

On the Virtues of Free Cash Flow

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Free cash flow. We love it. We talk about it in our sleep. Even the name "cash flow" is pretty sweet: We all like cash, and "flow" sounds so darn easygoing. At Motley Fool Stock Advisor, we prattle on and on about the merits of companies blessed with free cash flow. But what exactly is free cash flow? What does it represent? And how do you know if you've got it?

Put simply, free cash flow is the money left over after a business has done everything it needs to run its business. It's the money in the pot at the end of the day. Money that can be given back to shareholders as dividends, or used to buy back shares, or invested, or just socked away. Free cash flow is good. We like it when businesses do their thing and then have money left over.

Easier Than Pi

The good news is that calculating free cash flow isn't calculus. Don't believe it? Check out this simple formula:

Operating Cash Flow – Capital Expenditures = Free Cash Flow

The super good news is that all this stuff is laid out for you right in the Statement of Cash Flows. Operating cash flow is especially easy to find. It's the final entry in the section "Cash Flows From Operating Activities" on the Statement of Cash Flows. It might also appear under the moniker "Net Cash Provided by Operating Activities," so don't let that confuse you.

Tracking down capital expenditures isn't much harder. It's (usually) the first line under "Cash Flows From Investing Activities," just below where you found operating cash flow. This is the amount the company spent on capital expenditures (shortened to "cap ex" if you're really cool). Simply subtract cap ex from operating cash flow and viola!

Who's Got It?

A positive number indicates that a business is throwing off excess cash. Let's take an example:

Corporate Executive Board (NASDAQ: EXBD) provides what it calls collaborate business research to more than 1,800 client organizations, including more than 70% of the Fortune 500 companies. For the privilege of joining this network, customers (typically corporate execs spending their company's dime) fork over \$31,000 a year. Each year, a full 90% routinely renew their subscriptions.

By growing earnings consistently -- again, primarily through paid-up-front subscription fees -- while keeping capital expenditures low, Corporate Executive Board can't help but generate lots of free cash. As a result, free cash flow has grown each year since 1999 -- from \$16 million in 1999 to \$30 million in 2000 to \$40 million in 2001. We expect more of the same over the next three to five years.

What's that mean for shareholders? Well, at around \$33, EXBD trades at just over 28X this year's free cash flow per share. If free cash flow continues to grow at around 25% per year (and we think it will), that leaves room for a double in just over three years. And we've got some wiggle room. After all, this assumes the stock continues to trade at around 28X free cash flow, which is a bargain in our view, given the consistent growth in cash flow and earnings, and more specifically, our expectations for more of the same. Obviously, if this multiple expands, we do even better.

The Big Picture

Like most anything, detailed free cash flow analysis can become contentious. Along with cap ex, for example, one might subtract out deferred income taxes, arguing that this doesn't represent cash from operations. One might likewise distinguish maintenance cap ex from growth cap ex, and subtract only maintenance expenditures from operating cash flow. Still, operating cash flow minus cap ex is a solid start.

And remember, as with earnings, what you're looking for more than anything is a trend. You want positive free cash flow numbers, but you really want your companies to consistently produce free cash on a regular basis. And you want them producing more free cash each year than the previous year. If they aren't, you want to know why -- and it better be good!

Unlike earnings, which are routinely dressed up with one-time charges, or pro forma reporting, or all sorts of other chicanery, free cash flow gives us a pretty good look at what is going on inside a company. After all, when beating the Street is all that matters, CFOs do their best to make their income statements sing. On the Statement of Cash Flows, what you see is pretty much what you get.

So if you want to see what a company really looks like -- in the morning once the mascara's smeared and the Lemon Sorbet eye shadow's creased -- check out the Statement of Cash Flows. That's where you'll find free cash flow, and where steady growers like Corporate Executive Board truly shine.