

# How to Use Cash Flow Analysis to Evaluate Investment Opportunities?

Cash flow analysis is crucial when making an investment. You need to ensure that your business has the liquidity to invest, and you want to limit the risk that the cash flow investment will *not* produce the results that you want.



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In this guide, we're going to explain how to evaluate investment opportunities using in-depth cash flow analysis.

## What Is Cash Flow Analysis and Why Is It Important for Investors to

# Understand It?

If you want to learn how to evaluate cash flow, you *need* to understand cash flow analysis. This is a concept that revolves around you using the three types of cash flow to:

- Analyze liquidity
- Understand where money is coming in
- Understand where money is going out

At its core, cash flow analysis helps you understand your cash position for a specific accounting period. Investing in a business, for example, can seem like a smart decision when the company is profitable.

However, there are times when a company can show profitability, yet the business has *negative cash flow*.

## How To Use Cash Flow Analysis to Evaluate Investment Opportunities?

If you want to evaluate investment opportunities, cash flow analysis can help. You can analyze potential outside investments to determine risks, but in our case, we're focusing on analyzing your *own* cash flow to understand investment opportunities.

For example, let's assume that you analyze your line items and find the following:

- Sales for product A are falling and have been for years
- Sales for product B are rising drastically, but they do not meet the revenue of product A

In this scenario, there may be investment opportunities in

product B. Perhaps you will have the chance to open a new office or warehouse to fulfill more orders for this product because you've had to turn down orders.

Cash flow analysis will allow you to learn:

- If you have the liquidity to open a new warehouse
- What *may* happen if you invest in these activities

Additionally, you may find opportunities to acquire in a competing company that sells Product A, and you can recuperate some lost market share by doing this.

**Note:** Some of the biggest companies in the world had solid investments even when their analysis showed that they weren't making any money. Uber is a prime example of a company that attracts investors due to the potential of the company, although it lost a lot of money each quarter.

## The Benefits of Cash Flow Analysis for Investors

A cash flow investment has its own benefits for investors, such as:

- Understanding how much cash the business generated for a specific period of time
- Clarity of where cash is coming into the business
- Discovering whether the investment will be viable now and in the future
- Better understanding of the working capital of a business if you plan to invest

Cash flow analysis provides you with insights into the viability of an investment. If you're investing in a business

that you do not own, you can use this data to understand the company's working capital, revenue and cash flow.

## The Limitations of Cash Flow Analysis for Investors

Cash flow analysis does have its own set of limitations for investors. First and foremost, these documents do not show you if management has recently changed or the business's long-term plans.

You'll need to do a lot more due diligence to understand whether the investment is viable or not.

Market and business research will need to be performed to learn if the investment is worthwhile *because* growth is never infinite. If the market is starting to move away from the product, service or business itself, it may not be a good time to invest.

## How To Get Started with Cash Flow Analysis?

Getting started with cash flow analysis requires you to generate a cash flow statement before you do *anything* else. Software can help you automate this process, and tools like <http://cashflowfrog.com/> reduce errors and allow you to view data in real-time.

Once you have your cash flow statement, it's time to:

- Review the spreadsheet to identify trends from one reporting period to another.
- Examine operating income to learn if it exceeds net income. If it does, it means that the investment can still grow.

- Review positive cash flow to understand if the only reason for the cash flow is the sale of its assets.
- Calculate the free cash flow of the business or operation.
- Look for negative cash flow and gain insight into why the cash flow is negative.

There are times when cash flow can be negative, yet the reason is due to rapid expansion or other spending meant for long-term growth.

## In Conclusion

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If you want to evaluate investment opportunities, conducting a cash flow analysis can help. The more data and information that you have prior to the investment, the easier it will be to understand the viability of the opportunity offering consistent ROI.