

# UNDERSTANDING THE 5 C'S OF CREDIT

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APRIL 2025

***Franklin International***

# AGENDA

- Introduction
- Overview of the Five C's of Credit
- Each Factor's Role in Credit Analysis
- Why Do they Matter in Business Lending Decisions?
- Credit Applications
- Investigations
- Case Study
- Q&A

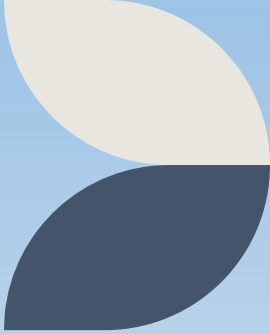
# THE 5 C'S

The **5 C's of Credit** are key factors lenders use to assess a borrower's creditworthiness:

- Character
- Capacity
- Capital
- Collateral
- Conditions



# CHARACTER – BORROWER’S TRUSTWORTHINESS



<b>APPLICATION FOR COMMERCIAL CREDIT</b>		MAIL THIS APPLICATION TO:	
HAJOCA CORPORATION			
Applicant: Business or Corporate Name		Application Date	
Business Street Address		Billing Address	
City	State	Zip Code	City
			State
			Zip Code
Business Telephone No.	Business Fax No.	Year Business Was Established	
Business Email Address		Contractor's License No.	
Applicant is Engaged in the Business of		Amount of Monthly Credit Desired	
Sales Tax Exempt? <input type="checkbox"/> Yes* <input type="checkbox"/> No		*If Yes, Please Attach a Copy of Valid Exemption Certificate	
		Federal Tax ID #	
Type of Business <input type="checkbox"/> Proprietorship <input type="checkbox"/> Partnership <input type="checkbox"/> Corporation <input type="checkbox"/> LLC			
Business Building is <input type="checkbox"/> Owned <input type="checkbox"/> Rented/Leased		Monthly Statement Required? <input type="checkbox"/> Yes <input type="checkbox"/> No	
Invoice Delivery Options: <input type="checkbox"/> Mail <input type="checkbox"/> Fax <input type="checkbox"/> E-mail			
<b>PLEASE ATTACH A COPY OF APPLICANT'S MOST RECENT FINANCIAL STATEMENT</b>			
<b>BANK OR SAVINGS AND LOAN ASSOCIATION:</b>			
Name	Branch Address	Account No.	Phone No.
<b>SUPPLIER REFERENCES:</b>			
Name	Address	Phone No.	Account No.
			Fax No.
Have You Done Business with Other Hajoca Locations? <input type="checkbox"/> Yes <input type="checkbox"/> No If Yes, Please List:			
Has a Tax Lien or Civil Suit Been Filed Against Applicant or Any of Its Principals, Partners, Officers or Directors Within the Past Six Years? <input type="checkbox"/> Yes <input type="checkbox"/> No			
Has Applicant or Any of Its Owners, Principals, Partners, Officers or Directors Ever Filed a Voluntary Petition in Bankruptcy or Been Adjudged Bankrupt? <input type="checkbox"/> Yes <input type="checkbox"/> No			
Is Applicant or Any of Its Owners, Principals, Partners, Officers or Directors a Guarantor or Endorser of Debts or Notes Owed by Other? <input type="checkbox"/> Yes <input type="checkbox"/> No			
Are There Any Past Due Taxes Owed by Applicant? <input type="checkbox"/> Yes <input type="checkbox"/> No			

**GENERAL TERMS:** This Credit Application ("Application") is between Hajoca Corporation ("Hajoca") extending credit and the Applicant named on page one hereof ("Applicant").

- A borrower’s reputation and track record for repaying debts. This includes credit history, references, and past financial behavior.
- The willingness of the debtor to pay obligations
- Morality
- Integrity
- Trustworthiness
- Quality of management
- The Company / Individuals previous background

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## WHAT SHOULD BE ON IT

- Company Information
- Business Information
- Bank Information
- Proprietor Guaranty
- Terms of Sale
- Appropriate Signature
- Approval Signatures
- Billing Address
- Type of Business
- Your terms and Conditions
- D&B Number

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# CAPACITY – ABILITY TO REPAY

The borrower's ability to repay the loan, assessed through income, employment stability, and debt-to-income (DTI) ratio.

## Key Ratios:

- Debt-to-Income (DTI)
- Percent Current - %Current
- Debt Service Coverage Ratio (DSCR)
- Red flags: High DTI, irregular income sources
- To operate successfully and the ability to pay when the debt is due
- Measured by the applicant's ability to generate positive cash flow

# CAPITAL – BORROWER'S FINANCIAL STABILITY

- The borrower's personal investment or financial reserves, such as savings and assets, which demonstrate financial stability.
- The equity or net worth signifies the financial strength
- The trend of business is significant and weighs heavily in the overall judgement of the customer

# COLLATERAL – LOAN SECURITY

- Assets pledged by the borrower to secure the loan, reducing the lender's risk in case of default.
- Role in Risk Mitigation
- Examples: real estate, vehicles, inventory, equipment
- Loan-to-Value (LTV) ratio impact
- Additional resources in assets or other equities
- UCC Financing statements
- Security Agreements
- PSI (Priority Security Interest)

# CONDITIONS – EXTERNAL FACTORS

External factors such as interest rates, industry trends, and economic conditions that may impact repayment ability.

Key Considerations:

- Regulatory impact (Fair Lending, CRA, etc.)
- Economic climate
- Business cycle
- Industry risks
- Community
- Fiscal
- Political

# CHALLENGES CREDIT PROFESSIONALS FACE

## **Market Volatility & Economic Uncertainty:**

- Fluctuating raw material prices / geopolitical instability can impact customer liquidity & ability to pay.
- Global economic downturns or trade restrictions can lead to increased credit risk.

## **Regulatory & Compliance Risks:**

- Strict environmental and safety regulations can create financial strain on customers, affecting their creditworthiness.

## **High Customer Concentration Risk:**

- Many manufacturers rely on a few large customers, making the business vulnerable to financial distress in key accounts.
- The impact of a single major default can be significant.

## **Supply Chain Disruptions:**

- Delays in supply chains due to raw material shortages or logistics issues can lead to delayed payments.
- Just-in-time inventory practices mean any disruption can quickly impact cash flow.

# CHALLENGES CREDIT PROFESSIONALS FACE

*CONT.....*

## **Credit Risk Assessment in a Technical Industry:**

- Understanding the financial health of specialized companies requires in-depth industry knowledge.
- Evaluating risks for customers in emerging markets with limited credit history is challenging.

## **Managing International Credit Risk:**

- Exporting outside U.S. involves foreign exchange risk, varying credit laws, and geopolitical uncertainty.
- Political instability in certain markets can lead to sudden payment defaults.

## **Fraud & Counterparty Risk:**

- Increasing cases of fraud in credit applications and fake companies seeking supplier credit.
- Identifying fraudulent accounts before extending credit requires enhanced due diligence.

## **Balancing Sales & Risk Management:**

- Sales teams may push for extended credit terms to close deals, while the credit manager must mitigate financial exposure.
- Striking the right balance between growth and risk is a constant challenge.

# SUMMARY OF THE 5 C'S

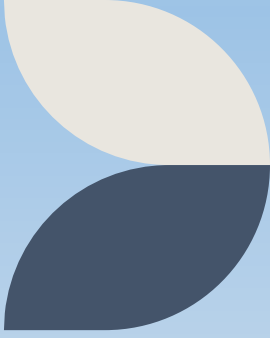
What are the best practices for Credit Professionals  
in applying the 5 C's?

# KEY TAKEAWAYS FOR CREDIT PROFESSIONALS

- Assess financial health comprehensively—look beyond revenue to debt ratios, profitability, and industry risks.
- Ensure collateral is sufficient to secure the loan in case of default.
- Monitor past payment behavior as an indicator of future performance.
- Align credit decisions with the borrower's business outlook to minimize risk.

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# **Q&A AND DISCUSSION**



# Comparison: 5 C's vs. 7 C's of Credit

The **5 C's of Credit** are the traditional framework used to assess a borrower's creditworthiness. The **7 C's of Credit** expand on this model by adding additional factors that provide a more detailed risk analysis.

## Key Differences

The **7 C's of Credit** build on the traditional 5 C's by adding **Control** and **Cash Flow** to consider **external risks** (such as regulations and industry shifts) and **internal financial liquidity** (day-to-day cash movement).

The **5 C's focus on borrower-specific factors**, whereas the **7 C's provide a more holistic view**, incorporating both borrower-related and external influences.

Factor	5 C's of Credit	7 C's of Credit
Character	✓	✓
Capacity	✓	✓
Capital	✓	✓
Collateral	✓	✓
Conditions	✓	✓
Control	✗	✓ (Focuses on regulatory and industry-specific risks affecting credit decisions.)
Cash Flow	✗	✓ (Considers the movement of funds to assess liquidity and ability to meet obligations.)

# CASE STUDY:

## CREDIT MANAGER'S DECISION CREDIT – USE THE 5 C'S TO MAKE YOUR DECISION

### **Company Background**

- **Lender:** GrowthBank Financial Services
- **Borrower:** PawTech Manufacturing, Inc.
- **Industry:** Pet Supplies Company
- **Credit Request:** \$80,000

## Scenario 1:

### **Borrower Profile:**

- **Revenue:** \$5M annually, with steady growth over the last five years.
- **Profit Margins:** 12% with consistent profitability.
- **Debt-to-Equity Ratio:** Low (1.2:1), indicating a manageable debt load.
- **Collateral:** Secured by accounts receivable and inventory worth \$1M.
- **Credit History:** Strong, with a history of on-time payments on past obligations.
- **Industry Outlook:** Favorable, with increasing demand for chemical products.

## Scenario 2:

### **Borrower Profile:**

- **Revenue:** \$10M but declining due to supply chain disruptions.
- **Profit Margins:** Shrinking, down to 3% due to rising production costs.
- **Debt-to-Equity Ratio:** High (4:1), signaling significant financial leverage.
- **Collateral:** Limited, as most assets are already pledged for existing loans.
- **Credit History:** Spotty, with recent late payments and a history of cash flow struggles.
- **Industry Outlook:** Volatile, with increasing regulatory restrictions on chemical manufacturing.

## Scenario 1:

### Decision & Rationale:

✓ **Approved for a \$80k credit:**

- The company has a **strong financial position**, low risk of default, and sufficient assets to secure the loan.
- Their **working capital needs align with the LOC purpose**, ensuring liquidity for raw material purchases.
- A **solid repayment history** minimizes default risk.

### Outcome:

- SwiftTech **uses the credit line efficiently**, ensuring smooth operations.
- They **expand production** without cash flow disruptions.
- GrowthBank **earns interest revenue** while maintaining a low-risk lending relationship.

## Scenario 2:

### Decision & Rationale:

✗ **Denied the \$80k:**

- The company is **financially unstable**, with declining revenue and profits.
- High debt levels increase the **risk of non-repayment**.
- Weak collateral position** limits lender security.
- A **volatile industry outlook** raises concerns about long-term sustainability.

### Outcome (if approved anyway):

- SwiftTech struggles to **make interest payments**, leading to defaults.
- GrowthBank **faces financial losses** due to non-repayment.
- The **borrower eventually files for bankruptcy**, leaving the lender with bad debt.

# Separate Handout



## 5 C's of Credit Cheat Sheet

- **1 Character (Trustworthiness & Credit History)**  
Assesses the borrower's reputation for repaying debts.  
Factors: Credit score, payment history, references, past financial behavior
- **2 Capacity (Ability to Repay)**  
Measures income and financial stability to determine repayment ability  
Factors: Debt-to-income ratio (DTI), employment history, income sources
- **3 Capital (Financial Strength)**  
Evaluates the borrower's assets and personal investment in the loan  
Factors: Savings, investments, down payments, net worth
- **4 Collateral (Security for the Loan)**  
Assets pledged to secure the loan in case of default  
Factors: Real estate, inventory, equipment, vehicles
- **5 Conditions (External Factors)**  
Considers market conditions and how they affect loan repayment

## **Lending Risk Checklist**

1. Evaluate Credit History
2. Assess Debt-to-Income Ratio
3. Verify Capital Reserves
4. Confirm Collateral Value
5. Consider Market Conditions