

## Research Comments

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#### What is Free Cash Flow?

It is not uncommon for many investors to evaluate investment alternatives based on some comparison of earnings multiples. In recent years, some investors have begun to focus on cash flow in their valuation analysis. By its very nature, cash flow is of paramount importance to fixed income investors. In fact, fixed income investors would prefer management to maximize cash flow and minimize earnings, due largely to the different tax consequences of interest versus earnings and in particular to the double taxation of earnings itself.

Cash flow wears many disguises and is not a well-understood concept. It is generally defined by the investor as earnings before interest, taxes, depreciation and amortization (EBITDA) and by accountants as cash flow from operating activities (OCF) as defined under GAAP.

The deficiencies embodied in EBITDA are, like cash flow itself, sometimes masked by the ease in which the cash flow number is obtained. For example, although EBITDA is cash flow available to the firm (i.e., it is independent of the capital structure chosen by the firm), it makes no allowances for important changes in working capital that can severely affect firm liquidity. From the fixed income investor's perspective, this is hugely important. OCF under GAAP, although capturing the full impact of working capital changes, is also deficient in that it is not true "firm cash flow." That is, it captures the effect of the capital structure choices of the firm and is not comparable across firms with differing capital structures, even within the same industry.

Compounding the difficulty of cash flow is the fact that it contains many elements including net income, depreciation, amortization, inventory turns, receivable turns, and payable turns, among others. Many of these fundamental elements of cash flow are not directly measurable. They must be ferreted out through a process that many are not willing to undertake.

As difficult as cash flow is to conceptualize, the concept of free cash flow (FCF) is even more difficult, due in part, perhaps, because it is one step further removed from investor focus than cash flow itself. FCF is the investment equivalent of stepping into an abyss, littered at the bottom by many definitions, interpretations, and failed investment decisions caused by an errant focus on earnings or EBITDA alone. It is free cash flow, not earnings or EBITDA, which allows firms to invest in themselves, repay creditors, and enrich equity holders.

There are several definitions of FCF. The most popular one is probably EBITDA – Capital Expenditures (CAPX). Another definition is OCF – CAPX. In order to account for the capital structure effects included in OCF, many analysts will add the after tax interest cost to OCF and then subtract CAPX. The definition that I prefer is EBITDA – Interest – Taxes – CAPX. I would further modify this definition to include extraordinary changes in working capital requirements. However, the hope would be that proper management of working capital over time would result in a somewhat self-funding mechanism. That is, increases in inventory and receivables would largely be funded by increases in payables. This is not true in many cases and should be monitored very

closely. Fundamental liquidity problems can appear to occur very quickly when monitoring only earnings or EBITDA.

Implicit in this definition is that the creditors must be paid their interest and that the tax man probably has a senior lien on nearly everything. From a "firm cash flow" perspective, EBITDA – CAPX is probably an appropriate definition of FCF. However, I do not agree that it represents true free cash flow. After all, the capital structure is already in place and each component must be fed. The creditors must be paid (interest), the tax man must be paid (taxes) and the firm must invest in itself (CAPX). Short of acquisitions at multiples that are less than current debt/EBITDA leverage, the firm must have free cash flow (EBITDA – interest – taxes – CAPX) to de-lever on both a multiple and an absolute basis. Equity offerings could also reduce leverage, but our analysis is designed to identify potentially self-funding (i.e., self de-leveraging) credits, all other things being equal. As fixed income portfolio managers, our charge is to identify credits which will pay interest as stated. Our FCF analysis is a facilitator of this selection process.