ineligible for a SBA guarantee.
For example: VA/FHA home loan, student loan, SBA loan, and business & industry loan.
Must not have any unpaid back taxes.
Potentially acceptable reasons for bankruptcy:

Marital dissolution
Loss of job
Catastrophic illness without insurance

***Capacity*:** **Do you have an ability to achieve performance in the business?**

You must have specific industry experience if you are seeking financing for a start-up business.

Resumes of each owner who will be active in the business are required.

Resumes of employees who are critical to the business are required.

Resumes should focus on a person's skill base as it related to their work history, education, training, offered franchise training, which will make them successful in their business.

***<u>Collateral</u>*:** **Is there sufficient collateral to fully secure the loan?**

The desired goal is to provide adequate collateral to cover 100% of the loan amount with the liquidation value of the collateral.

Advance Formula is the percentage value assigned to different types of collateral to determine the liquidation value/collateral value.

Advance Formulas can vary from bank to bank, but the SBA advance formulas are consistent.

Non-owners can pledge collateral on your behalf. (Must complete a loan application, personal financial statement, and provide the most recent 3 years of past tax returns).

***<u>Cash Flow</u>*:** **Does the business have an ability to generate adequate cash to repay the requested loan?**

<u>Start-ups</u> - Cash Flow Analysis is based on projections

Cash Flow Projection:
- Are the sales/revenue achievable?
  - Tested by asking questions like:
    - Average ticket sale per customer?
    - Average charge per hour?
    - Number of days of operation per month?
    - How long will it take to collect on A/R?
- Are the costs of goods reasonable?
  - What is the mark-up for the industry?
  - How many vendors/suppliers?
  - When do you have to pay the vendors?
- Are the operating expenses reasonable?
  - Number of employees versus wage costs
  - Marketing plan and advertising costs
  - Lease for space

Taxes
Insurance

Existing Businesses - Cash Flow is based on historical performance and projections

Traditional Cash Flow analysis is calculated as follows:

Net Profit (loss)
+ Depreciation Expense
+ Interest Expense
+ Amortization Expense
= Traditional Cash Flow

You should have the Traditional Cash Flow to cover your debt service requirement (loan payments) by about 1.25 times.

For example: If your monthly loan payment is $1,000; then your business should generated Traditional Cash Flow of about $1,250 monthly.

Capital: **Do you have an adequate capital/equity injection to qualify for the loan?**

Capital is the cash or in-kind assets that the owners contribute to the business

Capital is identified in the equity section of the Balance Sheet, in many ways depending upon the legal structure of the business. Such as Sub 'S' or Corporation 'C' (Common Stock, paid in capital, retained earnings).

Leverage is the amount of debt versus your equity (debt to equity ratio).

Start-ups: Loan amounts of $100,000 or less, debt to equity ratio of up to 4:1/5:1. In other words, for every dollar of equity, you can have $4 to $5 in debts. For loan amounts over $100,000, debt to equity ratio of 2:1.

Existing businesses: Debt to equity ratio of up to 4:0/1:0. However, the industry you are in may allow a higher debt to equity ratio.

Acquisition of a business: Debt to equity ratio of 3:1

If you have a note payable that can be subordinated to a bank loan; then that note payable can be analyzed as equity. ***Subordination*** means that the creditor is willing to wait for principal and/or interest reduction on their note payable if there is not enough cash to repay all of the debt.

For instance: Notes Payable from shareholders, family members, friends, seller or private investor.