

## CASH FLOW BASED LENDING FOR SMEs



By Ulla Balle

### ➤ INTRODUCTION

One great opportunity in SME financing is shifting the mindset of financial institutions (FIs) from their current focus on collateral based lending to a cash flow-based approach.

Bankers generally see SMEs as “high risk” for lending and thus incorporate higher levels of security for lending to this segment in their policy and procedures. There is a basic contradiction in the demand and supply side of SME finance as SMEs typically do not have immovable assets that can be used as collateral. Cash flow based lending is an approach that can assist FIs in their lending to SMEs.

A typical scenario that occurs in SME banking is when a SME receives an order that requires the SME to supply

goods in a certain period of time. Given that the project has just arrived, the SME will typically need cash to produce or acquire these products. This sudden need for cash may necessitate that the SME seek assistance from a financial institution (FI). In such a scenario, the FI will ask for a provision in the form of some kind of tangible collateral. Registering this collateral before the disbursement of funds can take place is often a lengthy process. During these delays the SME is at risk of losing good business opportunities and revenues. Eventually, when the loan is disbursed the SME may be tempted to divert the funds to other things that will not necessarily assist or generate income for the business. If this is the case, the SME owner is at risk of being unable to repay the loan.

Although banks already appreciate the profitability of SME finance, there remains a lack of knowledge and skills in providing sufficient and different forms of lending to SMEs. Through building awareness of the benefits of cash based lending for growing businesses, these challenges can be incrementally overcome. The strongest argument to help bankers make this shift in their thinking is the profitability of the SME loan portfolio.

### About GrowthCap

Over the past few years FSDK has been at the forefront of SME banking development through conducting market assessments and studies in areas such as trade finance and SME equity funds, as well as supporting development of the credit reference bureau. Through its partnerships with its Action Research Partners (ARPs), FSDK's GrowthCap initiative is supporting adoption of SME best practices by individual financial service providers.

This paper is part of a series of Technical Notes and Resource kits that are being developed out of work with the ARPs. These provide detailed information about the best practices and are intended for use by financial service providers and those supporting such institutions which are entering the SME market.

### Abstract

This Technical Note looks at the nature of cash flow based lending, how it meets particular funding needs of certain SMEs and the issues faced by FIs in providing this form of finance to smaller businesses.

**Ulla Balle is the GrowthCap partnership manager.**



**LOAN APPROVED**

## ➤ WHAT IS CASH FLOW BASED LENDING?

Cash flow based lending is a lending technique based on and backed by the SME's cash flow; as opposed to asset based lending where the loan is secured by the SME's assets.



**For cash flow based loans, the loan amount is based on the SME's actual revenue generation and capacity to repay**

The primary difference between these two types of lending mechanisms is that in asset based lending the income as a source of repayment is of secondary importance; the **loan amount** is usually based on the value of the property or asset being offered as collateral and not the capability of the business to generate cash. Additionally, the **term of the loan** and the **mode of repayment** are not based on the borrower's cash flows. Usually, these are short term, single-payment loans. The best example of this type of lending is pawnshop lending, where the loan amount is based on the value of the item being pawned.

For cash flow based loans, the loan amount is based on the SME's actual revenue generation and capacity to repay. Furthermore, the repayment schedule is based on the timing of the SME's cash inflows. For this loan, collateral can be taken however it is not the primary consideration for the loan. One of the advantages for cash flow based lending is that loan size, terms and repayment mode are all based on the SME's actual cash generation and hence the risk of default due to diversion of funds is reduced. It's important to note, cash flow based lending is best suited for short-term working capital loans because these types of assets are a generating source of repayment, together with profit.

## ➤ CASH FLOW BASED V ASSET BASED LENDING

In most developing countries, SME lending in traditional banks is backed by properties. When a business owner applies for a loan one of the first question s/he will hear is "What type of security do you have?" In loan processing short-term assets such as account receivables, inventory or machinery and equipment are not really considered applicable types of assets as security.

Cash flow based lending is better suited for SMEs as it is based on the expected income of the company. Its credit rating and collateral is either not required or based on movable short-term assets such as inventory, floating debenture, debtors etc.

Admittedly, most SMEs are not able to provide reliable financial reports and projections to the banks, and if they are the reports may be fictitious generated only for the purpose of obtaining the loan. Also they may have very poor or no credit references. These challenges present a major problem for banks when considering cash flow lending.

Many FIs issue asset-based loans when they cannot validate the borrower's financial statements and where credit rating is not available. The major weakness for this type of lending is that fixed assets cannot support the repayment of the facility. In developing economies, a major weakness in asset based lending is that FIs are focused on mainly evaluating the value of the asset. This presents a problem as fixed assets cannot repay a facility. This focus does not take into account the ability to repay and hence can be of much higher risk both for the FIs in relation to reinforcing higher provisions and bad debts; and for the SME in relation to the risk of going out of business.

In a cash flow based loan, the documented cash flow and credit rating of the business applicant plays a key role in determining how much or if a business can borrow in the first place. However as noted earlier, this is precisely the type of information that many SMEs are unable to supply in support of their applications for funds. In order to have more reliable financial data to assess the capability of the SME to meet the obligations of any loan, banks need to change behaviour from requesting financial reports, that may be inaccurate and/or fictitious, to training staff so that they are able to collect the necessary information and construct a reliable financial statement.



A key to unlocking this dilemma between the current practices of FIs and the financing needs of SMEs, is for both the SME borrower and the FI lender to better understand the cash flow cycle of the business needing the funding.

### > UNDERSTANDING THE CASH CONVERSION CYCLE OF A SME

The cash conversion cycle (CCC) is a cash flow calculation that attempts to measure the time it takes a business to convert its investment in inventory and other resource inputs into cash through sales of goods and/or services. In other words, the CCC calculation measures how long cash is tied up in inventory before the inventory is sold and cash is collected from customers.

Understanding the CCC helps to determine the financing needs of a business' operating cycle. It will help establish the cash

generation terms of the business which in turn will help in setting up a repayment schedule for a loan.

Before a business receives payments for goods, there are a number of items to be considered. First, SMEs typically know that their business has to pay their supplier on order, which means that s/he needs funding for purchasing goods/materials up front. In addition the SME owner appreciates that it may take some time to receive and sell these goods. If it's a manufacturing business, the SME must also take into account the time it takes to produce a final product. In the CCC, there are some situations where the business has to sell goods on credit, which means that it can take even longer before the business actually receives payment for the goods they originally purchased. Most SME business owners know exactly how long each step of the CCC takes. They do not necessarily know how to transform and articulate this information as a finance need and determine when they will be able to repay a potential facility. The CCC can be calculated relatively simply as detailed in Figure 1 below.

**Figure 1: Calculating the Cash Conversion Cycle**

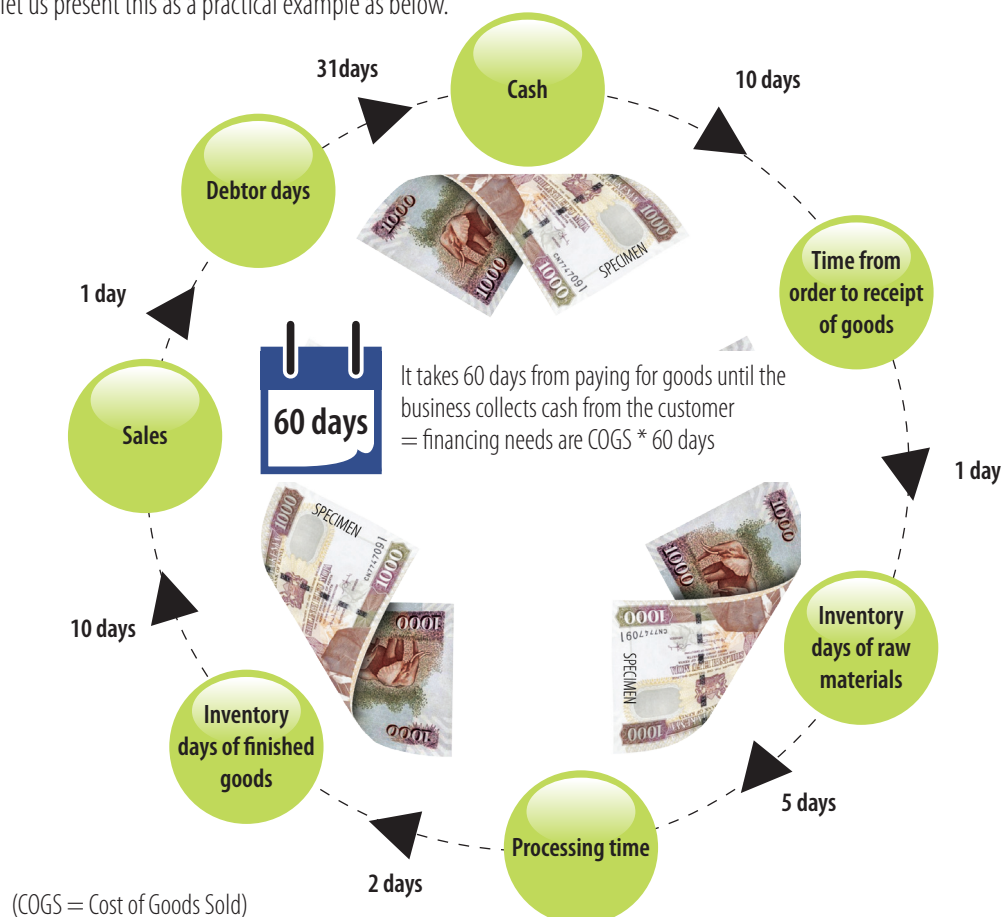


All three of above smaller calculations will have to be made before the CCC calculation can be completed.





Now let us present this as a practical example as below.



Looking at the diagram above, it is clear that this business would not be able to repay any funding loan before the end of 60 days. In this case s/he would fail repaying an installment on an asset-based type of loan for two months; which is typically what many SMEs would be offered. This demonstrates why collateral based term loans are not suitable to meet the short term needs of many SME businesses. If the business negotiates a payment term of the order of goods/raw materials, then the credit days can be subtracted (= partly financed by a supplier). In the above example if the business gets a credit line from its supplier of 15 days, then the CCC will be reduced to 45 days. This means it takes the business owner 45 days from paying for his/her inventory to receive the cash from their sale. This would have to be compared to other businesses in same industry over time to see if the CCC seems reasonable or whether it can be improved nearer to industry norms.

### ➤ ASSESSING THE CASH GENERATION TO COVER FOR LENDING REPAYMENT

One of the contradictions between the supply and demand of financing for SMEs is the fact that most SMEs cannot provide the basic requirements for accessing lending from a FI.

Most FIs will require financial reports, credit reports and cash flow projections to assess the business' capacity to repay a facility. However, most SMEs do not produce such financial reports and cash flow projections. Therefore, when a SME needs finance, it will typically get this type of information produced by an external business service provider. In most developing



**At the end of the day, cash is the only factor that can repay a loan; collateral is only the second way out if cash is not generated to repay a facility**

countries the accuracy of this externally generated data is questionable and tends not to reflect the real situation of the business' operations. Thus, the FIs are risk assessing the capacity to repay the facility based on incorrect data and the SME risks getting a loan that it will be unable to repay. This in turn can lead to problems with repayment and default.

This information disconnect applies to both asset based and cash flow based lending. It is very important for FIs to realise that if they continue to provide financing to the SME sector-based on assets/collateral with poor financial information about CCCs of these businesses then, they jeopardise their SME portfolio quality through poor repayment ability and default of the loans. Furthermore, the financial sector will continue to perceive SMEs as a high-risk segment of the business market.

FIs need to change their mindset from seeing collateral based lending techniques and corporate lending techniques as the first/obvious choice for lending to SMEs and really understand the SME segment and the way they operate their businesses. It is important for the FIs to allocate and train their staff to partner with the SME businesses in order to adequately assess an SME's capacity to repay a facility. This should involve on-site visits to the business; interacting with the business owner to understand the operation of the business; interviewing the business owner to obtain the evidence needed to understand the CCC and assessing the SME's ability to generate cash

from the business. GrowthCap's resources on relationship management approaches techniques and training help bank staff to better understand SME business operations.

At the end of the day, cash is the only factor that can repay a loan; collateral is only the second way out if cash is not generated to repay a facility. Typically this takes a long time and involves a lot of expense to convert collateral into cash for the sake of repaying a facility.

Standard requirements to be able to assess the CCC include: documentation in form of invoices from suppliers; invoices issued by the business; sales records; supplier and customer references in addition to a thorough interview of the business owner. It may be necessary to crosscheck with the suppliers the invoices provided. FIs can still request collateral but do so in the form of floating collateral over inventory and/or receivables to back up the facility.

Bankers in charge of SME clients need to be trained to adopt this more practical assessment approach by getting to know more about how their clients businesses operate rather than using a desk top theoretical approach. Assessment tools/systems can be developed to assist the FIs to use this more practical approach, in a structured and reliable manner, to generate the necessary output and to add value by providing better financial assessment of and for the SMEs.

If FIs invest in technology, resources and training human resources properly, this can be a very profitable business segment for FIs. At the same time it can add value through increased growth of the SME sector with added benefits of increased employment and improved local supply to the corporate sector.

### > KEY QUESTIONS TO ASK FOR INTRODUCING CASH FLOW BASED LENDING APPROACHES

Bankers and/or consultants working with banks that are considering introducing cash flow based lending approaches to SME customers need to consider some key questions. What is their strategy and what resources are needed in order for FIs, such as banks, to consider adopting cash flow based lending techniques.

#### Strategic considerations

- What is the bank's overall strategy i.e. mass market Vs. Niche?
- Is it necessary to undertake an initial diagnostic review of the bank's current SME Banking Practices?
- Does this fall under the bank's target market?

- What is the current liquidity status to ensure adequate liquidity for this type of lending activities?

#### Structures and Knowhow

- Are there sufficient supporting structures i.e. relationship management Vs. portfolio management or a mix to manage and understand cash flow based lending techniques?
- What is the availability of in-house knowhow about these different approaches or access to external support for specialised knowhow?

#### Processes and policies

- What evidence do you need to have from customers to back-up CFL?
- Does the credit policy allow alternative forms of collateral, i.e. debentures, inventory, debtors etc.?
- What approaches and processes do banks need to be able to authenticating financial data & sustainability of the approaches?
- What systems & processes are in place for data collection & analysis, availability & scope e.g. origination, scoring, decision tools?
- Are there systems & processes of evaluating alternative collateral such as inventory & receivables?

**Acknowledgements:** The authors wish to acknowledge the feedback given by several local GrowthCap consultants in helping to shape this final document and the final editing undertaken by Dr Pat Richardson, as an international adviser to GrowthCap.

The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA), Agence Française de Développement (AFD) and the Bill and Melinda Gates Foundation.



**BILL & MELINDA  
GATES foundation**



info@fsdkenya.org • www.fsdkenya.org  
FSD Kenya is an independent trust established to support the development of inclusive financial markets in Kenya  
5th Floor KMA Centre • Junction of Chyulu Road and Mara Road, Upper Hill  
P.O. Box 11353, 00100 Nairobi, Kenya,  
**Tel** +254 (20) 2718809, 2718814 • **Cell** +254 (724) 319706, (735) 319706