



KREDED



HELPING BUSINESSES
KEEP THE LIGHTS ON

LET'S TALK ABOUT CASH FLOW

A beginner's guide to CASH FLOW.
What it is, what is not, and what lenders look for.

www.kreded.com

CONTENTS

- 2 Introduction
- 3 Defining a cash flow
- 4 What is not cash flow
- 5 Traditional cash flow
- 6 Statement of cash flow
- 7 What lenders look for

INTRODUCTION

As we learned in Let's Talk About Loans (*Book 1 of the Let's Talk About series*), the main goal of a lender is to get their money back.

Lenders do not provide loans with the intention to take over the collateral to collect their principal; they extend loans to those businesses they think have the capacity to generate cash to repay the loan according to the terms agreed on, and make some extra income by collecting interest.

Among other things, lenders rely on their analysis of the financial performance and financial position of a business to determine if it is a credit worthy business.

This process is typically called underwriting or credit analysis. The following pages will show what underwriting looks like and how it is linked to cash flow.

WHAT IS CASH FLOW?

Cash flow is inflow or outflow of cash, measured by the business' capacity or lack thereof to produce cash from the sale of goods and services, after it has accounted for certain expenses for a period of time.

When a business produces a positive cash flow, it is said it has a surplus; when a business shows a negative cash flow, it is said it has a deficit.

Cash flow should not be confused with gross profit or net profit. A business can produce positive cash flow from operations and still report losses.

There are several ways to determine cash flow when seeking a business loan. It is typically based on the lender's internal underwriting criteria, methodology, business strategy, and risk.

Also, depending on the loan type, some lenders will use different variations of the cash flow. The two most common ones are the traditional cash flow analysis and the cash flow from operations analysis. *We will discuss both on the following pages.*

What is important to keep in mind is whether the lender uses the traditional method or the cash flow from operations method, is that it should always be positive and sufficient to cover all the debt of the business.

WHAT IS NOT CASH FLOW

1 Cash flow is not sales.

2 Cash flow is not gross profit.

3 Cash flow is not net profit.

4 Cash flow is not cash in the bank.

TRADITIONAL CASH FLOW

Traditional cash flow is determined by using EBITDA or Earnings Before Interest, Taxes, Depreciation and Amortization.

It discounts any changes in accounts receivable, accounts payable, and inventory.

Below are two examples of traditional cash flow analysis.

Net Income (Loss):	(\$50,000)
Interest expense:	\$15,000
Taxes expense:	\$ 5,000
Depreciation:	\$35,000
Amortization:	\$ 5,000
EBITDA:	\$10,000

As shown in the above example, some companies can report losses and still report a positive EBITDA due to the add back of non-cash expenses such as depreciation and amortization, and some other tax benefit expenses such as interest and taxes .

TRADITIONAL CASH FLOW

In the following example, the company reported a positive net income; which afforded it a much higher loan repayment capacity of \$110,000, potentially qualifying the company for a much higher loan.

Net Income (Loss):	\$50,000
Interest expense:	\$15,000
Taxes expense:	\$ 5,000
Depreciation:	\$35,000
Amortization:	\$ 5,000
EBITDA:	\$110,000

STATEMENT OF CASH FLOW

As the name implies, the statement of cash flow, accounts for activities that impact cash from the receipts and payments of cash.

It is important to note that the statement of cash flow is broken down into three sections: a) operating activities, b) investing activities, and c) financing activities.

The goal of this analysis is to assist investors (*lenders included*) assess the business' short and long term financial health by assessing several qualifying factors such as:

- a) The business' ability to generate positive cash flow in future periods.
- b) The business' need for external financing.
- c) The business' ability to meet its financial obligations.

The following example, provides a snapshot of the statement of cash flow.

STATEMENT OF CASH FLOW

Net income:	\$390,000
<i>Adjustments to reconcile net income to net cash used in operations</i>	
Depreciation:	\$65,000
<i>Change in working capital</i>	
Accounts Receivable:	-\$455,000
Inventories:	\$165,000
Prepaid expenses:	\$0
Accounts Payable:	- \$230,000
Accrued expenses:	\$8,000
Income tax payables:	\$140,000
<i>Net cash provided by operating activities:</i>	<i>\$83,000</i>

Note that the lender will review and analyze the entire statement of cash flow, including the investing and financing sections; however, based on the above example, we can deduce that the business is generating positive cash flow from operations.

STATEMENT OF CASH FLOW

Cash flow from investing activities:

Fixed assets	\$0
--------------	-----

Net cash used in investing activities:	\$0
---	------------

Cash flow from financing activities:

Sale of stock:	\$0
----------------	-----

Net repayments on line of credit:	-\$100,000
-----------------------------------	------------

Principal payments on long-term debt:	-\$75,000
---------------------------------------	-----------

Net cash from financing activities:	-\$175,000
--	-------------------

Net increase (decrease) in cash:	-\$92,000
----------------------------------	-----------

Beginning cash:	\$588,000
-----------------	-----------

Ending cash:	\$496,000
---------------------	------------------

The above reconciliation shows a decrease in cash. The ending cash should match the cash reported in the balance sheet for the corresponding period of the statement of cash flow.

With this analysis the lender is able assess how the company generates and manages its cash.

DEBT SERVICE COVERAGE RATIO (DSCR)

The Debt Service Coverage Ration (DSCR) is a metric used to determine the business' repayment capacity based on the parameters of the proposed loan.

Let's look at an example of a business seeking a \$500,000 loan. The lender is proposing a 7 year term and amortization at 5.0%. The following example applies the traditional cash flow method to qualify the business for the \$500,000 loan request.

Net Income (Loss):	\$50,000
Interest expense:	\$15,000
Taxes expense:	\$ 5,000
Depreciation:	\$35,000
Amortization:	\$ 5,000
.....	
EBITDA:	\$110,000
Annual Debt Service:	\$84,803
Annual DSCR:	1.30x

The annual debt service is the monthly payment of \$7,066.95 ,based on the term of 5% amortized over 7 years, multiplied by 12 months.

Based on our understanding of what the expected DSCR of 1.20x or higher, this borrower qualifies for the loan as it shows sufficient cash flow to repay the loan.

WHAT LENDERS LOOK FOR

Lenders want assurance that they are going to receive monthly payment that will make earn interest income and for that the business (borrower) must show substantial and sustainable cash flow trends. Here a few of the items lenders look for.

1

Debt Service Coverage Ratio of 1.20x or higher *(depending on the industry and risk of the loan).*

2

History of steady or increasing positive cash flow.

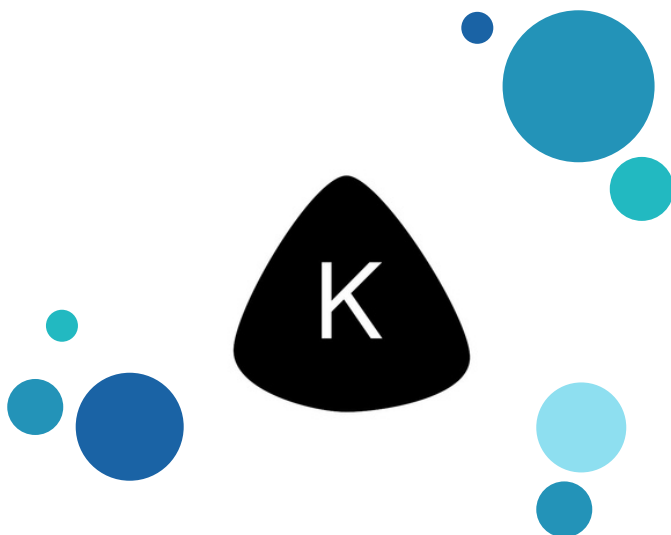
3

Trends of upward sales.

4

Clean balance sheet. *(Balance sheet with minimal levels of debt).*

ABOUT KREDED



KREDED

KREDED is an innovating commercial loan marketplace, servicing middle market companies. Our mission is to help businesses keep their lights on by giving decision makers more time to focus on operating their businesses; while providing convenience and a streamlined funding process.

You can email KREDED at capital@kreded.com
