The 5 Cs of credit analysis

If a little does not go, much cash will not come.
Chinese proverb

In this article we continue with discussion of the 5 Cs of Credit which began in the last two articles. So having discussed Character and Capacity in the last two articles, we now turn to the third element of the 5 Cs of Credit, which is Capital. Capital refers to financial reserves such as assets belonging to promoters of a business e.g., personal savings, investments, property, land, etc., that can be deployed into a business. After all, there is a saying that it takes money to make money, so to start with the promoters of a business have to invest their own funds to provide the capital or funds needed to cover start-up costs, acquire machinery and equipment, and provide working capital.

According to Noradiva and Azlina (2016) capital represents ownership and demonstrates commitment and confidence in the business. Strischek (2000) also suggests that capital is what is needed to get the business going beyond the break-even point into the early stages of a profitable operation that subsequently matures into a business investment that generates a satisfactory return on equity. Therefore, capital reflects the stake the owners are willing to risk should the business fail. The more promoters put into a business the less the risk of default on a loan. As expressed in the Chinese proverb above "*if a little does not go, much cash will not come*". In other words, people have to take risks with their own money first, if they want to make more money.

Assessing capital

When assessing capital for an individual borrower, financial institutions look for financial assets that the borrower might have such as a bank account, investments, and others. In addition, they assess the contribution that the promoter has committed to make to the project. These would indicate the extent to which the borrower is willing to put up own assets towards the project to demonstrate willingness to share in the risk. Sometimes people say, ‘if I had my own money why would I turn up to apply for a loan?’, and it might sound quite reasonable. However, the reasons given above that people need to demonstrate commitment to their own businesses are very important and cannot be overlooked in the credit analysis process.

In the case of enterprises or firms such as SMEs, capital is assessed using a similar approach except that the process gets a bit complex in that it is the enterprise that is assessed because the enterprise is supposed to be a legal entity that should be separate from its owners. Two ratios are used to assess capital for enterprises or firms, namely: Debt ratio and Debt-to-Equity ratio (Noradiva and Azlina, 2016). These are leverage ratios as they assess the extent to which a firm’s assets have been financed by debt and its ability to service the financial obligations when they are due. As a consequence, a firm with more capital can access significant debt compared to one with low levels of capital because it will be assessed as being better able to meet its financial obligations.

- ✓ Debt ratio

This ratio is calculated as Total Liabilities divided by Total Assets. Both items in the formula are to be found in the balance sheet. Liabilities finance acquisition of assets needed by a business, and the level of liabilities is influenced by the level of capital invested by the owners of the business. The more capital invested by the owners, the more a firm can access debt finance to invest in more assets. Therefore, Debt ratio essentially compares the proportion of total assets financed by total liabilities. There is no rule of thumb for this ratio but it is important for borrowers to not over-leverage or over borrow as it could result in a significant portion of their profits going to service debts at the expense of reinvesting and growing the business. Over leveraging would also limit the extent to which a firm can access additional debt finance for the business. Therefore, an appropriate level of capital must be maintained by firms in order for them to benefit from having access to debt to invest in the business. Debt is supposed to be a relatively cheaper source of financing compared to owners’ equity hence the reason firms strive to maintain appropriate capital levels that allow them to leverage more debt whenever they need it.

- ✓ Debt-to-Equity Ratio

This ratio is calculated as Long-term Debt divided by Equity. Both items in the formula are to be found in the balance sheet. Debt-Equity Ratio as it is usually referred to compares debt and equity to determine the firm’s capacity to meet long-term obligations when they fall due. Peprah, et al (2017) suggest that capital is important because, a firm with high equity (capital) is capable of covering all expenses to ensure break-even and profitability. There is no rule of thumb for this ratio but a ratio of 1:1 is considered adequate, even though it may vary by industry (Ramagopal, 2018).

Conclusion

The point of assessing a borrower's or a firm's capital is to look for indicators that the borrower is willing to commit more resources to the business as the promoter. Except perhaps for venture capitalists, typical lending institutions; banks, MFIs, etc., are not in the business of providing all the needed capital to finance enterprises, but would like to see a certain level of commitment through own resources deployed in the business by promoters. The more a promoter invests in a business, the more the level of commitment, and the greater the chances that the business would succeed.

Assessment of capital is very important in credit decision making. It reflects the level of risk a promoter is willing to take in order to see their dream become reality. In credit risk assessment, capital has to be assessed separately as one of the 5 Cs of credit and a borrower has to score well on it to stand a chance of obtaining a loan.

In the Ghana study referenced in the last article on capacity, both local banks and foreign banks operating in the country ranked capital as the least important (number 5 on a scale of 1 to 5), which might appear strange but not so to those concerned as they place more importance on other elements of the 5 Cs of Credit.

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