The RMA Journal has provided a forum for some spirited debate about the usefulness of global cash flows (see the end of this article). Here, the author discusses GCFs, their construction, and their application in enhancing loan decisioning.
Typically and understandably, commercial lenders depend on cash flow from a business as their primary repayment source for a loan; real estate lenders rely on cash flow from real estate; and private bankers usually look to an individual’s personal cash flow. As a secondary source, commercial and real estate lenders often rely on guarantors. When the guarantors are individuals, then personal cash flow becomes that source (along with personal liquidity).

So, with the exceptions of nonrecourse and capital market lenders, most lenders prepare personal cash flow statements (PCFs) to understand their secondary repayment sources. PCFs are thus commonplace in the lending business, and most institutions have some sort of policy or template for preparing them. Global cash flows (GCFs), on the other hand, are less widely accepted. I have found GCFs to be one of the most important items in my credit toolbox, and I know that others share this opinion.

What Is Global Cash Flow?

Global cash flow, which is a variation of personal cash flow, blends business income and business debt service into the same model. Figure 1 presents a sample PCF that is transformed into a GCF; two lines have been bolded to distinguish the differences. As can be seen, the PCF becomes a GCF (sometimes also called a universal cash flow) by the addition of 1) cash flow before debt service of the closely held business as a cash flow item, and 2) debt service of the business as a debt service item. The difference seems minuscule, but the results tell two different stories. Please note that the presentation in Figure 1 is just one way of structuring a GCF. Other equally useful styles exist.

A PCF identifies an individual’s or a family’s income and spending habits. It isolates how much a family takes in and how much it pays out. The family in Figure 1 is barely making ends meet. The income is nearly fully consumed by day-to-day living expenses. Clearly, this family’s net cash flow supports little to no additional debt. However, the GCF makes allowance for all cash flow

---

**Answer:** Global cash flow.

**Question:** What type of repayment measure may merit greater consideration than it currently receives?
and debt service of closely held businesses in which the family has an interest. This combination of personal and business finances eliminates the corporate shield, for analytical purposes, between a business and its individual owner. Effectively, it’s the same as a PCF if the business had never been incorporated and instead operated directly in the name of the individual. Except for sole proprietorships, this doesn’t happen in practice due to liability and other reasons, but that doesn’t mean our repayment analysis must remain separated.

For the GCF to be meaningful, business cash flow must represent the amount that the family could have withdrawn and spent or repatriated to personal assets if it wanted to, whether or not it actually did. Many banks differ in the treatment of this one aspect, but to me it makes all the difference. Some underwriters are told to consider only distributions actually taken by the individual from the business. However, I’m sure all of us have noted instances where no distributions were taken and all business cash flow was retained, either for growth or for distribution in the future. If the individual was entitled to take and could have taken the cash flow but instead chose not to, then the company and individual should be viewed in the aggregate, and business cash flow should be incorporated into the PCF to create a GCF.

The accurate calculation of business cash flow available before debt service for withdrawal by the individual is critical. The underwriter is free to use NCAO (net cash after operations), EBITDA (earnings before interest, taxes, depreciation, and amortization), or any other preferred method of determining business cash flow. However, the final result must be net of any recurring capital expenditures or other non-income-statement calls on operating cash flow.

When to Use Global Cash Flow

Anytime a lender’s obligors include a business entity as borrower and the individual who owns that business as guarantor, or vice versa, the global cash flow will provide a combination picture of the two major repayment sources (business cash flow and PCF). This combination is important because either source, by itself, may not represent a fair picture of repayment ability in one particular year. To understand why, consider a few familiar scenarios:

- The business owner takes only enough money to live on because he or she will earn a 50% return on capital by reinvesting every dime back into the enterprise instead of a 10% return in the stock market.
- The business owner took no distribution in 2005 until bonuses were paid out in early 2006, at which time the business owner took as much as he or she could.
- The medical practice consistently reports cash flow of zero because every dime earned is paid to the individual to better manage liability.

There are many other reasons—some I couldn’t even guess at—why available cash flow might be either withdrawn in full or not withdrawn at all. In the first two scenarios presented above, PCF might be very low and business cash flow sizable. In the last scenario, business cash flow is nil and personal cash flow might be very sizable. When the individual and the business act as one—in the sense that cash is free to flow between the two or to remain with any one—the GCF eliminates all boundaries and allows for that free movement potential of the cash flow to be considered in a credit decision.

There are times when the PCF alone will tell an important story—for example, when you wonder whether a company prin-
Principal is taking too much in the form of officers’ compensation. It will tell you if the individual lives a lavish lifestyle by revealing the amounts paid for real estate tax, insurance, credit cards, mortgages, and auto loans. The PCF will then show whether salary (if any) and other income are enough to cover these bills. If the storyline points to a negative personal cash flow, the individual has an outside source of cash in the form of business cash flow. A global DSC can also reveal that the individual needs to fund the company’s negative cash flow, as is common with start-ups. Even though the business is not a cash flow source upon which the lender can directly rely, it is a cash flow source upon which the individual borrower may draw at his or her discretion to meet personal and other obligations, including those to the private banker.

When Multiple Individuals Guarantee

The GCF shown in Figure 1 depicts a simple cash flow, when one individual owns one or more businesses. When multiple individuals who own a business are co-obligors on a loan, then the GCF takes on one additional step (albeit a very simple one). It is no longer appropriate to simply place business cash flow and debt service directly into the PCF.

It may be tempting to simply split business cash flow and debt service in proportion to the individuals’ ownership in the business and place that number into the individuals’ PCFs. As long as all three individuals have very, very similar PCFs, this might be okay to do, as the results for all individuals will be roughly equal. More times than not, however, multiple individuals are far from equally endowed.

Assuming there are three equal partners in a business, the multiple-individual GCF might look like the one shown in Figure 2. In this example, three individuals—partners in a small law firm—are jointly and severally liable as guarantors.
Using Global Cash Flow

on a bank loan to the P.A. Like most professional practices, the P.A. distributes all cash flow to the individuals in the form of officers’ compensation, so it reports roughly break-even cash flow.

When there are multiple owners of a business, all of whom are obligors on a loan, the banker will want to aggregate the personal cash flows first. Unlike the previous example of a single individual owning a business, the business’s cash flow is not flowed through pro rata to the individuals’ PCFs. This is because we want to show all cash flow to which they are jointly entitled—and all debt service on which they are jointly obligated—separate from the PCFs.

Personal cash flow is shown for each individual net of personal debt service. Since the three are not jointly liable for one another’s personal liabilities, debt service on personal loans should not be shown as global debt service.

This GCF presentation allows us to quickly see that Sam Howe is the strongest of the three guarantors. The detailed PCFs would show us the sources of his personal income. To the extent Sam received other income independent of the P.A., the credit would be strengthened by virtue of having a separate income stream contributing to a favorable PCF (and thus an additional repayment source).

Reviewing the detailed PCFs would also reveal important information about Jeffrey Dewey and Chris Cheatum. They might very well be earning a much lower salary than Sam. Then again, since they are one-third partners, it’s likely that the salaries are roughly equal. It’s possible that Jeffrey and Chris have grander lifestyles than Sam. This detailed PCF review tells us an important story about our three guarantors and allows us to identify not only the stronger guarantors, but also the more fiscally responsible ones.

We also see that the firm’s cash flow, as managed by the principals, is not sufficient to cover debt service by itself. In fact, business DSC in this case is 0.94X. While this might yield a loan decline in its own right, we can see that the guarantors are saving more than enough money to bridge the company’s debt service shortfall. Indeed, when combining business and personal cash flows (to arrive at GCF), we find a strong global DSC well in excess of 4X. Thus, we can see that the guarantors have the means to prevent default on the loan to the P.A., possibly by taking smaller salaries.

Conclusion

The large majority of commercial- and private-banking credit relationships involve individuals and their closely held companies. Often, money flows between the individual and the company as needed. The global cash flow is a tool designed to tear down the barrier and show how much money is left for the bankers after the individual’s and the company’s basic needs have been satisfied. However, the GCF is not necessarily a replacement for PCF and business cash flow.

Much can be said about the details that go into creating PCFs and GCFs. Such details are better left as topics for other articles. Here, we have viewed GCF’s more broadly and, I hope, made a case for their usefulness in decisioning the average loan.

I am sure many still see GCF’s as superfluous to a PCF and a business cash flow. I certainly respect that opinion, as not everything in credit is completely consistent between individual practitioners. However, I am a big believer in doing what makes the most sense in any given situation; and as long as bankers can successfully defend their approach as being the best possible approach—whichever approach that may be—they cannot possibly go wrong.

Contact John Cassis by e-mail at john.cassis@wachovia.com.

As long as bankers can successfully defend their approach as being the best possible approach—whichever approach that may be—they cannot possibly go wrong.

Previous Articles on GCF

Appearing in The RMA Journal


The RMA Journal’s 2007 editorial calendar runs the gamut of financial services risk management issues. The Journal welcomes in any issue contributions from bankers that add to our legacy of excellence in credit fundamentals, including considerations in lending to a particular industry or “spilled milk” lessons learned. We also invite your contributions to our growing wealth of information on enterprise risk management, operational risk management, or market risk management. The Journal’s Guidelines for Authors is available at www.rmahq.org: Under “Quick Links,” click on “RMA Journal”; scroll down to “Journal Information” and click on “Guidelines for Authors.” E-mail the editor at bfoster@rmahq.org about your interests, ideas, and questions.

—2007 Editorial Calendar—

February: Enterprise Risk / Global Banking  
Articles due December 1

March: Market Risk  
Articles due January 1

April: Community Banking  
Articles due February 1

May: Operational Risk  
Articles due March 1

June: Credit Fundamentals  
Articles due April 1

July/August: Regulatory Risk  
Articles due May 1

September: Small Business Banking  
Articles due July 1

October: Commercial Real Estate Lending  
Articles due August 1

November: Retail Lending / Interest Rate Risk  
Articles due September 1