THE 5 C'S OF CREDIT WORKBOOK

Keys to Bank Approval

Understanding Live Oak Bank's "C's of Credit" will prepare you for the loan application process, paving the way to approval and funding.

DEDICATED TO THE DOERS™

Utilize this workbook to take personal notes and gain insight into how to set yourself up for success. Every business has its unique goals and challenges so take time to prepare for the loan application process by considering each of the 5 C's.

Capital is just one way we invest in you.

Why Live Oak

Service
We strive to provide unmatched service and an unwavering dedication to your success.

Know-How
We'll take you where you need to go with our deep industry and product expertise.

Efficiency
Our commitment to efficiency and transparency helps you avoid costly mistakes.

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THROUGH THE LENDER'S LENS

At the core of the loan process is a credit analysis to determine the risk associated with making the loan, as well as the likelihood that the loan would be repaid. In business financing, it is not just a matter of evaluating the business, but also the person(s) associated with its ownership and operations. Most credit analyses use these five categories to evaluate the risk of a loan:

Character | **Capital** | **Conditions** | **Collateral** | **Cash Flow**

Documents needed to begin applying for business financing:

Character | Can we trust you?

With each interaction, the lender is gathering whether the borrower and guarantors are honest and have integrity. The lender needs to be confident the applicant has the background, education, industry knowledge and experience required to operate this business successfully. This all amasses to answer the question of "Can we trust that you will be able to run this business successfully and be able to pay back our loan?"

Businesses don't run themselves, people run them, and those people have a personal financial history that can help paint a picture of their (likely) future behavior. Many factors influence loan approvals and personal finances, and credit can significantly impact your ability to borrow money for business purposes. A lender will examine the personal credit reports and personal financial statements of borrowers and guarantors associated with the loan.

Your credit report is your track record of prior debt repayment. Your credit report compiles your debt story in one place and tells a reader what debt you've historically and currently had and how successful you are at paying that debt back. Balances, credit limits and payment history are reported from your credit cards, student loans, mortgages, car loans or other lines of credit. Payment history is one of the largest factors in your credit score. It is wise to check your reports before talking to a lender; if there are any delinquencies, be prepared to explain.

Scores are based primarily on the following:

1. Payment history
2. Revolving credit availability
3. Age of accounts
4. Collections
5. Personal bankruptcies
6. Liens and judgments

Capital | What is your investment?

When asking to borrow money from a lender, it is only natural for the lender to ask what personal investment you plan to make or have already made in the business. Contributing personal assets demonstrates that you are willing to take a personal risk for the sake of your business; it shows that you have "skin in the game." The amount needed varies depending on the size, use and type of loan you are requesting.

To assess your personal financial position, the lender will request a personal financial statement (PFS). The PFS is a summary of your assets (things of value you own) and your liabilities (your debts or obligations). From these numbers, you can calculate your net worth, which is assets minus liabilities. Depending on the lender and the type of loan, positive net worth may not be a requirement to qualify for the loan.

Your PFS is also another indicator of your financial responsibility. The types of assets and liabilities you accumulate reflect long-term planning behaviors or short-term spending behaviors. Credit card debt, even in smaller amounts, can appear as a less favorable type of spending behavior when compared to larger student debt balances used to invest in your education, or even an affordable mortgage for a house. Savings are essential as it shows the lender that you are living within your means. There is no silver bullet, and at every stage of your life, someone will look at your PFS differently.

Questions to Consider:

- Does your PFS align with your past and current job positions?
- Does your PFS reflect a history of responsibility when it comes to managing your personal finances?

Credit Resources:

How to Read Your Credit Report

Free Annual Credit Report

5 Things to Check on Your Credit Reports

Check Your Scores More Than Once a Year for Free

Personal Financial Statement Resources:

What Does Your Net Worth Really Mean?

Starting a Business? Shore Up Your Personal Finances First

Personal Financial Statement Template

Notes:

Conditions | What is happening?

This "C" represents the lender getting a grasp on how you will use the money and the industry's health. There are several things that factor into how the lender evaluates the conditions. Lenders like to see positive trends and robust business plans with a thoughtful plan for growth and continuity.

Collateral | What if you don't pay it back?

A lender is not just interested in what happens if everything goes well; they also have to consider the worst-case scenario. What happens if the borrower chooses not to pay back the loaned money? Collateral helps solve this problem by acting as a secondary source of repayment. A lender will consider the value of the business' assets and the guarantors' personal assets as potential collateral for the loan. Collateral also acts as a psychological motivator, as people tend to get more resourceful when they have something to lose. Collateral is an important consideration, but its significance varies depending on the type of loan. A lender will be able to explain the types of collateral needed for your loan.

Common collateral needed for business financing by type:

Buying an existing business: ______

Expansion and construction: ______

Start-up costs: ______

Working capital: ______

Refinancing: ______

Notes:

Cash Flow | How will you pay it back?

Ultimately to approve the loan, the lender wants to get comfortable with how your business will successfully repay the loan. In business financing, there is a different paradigm in evaluating repayment ability than in consumer financing. The repayment ability comes from the business's cash flow — the amount of cash available after ordinary business expenses have been paid. The company should have sufficient income to comfortably support its business expenses and debts while also providing principals adequate salaries to fund personal expenses and debts. Cash flow management is an imperative skill for any small business owner.

Terminology

Revenue
The amount of money generated from business sales and activity. Also referred to as income, sales or "the top line."

Cost of Goods Sold (COGS)
Cost of the materials to perform the services you deliver and goods sold. COGS is the primary variable or direct expense for the business because it varies directly with sales volume.

Gross Profit
Money available for the company to meet its overhead and other general expenses.

Operating Expenses
General expenses of the business not directly associated with a sale. Also known as overhead costs or indirect expenses.

Net Income
The resultant dollar amount after all other expenses have been subtracted from gross profit.

Net Operating Income (NOI)
A simplistic measure of the company's cash flow available. Calculated by adding add-backs to net income.

Margin
Ratios created to translate dollar amounts into percentages to express efficiency.

Debt Service
Total dollar amount owed for principal and interest payments on debt.

Add-backs
Expenses that are assigned to cash flow to normalize a profit and loss statement. Normal add-backs include interest, taxes, depreciation, amortization, one-time expenses, personal expenses and owner's benefits in excess of market such as compensation or rent.

Working Capital
Money available for day-to-day business operations.

Soft Costs
Expenses associated with getting the loan — also called closing costs.

Debt Service Coverage Ratio (DSCR)
Ratio indicating the ability to pay down debt. DSCR of greater than one indicates enough cash flow to pay owner and debt obligations.

EXAMPLE SCENARIO & CASH FLOW 101

For Sale	
Price of Business Assets	
Price of Real Estate	
Total Purchase Price	

Prior Year's Performance	
Annual Revenue	
Net Income	
Add-Backs	
Net Operating Income	

Annual Debt Service	
Owner's Compensation	
Excess Cash Flow	
Debt Service Coverage Ratio	

Prior Year's Key Metrics	
COGS %	
Wages %	

$ Revenues
– $ Cost of Goods Sold (COGS)

= $ Gross Profit
– $ Operating Expenses

= $ Net Income

↓

$ Net Income
+ $ Add-Backs

= $ Net Operating Income

↓

$ Net Operating Income
– ($ Debt + $ Owner Salary)

= $ Excess Cash Flow

($ NOI – Owner's Compensation)
/ Total Debt Service

= DSCR

$$\frac{\$\ \text{COGS}}{\$\ \text{Revenue}} \times 100 = \text{COGS \%}$$

Loan Structure

Type of Loan: ______

Interest Rate: ______

Term Length: ______

Working Capital: ______

Soft Costs: ______

Total Projected Costs: ______

Equity Required (>10%): ______

Total Loan Amount: ______

Monthly Payment: ______

Annual Debt Service: ______

This guide is meant to serve as an educational overview and does not determine final numbers.
Be sure to speak with your lender to discuss options for your specific scenario.

CONCLUSION

Character, capital, conditions, collateral and cash flow are the pillars of typical credit analysis. These five areas help the lender evaluate the owner and the business to understand better the risk of making the loan and the likelihood that the borrower will successfully repay the loan.

To learn more, visit liveoakbank.com

Notes: