SharePad's **Phil Oakley** explains how to use free cash flow to your advantage

FREE CASH FLOW: WHAT IT IS AND HOW TO USE IT

The best investors don't spend huge amounts of time looking at a company's profits. Instead they spend a lot of time looking at its free cash flow in order to work out how good or bad a company's shares might be as an investment.

By focusing your attentions on free cash flow it is possible to get closer to the truth about a company's financial performance. Too many times investors have learnt the hard way that profits aren't always real. Free cash flow is a much better way to spot really good companies while keeping you away from the really bad ones. This is what successful investing is all about.

This article is going to show you how to calculate and use free cash flow numbers to:

- Check the quality of company profits.
- Spot high-quality companies.
- Check the safety of dividends.
- See why low or negative free cash flow isn't always a bad thing
- Value a company's shares.

What is free cash flow?

In layman's terms it is the amount of cash that a company has left over every year to pay its lenders and shareholders. It is essentially a company's cash profits. It is called free cash flow because the company is free to do anything it wants with it. For example, it can use it to do the following:

- Pay dividends.
- Buy back its own shares.
- Expand its business so it can make more money in the future.
- Buy other companies.
- Pay off its debts.

There is no universally accepted way to calculate a company's free cash flow but essentially there are

1. Reckitt Benckiser FCF

← Prev Next →	2011	2012	2013	2014	2015	2016
Fiscal period ending	31/12/11	31/12/12	31/12/13	31/12/14	31/12/15	31/12/16
£ millions unless stated	Q4 IFRS	Q4 IFRS	Q4 IFRS	Q4 IFRS	Q4 IFRS	Q4 Prelim
FREE CASH FLOW						
Net cash from operations	1,753.0	1,895.0	2,144.0	2,596.0	1,815.0	2,438.0
Capital expenditure	(205.0)	(177.0)	(224.0)	(184.0)	(179.0)	(393.0)
Dividends from joint ventures	-	-	-	-	-	-
Free cash flow for firm (FCFf)	1,548.0	1,718.0	1,920.0	2,412.0	1,636.0	2,045.0
Dividends paid to minorities	(7.0)	(110.0)	(28.0)	(1.0)	(2.0)	(1.0)
Interest paid	(35.0)	(34.0)	(49.0)	(58.0)	(54.0)	(56.0)
Interest received	22.0	27.0	25.0	26.0	23.0	40.0
Free cash flow for equity (FCF)	1,528.0	1,601.0	1,868.0	2,379.0	1,603.0	2,028.0

two types that you need to be aware of which are shown in the tables that follow.

- Free cash flow for the firm (FCFF): This is the amount of cash left over to pay lenders (interest) and shareholders. This is calculated by taking the net cash from operations (which is a company's trading cash flow less tax paid), adding any dividends received from joint-venture companies and then taking away capital expenditure (the amount of money spent on new assets). During 2016, **Reckitt Benckiser (RB.)** generated just over £2bn of free cash flow, which is available to pay interest to lenders, dividends to shareholders or any of the other options listed above. This was up from £1.6bn in 2015 but was not as high as the £2.4bn generated in 2014.
- Free cash flow for equity (FCF): This is the amount of cash that essentially belongs to the company's shareholders. As an investor in shares, this is the number you should be paying a lot of attention to. To calculate it, you take FCFF and then take away the interest paid to lenders, dividends paid to preferred and minority shareholders and then add any interest income received.

Generally speaking, it is usually a good sign that a company generates free cash flow, but like many numbers it is meaningless in isolation. You need to know how to put them to good use so that you can learn something about the companies you are looking at.

Examples of consistently high cash converters

Name	Free cash conversion (%)	Free cash conversion 5-year average (%)
Shire	130.1	108.2
Imperial Brands	227.5	117.3
RELX	114.2	110.1
InterContinental Hotels	135.1	114.5
Bunzl	104.8	115.8
Paddy Power Betfair	133	100.2
Informa	109.9	104.6
Micro Focus International	126.2	121.4
Rightmove	107.8	108.9
Spectris	142.7	108.8

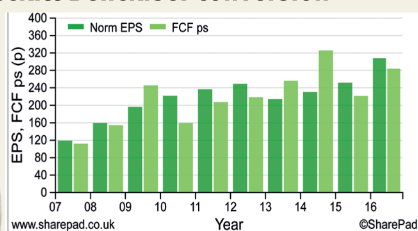
Source: SharePad

Checking the quality of profits

A sign of a company with high-quality profits is that it turns a large proportion of its profits into free cash flow. You can check this out by comparing a company's underlying or normalised earnings per share with its free cash flow per share. Free cash flow per share is calculated by taking a company's free cash flow to equity and dividing it by the weighted average number of shares in issue for the year.

Reckitt Benckiser has been consistently good at turning its profits into free cash flow. This is one of the reasons it is popular with investors.

2. Reckitt Benckiser conversion



Companies that struggle to consistently convert their profits into free cash flow rarely make good long-term investments. This is because they need to spend too much money to maintain or grow their existing profits. In stark contrast, many of the most successful companies can grow without spending lots of money and produce growing amounts of free cash flow for their shareholders.

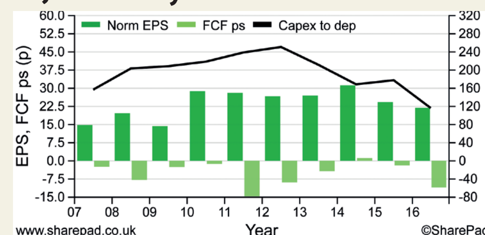
Companies can have low or negative free cash flow because they are investing for future growth, but sooner or later they have to start generating free cash flow or else the money invested will not have been worth it. I'll have more to say on this later.

If companies cannot eventually convert a high proportion of their profits into free cash flow then there may be grounds to question whether their profits are believable. This has been particularly true of smaller companies on the alternative investment market (Aim). Many potential basket cases could have been avoided by simply looking at their free cash conversion performance or lack of it.

It is also a good idea to closely scrutinise the free cash conversion of asset-intensive companies where the actual cash flow needed to replace existing assets (known as replacement or maintenance capex) is considerably more than the annual depreciation expense in the income statement.

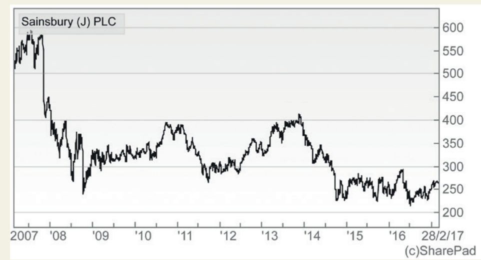
Other things being equal, this would lead to free cash flow being less than profits. Supermarket companies such as **Sainsbury's (SBRY)** have spent considerably more on new assets (capex) than depreciation for years as a result of opening up lots of new stores. Sainsbury's has hardly produced any free cash flow for more than a decade. In fact, quite often cash has been flowing out of the company.

3. J Sainsbury conversion



Is Sainsbury's overstating its profits? Not necessarily, as you do not know the annual cash maintenance capex costs. However, one thing for certain is that Sainsbury's has been a poor long-term investment. Its inability to produce free cash flow has played a significant part in that outcome. ▶

4. J Sainsbury price chart



▶ Software companies can also have poor free cash flow conversion if they decide to spread the costs of software development over a number of years rather than expense them against revenues as incurred. This can lead to expenses such as the wages of computer programmers being treated as assets rather than expenses.

For example, two identical software companies have teams of software developers that each cost £1m in wages per year. If one company expenses them against revenues then its profits and cash flows will be the same. If the other spreads the cost over five years (£200,000 per year) its profits will be £800,000 higher and its free cash flow will be the same as the first company but £800,000 lower than its profits. Thinking that the second company was more profitable than the first one would be a mistake.

Using free cash flow to spot highly profitable companies

This can be done by looking at something called a free cash flow margin. This expresses a company's annual free cash flow to equity as a percentage of its turnover (revenue). Consistently high free cash flow margins can be the hallmark of excellent businesses.

Companies with consistently high free cash flow margins

Name	FCF margin	FCF margin 10-yr avg
Rightmove	63.5	56.1
Auto Trader	52.7	37.0
Indivior	35.2	47.5
InterContinental Hotels	30.9	21.8
Playtech	29.9	45.3
ZPG	26.6	27.7
Moneysupermarket.com	26.2	20.0
Charles Taylor	24.4	12.5
PayPoint	24.0	14.6
Dignity	23.8	12.7

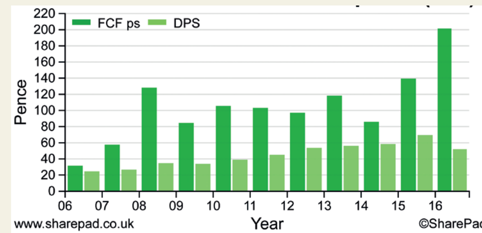
A sustainable free cash flow margin of over 10 per cent is generally considered good.
Source: SharePad

Checking the safety of dividend payments

A dividend is a cash payment to shareholders. It therefore makes sense that a company's dividend is safer and more sustainable if it can be paid out of free cash flow. You can check if this is the case by seeing if the company's free cash flow per share is greater than the dividend per share.

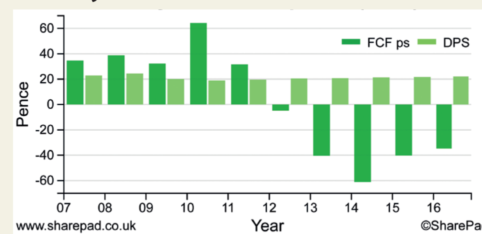
InterContinental Hotels (IHG) has been able to pay its dividend comfortably from free cash flow.

5. InterContinental Hotels FCF dividend cover



Dairy Crest (DCG), on the other hand, has not been able to do this in recent years. This might be due to heavy capital investment. However, companies that can cover their dividend after all capex has been paid for – not just maintenance capex – have safer dividends and can be better placed to grow them in the years ahead.

6. Dairy Crest dividend cover



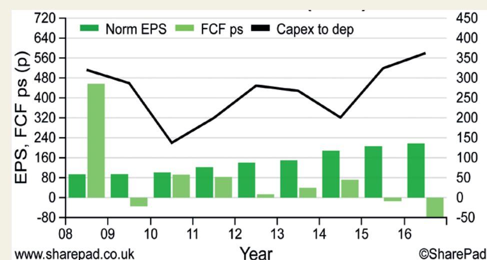
Is negative or low free cash flow always bad?

No, it is not. Companies that are investing in new projects for future growth tend to have high capital expenditure bills which reduce free cash flow. Shunning a company for investing for future growth does not make sense if that investment will lead to higher free cash flow in the future.

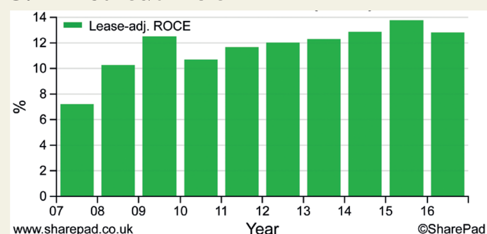
> 'It therefore makes sense that a company's dividend is safer and more sustainable if it can be paid out of free cash flow'

One way in which investors can see if money is being well spent is to look at the trends in return on capital employed (ROCE). Low or negative free cash flow combined with a decent and rising ROCE can be a sign that a company is adding value for its shareholders. When the heavy investment slows down, free cash flows can increase significantly.

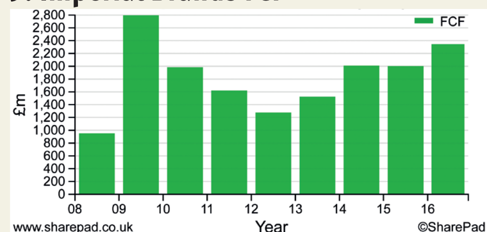
Costa Coffee and Premier Inn owner **Whitbread (WTB)** has been investing heavily in recent years, which has resulted in negative free cash flow per share.



But its ROCE has been creeping up and is at a reasonable level.



In fact, sometimes having lots of free cash flow can be a sign that a company has run out of growth opportunities. This might not be a bad thing. These companies try to keep their shareholders happy by paying larger dividends and buying back shares. They may also try to grow by buying companies. Tobacco companies such as **Imperial Brands (IMB)** may be a good example of this.



Using free cash flow to value shares

One way some investors try to identify undervalued shares is by looking for ones with high free cash flow yields. This is the free cash flow per share expressed as a percentage of the current share price. The higher the free cash flow yield, the cheaper the share is seen to be.

High free cash flow yield shares are sometimes seen as possible takeover targets for private equity groups. This is because the free cash flow can be used to support the large amounts of debt that private equity buyers tend to use to finance their takeovers. A free cash flow yield of over 10 per cent is considered to be high.

As with high dividend yields, high free cash flow

Dairy Crest (top right), Whitbread (top left) and Reckitt Benckiser (bottom) have produced good free cash flow in recent years, but Sainsbury (above left) has struggled

'It is called free cash flow because the company is free to do anything it wants with it'

yields can be value traps. They could be telling you that the company's free cash flow is unsustainable or that growth prospects are poor. Just as highly indebted companies have low PE ratios (or high earnings yields) to reflect their increased riskiness, high free cash flow yields can be giving you the same message.

Companies with the highest free cash flow yields

TIDM	Name	FCF yield
RUS	Raven Russia	23.7
GEMD	Gem Diamonds	23.1
PFD	Premier Foods	20.2
TNI	Trinity Mirror	18.2
PFC	Petrofac	13.9
DEB	Debenhams	13.4
BDEV	Barratt Developments	13.2
INDV	Indivior	12.1
FOXT	Foxtons	12.1
DFS	DFS Furniture	11.6
MCLS	McColl's Retail	11.4
CNCT	Connect	11.3

Source: SharePad