

Figuring out a Company's Free Cash Flow

How to find good companies that have free cash flow

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Last week I wrote about how to [read the Statement of Cash Flows](#). In it I mentioned that cash flow is an important measure of a business for investors. But that article focused on the mechanics of reading the actual Financial Statement, what to look for, and how to interpret the results.

Today I want to go onto the next step, and show how cash flow can be used to find attractive investment opportunities. First I will discuss the concept of free cash flow in more detail to give you a good idea why I feel it is important for a company. Then I will show you how to use the stock screener look for potential investment and trading candidates.

There is a reason we want to look at cash flow in addition to earnings. Without cash flow to fund growth and pay dividends, a company will eventually cease operating. The problem is that on the income statement, cash flow is obscured by all the non-cash accounting adjustments. Provisions for bad debt, writing down goodwill, restructuring charges, and inventory write-downs are just some examples of this. Those adjustments depend on management's subjective estimates of the future and are typically buried operating expenses. What we want to really know about is how much free cash flow a company has.

So what exactly is free cash flow? One way to define it would be that it is the money earned from operations, and after they have paid all their bills, which they can actually put into its savings account. Free cash flow is cash from operations (often called operating cash flow) minus capital expenditures (investments in property, plant, and equipment). Without free cash flow, it's difficult for a business to pursue new opportunities, acquire other businesses, or pay the shareholders anything. If they have free cash flow, a company can do all these things, as well as pay down debt, and save (retained earnings), building shareholder equity.

There are other reasons to focus on operating cash flow, even if most investors concentrate on earnings. All things being equal, cash flow presents a clearer picture of a company's actual performance, simply because it reflects money received and paid out during a given interval, where earnings are based on all manner of estimates and assumptions. If Enron had been required to disclose its mark to market math, you would have seen the outrageous assumptions management was making – and why earnings were not what they seemed.

In June last year, WorldCom disclosed that it overstated its cash flow by almost \$4 billion over 16 months. It was that announcement that put the telecom company's future in doubt, eventually adding it to the list of corporations felled by shady bookkeeping. But to give you an idea of how much cash flow and net income can differ, the internal audit found the company had overstated its cash flow by \$3.8 billion over the past five quarters. Yet once it was corrected it wiped out \$1.4 billion in profit for 2001 and \$130 million for 2002. Ever wonder where other \$2.73 billion went?

The numbers you need to calculate free cash flow are on the Statement of Cash Flows, and you need at least two. For example, you need to subtract the second quarter's cash flow numbers from the third quarter's to see the third quarter's results alone. If operating cash flow is strong, the theory goes, the quality of earnings should be strong too. After all, cash is real, and unlike earnings, it is not subject to the whims of the accountants.

Unfortunately, that is not strictly true. Like anything else in financial statements, even cash flow is adjusted, or at least subject to quality issues. It's true that cash flow is harder to manipulate than earnings, but there's a surprising amount of flexibility in how cash flow can be reported.

First you can start with the cash flow reported, usually called operating cash flow in annual reports, and subtract capital expenditures. Many companies call EBITADA (earnings before interest, taxes, depreciation, and amortization) cash flow. It is not. To determine a company's free cash flow from EBITDA, you would need to deduct the taxes, add back the interest, deduct working capital (the amount needed to run the company), and deduct capital expenditures.

But there are still adjustments that may need to be made. One that has had a large impact these past few years are tax benefits from stock options. That should be subtracted from operating cash flow because it isn't a true gain from operations. Leaving it in can cause you to think cash flow is stronger than it really is. To make things worse, different companies treat it in different ways.

Technology companies like Cisco and Lucent have always included the tax benefits from stock options in operating cash flow, while Microsoft included them in cash flow from financing. If a company lists the tax benefits from stock options on its cash flow statement (like eBay does) your work is easy. Unfortunately, most companies don't list it, so you need to look around the financials for the right tax benefits figure to deduct from operating cash flow.

Is it really worth all that trouble? Lucent is one case where it definitely was. After falling for a year, operating cash flow at Lucent turned positive in 2000. But analysts who knew the company weren't fooled, since it was entirely because of tax benefits. In fact, without the tax benefit, Lucent's 2000 operating cash flow was a negative \$760 million rather than the positive \$304 reported. Instead cash flow getting better like the statements seemed to indicate, it was actually getting worse.

Reporting practices vary in the same way for a number of other financing vehicles like the securitization of receivables. I did quite a lot of work in that area back in my banking days, and know it rather well. Certainly any type of financing company, department stores (that have store credit cards), or any supplier to major manufacturing companies is likely to use this kind of financing. You should also consider deducting one-time gains, deferred income taxes, and any other results that are not directly related to normal operations.

Unfortunately, even if nothing on the Statement of Cash Flows cash flows is out of the ordinary, there's still no guarantee that earnings are as solid as they appear. Aggressive revenue recognition policies, lax credit terms, or the use of off-balance-sheet transactions can all affect cash flow. The complex corporations of today cannot be boiled down to one number. But it is a good starting point. For instance, if you are looking for a company with free cash flow, it makes sense to look for businesses that can grow revenues, margins, and cash flow simultaneously.

Since all these adjustments can make figuring free cash flow very complex, just start with the original simple formula I mentioned first: Operating cash flow minus capital expenditures. For most large and stable companies the other numbers are often not large enough to matter significantly, so you can still get a reasonably accurate view of their free cash flow growth with just the simple formula. But once you're ready, you can start looking for those non-operating sources of cash, especially tax benefits from stock options, to arrive at refined free cash flow.

So now that we have gone over all this, let's use the Stock Screener to find good companies with free cash flow. If you haven't used the Stock Screener, I went over how to get the Deluxe Version as free download in my article [Stocks on Sale!](#)

First I'll start at my usual place, market capitalization. Since we specialize in options, I want to make sure that most of the results are optionable stocks. In this case I will allow any company with a market capitalization over \$500 million.

Now let's get to the heart of the matter. Under price ratios, the price/cash flow ratio let's you know what premium the market is giving a company's power to generate cash. The smaller the number, all other things being equal, the more of a bargain it is. With that in mind, I first want those companies that have a price/cash flow ratio below 15.

I also want the price/cash flow ratio greater than zero. A negative number would be bad. You know the stock price is not negative, so that means only one thing; cash flow is negative. Next, because this ratio varies widely from industry to industry, I also want to judge each company on its industry terms. So I want the price/cash flow ratio to be less than the industry average.

Next I want to look not just for companies that have generated extra cash, but that have also increased their business over time. So I looked for the quarterly revenue growth for the past year to be at least 25% better than the average over the past 5 years. Under investment returns, I also added a key efficiency ratio: return on equity. I want to make sure the companies I get have above-average profitability compared to other companies in the same industry.

And we're not finished until we look at debt levels. After all, cash-rich companies should be paying off their debts. So I first looked for companies that have reduced their debt that owe less than others in their industry – and has seen debt drop over the past year – freeing up cash for other uses. Below is exactly what the screen I built looked like:

Deluxe Screener		
▼ File ▼ Edit ▼ View ▼ About		
Free Cash Flow		
Field Name	Operator	Value
Market Capitalization	>=	500,000,000
Price/Cash Flow Ratio	<=	15
Price/Cash Flow Ratio	>=	0
Industry Average Price/Cash Flow Ratio	<=	Industry Average Price/Cash Flow Ratio
Quarterly Revenue Growth Above 5-Yr ...	Since	<In The Last Year>
Return on Equity	>=	Industry Average Return on Equity
Debt to Equity Ratio	<=	Industry Average Debt to Equity Ratio
Debt to Equity Ratio Decreased	Since	<In The Last Year>

Now just click the "Run Search" button and you're off. Within a minute or so (depending on how complex your criteria), the results appear in the results pane. You can also save this formula for use later by choosing File | Save As and typing in an appropriate name. That way over time you can build up a library of formulas so that you don't have to start from scratch every time. Below are the results of this screen:

Free Cash Flow

 Compare With:

Sym...	Company Name	Price/...	Industry...	Return ...	Industry...	Debt ...	Industry ...
TM	Toyota Motor Corporation	8.40	3.40	7.70	5.90	0.51	2.75
HMC	Honda Motor Co., Ltd.	8.10	3.40	15.20	5.90	0.39	2.75
WM	Washington Mutual, Inc.	9.10	15.10	19.30	12.20	0.67	1.27
UTX	United Technologies Corporation	8.70	14.10	26.80	8.70	0.55	1.25
RTP	Rio Tintopic Ads	10.10	9.50	15.00	7.70	0.36	0.70
INGR	Intergraph Corporation	2.50	24.40	72.40	1.10	0.00	0.08
STT	State Street Corporation	10.70	12.00	21.20	18.80	0.27	1.16
OHP	Oxford Health Plans, Inc.	9.20	18.30	44.70	9.60	0.21	0.29
NCEN	New Century Financial Corporation	4.60	10.20	50.50	31.60	0.02	21.63
GFI	GOLD FIELDS LTD ADS	10.20	7.70	27.80	14.80	0.10	0.23
ROST	Ross Stores, Inc.	10.10	9.40	32.50	10.70	0.04	0.28
THC	Tenet Healthcare Corporation	4.30	8.50	21.40	14.80	0.66	0.92
SHW	Sherwin-Williams Company	8.80	8.70	23.20	14.90	0.38	0.70
ITT	ITT Industries, Inc.	8.70	14.20	21.60	4.30	0.28	0.67
TMK	Torchmark Corporation	11.10	16.10	15.30	9.10	0.20	0.31
JWA	Wiley(John)Sons 'a'	9.70	11.20	23.90	17.00	0.62	0.68
LH	Laboratory Corporation of Americ...	11.50	34.60	16.20	0.60	0.33	0.35
FELE	Franklin Electric Co., Inc.	11.50	14.20	21.00	4.30	0.17	0.67
ELUX	AB Electrolux	5.10	7.20	18.00	8.00	0.00	0.84
AMCR	Amcor Limited	6.00	6.00	19.40	4.50	0.25	1.53
LTD	Limited Brands, Inc.	7.70	9.40	11.10	10.70	0.05	0.28
RI	Ruby Tuesday, Inc.	11.30	8.20	17.60	14.00	0.41	0.78
MTG	MGIC Investment Corp.	5.50	7.70	19.60	14.60	0.19	0.48
FD	Federated Department Stores, Inc.	7.00	7.90	14.40	5.90	0.60	1.03
FDP	Fresh Del Monte Produce Inc.	4.20	9.30	27.60	8.90	0.14	0.58
EC	Engelhard Corporation	8.80	8.10	15.90	8.30	0.23	0.51
PIR	Pier 1 Imports, Inc.	8.50	19.30	19.70	14.10	0.04	0.07
RNR	RenaissanceRe Holdings Ltd.	7.40	101.40	28.80	1.40	0.20	1.15

Would these stocks be good candidates for a bullish trade or investment? I'm afraid it would take a more research to determine that. But this is a list of companies that are selling at relative low prices relative to their cash flow. They also have a better return on equity and lower debt than other companies in the same industry. They are relatively large companies that have been paying off their debt and whose revenues are growing. So I would say it is certainly a good place to start.