Equipment Financing and The Five Cs of Credit Evaluation

Equipment financing lenders, as well as banks, use the Five Cs to evaluate loan applications: Character, Credit, Cash Flow, Capacity and Collateral. However, while banks look at small-to-medium size companies from a Fortune 500 perspective, equipment financing companies see applicants from a small business perspective, which highlights a sixth C: Common Sense.

Here is what a lending institution means when referring to the Five Cs:

Character - Every lender wants to understand what type of borrower an applicant will be in order to make smart, safe credit-granting decisions. The longer a company has been in operation, the more its payment history and outstanding credit reveal management's attitude toward debt and making timely payments. Public records and references can come into play; still, the most reliable yardstick is the character of a smaller company's owners. How they manage their personal financial obligations is usually a reliable indicator of the likelihood of their making timely payments. The more closely held a company, the more attention given the personal credit history of those in charge and their prior business history. No matter how solid a business plan appears and how reliable a company's owners have been in the past, the realistic lender also wants the assurance of personal guarantees from the company's owners. This may take the form of a signature or a pledge of cash or other collateral.

Credit - Business credit reports offer a quick glance at a company's willingness to pay trade accounts on time, as well as any derogatory public records, such as suits, liens, or judgments that negatively affect a company's credit rating. Such reports also show any UCC filings. Potential equipment lenders are interested in the depth of a business's borrowing history. The longer a company has been in business, the easier it is for a lender to determine credit stature; a good ten- or twenty-year credit history obviously carries enormous weight. This places a startup company less than two years old at a disadvantage. So, when traditional data sources, such as Dun & Bradstreet and Paynet cannot supply adequate information, the personal credit histories of a company's owners become highly important.

Cash Flow - Lenders want to see that any company applying for a loan earns enough money to meet payroll, cover fixed operating expenses, and comfortably make timely payments on a new equipment loan or lease. While there are a number of ways to define cash flow, lenders most often calculate the cash flow available to repay new debt as net profit plus such non-cash expenses as amortization and depreciation.

Capacity - Capacity is similar to a football team's depth chart. The capacity to weather bad times is equally important to a company seeking funds. Capacity acknowledges that sometimes unforeseen things happen: a key employee becomes unable to work; a major customer is lost; an economic turn-down drastically reduces demand for product or services. Any number of other unlikely – yet possible – disruptions can negatively affect a company's cash flow. And these disruptions can be temporary or permanent. So, capacity measures a company's ability to pay off an equipment loan or lease with cash reserves or its ability to quickly convert real estate, stock, or other assets into enough funds to cover debt.

Collateral - How much collateral, above and beyond the equipment being financed, a company needs to secure a loan or lease depends largely on the nature of the lender and status of the business. A traditional bank often requires a blanket lien on all assets of the business while an equipment finance company normally uses only the equipment for collateral. A few lenders also offer sale-leasebacks and refinancing of existing equipment debt. This allows a company to free up cash flow or lower their monthly payment through equipment loans or leases.

Common Sense - Every decision to purchase and every decision to grant financing must be based on common sense. A lender needs to understand how additional equipment will increase the company's stability and growth. Notwithstanding the risk every lender takes and the gamble every company makes when purchasing new equipment, for both lender and borrower, the foundation of a decision to finance equipment begins and ends with common sense.

Crest Capital http://www.crestcapital.com is a business equipment financing company headquartered in Atlanta.