A Guide to Cash Flow Forecasts

RISKTURN

Cash Flow Forecasts

One of the most crucial and hardest components of forecasting is dealing with the uncertainty that comes with the trend of variables into the future

A cash flow statement is a financial statement that summarizes all cash inflows a company gets from its ongoing activities, as well as from external investment sources. It also covers all cash outflows for business and investing operations over a period of time.

Investors and analysts may get a picture of all the transactions that take place in a company's financial records, and each transaction adds to its success. Since it tracks the cash generated by the firm in three primary ways—operations, investment, and financing—the cash flow statement is said to be the most intuitive of all the financial statements. Net cash flow is the total of these three components.

Cash Flow from Operations (CFO)

This area comprises transactions from all operational business operations and covers cash flows from operating activities (CFO).
Starting with net income, the cash flows from the operations segment reconcile all non-cash items to cash items comprising operational activities.

Moreover, this section accounts for Cash inflows and outflows that are directly related to a company's primary business operations.
Buying and selling merchandise and supplies, as well as paying its workers' wages, are examples of these operations. Investments, loans, and dividends are not included in the total inflows and outflows.

Cash Flow Forecasts

Cash Flow from Investing (CFI)

The cash flow statement's second section examines cash flows from investing (CFI), which are the outcome of investment profits and losses.
Cash spent on property, plant, and equipment is also included in this part. Analysts include changes in capital expenditures in this section (CapEx).

When capital expenditures rise, cash flow often falls.
However, this isn't necessarily a bad thing because it might suggest that a firm is investing in its future operations.
Companies with high Capex are more likely to be expanding.

Cash Flow from Financing (CFF)

The cash transfer between a company's owners, investors, and creditors is measured by cash flow from financing activities (CFF). The net flow of capital utilized to run the firm, including debt, stock, and dividends, is shown in this report.

When the cash flow from finance is positive, it signifies the firm is bringing in more money than it is taking out. When the figure is negative, it might indicate that the corporation is paying down debt, paying dividends, or buying back stock.

Cash Flow Forecasts

Probabilistic Cash Flow Analysis

Predicting your cash situation should be a key concern for every business since keeping track   of your cash flow allows decision-makers to plan for the future, and make smarter decisions. At its most basic level, a cash flow prediction can tell you whether you'll have positive cash flow (more money coming in than going out) or negative cash flow (more money going out than coming in) at any particular moment in time.

To guarantee that a cash flow forecast provides actionable business insights, start by establishing the business goal that the forecast should support. Cash projections are most typically used for one of the following purposes:

- Planning for short-term liquidity: Keeping track of the cash available on a daily basis to guarantee that your company can meet its short-term obligations.
- Visibility of covenants and important reporting dates: Projecting your cash levels for critical reporting periods such as the end of the year, quarter, or month.
- Planning for growth: Ensuring that the company has enough working capital on hand to cover future revenue-generating initiatives.

Based on your business goals and working conditions, you'll be able to tilt the scope of your forecast accordingly. Businesses with debt, for example, will benefit from developing a cash projection to assist them plan for upcoming payments.

You may reduce the cash buffer required for unplanned costs and make better use of your company's spare cash with an accurate cash flow forecast. You may also prepare ahead for any anticipated cash shortages and better control investment risks. Furthermore, an accurate and timely prediction can assist raise the forecaster's profile and reputation among relevant business stakeholders.

Cash Flow Forecasts

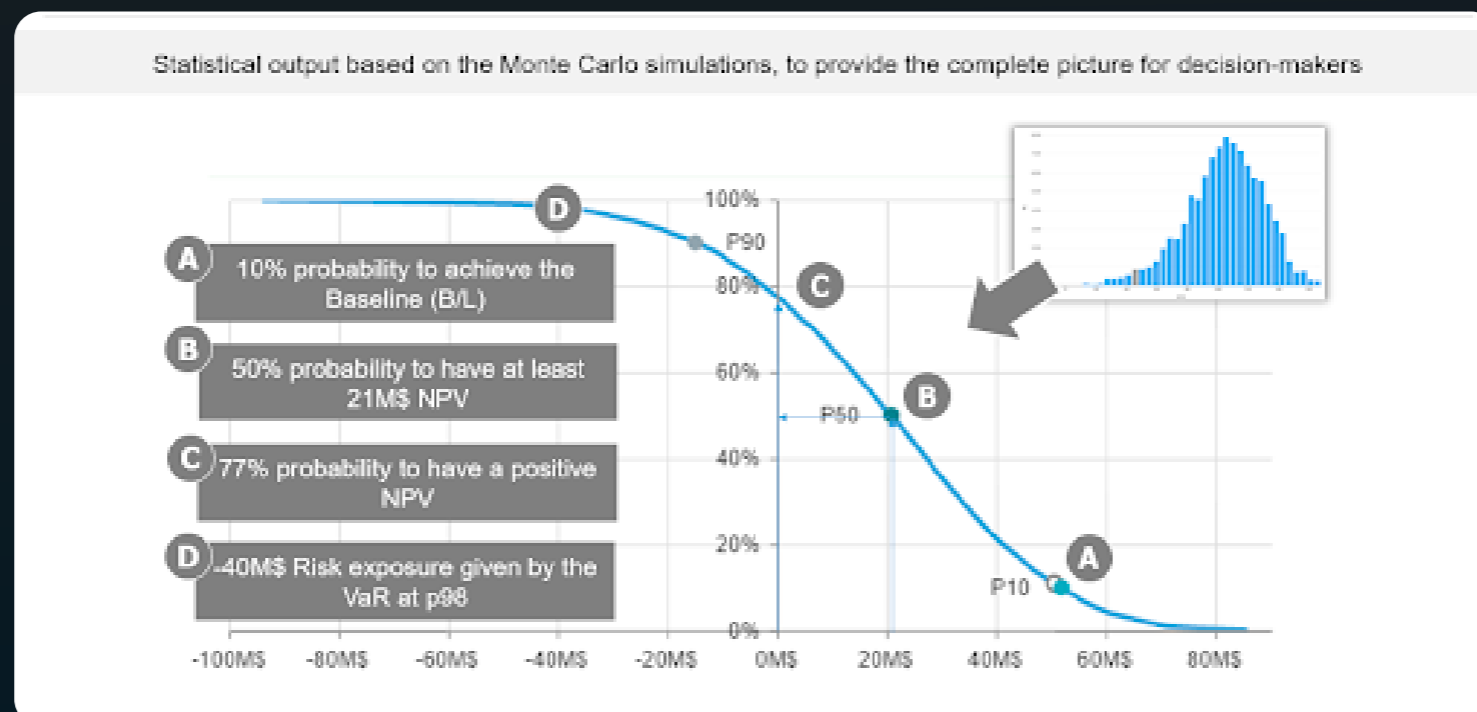## How to read the results of a Cash Flow Forecast

Any Cash Flow Forecast analysis requires a solid understanding of how results are presented. The following paragraph focuses on the two most widespread representations: cumulative results and results over time.
A cumulative representation of a forecasted NPV is shown in the figure below. Cumulative representations encompass all the percentile values of the calculated probability distribution. Generally speaking, there are four points that should be taken into consideration:

- A) P10, the tenth percentile. If we move to its right, we will find the values for the 10% top-performing scenarios). By contrast, if we move to the left of P10, we will find the remaining 90% of cases
- B) P50, the fiftieth percentile (i.e. half of all scenarios will be better performing than the P50 value, half will be worse performing)
- C) P90, the ninetieth percentile. If we move to its left, we will find the values for the 10% worst-performing scenarios). By contrast, if we move to the right of P90, we will find the remaining 90% of cases
- D) P98. It is common practice to use the value of P98 to estimate the Value at Risk (VaR) indicating the maximum exposure for the company in case of an extremely unfavorable conjuncture

The percentile values are generally compared to the baseline value (i.e. the result of deterministic calculations, before any simulation is performed). If the baseline value lies far ahead of the P50, it means that our initial guess was too optimistic. By contrast, if the baseline value falls far behind the P50, it means that our initial estimate was too conservative.

Cash Flow Forecasts

Statistical output based on the Monte Carlo simulations, to provide the complete picture for decision-makers

A representation for the Discounted Cash Flow (DCF) is presented below. It uses the predicted future cash flows to determine the value of an investment. DCF analysis aims to determine the current value of an investment based on future forecasts of how much money it will earn. This pertains to decisions made by investors in firms or securities, such as acquiring a company or purchasing a stock, as well as capital budgeting and operational expenditures decisions.
There are five major points to consider:

- **P1, the second percentile. Refers to the worst-case scenario which corresponds to the 1% of all investment outcomes. It is usually used as the conservative Value at Risk of the NPV).**
- **P10, the tenth percentile. It defines the threshold between 10% of the most unfavourable results with the remaining 90%. It's widely used as a conservative evaluation of any type of investment.**

Cash Flow Forecasts

- **P50**, also known as the Median value, represents the most probable result that can be expected from your investment.
- **P90**, the ninetieth percentile. It's usually considered as a reference to evaluate a lucky investment scenario, taking into account the most favorable 10% of the simulation results.
- **P100** represents the best-case scenario which corresponds to 1% of all investment outcomes.
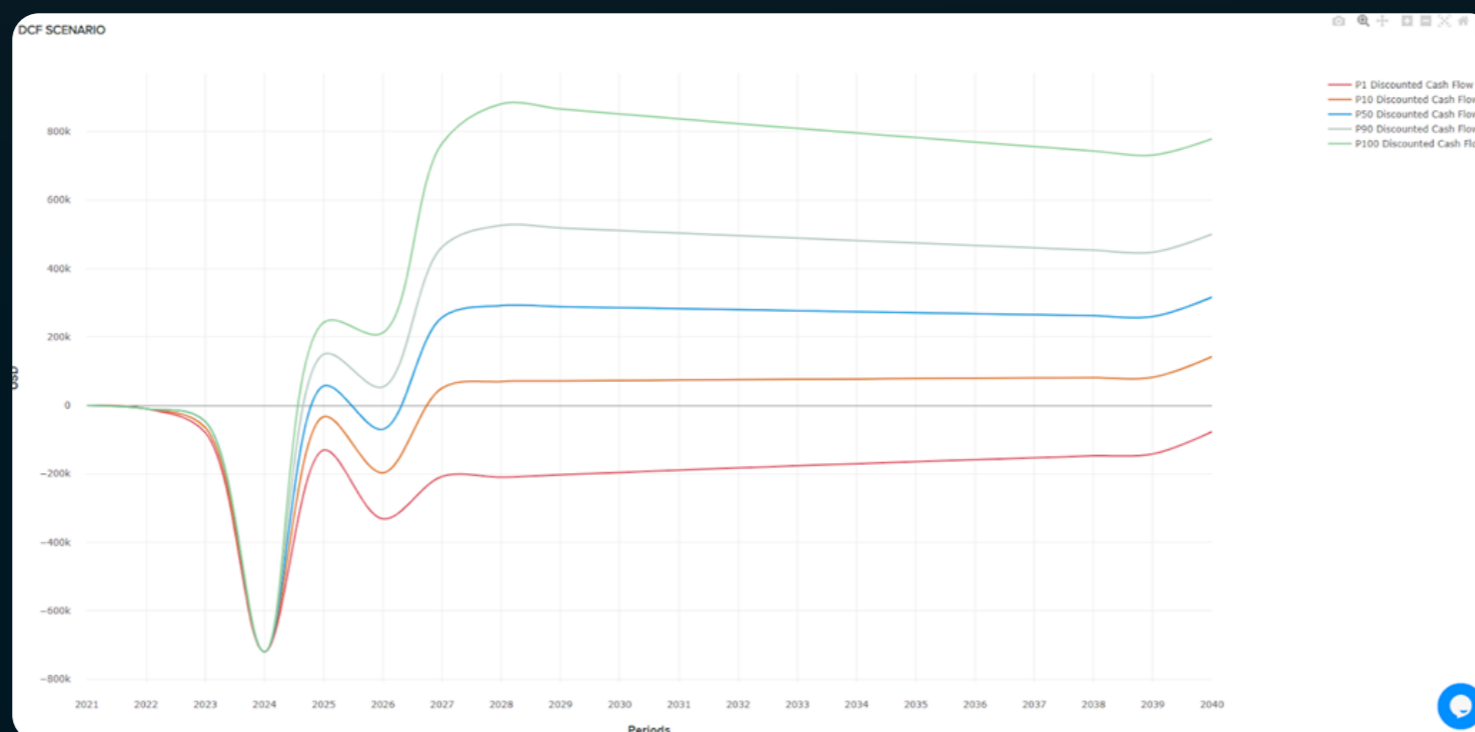
Cash Flow Forecasts

Cash Flow forecasts on Riskturn

A solid financial model is necessary to build any Cash Flow Forecasts.
Begin by creating a configuration and an associated analysis on Riskturn.

After that, set up the calculation structure with all variables and KPIs in the associated configuration. Then, move to your model analysis to enter all data and perform calculations on the inputs. We have a new guide coming soon with tips about financial modeling. Follow us on Linkedin to know when we release it.

Cash Flow Forecasts

Once the financial model is set on Riskturn, It is time to move to the baseline dashboard section. In Riskturn, "baseline" always refers to the result of deterministic calculations (i.e. when no risks and no Monte Carlo simulations have been applied to the model).
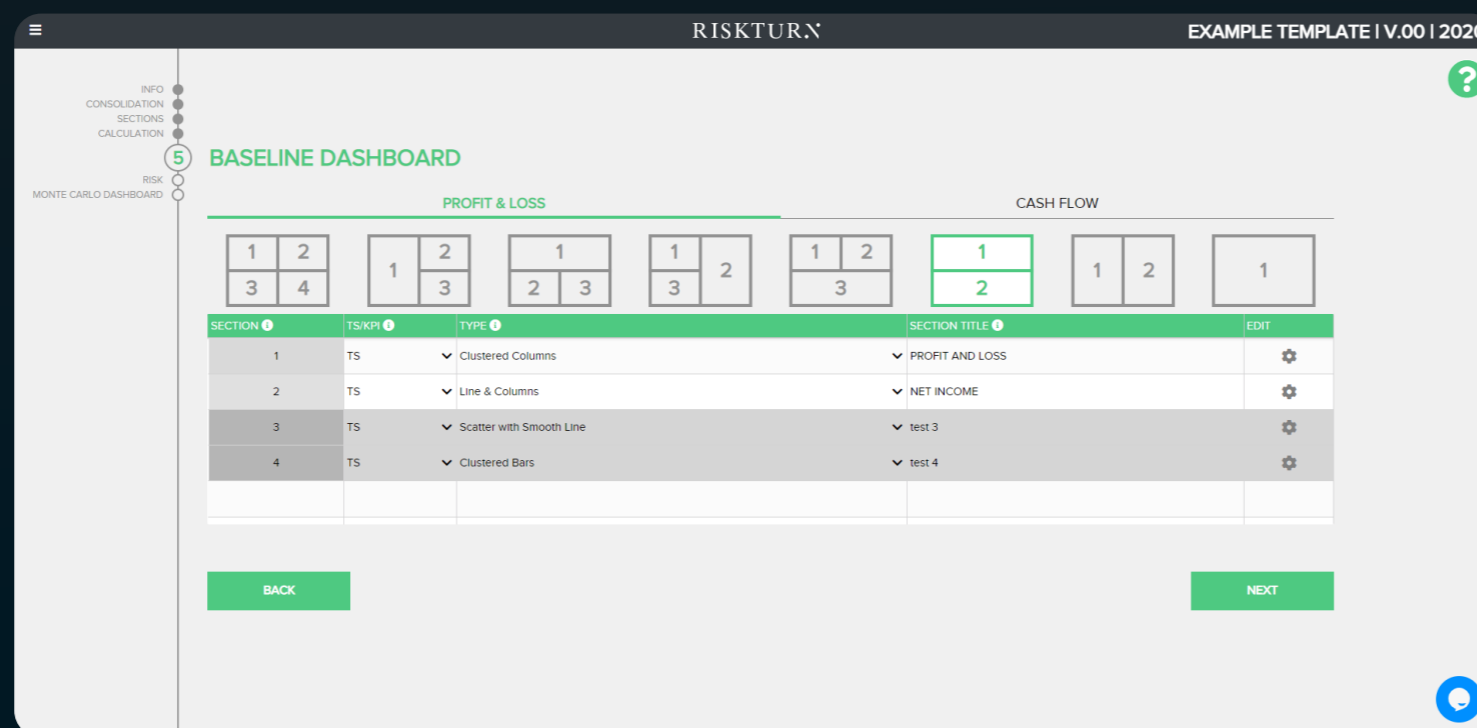
You can navigate through different graphs and download/export them as CSV.
To set up a baseline dashboard, you need to move to the corresponding section in the configuration file for your model.

Cash Flow Forecasts

After that, it is time to enter some risks. Before adding any, make sure to select all KPIs that will be impacted in the risk section in the configuration.

Adding risks in Riskturn is possible even for people that do not have a longtime experience with risk definition.

Once a risk is created, you can choose either the advisor mode or the advanced one (for experts).
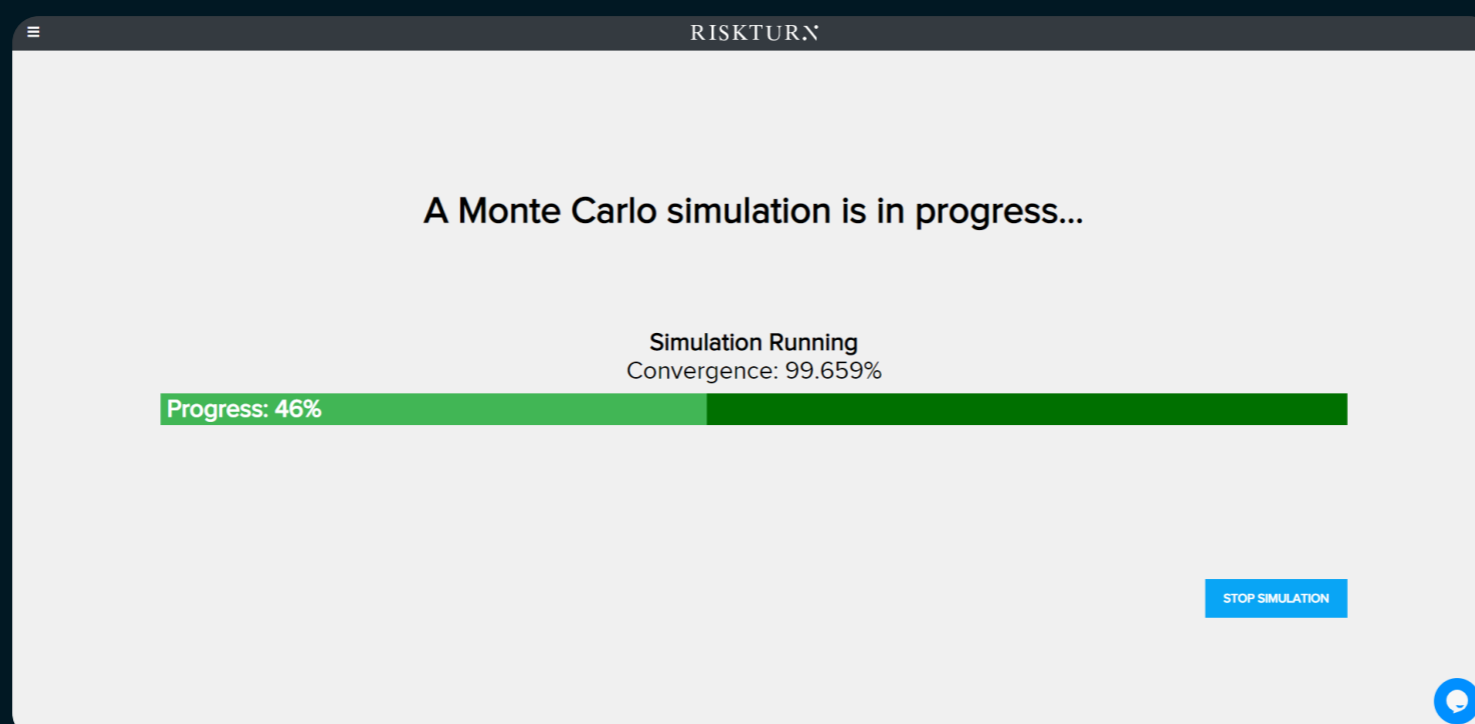
Cash Flow Forecasts

The advisor page offers a step-by-step process that guides users along. First, create a risk description and decide if the risk is a threat or opportunity to your business. Then, you need to decide the probability of that risk happening. Sometimes it is hard for analysts to estimate that. A good rule of thumb is to reach out to people that may have past experience with that. For instance, if you are trying to model a risk that is related to a cyberattack, it is common practice to discuss with your IT team what the risk exposure is, given the taken cybersecurity measures.

After that, the impacted variables need to be selected. Examples of impacted items may be the number of products sold, inflation prospects, commodity prices, etc. Next, users need to choose the probability distribution for each risk, independently. In the advisor mode, only a limited amount of distribution is present. The advanced mode offers more probability distributions to choose from, including types only used by very experienced analysts.
Finally, users can calculate the overall impact range on KPIs (min, max and most likely).

Cash Flow Forecasts
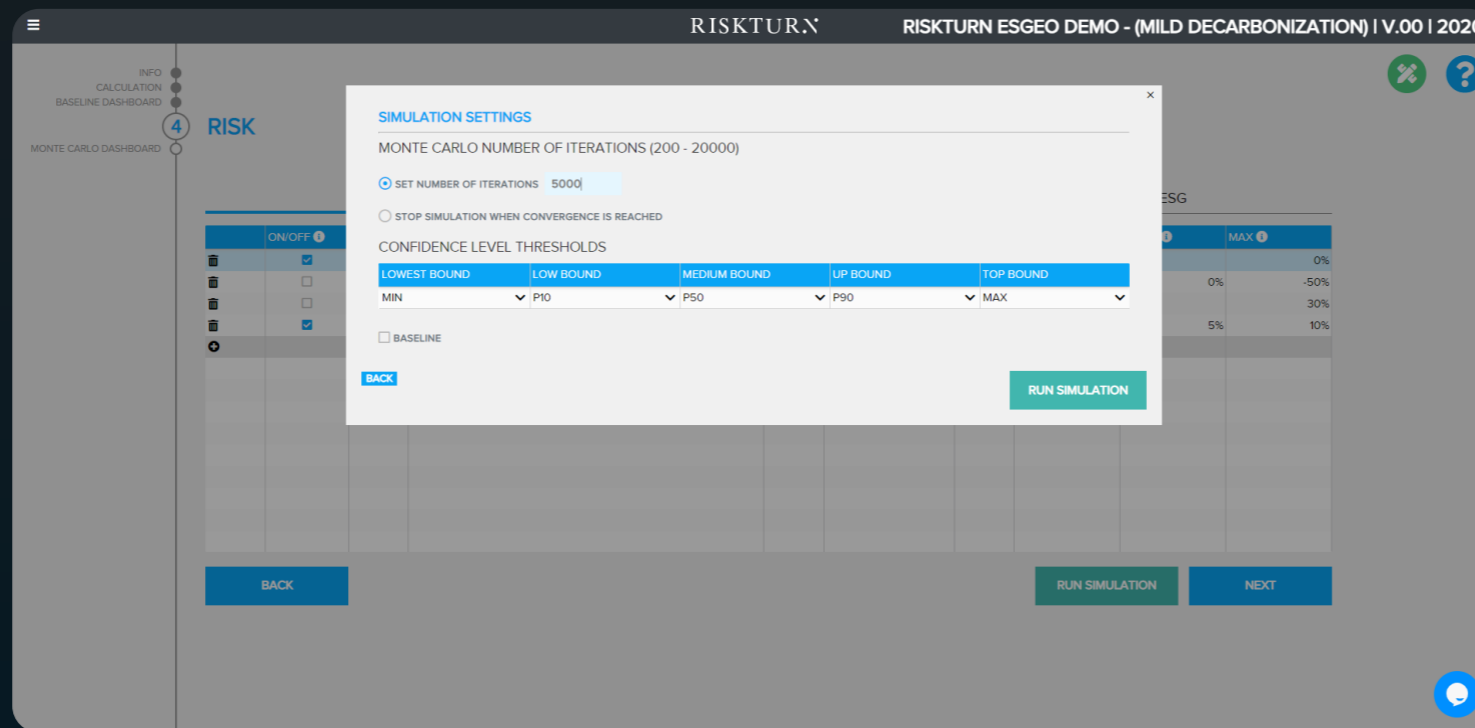
When all risks have been entered, you can launch the Monte Carlo simulation with the desired number of iterations. If you are unsure what a reasonable number of simulations is, you can use the "reach convergence" option. The simulation will stop when any additional iteration that is calculated does not move the final results.

Cash Flow Forecasts

The results of your cash flow forecasts are shown in the Monte Carlo Dashboard section. As always, you need to configure what graphs are shown in the corresponding section in the associated configuration file.
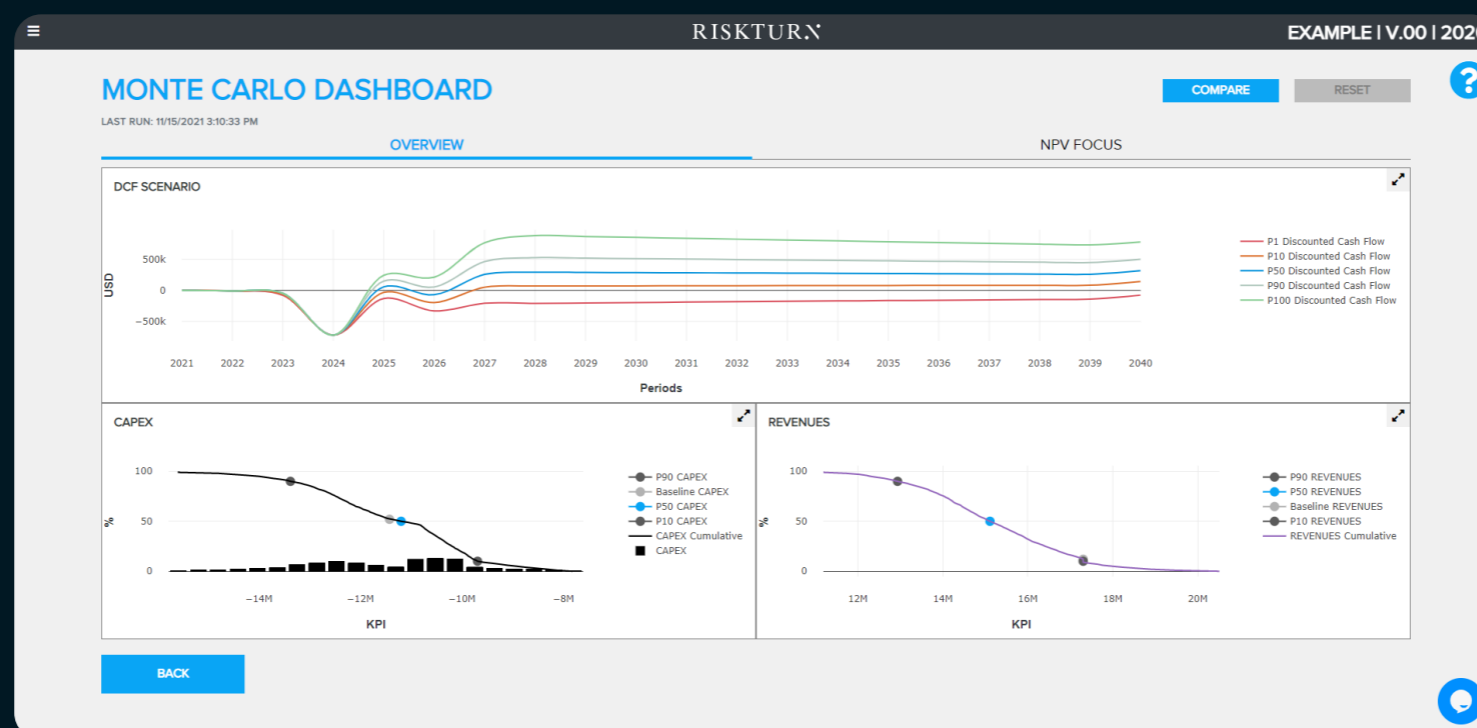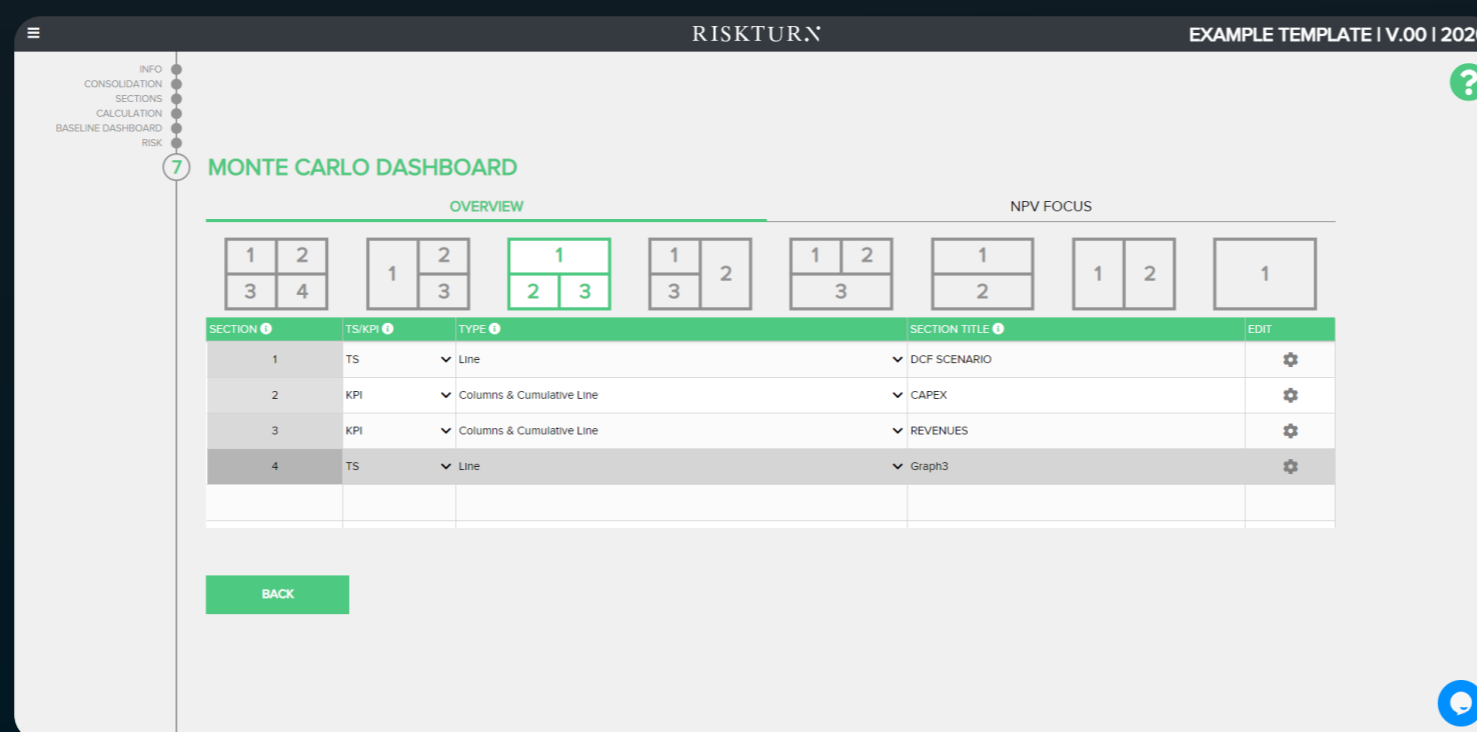
Thanks for reading this guide!

If you have any questions, please feel free to contact us info@riskturn.com or schedule a demo to discuss with our team if we can help with your business goals.

Riskturn is a web application for strategic portfolio planning, enterprise risk management, and structured finance, boosted by a Monte Carlo engine. Evolve without disrupting your approach.