



Follow the Money

Does cash flow provide better visibility than earnings?

BY CHRISTOPHER WRIGHT

“One of the misperceptions that I feel is pretty prevalent in the investment community is that cash flow is less manipulable than earnings, which isn’t always the case,” Morningstar senior analyst Eric Landry says. He cites the example of Teleflex, which reported 32 percent growth in free cash flow (FCF) in 2005 following a restructuring. If the sale of US\$40 million in receivables was subtracted, however, the growth in FCF was only 12 percent. Other problems with cash flow abound.

Charles Mulford, professor of accounting at the Georgia Institute of Technology, director of research for Cash Flow Analytics and co-author of books on the subject, agrees that, although cash flow from operations is less subject to accounting manipulation than earnings, it still presents a host of problems. “GAAP gives so few guidelines on how to classify cash flow between operating, investing, and financing activities, it’s easy to classify similar transactions differently,” he says. One example is WorldCom’s subterfuge of capitalizing ordinary expenses to boost operational cash flow. With respect to the currently popular FCF measure, Mulford points out that GAAP does not define it, thus allowing as many definitions for it as there are analysts.

Given all the uncertainties surrounding cash flow, what is the case for cash flow as a measure of company value, and how do professionals who acknowledge its limitations still manage to produce superior results by using it?

Discounted Cash Flow Analysis

American Power Conversion (APC) was a struggling company throughout much of 2006, but Morningstar’s

Landry saw top-line revenue growth and believed that the managers could fix the problems that were bedeviling operations. His discounted cash flow (DCF) model produced an intrinsic value for the company much higher than the stock price or some multiple of depressed earnings suggested. APC was soon thereafter acquired by a French company for even more than Landry thought it was worth.

Morningstar is primarily an old-fashioned DCF shop, Landry says. “Determining sustainable cash flow is the life blood of any investment. When you get down to it, the value of any investment is the sum of all the future cash flows discounted at an appropriate rate.” It will ever be thus, he believes. Although he includes other metrics in his analysis (P/E multiples, earnings before interest, taxes, depreciation, and amortization [EBITDA], and so forth), Landry views these metrics as simply shortcuts for a full-blown DCF treatment.

Landry recognizes that DCF analysis is not perfect. “What a lot of people say is ‘DCF is no good because nobody can tell the future, so why bother with an elaborate forecast?’ They have a point,” he says. But, he argues, cash flow modeling should have a place in every investor’s toolkit. “Those who come up with the best inputs usually win. The trick that separates the men and women from the boys and girls is the ability to ferret out sustainable cash flow. Those of us who are able to pick out the bits and pieces that aren’t sustainable—and add in pieces that are—will have a better estimate of intrinsic value. That’s where the rubber meets the road.”

Analysts face several choices in their DCF model. One Landry makes is to look at cash flow to the company before payments to debtholders and

KEY POINTS

- Cash flow may be less manipulable than earnings but still has problems.
- Despite problems, the view is widely held that cash flow belongs at the heart of financial analysis.
- Analysts who are adept at identifying sustainable cash flow will achieve the best results from their discounted cash flow (DCF) models.
- Free cash flow metrics support a variety of growth and value investment strategies.

equityholders to, as he expresses it, “get a picture of the pure operations.” He strips out anything unrelated to operations—whether it be investment transactions, gains or losses in nonoperating businesses, income tax distortions, or hindrances or benefits from leverage—to arrive at the sustainable operating performance of the enterprise.

Does DCF belong at the heart of financial analysis? “Definitely,” says Professor Mulford. “There are obviously questions about how cash flows should be defined and the discount rate and all that, but that’s what the value of a firm is.”

What about all the other things that affect share prices, such as company news (e.g., the CEO is going to jail) or market psychology (institutional herding)? “All those things indicate changes in perception of future cash flows,” Landry says. “Whether those perceptions are correct or not is up to the analyst to figure out.” Mulford says they are all short-term distractions. The market will eventually recognize the true value of future cash flows and price them accordingly.

Free Cash Flow

Osterweis Capital Management in San Francisco relies heavily, but not exclusively, on FCF in its analysis. The firm starts with net income plus depreciation and amortization plus changes in working capital and deferred taxes. After other refinements, it compares the results obtained by subtracting maintenance capital spending versus

subtracting total capital expenditures. According to firm president John Osterweis, subtracting maintenance capex “gives you an idea of how free cash flow—generative the business will be in a steady state” after any system or facilities build-out or other period of high capital spending for growth. “Once that system is built, capex drops off precipitously and revenue and gross cash flow start to increase rapidly.” Cable and satellite TV are two U.S. industries that had negative FCF as they cycled through heavy spending for expansion but went on to generate high FCF.

One Osterweis strategy hinges on finding companies approaching the inflection point. “Very often, stocks will move up fairly sharply as a company moves from cash flow negative to cash flow positive,” he says. His job is to find stocks that go up, so finding companies at inflections is central to what he does.

He is looking for companies that will be terrific businesses at maturity, ones that will bring in new customers at, perhaps, a 90 percent profit margin. He doesn't wait for companies to announce they are about to transition to positive cash flow as XM Satellite Radio did in 2006. He does his own analysis and tries to anticipate when the shift will occur. “If a company will be a free cash flow machine on a fully built-out basis, we get real interested and may buy it early on when it's still in a rapid growth phase,” he says.

A second Osterweis strategy compares investment opportunities by their relative valuations as indicated by their projected price-to-FCF multiples. Two companies with the same EPS may have significantly different free cash flows. “Just looking at P/E might give you a very false view of which is the cheaper of the two stocks,” he says. He looks ahead two or three years. “Based on price to future free cash flow, the stock may be absolutely dirt cheap even if it doesn't appear to be cheap based on today's metrics,” he says. He gets interested at a P/projected FCF multiple of 10; indeed, he was “pretty excited” when he saw he could buy the Yellow Pages companies at a multiple of six on this basis.

A third strategy of Osterweis mines opportunities arising from high FCF. Companies flush with cash can self-finance, invest heavily in new capacity, deleverage, support more leverage, make acquisitions, buy back stock, or pay higher dividends. Such companies also attract financial and strategic buyers. Osterweis will invest in mature companies with high FCF even if the companies aren't growing.

But FCF analysis has its limitations. It's not useful for evaluating financial companies (spread lenders), whose FCF may be increasing only because loans are being paid off rapidly. Osterweis also acknowledges that some companies with too much cash on their hands begin to make stupid mistakes—for example, pursuing inferior internal growth projects, or paying too much for acquisitions. Mulford questions the wisdom of companies picking stocks and amassing an investment portfolio with their spare cash. “The investor doesn't need them to do that,” he says.

Investors can profit, however, from such mistakes. Osterweis notes, “Sometimes, after managements do really stupid things, they get thrown out; new management comes in and is able to clean up the company. That's often a very interesting time to invest.” He invested in Regal Entertainment Group after a period of overbuilding in the U.S. movie theater industry when major exhibitors, to shrink capacity, were disavowing leases under bankruptcy protection. “You knew the company would get back to being a free cash flow monster,” he says. “It was a terrific investment.”

Follow the Bouncing Ball

Although many would take the position that cash flow should remain the centerpiece of financial analysis, few would argue that analysts should look at cash flow to the exclusion of everything else. For one thing, some evidence suggests that earnings are a better predictor than cash flow of share price increases. A report published in 2005 indicates that a study of 2,300 companies between 1987 and 1997 found 58 percent of returns attributable to growth in earnings before one-time accounting

charges whereas only 33 percent were attributable to increases in cash flow.

Mulford is aware of such studies. He says you can't focus solely on cash flow and forget about earnings or vice versa. Investors will pay up for earnings but will at some point demand confirmation of earnings with cash flow. His own seven-factor share price appreciation model has an earnings component in addition to three factors related to cash flow. He says the model significantly outperformed a carefully matched index over the 11-year period ending in 2005 (see “Examination of Abnormal Returns” at www.cashflowanalytics.com).

For Landry, Mulford, and Osterweis, cash flow is more than a data point, more than one screen among many. It dominates their analyses. All three recognize its shortcomings, but enough of the edifice remains that, for them, cash flow tells the story and guides the investment decision. “When properly applied, cash flow analysis is one of the more effective valuation tools,” Mulford says. “The problem is that cash flow is so flexibly defined, so inclusive of nonrecurring items, and so easily manipulated by reporting companies that improper conclusions are a very real possibility.” The challenge for analysts, then, is to acquire enough skill and knowledge to avoid the pitfalls and to produce results as meaningful as those obtained by adept practitioners of the art. ▀

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RECOMMENDED RESOURCES

“Is Cash Flow King in Valuations?”
Financial Analysts Journal (March/April 2007)
(cfapubs.org)

“Cash Flows, Accruals, and Future Returns”
Financial Analysts Journal (July/August 2006)
(cfapubs.org)

The Ability of Earnings to Predict Future Operating Cash Flows Has Been Increasing—Not Decreasing”
Abstracted in the *CFA Digest* (May 2006)
(cfapubs.org)

“A Free Cash Flow Investment Anomaly”, *Journal of Accounting, Auditing & Finance* (Winter 2000)