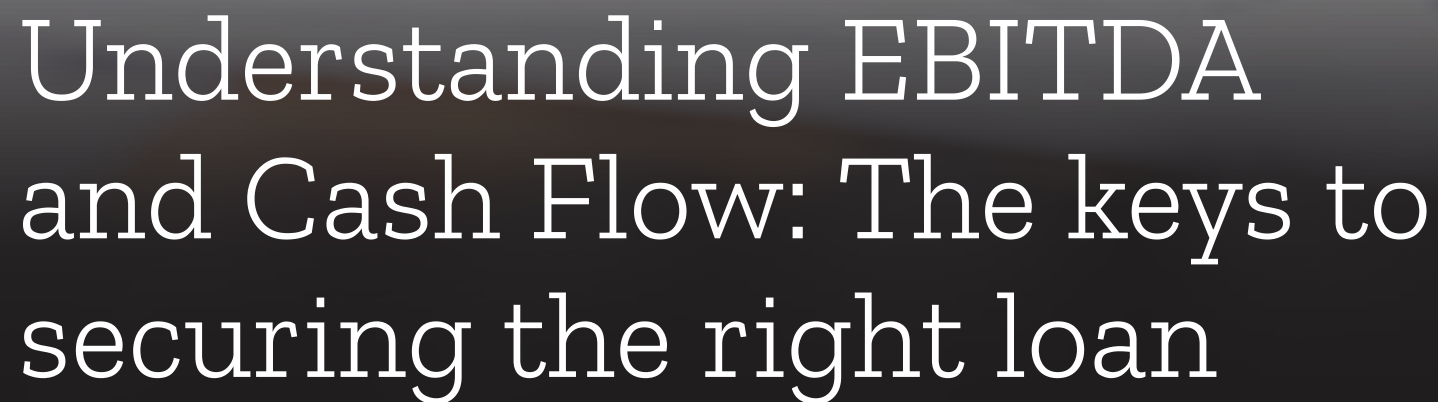


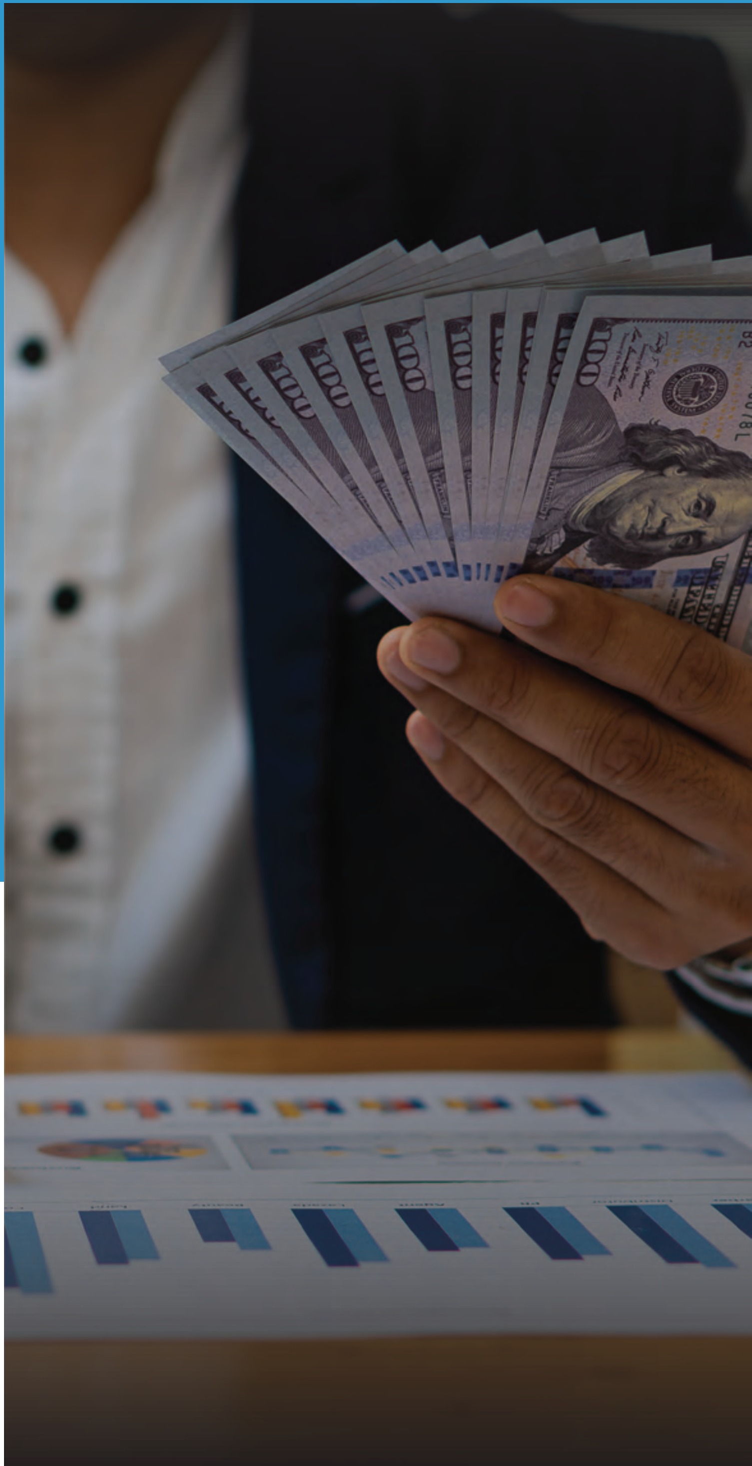
Understanding EBITDA and Cash Flow: The keys to securing the right loan

The keys to securing the right loan

Cash flow is an important part of the loan underwriting process for small businesses. This essential number reveals key insights into an organization, so lenders can expediently connect clients with the loan products that make the most sense for them. Cash flow can be calculated once a borrower's tax forms and other financials are in hand and is a necessary metric used to help gauge the extent to which a lender can expect a loan to be repaid. Here, you can learn more about the importance of cash flow in loan underwriting and how this important figure is typically calculated.

What's covered in this SmartBiz ebook:

- The role of cash flow in underwriting loans
- What you should know about key cash flow metrics EBITDA and DSCR
- Using tax returns, profit and loss statements, and debt schedules to calculate cash flow
- Information about SBA 7(a) loans and bank term loans so your clients can compare best funding options side by side



The important role cash flow plays in loan underwriting

To get a loan, small businesses need to demonstrate that they are good candidates and that they can pay it back. That's one area where cash flow comes into play. But there are a few other reasons why cash flow plays such a vital role in the underwriting process:

Higher rates of application approval

Cash flow is among the most important factors lenders assess while processing loan applications. Knowing cash flow information helps guide a given business to the loan for which they are most likely to qualify. That's because certain loans require certain levels of cash flow, and if a borrower doesn't meet those qualifications, they can more quickly move on to other loan types.

More organized financials

To verify their cash flow, prospective borrowers must submit tax returns, debt schedules, and other documentation, all of which will be necessary for a complete loan application. By gathering the client documentation that lenders need to calculate cash flow, you begin to assemble the loan application documentation, which helps to expedite the application process.

Stronger client relationships

When you gain a more detailed understanding of a small business customer's cash flow, you can gain deeper insight into their organization. This knowledge can help you better understand your clients' business goals and financing needs. Maybe they will be best served by a smaller loan now and a larger loan in five years or, perhaps, a best-in-class SBA 7(a) loan. Understanding your client's cash flow is the first step helping them identify optimal choices, leading to a meaningful, long-term relationship built on trust and confidence.

How cash flow is considered in the underwriting process

Banks need to feel confident that a borrower's business has historically earned enough money to afford their monthly loan payments and predict that the business will continue bringing in enough revenue to repay the loan throughout its term. Cash flow, tax returns, profit and loss (P&L) statements, and two additional cash flow metrics are key to making a persuasive case.

The importance of EBITDA in the underwriting process

EBITDA is a cash flow metric that stands for "earnings before interest, taxes, depreciation, and amortization." Once EBITDA is calculated, the lender will look at the borrower's most recent P&L statement. This way, the lender can see whether the borrower's EBITDA is on track to stay in line with what's on the borrower's tax returns. Lenders may also compare this information to bank statements from the same time frame.

The next step is for the lender to measure the tax return and P&L EBITDA value against the borrower's monthly loan payments. That includes your client's current monthly debts plus the amount per month they would pay for their new loan.

How EBITDA is measured, calculated, and utilized

Calculating EBITDA begins with finding the borrower's net income, which is often one of the last line items on their tax return.

With the net income identified, it's time to find the EBITDA line items: interest, depreciation, amortization, and officer's compensation. Once the EBITDA value is calculated, it gets added to the net income to result in the figure "cash available to service debts." This step can be very straightforward, but, in some cases, may require additional paperwork.

The next step is calculating the business' debt service coverage ratio (DSCR), which measures a business's cash flow versus its debt obligations - the borrower's EBITDA divided by annualized debt (monthly loan payments multiplied by 12). The customer's DSCR is then compared to the borrower's tax returns and the P&L statement.

Lenders will look for a DSCR value of at least 1.0. This value indicates that the borrower can likely afford all their current expenses and loans, and the loan for which they're applying.

Cash flow calculation examples

Putting all these steps into practice starts with looking at the borrower's financial documents. Together with your client, you can calculate cash flow to determine in advance the types of loan that make sense for them.

1040-C tax return EBITDA calculation

Box 16 of a 1040-C tax return will display the borrower's interest. Depreciation appears in box 16, and net income in box 29. For form 1040-C, officer's compensation is included in net income. Adding these figures results in the borrower's EBITDA.

1120 tax return EBITDA calculation

For a borrower whose business instead fills out IRS Form 1120S, net income can be found on line 21. Depreciation is on line 14, and interest is on line 13, with officer's compensation on line seven. The sum of all these figures is the borrower's EBITDA.

P& L EBITDA calculation

P&L line items are not numbered, so identifying EBITDA figures involves reading the whole statement from top to bottom. Net income, interest, depreciation, and officer's compensation should all be on the page. Adding these figures results in the EBITDA for the period the P&L statement covers. Often, P&L statements cover less than a year of revenue and expenses. In that case, you'll need to extrapolate the P&L statement's EBITDA for the whole year. For example, a P&L EBITDA of $35,000 for Q1 must be multiplied by four to cover a 12-month span. That means the borrower's annualized EBITDA is $140,000.

P& L EBITDA calculation

Converting a debt schedule to a DSCR figure requires a detailed, accurate table of debts. Concrete numbers may best help explain this calculation. Let's say a borrower has three monthly debts – one of $300, another of $3,400, and another of $4,500. Per month, that's $8,200 in debt, or $98,400 per year.

Let's also say the $4,500 loan is being refinanced. In that case, you can subtract $4,500 *12 = $54,000 per year from the annualized debt. That leaves $98,400 – $54,000 = $44,400. Now let's also say the borrower is applying for a loan that costs $40,000 per year. The final annualized debt thus becomes $44,000 + $40,000 = $88,400.

Obtaining the DSCR requires dividing the EBITDA by the annualized debt. Carrying down the $140,000 from the P&L EBITDA example, the DSCR here would be $140,000 / $88,400 = 1.58. This figure is well above 1.0, making borrower approval likely.

Help your eligible small business clients successfully apply for a loan through SmartBiz

When you calculate your client's EBITDA and DSCR before they apply for loans, you know well ahead of time whether loan approval is likely. You and your client can then more quickly identify and apply for the loan options that best fit their needs and circumstances. By building shared knowledge and helping your customer get organized and ready for the loan application process, you can build great client relationships, increase your conversion rates, and streamline your loan processing.

To learn more about how SmartBiz can help you automate some of these calculations, streamline the documentation, and assess whether your customers can prequalify for a loan, visit the SmartBiz partner page and email partners@smartbizloans.com to book a one-on-one consultation with a Partner Relationship Manager. In the meantime, get to know the basics of SBA 7(a) loans and bank term loans so that, if your client's DSCR is 1.0 or greater, you can get them the funding they need.

More information about SBA 7(a) loans and bank term loans

Loan Merits | **SBA 7(a) Loans**

- Offers between $30,000 to $350,000 in loan funding
- 10-year term loan with monthly payments
- Prime + 2.75% variable interest rate – may be less expensive in the long run
- Receive funding within one month
- No prepayment penalty

Loan Merits | **Bank Term Loans**

- Offers between $30,000 to $500,000 in loan funding
- Two, three, or five-year repayment options
- Fixed interest rate – not susceptible to economic trends and prime rate changes
- Receive funding within one to two weeks
- No prepayment penalty

Components & Requirements | **SBA 7(a) Loans**

- Low monthly payment
- Low interest rate
- Lower fees than term loans
- Detailed loan application process requiring a dedicated, active client
- Requirements include, but are not limited to:
    - Proof of insurance
    - Business landlord documentation
    - Tax transcript verification
- Stricter use of loan proceeds than banks loan – must use for:
    - Working capital
    - Debt refinancing
    - New equipment

Components & Requirements | **Bank Term Loans**

- Typically higher monthly payments than an SBA 7(a) loan
- Slightly higher interest rate
- Minimum documentation required, but stricter parameters for cash flow and underwriting to qualify

  Can use for:
    - Construction
    - Remodeling
    - Business acquisitions
    - Partner buyouts
    - Tax refinancing
    - Working capital
    - Debt refinancing
    - New equipment

* WHAT YOU NEED TO KNOW: This material is intended to provide general information on relevant topics for small business lending. Be aware that this is not a comprehensive analysis of the subject matter covered and is not intended to provide specific recommendations to you or your business with respect to the matters addressed. Please consult legal and financial processionals for further information.