Understanding Free Cash Flow

Checklist

This checklist defines what free cash flow is and its role in a company's finances.

Definition

Free cash flow is a measure of financial performance and is defined as cash flow available for distribution among any parties that hold security in a company. It comprises the net income plus depreciation and amortization minus capital expenditure and any changes in working capital. The free cash flow is the cash that a company has available for use after paying out the necessary expenditure to maintain or expand its asset base. It matters, as it is a means for a company to boost shareholder value through, for example, mergers and acquisitions, R&D, paying dividends, or reducing debt. It can thus be viewed as an alternative bottom line.

Unlike earnings, free cash flow represents real cash. It is a very useful way to assess the financial health of a company as it is what is left after all the accounting assumptions built into the earnings have been stripped away. A company may seem to be generating high earnings, but only free cash flow indicates whether any real money has been generated in a designated period. Ultimately, the stock market's estimate of how much free cash flow a company will generate in the future is reflected in the share price.

Even a profitable concern may have a negative cash flow. This does not necessarily signal financial problems—it may indicate that the company is making large investments with potentially high returns. Shareholders may agree to forgo dividends one year or longer if they believe that such a strategy will produce better returns in the long term.

Free cash flow can, of course, vary from year to year, depending on the capital expenditure (usually referred to as capex) and any changes in working capital. Thus, no accounting year can be described as normal when measured purely by free cash flow. However, a company that has stable capex should in the long term have free cash flow that is roughly equal to its earnings.

It is important to remember that how a company uses its free cash flow matters a lot. A company using its free cash flow on share buy-backs (for example, when the share price has fallen below its intrinsic value) or to pay out dividends is more attractive to investors. Conversely, a company that pays out more of its free cash flow in dividends than it is generating is overstretching its spare cash.

Advantages

Rising free cash flow often indicates that increased earnings lie ahead. And when free cash flow booms as a result of revenue growth, cost-cutting, or debt reduction, a company is in a position to reward its investors promptly. This why analysts generally view free cash flow as a reliable metric for assessing value.

Disadvantages

Free cash flow is not immune to manipulation in the accounts as there are no regulatory standards for determining it. A company with a high free cash flow may be underreporting its capex, for example, or stretching out its payments. However, any impact is likely to be only temporary. Also important to note is that a company may have trouble sustaining earnings growth if free cash flow is poor, and it may be forced to increase its debt. In the worst-case scenario, insufficient free cash flow could tip a company into a situation of illiquidity.

More Info

Books:

- Brealey, Richard A., Stewart C. Myers, and Franklin Allen. *Principles of Corporate Finance*. 8th ed. McGraw-Hill/Irwin Series in Finance, Insurance, and Real Estate. Boston, MA: McGraw-Hill/Irwin, 2005.
- Stewart, G. Bennett, III. *The Quest for Value*. New York: HarperBusiness, 1991.

Article:

- Jensen, Michael C. “Agency costs of free cash flow, corporate finance, and takeovers.” *American Economic Review* 76:2 (1986): 323–329.

See Also

Best Practice

- Why EVA Is the Best Measurement Tool for Creating Shareholder Value

Checklists

- Assessing Business Performance
- Measuring Financial Health
- Preparing a Cash Flow Forecast

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