

# **DEVELOPING REALISTIC CASH FLOW PROJECTIONS FOR BUSINESS START-UPS AND EXPANSIONS**

By John Donovan, Butte SBDC

## **Background**

Developing accurate projections, especially the sales forecast is probably the most difficult part of building financials for your business plan. Unfortunately many people don't spend enough time and effort on this part of their plan and end up living with the consequences after their project is funded.

The numbers used for your forecasts are derived from numerous sources. However, the foundation for your forecast starts back in your market and competition analysis.

## **The Market**

As you do your research especially focus on the following questions:

- 1) What is your overall market size?
- 2) What is the growth potential?
- 3) How is the market segmented?
- 4) What is your target market strategy and have you clearly identified your product or product line?
- 5) Is my business idea good for this place, this time, and my resources?
- 6) Who are your competitors and what products and services are they providing?
- 7) Is your business impacted by national/world markets and economic conditions across the US and abroad? If so, in what way?

## **RESEARCH IS EVERYTHING**

You need to satisfy bankers and yourself that your plan and projections are viable. The best way to do this is to investigate every reasonable source of information that will help frame the market potential for your business. Plan on spending weeks if not months to do this. You should be able to go into your business knowing or at least reasonably assured that there is a piece of the market pie for you to **find and eat**. The surest way to lose your business is to use anecdotal, inaccurate, or incomplete information.

After you have gathered all of the possible pertinent information you will sift through and use the best parts for your plan and projections. There is still risk of failure but you will have improved your chances dramatically and increased your knowledge base significantly.

If you are still not confident about proceeding then change or even consider dropping your plan. **Things will not get better by going into business.**

## **WHERE IS THE INFORMATION?**

There are two primary sources of information; primary and secondary. Primary sources are usually not available in written form. Primary sources are typically interviews, questionnaires, surveys, focus groups, or first-hand observation. Most of this is too expensive and time-consuming for potential small businesses and sometimes difficult to interpret while secondary sources are generally more reliable and easier to find and use. Secondary sources already exist primarily in written form.

Make sure the information you gather is current and correct. This research is to help you survive. You should not be spending your time creating a pretty document.

## **The Big Picture**

Start with the national market and regional markets and work your way down to your own local target market.

First Stop : **The Encyclopedia of Associations** ( also check **Encyclopedia of Business Information Sources (Gale Research)**)

Gale Research Inc  
835 Penobscot Bldg.  
Detroit MI 48226-4094  
313-961-2242  
800-347-4253

These can be found at local libraries and technical assistance agencies such as SBDC's. Go to the index and look up the primary related business associations. Then go to the main directory and photocopy each association's profile. Start calling and try to get "cost of doing business surveys", industry statistics, business profiles, books, and periodicals that the association publishes. Don't stop there! As you speak with them ask them for other leads possibly outside the association. Some of this stuff costs money or you need to join. Plan on paying something because this information can be extremely valuable.

*Other sources :*

### **Directory of Business Information Resources**

Grey House Publishing  
Pocket Knife Square  
Lakeville, CT 06039  
860-435-0868

A guide to print media, electronic media, and trade shows for 93 industry groups.

### **The Franchise Annual**

728 Center Street  
PO Box 550  
Lewistown NY 14092-0550  
716-754-4669

Franchise profiles information, related data in regard to legalities, regulations, analysis, etc. Often you can acquire franchise profiles and percentage operating costs from some of the requested information.

### **Standard Industrial Classification Manual (for SIC codes)**

National Technical Information Service  
5285 Port Royal Road  
Springfield, Virginia 22161

Classifies businesses by the type of activities in which they are engaged. The SIC code number is very handy when looking up business types from various databases. **This is soon to change to the North American Industry Classification System (NAICS).** Check [www.census.gov/naics](http://www.census.gov/naics).

**Internet** – just a few favorites , don't stop here

<http://www.business.gov>

<http://govinfo.kerr.orst.edu/econ-stateis.html>

Used to set reasonable expectations about sales and to compute seasonal indices. Includes retail, wholesale, taxable service, manufacturing, and mineral.

<http://www.sba.gov>

SBA'S main website that will gain you access to their programs.

<http://www.sba.gov/SBIR/sbirq.html>

Information about the Small Business Innovative Research grant program sponsored by the SBA. Works well for high-tech and scientific firms.

<http://www.census.gov/svsd/www/monret.html>

Revised monthly sales and inventories that can be used to determine monthly sales revenues projected after an annual number is determined.

<http://ceic.commerce.state.mt.us>

State and county business statistics

<http://ceic.commerce.state.mt.us/C2000/PL2000/index.htm>

The interactive map, an update to the above site.

### **U.S. Industry and Trade Outlook '98**

DRI/McGraw Hill

ISBN 0-07-032931-1

Excellent guide for the "Big Picture" outlook for the U.S. for various industries. Provides in-depth profiles, analysis, demand, and trends for numerous industries.

### **Thomas Register**

These volumes contain company profiles, products, and services primarily for larger companies in the U.S. Generally these are not particularly useful other than to see how other companies advertise and possibly to offer insight into product mixes and advertising formats. Also possibilities for direct contacts with company personnel.

### **Dun and Bradstreet's Industry Studies – Industry Norms and Key Business Ratios**

Total analytical information on 10 major industries. Financial and general business conditions that influence each major industry. Benchmarking tools for evaluating industry performance, customers, and peers.

### **Statistical Abstract of the United States**

U.S. Dept. of Commerce

A standard summary of statistics on the social, political, and economic organization of the United States. Nice guide with easy to look-up information and trends on the U.S. and individual states.

### **Business Periodicals Index**

H.W. Wilson Co.

718-588-8400

Found at better libraries near you. Up to date articles that can give inside looks at recent trends and events in your industry.

### **“Industry Surveys”**

Standard and Poors

#### **1996 Survey of Buying Power**

Sales and Marketing Management Magazine

Bill Communications Inc.

355 Park Ave. South

New York, NY 10010-1789

800-443-2155

Information on population and income for every state by cities and counties includes per capita, per household incomes and BPI's and EBI's. (Buying power index and earning power index.)

### **Small Business Profiles**

Gale Research

800-347-4253

Information on 60 business types on various aspects of starting a small business.

### **New York Times Index**

**New York Times Co.**

**229 West 43rd Street**

**New York NY 10036-3913**

**212-221-5065**

Brief digests of articles related to your business that has appeared in the *New York Times* and its subsidiary publications.

### **The Lifestyle Market Analyst**

**SRDS**

**1700 Higgins Road**

**Des Plaines IL 60018**

**800-851-SRDS** <http://www.srds.com>

Demographic information on popular activities broken down by geographic market. Only available through universities and public libraries.

## **USING THE INFORMATION – WHAT TO DO NEXT**

OK, you have found some great information and you're loaded for bear. The big picture looks good or at least reasonable based on your research. The market is large or growing and you think there is potential in your area.

Now you need information on the county or city level. If you are going regional or national you have already gathered it. Let's take a look at local available information first.

### **Bureau of Business and Economic Research ( BBER)**

University of Montana, Missoula; 406-243-5113

Call for demographic information to assist you with the development of your projections and possibly with the narrative part of your business plan. Keep in mind that much of this information may now be found elsewhere especially on the Internet. BBER may suggest other places to investigate.

### **Montana Census and Economic Information Center**

Dave Martin (1424 Ninth Avenue, PO Box 200501, Helena MT 59620-0501)

Extensive Demographic and Socioeconomic Information 406-444-2896

Order **Montana county statistical reports** – individual counties will cost **\$25.00**

Website: <http://commerce.state.mt.us/ceic>

### **SBA Business Information Center – (BIC) Helena, Montana**

301 South Park, Room 334

Helena MT 59626-0054

406-441-1081

The BIC center has numerous guides and information that can be useful for a business. The **Entrepreneur Group business guides** can be very useful for building a basic framework for a specific business; you will still need to take into account the various local factors. If you are interested in the business guides call the BIC first to see if they have the guide you need on hand. The center also has Internet access, computers, copying machines and other valuable business information.

### **Montana Tourism Bureau**

406-243-5686; [www.forestry.umt.edu/ittr](http://www.forestry.umt.edu/ittr)

Found at the Institute for Travel and Tourism Research (ITTR) at the University of Montana. Have numerous reports and studies regarding tourist trends and demographics.

### **Various city, county, state, federal agencies**

Example: City clerk and recorder's office would have birth, death, vehicle license, and marriage information.

Example: MT. Dept. of Transportation will provide traffic counts by request for areas you are interested in.

### **Threshold Studies – various states**

The studies correlate business activity with demographics. For example, for every 1,000 population in Iowa you can expect 2 restaurants, 1 grocery store, 1 tavern etc. The best way to use a threshold study from another state is to make sure you are comparing somewhat similar areas and town sizes. Sometimes local county extension agents have copies of threshold studies from surrounding states. Unfortunately, Montana does not have any completed threshold studies at this time.

### **Yellow Pages – Local**

Obviously you should check your local and area yellow pages to find out who your competitors are but you can also call these businesses for an “activity check”. I.E., a busy group of competitors isn't *necessarily* a great sign but it probably indicates some potential for your market.

### **Meet with owners of similar businesses outside your area**

One of the best information sources is successful business people outside of your proposed area. These people are often proud of their success and willing to share this success with outsiders if they perceive you to be non-threatening. In some cases they will even let you examine their financials. This is a great way to copy and incorporate successful operating practices into your proposed business. Again, be sure to make apples-to-apples comparison adjustments; their situation will usually differ somewhat from yours. Also, you should plan on spending some dollars for phone calls, travel, and probably meals for these people.

## **Local Chamber of Commerce**

A source for local statistics and information.

## **Jean Bishop – Associate Professor, Head of Reference Services**

406-496-4281

<http://www.mtech.edu/library/menu1.htm>.

Go to the Montana Tech Library in Butte and get in touch with Jean. She is an expert on finding information and resources for start-ups and established businesses. Also, an excellent resource for patent and copyright information.

## **Trade Shows**

Attend trade shows to find out what potential competitors are selling and how they are marketing their products.

## **Montana Business Quarterly**

406-243-5113

[www.bber.umt.edu](http://www.bber.umt.edu)

Contains business profiles and economic research for Montana. Back issues can be purchased for \$10 each. Subscriptions are \$30 per year.

## **Local Business Development Corporation Studies**

Sometimes towns and municipalities have completed or paid for in-depth market studies for their areas. These are usually free but usually require some phone time to find out if studies have been done for your area.

## **SCORE**

Service Corps of Retired Executives – Program sponsored by the SBA that matches experienced volunteers with businesses that need expert advice. Look into your telephone book to find your local chapter.

## **Local Bankers, Realtors, and Insurance Companies**

These “real world” people work with businesses every day and usually have valuable insights into area market conditions.

## **Consultants**

If you have funds available you might consider hiring an expert in your field to assist with initial market assessments. Some caution is needed here in defining the scope and price for any engagement. You should also investigate the consultant’s background and successful experience in your business area.

## **Suppliers – Equipment and Goods**

One of the best sources for market potential are the suppliers of goods you plan on selling or suppliers of equipment you will need to run your business. An example of a goods supplier would be a Montana supermarket wholesaler such as Supervalu or Sysco Foods. These businesses often have staff people or consultants on-hand to give valuable advice and even do studies as to an area’s business potential. An example of knowledgeable equipment suppliers would be coin-operated laundry equipment wholesalers or car wash equipment wholesalers.

Some equipment suppliers also have in-depth performance studies and/or guides for equipment you will be using. These can be very valuable when bidding jobs or projects where

equipment performance, capacity, cycling times, and other factors are critical. For heavy equipment look at a “Blue Book” to figure this including ownership costs.

## **BUILDING YOUR FIRST YEAR CASH FLOW PROJECTION**

### **#1 - PRE-START-UP POSITION**

The pre-start-up section of your cash flow projection is useful to start-ups and expanding businesses. It helps to define and confirm the exact amount of debt and equity financing you will need and what type of financing will be needed: term debt, revolving credit line, seasonal line, short-term, long-term, etc. It also clearly defines where the initial infusion will be spent and how much will be left over as cash on hand to start or expand your business. (It should also correlate exactly with your “sources and uses of funding contained elsewhere in your business plan.)

**A - Total business start-up cost** - Add up the total cost of equipment, inventory, land, buildings, loan payoffs, and one-time pre-start-up expenses such as pre-paid rent, pre-paid insurance, and any other cash layouts you need to start or expand your business. This figure will be deducted from your available equity and loan start-up funds. When finished, the excess ending cash will roll to the top of your sheet as starting cash. Your ending cash must always be positive, otherwise you are out of money, which won't work.

**#2 – THE SALES FORECAST-** Now you are ready to actually see if your cash flow will support your business. (*Note: All figures used in your cash flow forecast should be rounded to the nearest dollar.*)

**A - Some background factors** - You have determined that your first year annual sales will be \$150,000. This was based on

- a favorable national industry outlook,
- a favorable economy,
- association information,
- favorable competition in your area,
- a proposed superior or unique level/type of service,
- threshold studies from a neighboring state indicating a market potential,
- product differentiation and availability not offered by others,
- demographics for your area indicating a large potential customer base cross-referenced by buyer profiles obtained,
- in-depth conversations with a friend successfully operating a similar business in a similar market outside of your area,
- the retirement of a large competitor,
- a national supplier stating that he supplies 3 times your proposed level of sales to a business in a town similar to yours,
- a local economic development study that highlights community needs including your products,
- large out-of-state demand for your type of product if you have mail-order capabilities,
- you have obtained an exclusive dealership in your area for an exciting and in-demand product,
- a general increase in manufacturing or large basic industry operation moving to your area,
- the availability of an excellent business location at a very reasonable price,
- availability of superior merchandise at an extremely low price not known or unavailable to your potential competitors,

- cross-checked your sales estimate with industry-average sales per square foot,
- Business and Industry Financial Ratios information indicating average sales for your type of business are about \$200,000, and so on and so forth.

*A preponderance of positive factors is a good indicator for your business potential.* These are just a few examples of positive factors and methodologies to determine what your initial forecasted sales level could be. Any of this relevant evidence should be used as an exhibit in the appendix section of your business plan. You can refer back to these exhibits to strengthen various parts of your narrative and financials.

**B – A micro look** - Now look at your sales forecast on a micro level. How many people on average need to walk into your store every day and purchase X amount of merchandise each to reach your forecast? Is this realistic based on average purchase amount for these types of products? Based on area demographics cross-indexed with customer profiles? Based on your store hours? Is your product really needed or can people buy the same thing at Wal-Mart for 80 percent of your price? You need to ask these types of questions prior to pulling the trigger.

**C – Seasonality of the forecast** – Many businesses sell their products or services at different levels at different times of the year. You need to get a handle on this. If you don't you will find yourself very short of cash on any given month. The Bureau of the Census Economic Census data will provide seasonal indices for a given industry sector. This information is available online at <http://govinfo.kerr.orst.edu/econ-stateis.html>. Trade associations, suppliers, consultants, business acquaintances, and others can also assist with determining the seasonality of your business. For example, 35% of your business may occur in December, 5% for January, February, and March, 7% for April and May, 10% for June and July, 3% for August, September, and October, and 7% in November. This will also affect your product purchasing cycle and your inventory needs. **Don't divide your annual sales by 12.**

**D - More than one product or service** - If you have more than one product or service you should initially break them out separately on some type of matrix and project them separately. They probably have different costs of good sold percentages and you need to illustrate this. Each category is likely to have separate seasonality profiles also. The SBA cash flow form #1100 can be modified to reflect this as well as any computer spreadsheet you are using. You can later combine them for your total annual income forecast.

**E – Sales build-up** - You are not going to come out of your blocks at full speed in regard to sales. Estimate a reasonable build-up. For example your first three months of sales might be \$6000 per month, then 2 months of \$8,000, then \$10,000 in month six. You might be able to confirm this build-up via association data, a similar business in Idaho that recently opened, supplier advice, or some other source. Don't rule out common sense.

**F - Cash sales versus credit sales** – If you are selling some or your entire product on credit you will need to account for this on your cash flow forecast. If you are using a computer you can build a “booked” sales line that represents your total cash and credit sales then apply percentage estimates of cash sales and credit sales against your total sales to determine the estimated dollar amounts. Let's say that 50 percent of your sales are cash and 50 percent are credit with an average collection of 60 days, (2 months). On \$6,000 total sales for your first month you show \$3,000 in available cash sales. The other “unavailable” \$3,000 will be shown on your credit collections line 60 days or 2 months later. Be conservative when estimating the availability of receivables. These “receivables” are a big issue especially with start-ups and growing businesses because you have spent

money to acquire your products or services but won't receive cash to run your business until later. You will need to finance the forecasted receivable deficit up front to cover your cash needs.

**#3 – COST OF GOODS SOLD (COGS)** - (sometimes shown as purchases or merchandise cost) **These** figures represent the price that **you pay** for your merchandise to be resold. **You need to know the dollar value and the percentage of sales that this cost represents.** For example if you sell something for \$100 and you paid \$50 for it then your cost of goods sold percentage is 50 percent, (50 divided by 100). How is this percentage determined? You need to contact your suppliers and find out what you will pay for a given product and what the suggested retail price or market-justified price will be. Divide your cost by your selling price and you have your percentage. Obviously for services, cost of goods sold does not apply. You should also consider competitor pricing for comparable products.

You now need to consult Robert Morris Associates (RMA) or Dun and Bradstreet annual statement studies and compare industry averages by percent with what you are forecasting. Your projections need to fall in their range for a couple of reasons. RMA and D&B data is fairly reliable and used by bankers and others. If you fall **below** normal ranges then you are better than everyone else in the U.S is. This is unlikely since you are just starting up and your local banker knows you are not going to do better than industry averages especially being the new person on the block. If you can unequivocally back this up then go for it but be prepared to logically prove it; otherwise go back to the drawing board. If you are **above** the average cost of goods percentage you also have a problem because you won't be competitive and will likely go out of business because you won't be able to cover your other costs. Again, back to the drawing board.

**A – START-UP INVENTORY** – One critical figure that needs to be determined early on is your start-up inventory level. **Once determined this figure needs to be plugged in as an additional start-up cost in the pre-start-up position on your forecast.** Initially you will need to determine if your industry has any special purchasing season or if you need to purchase your entire inventory at the beginning of the year. Assuming you are planning on replacing inventory as it is sold, you will first need to determine the total amount of inventory needed based on your forecasted sales. **Multiply your COGS percentage by your total forecasted sales, which yields your total annual inventory needed. Divide this total inventory by RMA, industry average, or D&B average inventory turns per year and this will give your needed inventory at start-up.**

<b>Example:</b>	Forecasted sales	=	\$100,000
	COGS percentage	=	50%
	Total Annual Inventory	=	\$100,000 x .50 = \$50,000
	Average Industry Inventory Turns	=	9 turns per year
<b>Therefore:</b>	<b>Start-up Inventory needed</b>	=	<b>\$50,000 divided by 9 turns = \$5,555</b>

**#4 – EXPENSES** - Every figure used here should represent a phone call, a letter, an informed estimate, a conversation, a quote, updated records, association estimates, "cost of doing business surveys", utility records, schedule C tax records, or any reliable source of information. In other words don't just pull numbers out of the air.

**#5 – Loan Interest and Principal** - Calculate your monthly payments on any loan(s) and break them out by interest and principal. If you have more than one loan or credit card then break them out separately by interest and principal. Interest is tax deductible and principal is not. This breakout is useful later for completing income statements and calculating various ratios.

**#6 – Capital Purchases and Other Start-up Costs** – Enter any capital purchases such as equipment, furniture, fixtures, or any major purchases that require cash outlays. Other start-up costs could

include your initial starting inventory and any other miscellaneous large start-up costs. Keep in mind that these items can occur at any time of the year and will affect your cash flow.

**#7 – Owner’s Withdrawal** - If you are a sole proprietorship or partnership then enter your personal cash withdrawals here. If you are incorporated then enter your salary above in the gross wages line. You need to at least cover your personal expenses. An exception is income from an outside source for your personal needs that may allow you to forego withdrawals from your business.

One way to determine an acceptable income is find the RMA average % owner comp for your type of business and multiply by your projected sales. Then see how it affects your cash flow.

**#8 – Income Taxes – Federal and State** – One area that will definitely impact your cash flow is taxes. Calculating tax from a cash flow statement is quite a paradox. You will need to calculate your tax based on your net income after depreciation. Since depreciation is a **non-cash** income statement and balance sheet item you will need to calculate your tax liability from an income statement forecast. You will need to apply 30 to 40 percent ( avg. 15% Fed., 10% State, 7 % S.E.) to your **net income after depreciation**. This may vary according to your personal situation and your company’s legal business structure. (proprietor, LLC, corp. etc.) Apply this amount **usually in quarterly amounts or when you expect the payments to actually fall due**. The amounts are placed on your cash flow forecast in the bottom section of your cash flow statement. (i.e. in the capital purchases , owner withdrawals **area.**)

**#9 – CASH POSITION (Ending Cash) – This figure needs to be positive for each month.** If you end up negative here you will need to make adjustments. You have several remedies: 1) Increase your loan or equity infusion. 2) Increase your projected sales. 3) Speed up collections on your receivables. 4) Reduce expenses. 5) Delay expenses or purchases at a more favorable time. 6) Reduce owner withdrawals. 7) Sell an asset for cash – you can enter this on the equity infusion line at the top and explain it in your notes.

**It is also important to have a cash cushion at the end of each month.** For most small businesses this should be a few thousand dollars at least. In some cases this could be as high as three months’ expenses.

The ending cash figure rolls up to the top of the sheet and becomes the starting cash for the following month.

## **FINAL NOTES**

1. Check and double-check your figures! The quickest way to have your business plan turned down is to have incorrect numbers. Your cash flow figures need to cross-index with all other figures in your business plan. **These figures need to be linked to the business plan text!**
2. Use of any loan proceeds and equity injections must be clearly shown in your proforma cash flow usually in the pre-start-up position. Periodic injections must also be clearly shown in regard to timing and amount. This should also correlate with your sources and uses statement contained in your business plan.
3. As you develop your figures have a sheet of paper handy to write down your assumptions as you go for each category. Line by line assumptions (sometimes called “notes” or “explanations”) are normally required as part of a business plan and will be on separate sheets following your figures. Bankers and other interested parties want to follow your logic and see that you were diligent in researching your projections. It will also be much easier than trying to remember later.
4. This is a classic application of computer spreadsheeting. Computerizing cash flow allows you to easily calculate “what if” scenarios and will save you loads of time.

5. ***PLEASE*** develop a group of advisors; legal, accounting, financial, SBDC, SCORE, and area business people you can ***TALK TO PRIOR*** to any financing for a business start-up, expansion or business purchase!