BUSINESS LENDING BASICS

HOW TO USE THE PRINCIPLES OF CREDIT FOR BETTER OUTCOMES

MCP FINANCIAL SERVICES

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Your Creditworthiness

Overview

In Australia, the market for business lending is significant. According to APRA data, the total debt owed by businesses to banks is approximately $880 Billion (as of June 2024). When adding Private Credit and ATO Debt, this figure exceeds $1 Trillion.

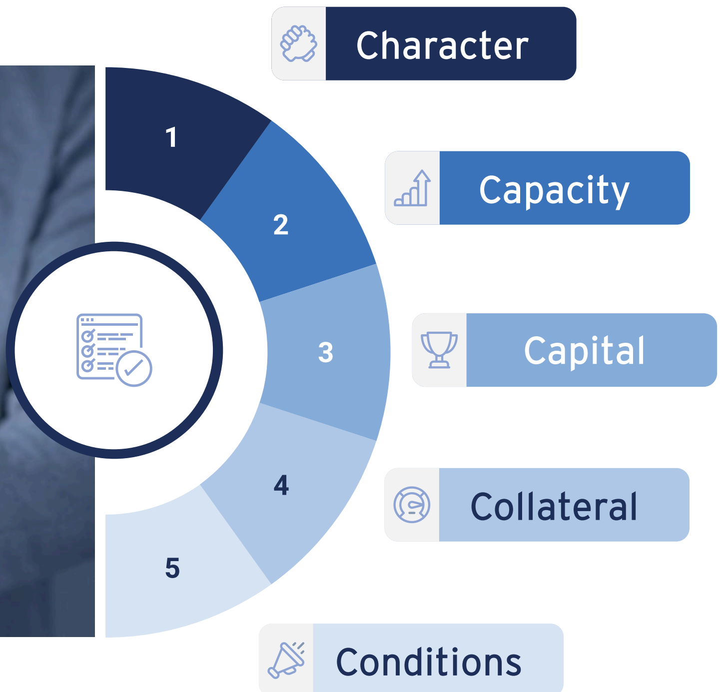
However, many businesses don't get the funding they seek. Too often, we find that this is because they do not clearly articulate their 'story' to lenders. In this situation, an experienced business finance broker can be of invaluable assistance.

The benefit for the business is twofold: the time, money and resources taken to collate and prepare the required information for a credit provider can be put to work to help the business as well.

Insight: A key learning is not to waste an opportunity to plan ahead.

The Five Cs of Credit

Banking credit and scoring models can be complex. In essence, they relate to financial fundamentals. A credit provider will typically follow the "Five C's of Credit". These are:



TIP: For more detailed information on the 5 Cs of Credit, you can visit our blog here

The Five Cs of Credit

01

Character

"Lending is not based primarily on money or property. No sir, the first thing is character." *J.P. Morgan*

Character is best summarised as a borrower's willingness to meet their credit obligations. In other words, how trustworthy and reliable are they?

- Character is reflecting in credit reporting, which has become increasingly sophisticated.
- A new credit reporting process (CCR), has replaced the old "negative" credit reporting, where only adverse events such as defaults and judgements appeared on credit searches.
- Since CCR, banks include information about your ongoing credit conduct, in real time. Your "character" will be measured in a less subjective manner via a credit score.

02

Capacity

"If you would know the value of money, go and try to borrow some."
Benjamin Franklin

Capacity measures historical, current and forecast cash flow or "free cash", and the ability to repay debt obligations from these sources.

Capacity is an area where business can get frustrated. It is the critical "first way out".

- Lenders want the option of multiple sources for retiring debt – cash, cash flow from business, asset realisation, or money from an external source.
- Lenders do not want to draw on assets or guarantors given the increasing level of compliance, uncertainty and adverse public relations. All lenders have responsible lending guidelines that they need to support.
- These guidelines are increasing the levels of bank speak or descriptive covenants in business loans.
- Measures of capacity include terminology such as DSR, ICR, Debt to EBITDA which are useful to research and understand.

The Five C's of Credit

03

Capital

"Capital is that part of wealth which is devoted to obtaining further wealth."
Alfred Marshall & Mary Paley Marshall

Capital is often confused with Collateral. Capital is the value of assets that a borrower owns, which may, or may not, include assets that are pledged as collateral for a loan.

- Lenders like to see some contribution or "hurt" or "skin in the game" from the borrower and this is where a contribution of capital is desired.
- An example of capital is a material level of deposit for a property purchase.
- As an example, a business or mortgage loan may be supported with a property given by a third party (guarantor) of considerable value but without any contribution of capital from the borrower. In this instance, there is a lot of collateral (second way out) but a lack of borrower contribution.
- If a borrower cannot make repayments out of free cash, can they draw on capital reserves?

04

Collateral

"One of the great responsibilities that I have is to manage my assets wisely, so that they create value." *Alice Walton*

Collateral is often confused with Capital. Collateral represents the assets pledged to support the loan – the "second way out" for the lender.

- Included in collateral are the traditional and tangible forms such as property or cash along with specific or general cover over a business and its assets.
- The quality of the collateral provided does in turn drive risk and in turn, pricing.

TIP: It is vital to understand collateral in detail when dealing with a financier.

The Five C's of Credit

05 Conditions

"Finance is not just about lending, it is about recovering loans also."
Raghuram G. Rajan

After meeting the other "Cs", the Conditions of your loan, such as the interest rate, the repayment term and the purpose of the money, are also critical factors.

The updated Banking Code of Practice talks of using more "Plain English" and aims to help borrowers understand their obligations or any covenants that apply to their lending after it is funded.

Covenants are restrictions or requirements that lenders place on a borrower, to provide a structure to monitor the performance of the borrower over the loan term.

SUMMARY

YOUR CREDITWORTHINESS

The 5 Cs of Credit: Character, Capacity, Capital, Collateral, Conditions.

Character	reliability and willingness to meet credit obligations and includes credit score
Capacity	a measurement of past, current and future cashflow in the context of debt repayment and includes responsible lending guidelines
Capital	the value of assets owned by the borrower, available to pledge as collateral if required
Collateral	the traditional and tangible assets pledged to support the loan, includes risk and drives pricing
Conditions	such as interest rate, repayment term, and covenants, which form the critical factors of the loan

How to Use the 5Cs

Protect your Credit History

In lending, your credit score relates to your character. Your credit score in Australia typically ranges from 0 to 1,000 or 1,200. The higher the score, the more financially trustworthy a person is from a lender's perspective.

Previous credit conduct, frequency of applications and other demographic factors such as employment, age, dependants, where you live now and your residential history – all affect your credit score. Since 2014, Comprehensive Credit Reporting (CCR) has included more details of the credit you have (such as actual loan terms and repayment history) in your report.

Although credit scoring is not new, it now includes deeper demographic data, which allows a credit provider to analyse high-volume historical behavioural data to produce a more sophisticated real-time credit assessment.

Be proactive by checking your credit score regularly. *Platforms like My Credit File, Get Credit Score, Experian, and Equifax allow you to safely view your credit score.*

How to Use the 5Cs

Gain Faster Approval

When financiers want to target a direct segment of a market with a product, they may set criteria for fast-tracking credit approval.

You could be eligible for immediate approval without the need to supply additional income documentation if you meet the stated conditions, such as:

- Have been in business for 2 years and have a registered ABN (Collateral/Capacity)
- Have a clear credit history (Character)
- You own a residential property (Capital)
- Your ATO Tax Portal is active and clear of overdue instalments (Character/Capacity)

In addition, the interest rate on this facility may be better than if you do not meet the criteria and need to supply other documentation.

How to Use the 5Cs

BUSINESS PLANNING

a

Your Business Plan

Create a well-written plan that clearly outlines your business strategy, financial projections, and future goals. You must demonstrate to lenders that you have a solid understanding of your business and industry.

Showcase your business strengths and emphasise the strengths of your management team, which may also reduce key person risks.

Insight: The business plan does not need to be long. Ensure the key assumptions and your "must win battles" are clearly stated and supported with good strategy.

b

Identify and Mitigate Risks

Be proactive in identifying potential risks to your business and develop strategies to mitigate them. Show lenders that you are prepared for various scenarios.

Insight: Every business or venture has risks. Solid businesses will speak to these and demonstrate how they can be mitigated.

c

Demonstrate Industry Knowledge

Your plan should show a deep understanding of your industry, market trends, and competitive landscape. Access industry reports and use accurate data such as size, markets and future impacts.

How to Use the 5Cs

KNOW YOUR NUMBERS

a

Basic Financials

When applying for credit, a business must demonstrate a thorough understanding of its finances, including the composition of revenues, gross margins and expenses.

Lenders also want to know what is happening now in the business, not just the historical performance. Show how you plan to use the borrowed funds and what impact it will have on the numbers going forward.

Provide well-researched, realistic financial projections that test upside and downside scenarios.

Insight: It is helpful to speak the lender's language. Financial measures such as "Debt Service Cover Ratio" and “Interest Cover Ratio" are not complex to learn, so don't be intimidated. See our blog on How to Fund Business Growth.

b

Provide Multiple Exit Strategies

Demonstrate to lenders how they'll get their money back by offering multiple scenarios for loan repayment.

Insight: Lenders want to see debt repaid and interest commitments serviced via cash generated from a business or project. This is referred to as the "First Way Out".

c

Manage Cash Flow

Do you know your Working Capital Days? Get a handle on your cash flow by forecasting short-and long-term trends. Make sure you understand the assumptions that affect key business areas.

Insight: Most businesses do not understand how much cash they need to sustain normal operations. Good businesses do, and fortunately these skills can be acquired. See our BUSINESS CASH FLOW GUIDE.

How to Use the 5Cs

FINANCIAL 'HYGIENE'

a

Good Processes & Management Information Systems (MIS)

When meeting with lenders, be prepared and ready with up-to-date paperwork, tax and statutory records and financial statements. Being organised shows professionalism and reliability (Character).

b

Cultivate Banking Relationships

Maintain ongoing relationships with banks, even when not seeking a loan. Regularly share information about your business's performance and plans, either by email or one-on-one.

c

ATO Conduct

The ATO is not a funding mechanism. Lenders will focus heavily on the business and owner/s history of meeting tax commitments when considering creditworthiness.

Insight: Lenders will consider the detailed payment history of all tax-paying entities, not just the entity that is seeking credit.

d

Covenant Management

Typically, lenders will require that borrowers continue to meet ongoing criteria to ensure the credit terms. Covenants can relate to quality standards (qualitative) or be based on numbers (quantitative) and generally help keep business planning on track.

How to Use the 5Cs

YOUR FINANCIAL LITERACY

By implementing these strategies, you can significantly improve your business's attractiveness to lenders and increase your chances of securing favourable conditions for overall lending terms.

Remember that building a strong relationship with potential lenders and presenting a well-prepared, financially sound business case are key factors in becoming a better prospect for borrowing money from banks.

It could be that the business (and business owners) need to acquire new financial skills to aid financial literacy. Fortunately, there are many resources for help and support.

Learning the language of credit will help you gain the esteem of lenders while providing insights you can use to run your business better.

What's Next?

Find a Finance Broker

Your finance broker will work in partnership with you to identify your ability to obtain credit based on the 5Cs.

Your broker will understand how to present your application on your behalf to increase the likelihood of an approval.

A reputable broker will deal with many credit providers and can find a finance product that delivers the proper finance structure, suitable flexibility and competitive interest rates for your needs.

Communicating your story along with an outline of all risks and mitigants are key factors.

About MCP Financial Services

Since 1999, MCP Financial Services has assisted individuals and businesses with financial broking and advisory solutions - from simple to complex. We have funded over $5 Billion in commercial, asset and residential finance while being involved in the purchase and sale of over 10,000 properties and businesses.

With representation in Melbourne, Sydney & Brisbane, along with several regional locations in Queensland, New South Wales & Victoria, we offer a vast network of professional services contacts.

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