

DOMINIC LAMBRINOS

THE INIC INSTITUTE

FINANCIAL COURSES THAT MAKE SENSE



How to Understand Cash Flow Finance in One Day

COURSE THREE - 11 MODULES



Module 1

Course Summary

The purpose of this course is to provide mortgage brokers with a package of information and advanced skills and tools in order to establish leasing as an additional profitable working income stream.

The objective is:

1. To introduce a range of new leasing products into your business offerings.
2. To better understand the intricacies of each constituent product and confidently package one or more of these together to satisfy a client's needs.
3. To understand how you would structure your fee schedule across the different leasing products.

In the real world, a client may approach you and say something to the effect of, "I need to purchase a truck so I can make more deliveries in order to meet increasing customer demand."

Unfortunately, however, there are multiple leasing arrangements this client can implement and without a deep understanding of each option (and without understanding the language in the fine print!) this client's requirements may not be properly satisfied.

For example, common issues arise when clients only focus on monthly repayments and do not completely understand the issue of ownership of the asset.

Not only will this course introduce you to leasing and even show you how to attract clients, but it will also teach you the skills necessary in order to profitably and efficiently meet business dilemmas such as the one alluded to above.

The intention of this course is to equip you with a novel and valuable set of skills and leasing products that you can offer your clients in addition to home loans, and is designed to ultimately differentiate you from your competitors so that you can enjoy a competitive sustainable advantage.

With the development of these skills it is intended that you will increase revenues via new incomes derived from these services. Further, you would benefit from improved client retention, increased referrals and the ability to earn a higher level of ongoing fees.

INTENDED PARTICIPANTS

This course has been designed for those who hold a Diploma in Financial Services (Finance/Mortgage Broking) although new entrants may also benefit as they develop the skills to deliver these services.

Participants will likely be mortgage brokers who wish to increase their product offerings and provide a more holistic service to their clients.

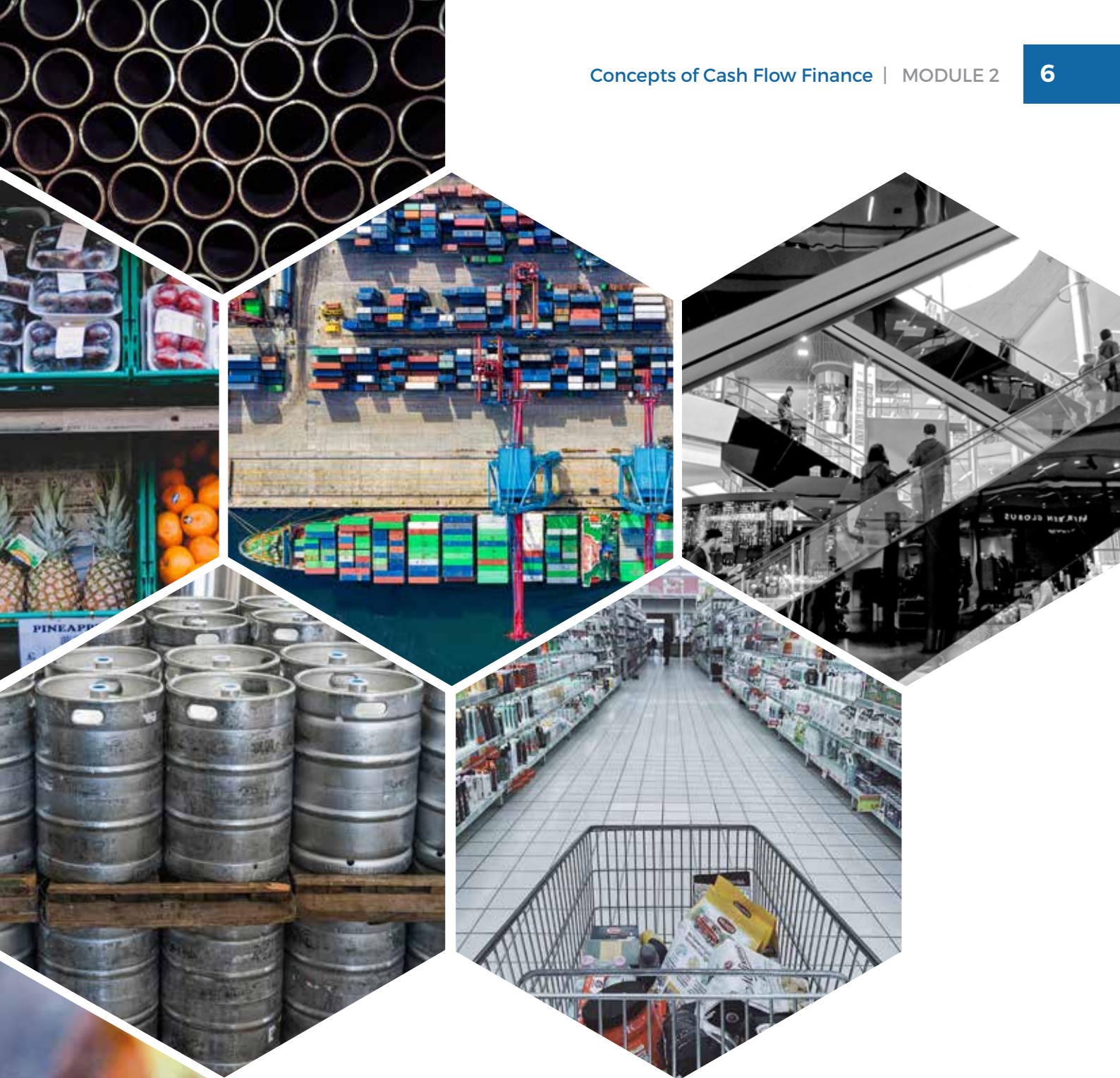
The course focuses on both the practical application and technical skills required to introduce leasing, and its constituent products, as an additional stream of income.



CPD HOURS

Industry bodies apply their own individual criteria for the awarding of continuing professional development (CPD) hours.

At present this course provides for 6 hours CPD for the Finance Brokers Association of Australia.



Module 2

Concepts of Cash Flow Finance

2.1 What Constitutes a Business?

- ❖ People can make money through two different means; they can work for a company and receive a salary, or they can operate their own business.
- ❖ Consequently, a business is an activity or enterprise that exists to make a profit.
- ❖ A business can make a profit by buying and selling goods, manufacturing goods for sale or it can be entirely service-based.
- ❖ This is clearly quite broad, so a business can be something obvious such as Google or a single professional IT consultant.

2.2 Business Structures – Discussion with the Author

There are several different types of business structures, but in Australia the main structures are:

Sole trader	This is the most common form for a small business. It suits a small/ single operation such as a tradesman, small accountant or solicitor, and even the typical small corner store. Generally sole traders do not employ many employees, if any at all.
Company	<p>A company is a separate legal entity, used by people in business to delineate their business activities from themselves.</p> <p>You can have a small company such as a family company where the directors and owners are the husband and wife, all the way to a public company where there is an independent board of directors and many shareholders, whose shares are traded on a stock exchange.</p>
Partnership	A partnership is when two or more people or companies agree to work in business together and share the profits in accordance with agreed percentages.
Joint venture	Joint ventures are like a partnership, but are usually used for a specific activity that has a limited life like a property development or an oil exploration platform.

Trusts	<p>A trust creates a relationship between a person acting as a Trustee who is entrusted to hold property or other assets for the benefit of a group of persons, referred to as the Beneficiaries.</p> <p>The Trustee is the nominal owner of the property and assets and the Beneficiaries are only entitled to hold their interest in the trust. Unlike companies a trust is not a separate legal entity, however some businesses are carried out through trusts.</p> <p>The ultimate say rests with the Settlor who has the authority to appoint and remove Trustees.</p> <p>There are three main types of trusts:</p>
Discretionary Trusts	<p>A discretionary trust permits the Trustee to distribute any surplus to beneficiaries at their discretion.</p> <p>This enables families, for example, to establish a business within a trust that allows their family members to act as beneficiaries to the trust without being involved in how the business is operated.</p>
Unit Trusts	<p>The Trustee of a unit trust has no discretion and income must be distributed in proportion to the units the beneficiaries hold (this is akin to a company distributing profits to shareholders via a dividend – the more shares you own the higher your dividend income).</p>
Hybrid Trusts	<p>Hybrid trusts combine elements of both unit and discretionary trusts into a more complex trust.</p> <p>For example, a hybrid trust can distribute surpluses discretionally, and distribute capital or capital profits in accordance with unit holdings. Overall hybrid trusts are not widely used and, as such, are not widely accepted by lenders.</p>

2.3 What is Cash Flow (Business) Finance?

- ❖ When a business requires funds, it has two avenues to acquire those funds; it can inject more equity in the business or it can borrow by using a business finance facility.
- ❖ Business finance is available from three main sources. Firstly, a business can engage a major or second tier bank. Secondly, a business can utilise the non-bank lending sector. Finally, business funds are also available from private investors.

2.4 Types of Business Finance

Business finance can be broadly categorised into three main groups:

1. Cash flow finance (the subject of this course)
2. Asset purchase finance (e.g. leasing and the subject of another course)
3. Property finance (commercial property purchases, construction of specific properties property development and the subject of another course)

Cash flow finance is the focus of this course, however there are other courses available that address asset purchase finance and property finance separately.





Module 3

Why the need for Cash Flow Finance?

Why The Need For Cash Flow Finance?

- ❖ Every business has expenses and overheads as well as purchase orders to fulfill. If we focus on a goods-orientated business, we can observe that a normal business cycle can take up to six months to complete; starting with the purchase of stock through, holding of stock, right through to the ultimate sale and finally the collection of money from the customer.
- ❖ In an idealistic world all customers would pay their invoices immediately. In the real world, however, most customers take anywhere from 30 to 90 days to pay and sometimes more.
- ❖ Where customers are unreliable and whilst a business waits for their outstanding invoices to be paid, they are likely to face cash flow pressure in finding the funds to purchase more stock, pay outstanding creditors and salaries/wages, and pay taxes.

“Cash flow finance releases financial pressures”



- ❖ This is where cash flow finance can come to the rescue. With the following finance products, a business is able to fund the gap between purchasing and importing stock, storing the stock in a warehouse and waiting for customers to pay after the stock has been sold.
- ❖ This might sound like it all too good to be true, but consider the following example...

Example:

Consider a company, Organic Energy, which imports and sells organic superfoods. Organic Energy has an outstanding debtors' ledger with \$100,000 owed to them for 30 days and has a total of \$50,000 in its bank account.

The director of Organic Energy is currently being bombarded with emails and phone calls from creditors demanding to be paid, the problem is that the total amount the company owes to its creditors is \$70,000 – more than what they have in the bank.

Cash at bank	\$50,000
Owed to creditors	\$70,000
Deficiency	-\$20,000

Organic Energy has two options, they can decide to wait for their debtors to pay them in full – which could take over 60 days (by which time their creditors are furious), or they can find a cash flow finance solution.

If Organic Energy decided to go with a Debtors Factoring facility they would be able to use their unpaid debtors ledger (worth \$100,000) as security and borrow against it.

Once they have provided their ledger to a lender and been approved for the facility they can receive an average of say 80% of the outstanding debtors ledger within 24 hours.

This would mean that Organic Energy would have \$80,000 available to draw upon overnight, which is enough to pay off the outstanding creditors.

Cash at bank	\$50,000
Debtors factoring	\$80,000
Owed to creditors	\$70,000
Surplus	\$60,000

The final 20% is paid back to Organic Energy once the debtor eventually pays their invoice.

INTERESTING NOTE

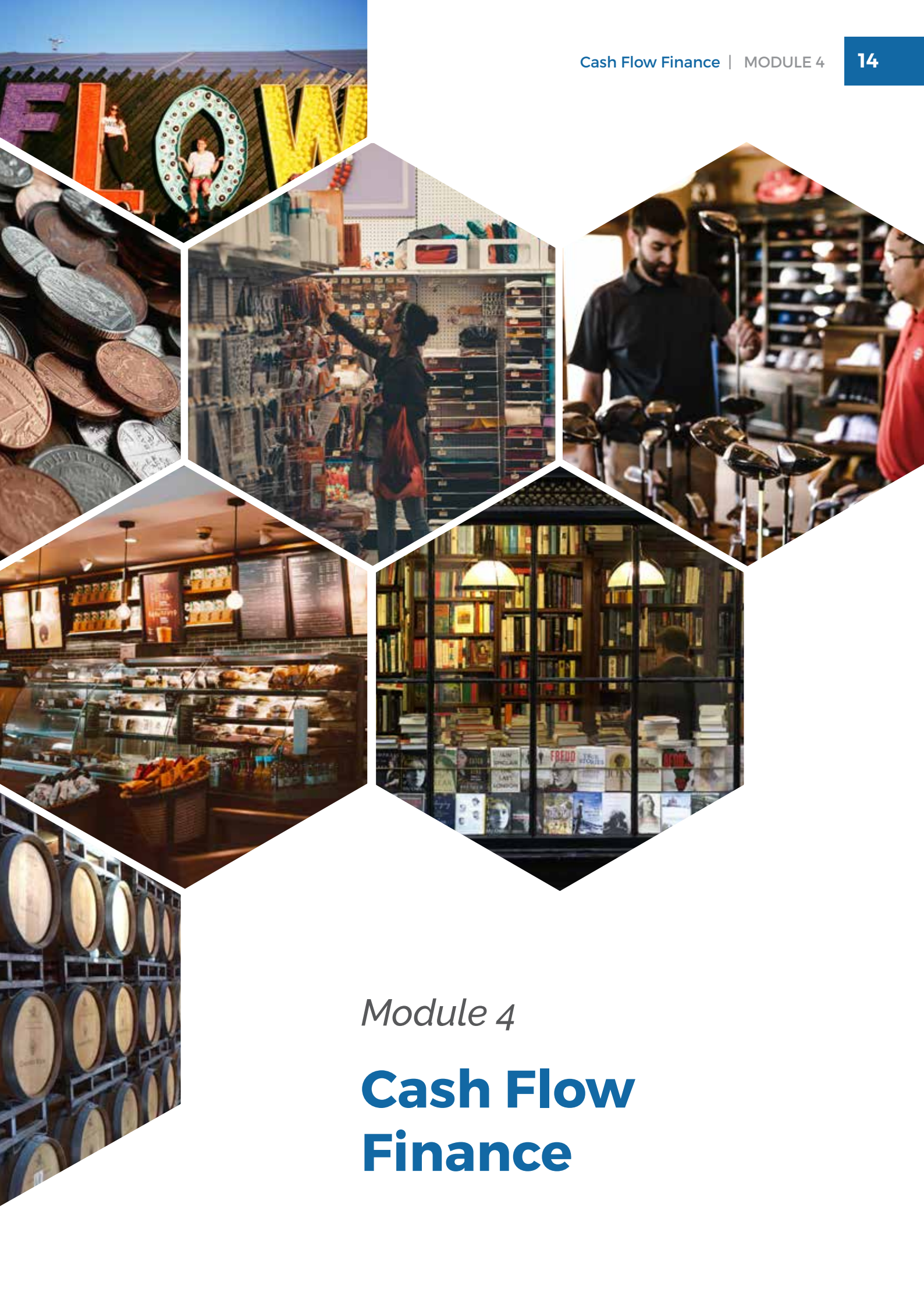
The great thing about this solution is that if Organic Energy is able to negotiate a discount from its creditors for immediate payment that exceeds the fees of implementing this facility then Organic Energy is not only in its creditors' good books but it actually makes money from implementing this cash flow solution.

DISCUSSION WITH THE AUTHOR



“Great plan. Could we get some more details?”

“In addition to Debtors Factoring, there are other cash flow finance solutions that are elaborated on in more detail following”.



Module 4

Cash Flow Finance

Cash Flow Finance

4.1 What is Cash Flow Finance?

- ❖ Cash flow finance is simply financing sought by companies who are looking to fund their operations, expand their business or purchase equipment or stock.
- ❖ Unlike a regular loan from a large bank that may take a house as security before offering finance, cash flow financing uses alternative assets as security, such as receivables (debtors) or stock.

4.2 Components of Cash Flow Finance

These are the main components used in cash flow finance:

i. Debtors

- ❖ All the money owed to the business by other people or businesses is compiled within the receivables (debtors) ledger.
- ❖ Generally a debtor cycle runs anywhere from 1 to 90 days, or longer, which means that from the point of sale to receiving payment can take over 3 months.
- ❖ In this case, cash flow finance can be used to bring the receipt of the debtors' money forward, so that instead of waiting 90 days a business can receive 80% or more of its receivables value in a very short time.
- ❖ The types of cash flow finance that allow this to happen are called **Debtors Factoring** and **Invoice Discounting**, both of which are explained hereunder.

ii. Stock

- ❖ The goods that are on hand and available for sale or in the warehouse are referred to as stock or inventory.
- ❖ Cash flow finance can assist where opportunities exist that require the purchase of more stock but the business does not have adequate resources to take advantage of these opportunities.
- ❖ The type of cash flow finance that allows this to happen is called **Inventory Finance**, which is explained hereunder.

iii. Importing

- ❖ This entails the purchase of stock and goods from other countries. Business are in most cases required to pay for overseas stock when it leaves the supplier's premises or is on the ship ready to depart the supplier's port (also known as Free on Board - FOB).
- ❖ Cash flow finance can assist by paying for the stock when it is FOB and, in some cases, even pay for up front deposits, which some overseas suppliers may require.
- ❖ The type of cash flow finance that allows this to happen is called Trade Finance, which is explained hereunder.

All 3 of these components play a significant role in cash flow finance, with alternate finance products available to meet these different cash flow needs.

Example

Let us continue our earlier example involving Organic Energy.

In order for Organic Energy to have products in stock and ready to sell they need to order and receive them from overseas; in their case they import directly from Brazil. It can take up to 5 weeks for the goods to arrive from Brazil and arrive in their warehouse, during which time they are expected to have already paid for all of the stock.

If this process is creating a hole in their cash flow, Organic Energy can implement a Trade Finance facility to fund the importing of stock from their Brazilian supplier, and this type of facility will be explained in further detail below.

Once the stock is in the warehouse it generally takes another 4 weeks for Organic Energy to sell all of their stock to customers. Clearly this is another 4 weeks that Organic Energy has to wait before being paid.

If it is this bottleneck that is creating the cash flow strain, then Organic Energy can utilise an Inventory Finance facility secured on this unsold stock to release funds, and this is also discussed in further detail following.

"Cash flow finance can assist where opportunities exist that require the purchase of more stock but the business does not have adequate resources to take advantage of these opportunities."

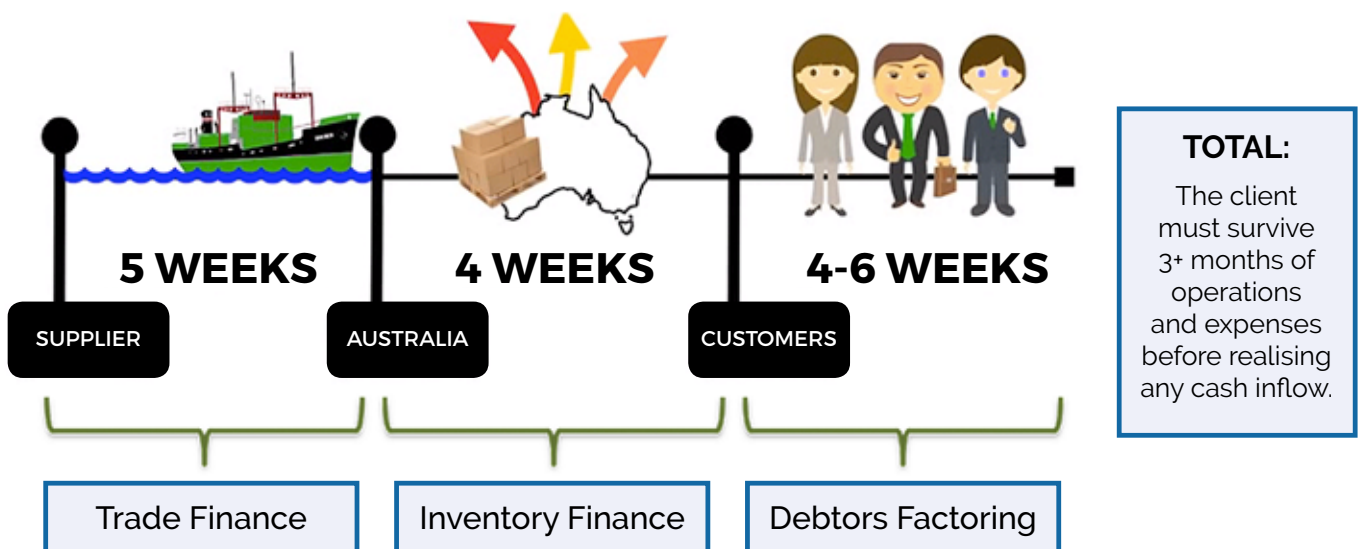
Finally, once all of the stock has been sold it can take up to 90 days for the customers to actually pay for their orders, and once again this means that Organic Energy has to wait even longer to capture their revenue.

If slow-paying customers are creating the working capital pressure, then a Debtors Factoring facility can come into play once the stock has been sold to generate cash flow using the unpaid invoices, and this will also be discussed in further detail following.

INTERESTING NOTE

The moral of the story is that no matter which stage Organic Energy is at in their business process cycle, there exists a cash flow finance solution to solve their working capital problem.

This idea is illustrated in the below graphic.



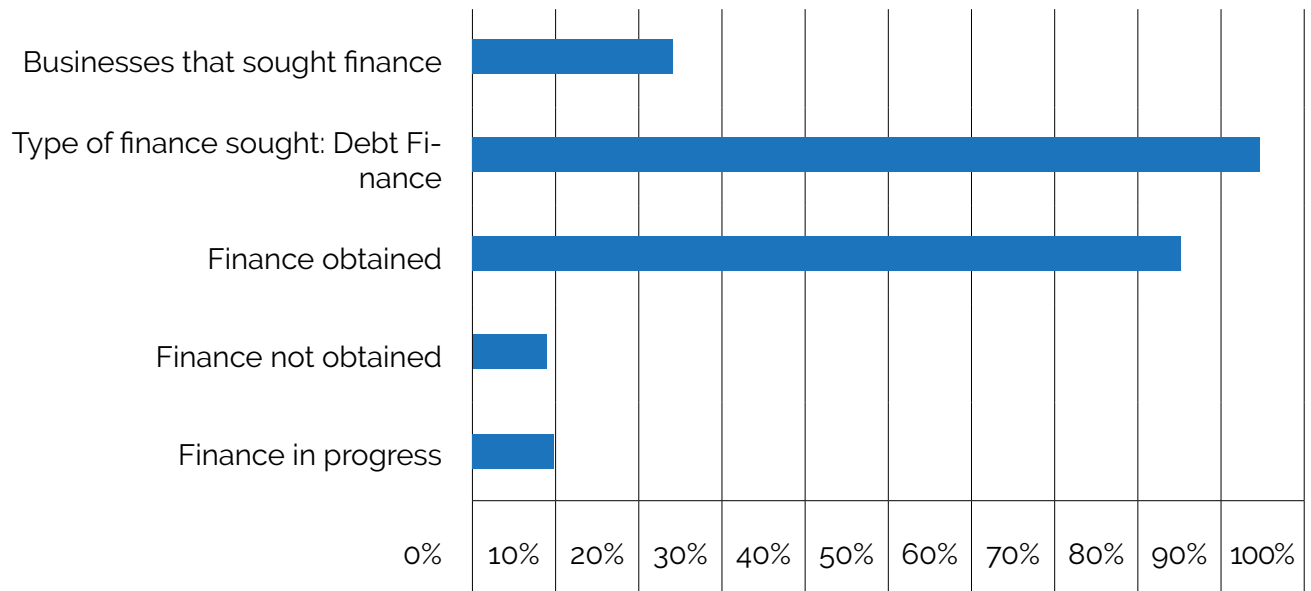


Module 5

The Benefits Of Cash Flow In Business

The Benefits of Cash Flow Finance in Business

- ❖ Results provided by the Australian Bureau of Statistics indicate that 92% of businesses seeking finance were doing so to maintain short-term cash flow or liquidity. I think this would be a high percentage amongst developed countries around the world.
- ❖ In other words, businesses have a strong demand for cash flow finance as evidenced below.



- ❖ The example involving Organic Energy highlights just some of the ways cash flow strains can be problematic for businesses.
- ❖ The following section of this course is designed to teach you how to apply the different products that constitute cash flow finance in order to tailor a strategy to plug and fill any working capital problems your client may be facing.

"Results provided by the Australian Bureau of Statistics indicate that 92% of businesses seeking finance were doing so to maintain short-term cash flow or liquidity".

5.1 What Does a Cash Flow Problem Look Like?

Problems in Business

- ❖ The three main problems brought to light through the Organic Energy example were:
 1. They couldn't afford to buy their existing purchases for stock
 2. It was too expensive to store the stock whilst waiting for it to sell
 3. Their customers were taking too long to pay
- ❖ In addition to these process-specific problems, there are numerous operational hurdles that businesses must overcome in order to realise a profit.
- ❖ For example, income is not stable in a business yet all of the major expenses; such as salaries, rent, interest, etc are all fixed.
- ❖ In other words, before you have your morning coffee you won't have made any money that day but many of your major expenses are already set in stone.

In a nutshell, any business who is cash flow tight will need cash flow finance. Some tips to identify these issues are:

- ❖ Do they have any cash at the bank?
- ❖ If their assets are less liquid than cash then chances are they will have trouble meeting short-term cash flow obligations.
- ❖ Check balances in the aged debtors and creditors ledgers and see if the debtors exceed the creditors for the next 30, 60 and 90 days.
- ❖ If they do not then they may experience some cash flow strains at some point.
- ❖ Is the business on time with paying their taxes?
- ❖ There are many more indicators of a business in cash flow trouble, but chances are a business will approach you and say, "I need \$X to do Y".
- ❖ The problem is, this business won't know how to get their \$X and it will be your responsibility to match one or more cash flow financing products to their situation in order to get them over the line so that they can achieve Y.
- ❖ Understanding indicators such as these will help identify which cash flow products are suitable, and some general rules of thumb are provided hereunder.

"In a nutshell, any business who is cash flow tight will need cash flow finance".

PROBLEM	SOLUTION
Late-paying customers	Debtors factoring
No cash to meet purchase orders	Trade finance
No cash to store idle stock	Inventory finance

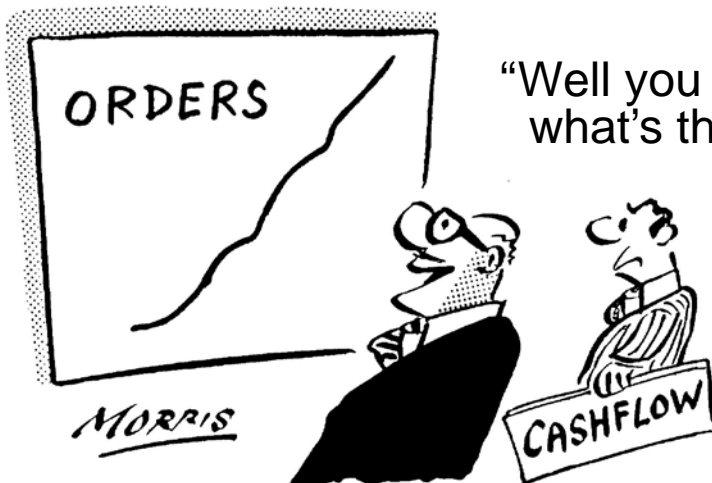
5.2 Solve The Problem

- ❖ A business will be concerned for the longevity of their business when they are facing pressure from their creditors.
- ❖ In other words, when they do not have enough cash in the bank they will be fearful of their salary and rent obligations, or letters of demand from their suppliers, or pressure from the tax office if they are behind on taxes, etc.
- ❖ Consequently, a cash flow finance solution can be easily sold as a means to alleviate them from this pressure so that they can keep their focus on the front-line management and growth of their business.

There are a few questions you can ask to identify a need for a cash flow solution:

- ❖ What are the immediate/short-term payment obligations?
- ❖ How much cash do you have at the bank?
- ❖ What value of receivables can you collect in the next two weeks?

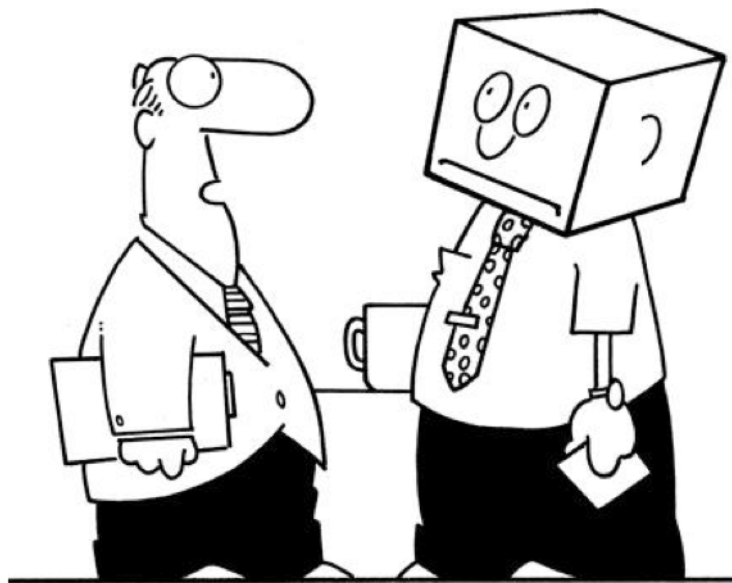
If their amount of cash at the bank plus the amount of their receivables that they can immediately collect still does not cover their short-term payment obligations then you know the business is going to need a finance solution in order to keep their business afloat.



For example, what you may find is this:

Late-paying customers	\$100,000	Creditors payable in 2 weeks	\$200,000
Debtors collectible in 2 weeks	\$40,000		
Total	\$140,000	Total	\$200,000
		Shortfall	-\$60,000

- ❖ You can see that this business is cash flow negative and is therefore in need of a business finance solution, so now it is a matter of finding out which solution is best for them.
- ❖ To help you figure this out, you could ask:
 - How much are you owed for goods sold in the last 90 days?
 - Do you have any concrete purchase orders (evidenced by documentation)?
 - How much stock do you currently have on hand?



Problem-solving can involve thinking outside the box.

- ❖ If none of this can be leveraged then you may have to consider other forms of financing (e.g. mezzanine/short-term loans) that may require the client to offer a more concrete form of security and are usually more expensive due to the greater level of risk the lender is taking on.
- ❖ In this case the client will have to provide a complete statement of their assets and liabilities so that you can see how much they are worth on paper.



Module 6

Debtors' Factoring

Debtors' Factoring

6.1 The Important Elements

A Debtors Factoring facility does not rely on property as security, but instead relies on three important elements to exist in the business. These are:

i. The Receivables Ledger

- ❖ The majority of the security relies on the value of the receivables and as discussed in previous examples, financing of these debtors is usually geared at 80% or more.
- ❖ The quality of the debtors is paramount, and therefore invoices that are 90 days old and over are normally excluded from the security.
- ❖ Likewise, debtors who perhaps owe amounts only 30 or 60 days old but who also have unpaid invoices from 90 days ago or more are similarly normally excluded from the security.
- ❖ The final exclusion relates to an area called concentration. If too much of the receivables ledger rests with one large customer the gearing will be reduced to a level less than 80% for that customer.
- ❖ Therefore, the important point to note is that the amount available under debtors factoring may not always be say 80% of that value.

ii. The Client

- ❖ When lenders do not use property as security, they rely more on the character of the borrower.
- ❖ Therefore, whilst defaults may not adversely affect an application in debtors factoring, bankruptcies may.
- ❖ A director's guarantee will almost always be required, accompanied by a personal statement of assets and liabilities.
- ❖ The directors do not need to have substantial assets (or property) to support a debtors factoring facility because the director's guarantee is required more to ensure that the directors comply with the terms of the facility rather than to support the security.

iii. The Debtors Themselves

- ❖ In distinguishing the receivables ledger and the debtors, a lender looks at the quality of customers your client has.
- ❖ For instance, if your ledger includes a customer that the lender has previously had problems with then that customer may be excluded from the security.

6.2 How Does It Work?

- ❖ Debtors Factoring is available as a disclosed or undisclosed service. A disclosed facility is where your client's customers are made aware that there is a debtors factoring facility in place.
- ❖ Some clients may see debtors factoring as a weakness and by disclosing it to their customers think that they are admitting they have cash flow problems to the world.
- ❖ In reality, Debtors Factoring is a cleverly engineered form of finance and experience shows that customers who are aware there is a Debtors Factoring facility in place actually improve their repayment cycle.
- ❖ The majority of facilities are disclosed.

6.3 Submitting Invoices

- ❖ Once a facility is approved, a lender requires all of the invoices to be uploaded on a daily, weekly or monthly basis.
- ❖ These invoices are usually uploaded using a secure Internet portal and are normally processed overnight providing your client with say 80% of the approved invoices available to borrow against the very next day.
- ❖ The main security a Debtors Factoring lender has is the debtors in the ledger. Accordingly, the lender keeps a separate receivables ledger in order to control their security.

6.3 Submitting Invoices

- ❖ The lender opens a new bank account in your client's name where your client can view the transactions and the lender has full operational control.
- ❖ When a new facility is created, all of the debtors are advised to make their payments into this new bank account.
- ❖ When an amount of money is received, a lender firstly withdraws their 80%, say, that they have lent on that invoice. They then withdraw their interest and charges depending on how long it took for the debtor to pay the invoice, and the balance is returned back to the borrower.

"Debtors Factoring is available as a disclosed or undisclosed service. A disclosed facility is where your client's customers are made aware that there is a debtors factoring facility in place".

6.5 - 90 Day and Bad Debts

- ❖ Bad debts and invoices that have gone into 90 days are immediately excluded from security.
- ❖ If the lender has provided funds against these debtors then the borrower will have two options:
 - i. Refund monies lent against these invoices back to the lender, or
 - ii. Replace the debt with a fresh invoice, which is what almost always happens.

6.6 How Much Does It Cost?

Depending on which lender is used, the finance can cost from mid-single digits to high teens in the non-bank lender space depending on the jurisdiction the borrowing takes place.

There are two types of charges that most lenders apply. The first is an interest charge and the second is a management fee.

The management fee is a set percentage applied against the gross value of all invoices issued. As a very rough rule, such a facility normally costs around 1.5-2% of average gross margin.

Case Study 1 – Debtors Factoring

Client Situation

The business is a wholesaler of ribs who precooks and provides all of the ribs to the leading restaurants in the country.

The problem identified with the business is that there are not enough pork ribs going around, and therefore the supplier of the pork ribs requires cash on delivery (COD) payment for each order.

After purchasing the ribs from the supplier, the business then cooks the ribs, freezes them for up to 6 months, sells them to their restaurant customers and then has to wait 90 days to be paid.

Further, the business has paid cash for all of their cooking and storage equipment.

The business has recently landed a new contract that would increase overall sales by 10%, but they cannot afford to purchase the additional ribs with the COD requirement without first being paid by their current customers.

In other words, they cannot fund guaranteed growth in the business.

Review

We start with a copy of the latest aged debtors' ledger and aged creditors' ledger.

You have reviewed these documents and have discovered the following:

- ❖ When you looked at the detailed receivables ledger you saw that one of the customers has 40 restaurants and represents 30% of the total ledger.
- ❖ When you looked at the ledger most of the customers are restaurants that are renowned for paying late, if at all. There is one customer in particular that you highlight:

Name	0-30 days (\$)	31-60 days (\$)	61-90 days (\$)	90+ days (\$)	Total (\$)
Carlo's Ribs	2,000	1,000	2,500	3,500	9,000

- ❖ In addition to Carlo's Ribs, you identify the two following clients that have debts over 90 days old:

Name	0-30 days (\$)	31-60 days (\$)	61-90 days (\$)	90+ days (\$)	Total (\$)
Super Ribs	0	0	0	15,000	15,000
Tasty Ribs	0	0	0	5,000	5,000

- ❖ When you compare the creditors and debtors ledgers you note the following:

Debtors	0-30 days (\$)	31-60 days (\$)	61-90 days (\$)	90+ days (\$)	Total (\$)
Total	300,000	450,000	126,500	23,500	900,000

Creditors	0-30 days (\$)	31-60 days (\$)	61-90 days (\$)	90+ days (\$)	Total (\$)
Total	50,000	200,000	300,000	150,000	700,000

Solution

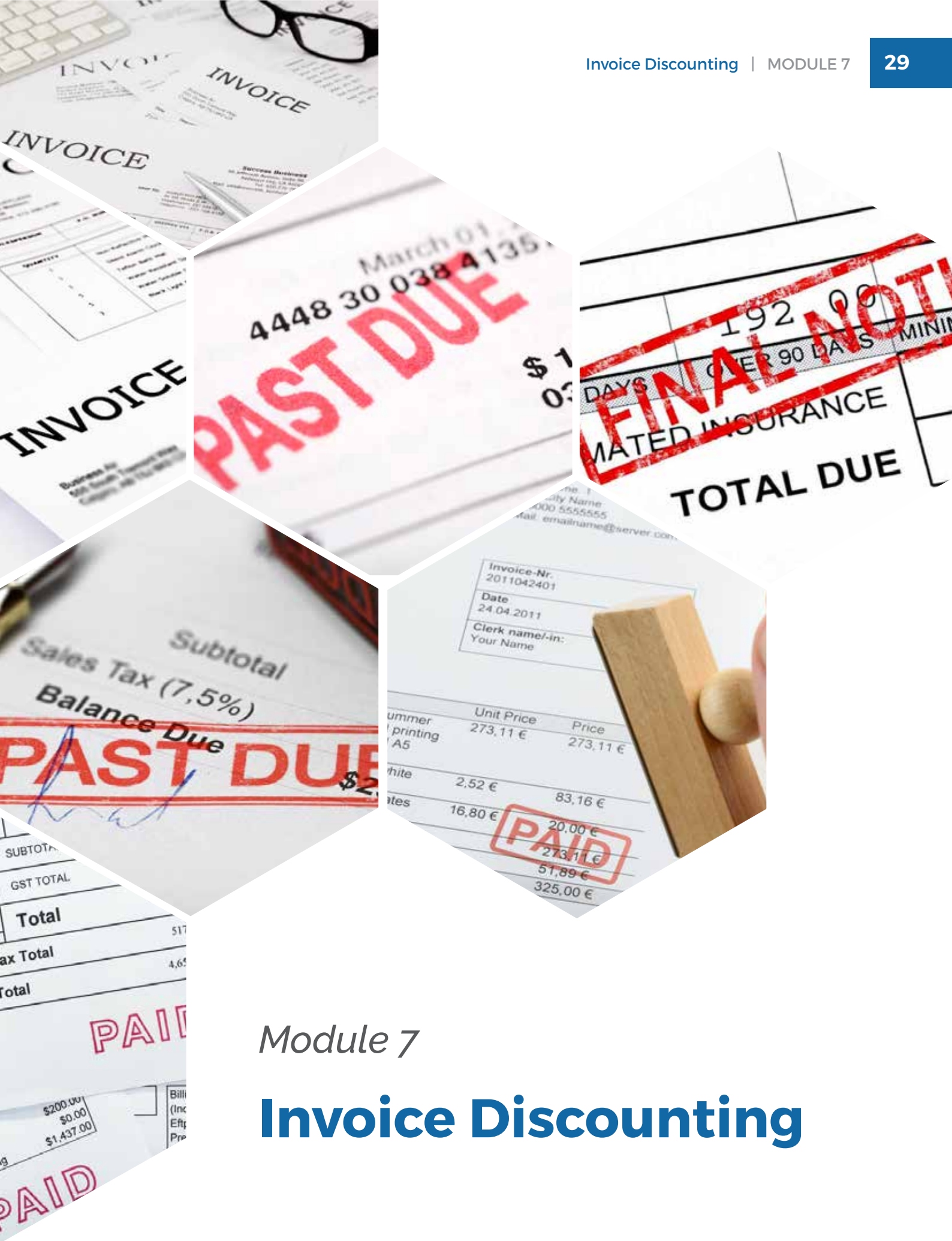
You saw that the business's problem could be resolved with a Debtors Factoring facility.

A possible facility could look like the following:-

- ❖ The entire balance for Carlo's Ribs of \$9,000 was excluded as security. The reason for this was that the lender believed that if a majority of the amount owing is in 90+ days then there is a good chance that the current and other balances will end up in the 90+ days category as well.
- ❖ Likewise, the amounts owed by Super Ribs and Tasty Ribs were excluded from the security.
- ❖ The balance of the ledger was approved for \$871,000 providing a total drawdown amount of \$696,800 at 80%, which was rounded to a \$700,000 limit.
- ❖ The lender dealt with the large customer that has 40 restaurants by agreeing to provide 80% of the total debt owed by the customer so long as the customer did not represent more than 30% of the total ledger, and if that amount increased past 30% any amount above this 30% would also be excluded from the security.



**“If an invoice is due in 30 days, we pay it in 60 days.
If it's due in 60 days, we pay it in 90 days. If it's
due in 90 days, then they probably don't
need the money anyway.”**



Module 7

Invoice Discounting

7.1 The Important Elements

An Invoice Discounting facility operates on similar principles to a Debtors Factoring facility, but instead of providing security against the whole of the receivables ledger, you client can procure finance on the back of any one or more invoices.

An Invoice Discounting facility does not rely on property as security, but instead relies upon the following three elements:

i. The Invoice

As the primary security is the invoice provided, the quality of that invoice is paramount.

In this regard, the invoice should be fresh and supported by an original purchase order and where applicable a goods delivered docket.

Invoices that are more than 90 days old are excluded and any invoice that surpasses this period is required to be repaid or refinanced with a new 'fresher' invoice.

ii. The Borrower

As in the case with Debtors Factoring and Trade Finance, we have learnt that business finance in the non-bank lending sector is strongly reliant on the character of the borrower.

Therefore, whilst minor defaults may not affect the application major defaults such as bankruptcies will adversely affect the application.

Furthermore, criminal charges particularly any charges around the issue of fraud will affect the applicant and the success of the application.

Note that an Invoice Discounting facility will always require a director's guarantee accompanied by a personal statement of assets and liabilities.

The directors do not need to have substantial assets (or property) to support an Invoice Discounting facility.

iii. The Customer

In an Invoice Discounting facility, a lender will conduct an audit of the borrower's customer to whom the invoice was issued assessing the integrity of this customer.

This is to ensure that the client is not in a position where they may have to be wound up.

Some Invoice Discounting lenders require that the customer be insured, in which case the insurance company applies additional more stringent tests to the customer.

Once this customer has passed all of these checks, any invoices issued to that customer will be able to be financed.

7.2 How Does It Work?

An Invoice Discounting facility is always a disclosed service. In other words, the customer to which the invoice relates to will always be aware that their invoice was used as security for finance.

Once all of the credit and character checks are conducted, the customer is notified and advised to pay the gross value of the invoice directly to the Invoice Discounting lender.

Invoice Discounting funding is for a relatively short period, generally for 42 days with large penalties applicable if the invoice is not repaid in this period.

7.3 Submitting Invoices

Once a customer is approved your client is able to lodge invoices with the lender be able to borrow a loan-to-value ratio (LVR) of approximately 75% against that invoice.

7.4 - 90 Day and Bad Debts

Bad debts and invoices that have gone into 90 days are immediately excluded from security. If the lender has provided funds against these customers then your client will have two options:

- i. Refund monies lent against these invoices back to the lender, or
- ii. Replace the debt with a fresh invoice, which is what almost always happens.

7.5 How Much Does It Cost?

Lending against one particular invoice attracts a much higher risk than lending against the total debtors' ledger.

Furthermore, Invoice Discounting is more akin in risk to Trade Finance (see next section) than it is to Debtors Factoring. Accordingly, costs associated with Invoice Discounting are more along the lines of Trade Finance.

"An Invoice Discounting facility is always a disclosed service. In other words, the customer to which the invoice relates to will always be aware that their invoice was used as security for finance".



Module 8

Trade Finance

8.1 The Important Elements

A Trade Finance facility relies on the inventory being purchased as well as other elements, which include:

i. The Type of Inventory Being Purchased

As the majority of the security is the stock being purchased, the type and quality of stock is important to how the transaction will be structured and priced.

The easiest form of Trade Finance to procure is when a customer has issued a purchase order and you order inventory to fulfill the customer's order.

This type of Trade Finance has a pre-existing exit and minimises the risk for a lender.

Where inventory is acquired to be held as stock in a warehouse the Trade Finance lender looks at stock turn, years in business and makes an assessment of how likely it is for your client to sell the stock.

The hardest type of inventory to finance is perishable foods and in these cases a purchase order is always a prerequisite, or a long-standing history of high volume of trading.

ii. The Borrower

Due to the risk inherent in Trade Finance lending, there is a lot of reliance placed on the character of the borrower.

Issues such as judgments and criminal charges will adversely affect the approval of an application.

As in the case with Debtors Factoring, a Trade Finance facility will almost always require a director's guarantee accompanied by a statement of assets and liabilities.

Whilst it is not necessary to show property in a statement of assets and liabilities, it certainly assists with procuring an easier approval.

Some lenders want to ensure there is property in this statement of assets and liabilities before lending any money.

"The easiest form of Trade Finance to procure is when a customer has issued a purchase order and you order inventory to fulfill the customer's order. This type of Trade Finance has a pre-existing exit and minimises the risk for a lender".

8.2 How Does It Work?

Trade Finance facilities are available as a stand-alone product or as a combined product with Debtors' Factoring.

In either case, most Trade Finance facilities operate on a 90-day churn. In other words, from the day money is provided to the original supplier to the date that the debt is due is a maximum of 90 days.

These 90 days include the time it takes to ship the product to Australia, store it and ultimately sell it.

In some instances, original overseas suppliers require a deposit to be paid when an order is placed; Trade Finance may not normally fund this deposit in most cases. This amount is therefore paid out of the client's cash flow. However there are some private lenders who do offer this type of service.

In the majority of instances, a Trade Finance payment usually occurs once the stock has been approved and has received the required papers to be shipped out of the overseas supplier's country.

Invariably, Trade Finance transactions are conducted in US dollars.

8.3 Importing Arrangements

Trade Finance lenders' policies surrounding this area are quite varied.

Some are happy for you to continue using your own freight forwarding arrangements, whilst other lenders require that you use their preferred freight forwarders.

In either instance, there is a substantial amount of paperwork and information all of which has to be in order before any facility can be drawn upon.

Some lenders even have consultants in overseas countries that are used to audit the shipments to ensure that they are in accordance with the original purchase orders.



“Just exactly how bad is our cash flow problem?”

8.4 How Much Does It Cost?

It is important to note that the lending risk for Trade Finance is one of the highest in the business finance portfolio.

As you will appreciate, the worst-case scenario for a lender is to have to take access of the inventory and then sell it at Auction, which will inevitably result in a large loss.

Accordingly, the return a Trade Finance lender expects to receive is one that is commensurate not only with the risk but also the understanding that they place themselves in a pseudo-equity position.

The cost of a Trade Finance facility is dependent upon the term; that is whether it is 30, 60 or 90 days, and as a general average is calculated on total of the amount lent as follows:

- ❖ An up-front fee, plus
- ❖ A percentage return for every 30 days that the facility remains unpaid up to 90 days.

This may initially appear excessively expensive, however please note that this is a facility that provides an opportunity for a client that they would not otherwise have available, and by taking advantage of this opportunity they are sharing the gross margin with the lender at the above rates.

Trade Finance facilities that are coupled with Debtors Factoring facilities are a less risky option for the lender, and will reduce the rate of interest paid.



Case Study 2 – Trade Finance

Client Situation

Your client is a retailer and wholesaler. They import Italian foods that they sell in their huge warehouse delicatessen and also stock some items that they sell to restaurants, hotels and catering companies through their wholesale and distribution division.

They recently identified through their retail division that certain salamis that they import from Italy have become extremely popular after they were shown on television in a popular cooking competition show.

The popularity of these salamis has become so great that customers line up before the store opens so that they do not miss out on buying them.

The salamis are flown every second day from Italy as air cargo and whilst they have a good reputation with the supplier, the supplier is unable to provide them with any credit.

Therefore, all purchases need to be paid before the plane takes off from Italy.

Unless your client is able to find more cash to buy more salami, they will miss out on the opportunity from these increased sales.

These salamis cost \$100/kg and your client is able to sell them at retail for over \$400/kg providing them with a 300% margin.



Case Review

You will need to have on hand a copy of the financial statements, copies of invoices from the Italian supplier and also a personal statement of assets and liabilities for each director.

When these documents are reviewed you discover:

- ❖ The financial statements show that the average gross margin for this business is 100%, and that this opportunity to sell these salamis will dramatically increase the company's gross margin.
- ❖ You notice that the statements of assets and liabilities shows that neither of the directors own any real estate assets, and in fact all of their assets are in the business.
- ❖ When you have reviewed the invoices from the supplier, you note that there is no deposit required at the time an order is made.
- ❖ You notice that your client is ordering three times per week in order to use their retail cash received to fund the purchases, because they do not have sufficient cash to make one large weekly or fortnightly order.
- ❖ You also notice that the customer's freight forwarding agent is an internationally accredited firm.

Possible Solution Using Trade Finance

You saw that the client's problem in this case could be resolved with a standard Trade Finance facility.

In this instance you approached a non-bank lender where a facility was approved and it could be drawn down upon within two weeks of the date you first lodged the application.

In connection therewith, the lender approved the following facility:

- ❖ The fact that neither director has any real property as security and that the type of goods purchased were perishable foodstuffs placed this transaction in the higher risk category.
- ❖ Mitigating this risk was the fact that the business has a very strong reputation in the 'popular food industry and the opportunity for trading these types of salamis from the recent media attention.
- ❖ The lender provided a facility equating to a month worth of purchases, which allowed your client to reduce the frequency of their orders from three per week down to two per month.
- ❖ This had the effect of reducing direct costs (e.g. shipping and freight) as well as reducing indirect costs required in managing multiple purchase orders.

- ❖ By being able to make one larger purchase from the Italian supplier, your client was able to achieve a slightly better price, which reduced their costs by another 3%.

The way you handled some of the problems you discovered during your review were as follows:

- ❖ As the directors do not own any real property as security, you were restricted to the number of private lenders with whom you could place this transaction, and therefore concentrated on non-bank lenders who were open to a higher risk transaction.

Cost

Due to the high turnover in trading salami your client is able to repay a facility within 6 weeks, thereby paying a flat fee of say for example 6% for every invoice.

As your client sells the salami for 300%, this fee does not adversely affect your client's profitability on this line.

In any case, your client received a discount for bulk buying of 3% as well as saving freight and indirect costs of another 1%. Therefore, the true cost of this facility after taking everything into account is 2.0%.

8.5 Inventory Finance

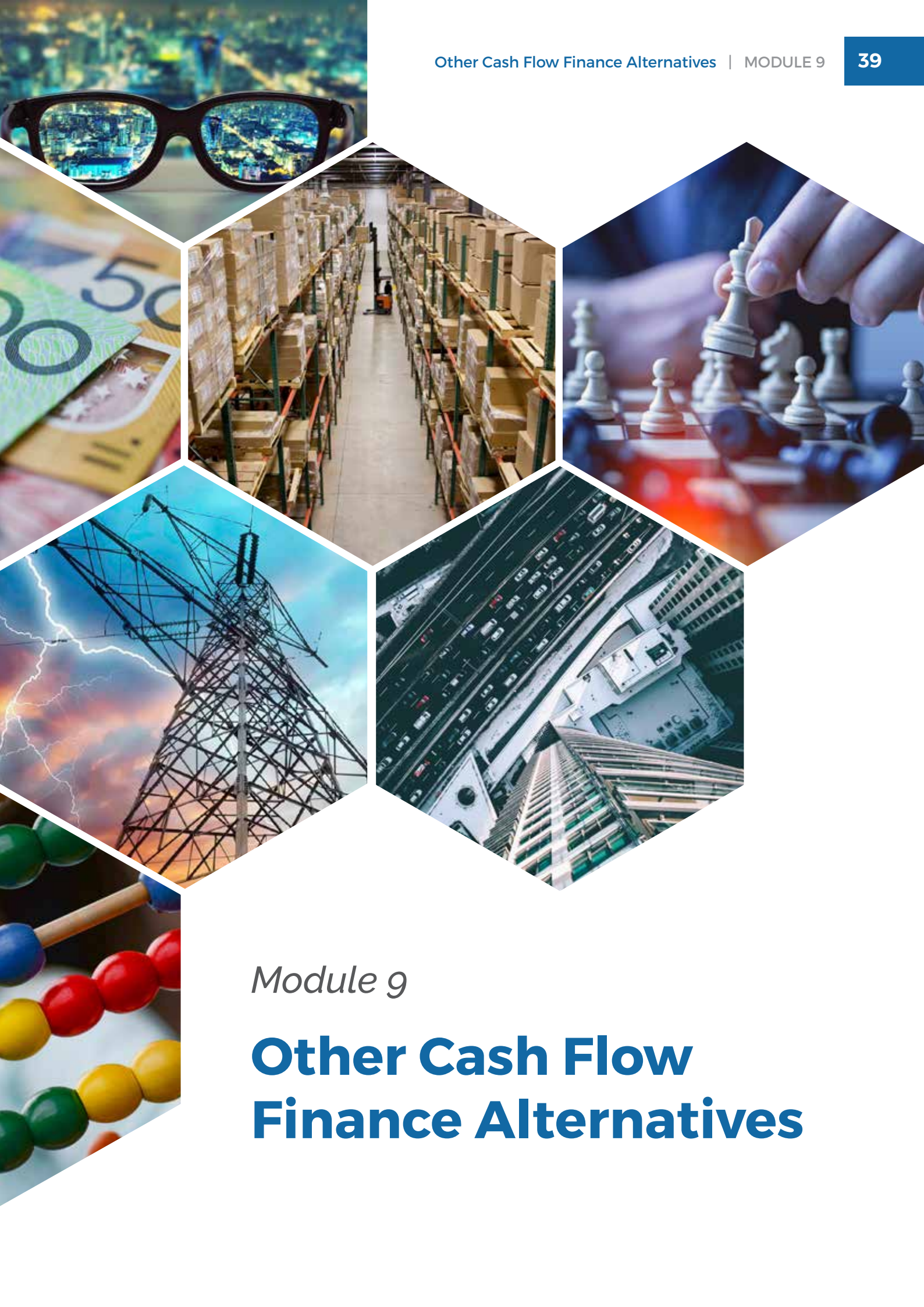
Synopsis

Inventory Finance works in exactly the same way as Trade Finance except that instead of paying an overseas supplier the facility is used to pay a local supplier.

The facility works on a 30, 60 and maximum of 90-day period, and the lenders look at the trading history of a business to ensure that it has historical evidence of being able to buy and sell stock on a timely basis.

The cost for Inventory Finance is very much in line with the cost of Trade Finance, and it is at the higher level of business finance risk and therefore attracts a higher cost.

In some instances, Inventory Finance lenders will require your client to house their inventory in their warehouse and the lender arranges for the stock to be delivered to customers by providing a logistics solution to your client.



Module 9

Other Cash Flow Finance Alternatives

The following products are raised for general information and a thorough understanding of these products is outside the scope of this course.

9.1 Sale and Leaseback

Raising funds through a sale and leaseback facility falls into the Asset Purchase Finance category of business finance and is only briefly described in this course. However, there is a complete course available on Asset Purchase Finance written by the same author.

A sale and leaseback can be used to free up the cash that is tied up in valuable equipment/assets (including vehicles). This requires a professional valuer to come in and formally value any equipment before a percentage of this value is released to the client.

Note that this option is only viable if the equipment is unencumbered or if the value assigned by the valuer exceeds any debt associated with the equipment.

This may be a more expensive cash flow option than, say, Debtors Factoring, however the exact interest rate charged for this type of facility is client-specific and depends on individual circumstances (i.e. it is determined by the lender on a case-by-case basis once they evaluate the level of risk associated with the particular client in question).

9.2 Merchant Cash Advance

This type of finance is particularly applicable to the retail industry, as this is an advance paid against future credit card and EFTPOS receipts.

The repayment of the debt is paid as a fixed percentage against future credit card and EFTPOS receipts and is paid automatically back to the lender each time payments are settled by your client's bank.

Whilst many lenders in this area will say that they do not charge an interest rate but rather a percentage of your client's future sales, a borrower should carefully check the total borrowing cost as it may amount to over 20% in some instances.

"A sale and leaseback can be used to free up the cash that is tied up in valuable equipment/assets. This requires a professional valuer to come in and formally value any equipment before a percentage of this value is released to the client".

9.3 Small Business Loans

These loans are becoming more popular for businesses that have a good credit rating, have been in business for more than one year and have an annual turnover of usually over \$72,000.

These facilities are generally used to:-

- ❖ Purchase inventory
- ❖ Purchase equipment or tools
- ❖ Growing the business
- ❖ Marketing campaigns
- ❖ Pay suppliers
- ❖ Pay creditors including tax payments and pay wages

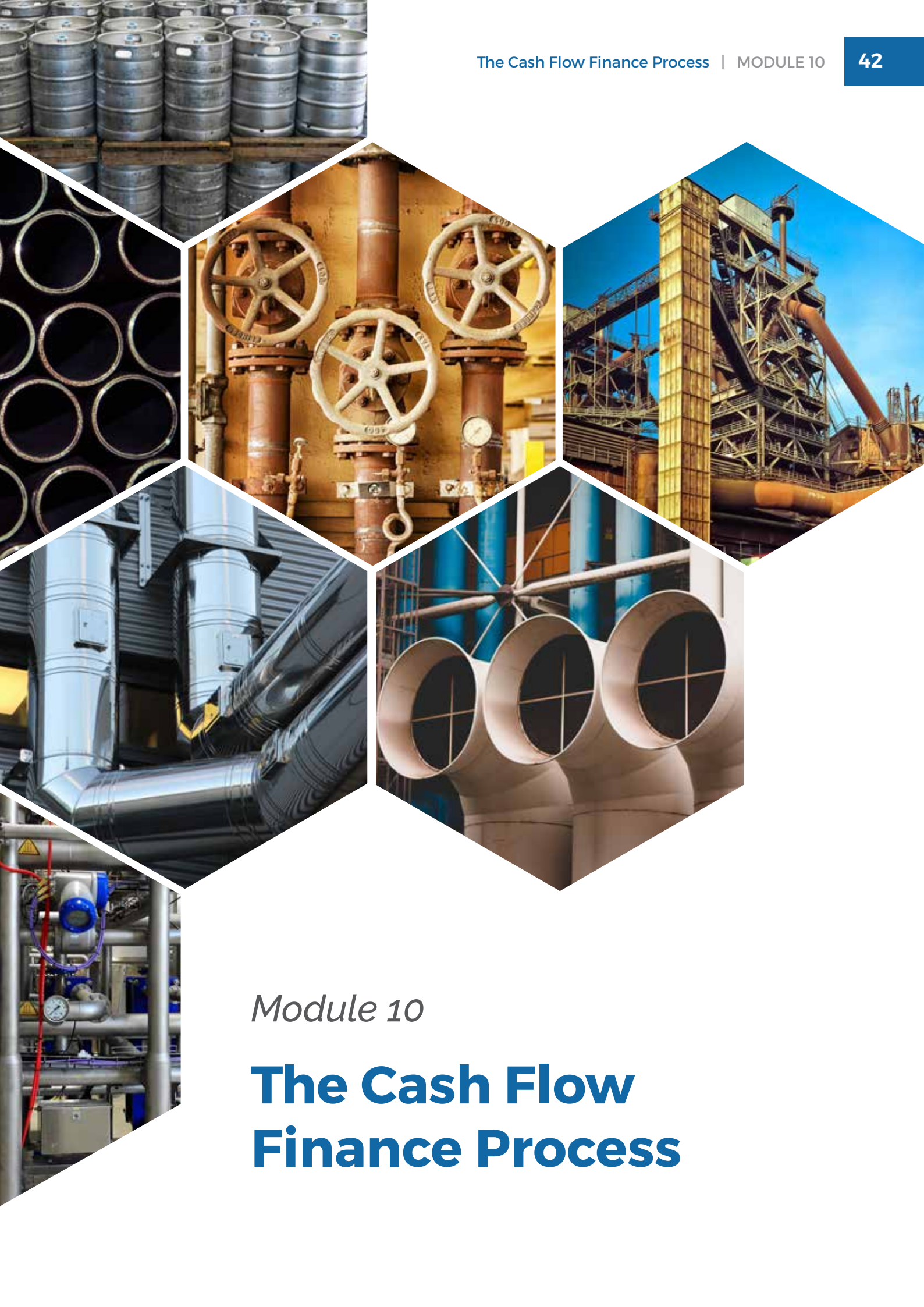
There cannot be any personal element in the use of the funds under this type of facility.

The term of these loans is usually for around 6 months and again the costs vary and a borrower should carefully assess the total cost of such a facility.

These loans are repaid in regular intervals and designed with your business' cash flow in mind.



"Obviously, our customers aren't trying hard enough!"



Module 10

The Cash Flow Finance Process

THE PROCESS

The flow chart below provides a general helicopter view of the entire cash flow finance process. Keep in mind, however, that every borrower is different and challenges associated with this work are often client-specific. This means that each client engagement may have its own intricacies that could slightly alter the process from what is provided below.

Stage 1



Stage 2



Stage 3



10.1 Early Stages

The first thing to happen is receiving an enquiry from a client, or an understanding of a need for Cash Flow Finance.

As mentioned earlier, however, the problem is borrower will only know that they need a certain amount of money for a particular reason. Most likely, most borrowers are now aware of the different types of cash flow solutions available or which ones are even applicable to their unique business situation.

Therefore, at step a broker may assist by providing a significant degree of problem solving in order to tailor a cash flow finance solution to the client's individual circumstances.

You will need to send an initial request for information so that you can undertake a quick analysis to see whether or not any subject deal is viable.

This request would most likely ask for the following information:

- ❖ 2 most recent years' financial statements (profit and loss statement and balance sheet).
- ❖ Debtors ledger.
- ❖ Creditors ledger.
- ❖ Current management accounts.
- ❖ Most up to date tax position of amounts owing (to see if the client is up to date with their tax liabilities or, if not, if there is an repayment arrangement in place).

Compiling and reviewing this information will take a bit of time; or it may take a broker a bit of time and in this case it is appropriate to enter into an mandate so that the borrower and their broker are is committed.

The Mandate

Since the broker will be charging a fee for the service, a mandate will reduce any possible future misunderstandings.

The mandate should set out the following:

- ❖ The borrower's particular situation
- ❖ The desired outcome
- ❖ The scope of responsibilities
- ❖ The anticipated fees and charges
- ❖ Appropriate policies (e.g. refund policy)
- ❖ An Authority to Proceed.

This mandate may also impose a fee that the client will pay with their signed and returned Authority to Proceed before the broker can continue further with the finance.

The Mandate Fee

It is important to understand that the broker will charge a fee and any future lender will also charge a fee. The lender will impose some fees that your borrower will have to pay and these can be out of the broker's control.

10.2 Documentation Stages

This stage is important because it is all about packaging the borrower's application together and submitting to a lender (who is already aware of the deal because it was pitched in principle with them earlier).

In addition to the important supporting documentation listed above, a lender may require additional ad-hoc documents depending on the client's unique circumstances.

Therefore, it is important to continuously liaise between the lender (and/or their representatives) and the borrower and their accountant/lawyer or whoever else may be involved in the process.

As this supporting documentation comes in it is important to analyse each piece of information and identify any possible problems that may arise.

These issues will have to be mitigated or extensively explained as the case is submitted to the lender because if the lender identifies an issue that you have failed to address then they can essentially cancel the entire deal and will often refuse to reconsider their decision.

This process can involve significant amounts of information flowing into and out of the office at different times and it is therefore important to stay organised and already have an established filing system.



"This process can involve significant amounts of information flowing into and out of the office at different times and it is therefore important to stay organised and already have an established filing system".

10.3 Final Stages

The final step is important because it is the last opportunity you will get in this case to foster a trustful relationship between the borrower and the lender.

This is where any unanswered questions from the lender will have to be adequately addressed.

Once the borrower signs the relevant documents the deal is essentially closed and any fees, if not already paid, are now payable. At this point, this will most likely only include commission/trail fees owed by the lender.

10.4 Cash Flow Tips to Help You Gather Business

There are many times during the year where businesses start feeling the pinch of reduced orders, holiday shutdowns, holiday payments, GST/VAT payments and debtor strain.

The below represents a few strategies that can help manage cash flow shortages and that you can share with you clients at any time.

Plan

Preparing a good weekly forecast will identify when to expect problems.

When these problems cause money to be tight, a borrower could consider the following measures.

Using Their Receivables

- ❖ In order to speed up the payment of outstanding invoices, your client could offer a small discount to their customers for early payment.
- ❖ This would be cheaper than organizing a finance facility at the last minute to cover a cash flow shortage.

Ask Their Creditors

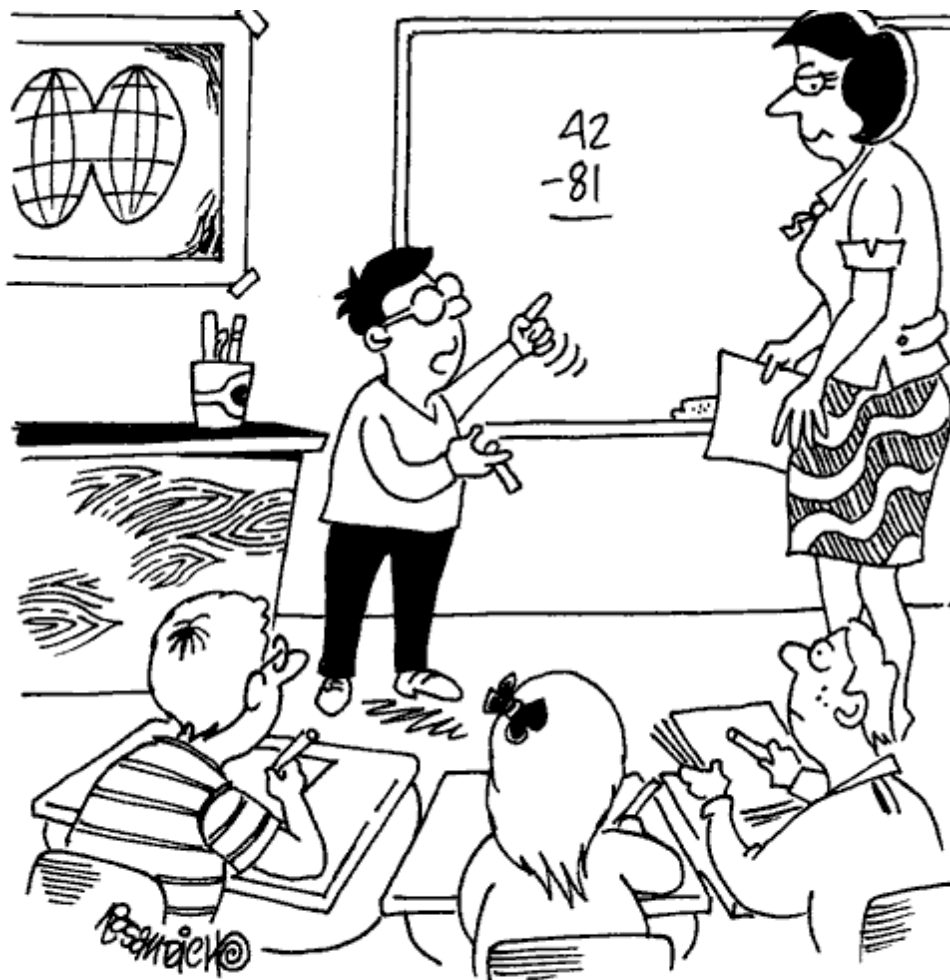
- ❖ A borrower could look through their creditors ledger and see if anyone on the list could wait to be paid late.
- ❖ Ensure a borrower understands that they should call these creditors and make repayment arrangements in advance because these creditors could be experiencing cash flow strains too.

Sell Inventory

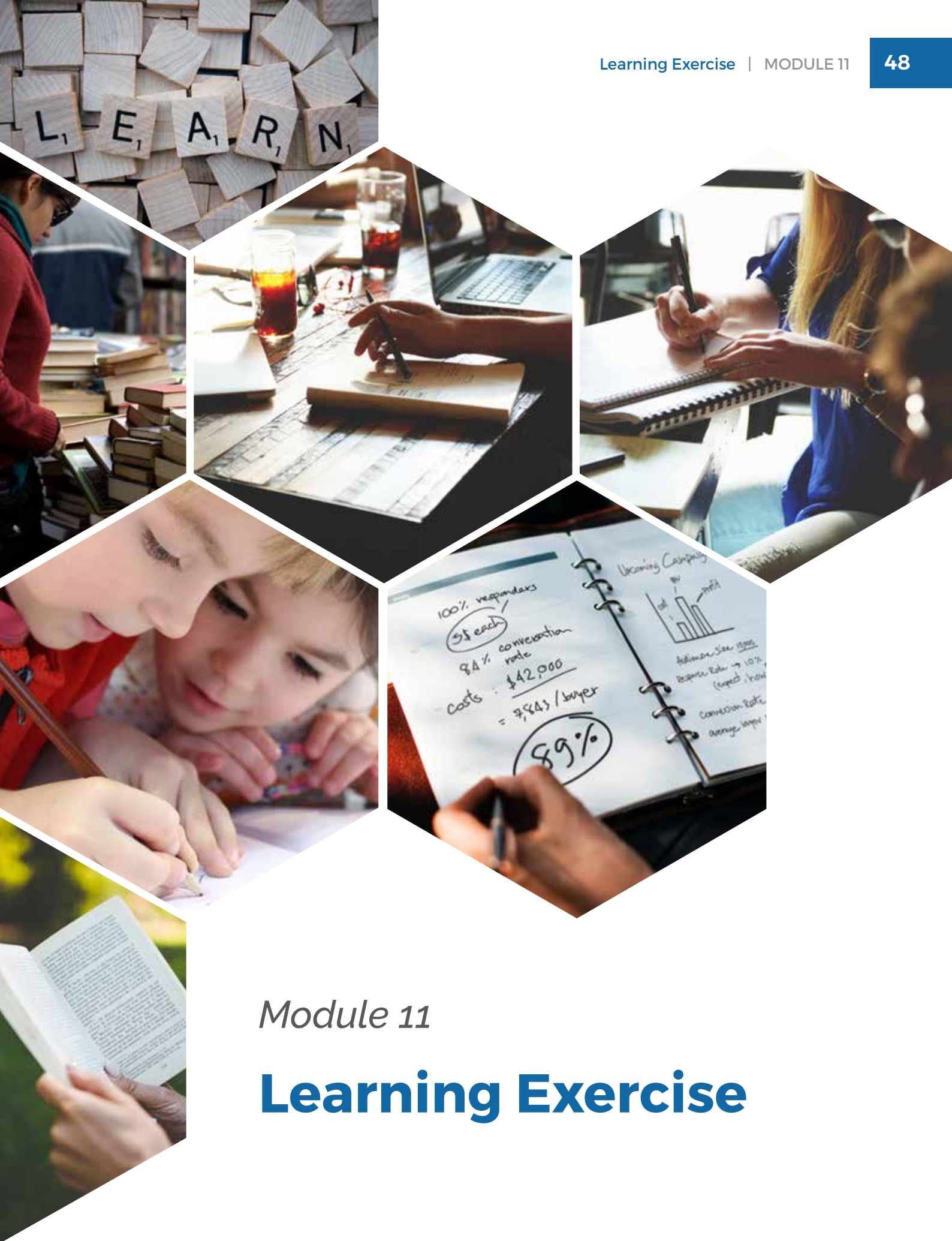
- ❖ A borrower could review their inventory and identify any items that could be discounted and sold especially on a sale basis.
- ❖ Spring cleaning and impulse sales could boost sales and increase a borrower's working capital, as well as attract new customers.

A borrower should be reminded that cash flow is a mindset that encompasses owners, management and all staff. Suggest the introduction of company policies that respect cash flow at all levels and in all departments so that this pressure can be avoided in the future.

Clearly these ideas tie in nicely to relieving cash flow pressures and could lead to the establishment of a cash flow finance solution; whether it be options discussed in this course such as Trade Finance, Debtors Factoring, Invoice Discounting and Inventory Finance, or through other means elaborated on in other courses by the author such as a Sale and Leaseback.



“Sure it can be done! Haven’t you heard of negative cash flow?!”



Module 11

Learning Exercise

Module 17: Learning Exercise

1.	These course notes are designed to provide you with an all-encompassing understanding of cash flow finance?		
		<input type="checkbox"/> True	<input type="checkbox"/> False

2.	Choose three types of business finance from the following:			
	Cash Flow Finance	<input type="checkbox"/>	Home Loan	<input type="checkbox"/>
	Credit Card	<input type="checkbox"/>	Personal Loan	<input type="checkbox"/>
	Property Finance	<input type="checkbox"/>	Asset Purchase Finance	<input type="checkbox"/>

3.	The three main reasons companies use cash flow finance are:			
	Expand their business	<input type="checkbox"/>	Purchase Stock	<input type="checkbox"/>
	Fund a larger Christmas Party	<input type="checkbox"/>	Pay for a new holiday	<input type="checkbox"/>
	Build a pool in their home	<input type="checkbox"/>	Pay for invoices	<input type="checkbox"/>

4.	The common types of cash flow finance are:			
	Trade Finance	<input type="checkbox"/>	Credit Cards	<input type="checkbox"/>
	Business Loans	<input type="checkbox"/>	Debtors' Finance	<input type="checkbox"/>
	Loan from Rich Uncle	<input type="checkbox"/>	Invoice Discounting	<input type="checkbox"/>

5.	If you had late paying debtors you would use:		
	Trade Finance		<input type="checkbox"/>
	Business Loans		<input type="checkbox"/>
	Debtors' Factoring		<input type="checkbox"/>

6.	Identify from the below list which options are opportunities to look for:		
	Taxes are behind and payments arrangements are in place		<input type="checkbox"/>
	Creditors are blowing out more than the debtors		<input type="checkbox"/>
	Minimal or no cash in the bank		<input type="checkbox"/>
	Suppliers are restricting trade		<input type="checkbox"/>
	All of the above		<input type="checkbox"/>

7.	Debtors Factoring relies solely on property as security?	<input type="checkbox"/> True	<input type="checkbox"/> False
8.	Debtors Factoring allows you to some to 80% finance of the debtors ledger?	<input type="checkbox"/> True	<input type="checkbox"/> False
9.	Trade Finance costs less than Debtors Factoring?	<input type="checkbox"/> True	<input type="checkbox"/> False
10.	Inventory Finance works the same as Trade Finance?	<input type="checkbox"/> True	<input type="checkbox"/> False
11.	Having tax arrangements precludes a cash flow finance facility?	<input type="checkbox"/> True	<input type="checkbox"/> False
12.	When engaging clients, it is important to find out what their problem is?	<input type="checkbox"/> True	<input type="checkbox"/> False
13.	It is important to keep details and a systemised procedure?	<input type="checkbox"/> True	<input type="checkbox"/> False
14.	It is important to buy clients coffee and lunch often?	<input type="checkbox"/> True	<input type="checkbox"/> False
15.	It is important to document the engagement clearly?	<input type="checkbox"/> True	<input type="checkbox"/> False
16.	It is important to celebrate copiously on settlement?	<input type="checkbox"/> True	<input type="checkbox"/> False

Congratulations!

You have just completed the 'How to Understand Cash Flow Finance in One Day' course. I hope you now have a much better understanding of how cash flow finance works.
Regards, Dominic.

Dominic Lambrinos

