INVESTMENT FOCUS: Cash is King

We've all heard the adage "cash is king, and profit is an opinion", but to unpack what this simple statement actually means, requires some further examination. In investments, much focus is placed on company earnings (Earnings per share, or EPS). This number can have drastic effects on a business's share price, particularly if EPS either over- or under-performs market expectations. The problem is that EPS is the "opinion" part of our adage, as EPS is based on accounting numbers, rather than cash-in-hand.

What is EPS?

In a company's financial statements, Net Income is equated with profit, to indicate whether earnings are growing through time.

Net Income = Sales – Cost of Goods Sold – Operating Expenses – Tax – Non Cash Charges (depreciation & amortization)

It sounds simple enough. However, all listed companies are obliged to report their financials in compliance with either US GAAP or IFRS accounting standards. According to iEduNote - GAAP is composed of a fusion of over 2,000 documents that have been developed over the last 60 years or so. In South Africa, companies have to comply with IFRS in preparing company financial statements. The way that these standards have developed over time has resulted in numerous assumptions having to be made in compiling results. The net result is that reported earnings are more of an art, rather than a science. Ultimately, they are no longer that useful as a measure of performance, or as a basis of valuation.

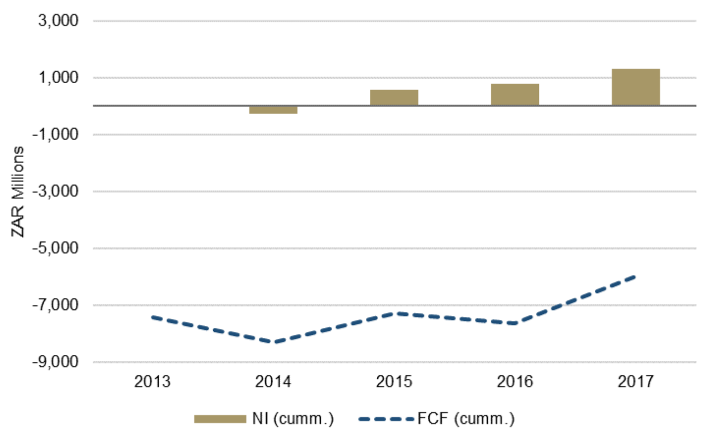
What is free cash flow?

This brings us back to the "cash" part of our assessment. Free Cash Flow (FCF) is calculated from the same financial statements as EPS, but there are a few extra steps required to derive it.

FCF = Net Income + Non Cash Charges + Interest Expense – CapEx – Working Capital

While the derivation is slightly more involved, the benefit of looking at FCF is that it can be reconciled back to actual cash in the bank (available for reinvestment / dividends). Typically, EPS cannot be.
Let us unpack some of the key concepts and explain by way of an example the importance of FCF relative to EPS.

Figure 1: RCL Net Income vs. Free Cash Flow (Cumulative 5 Years)



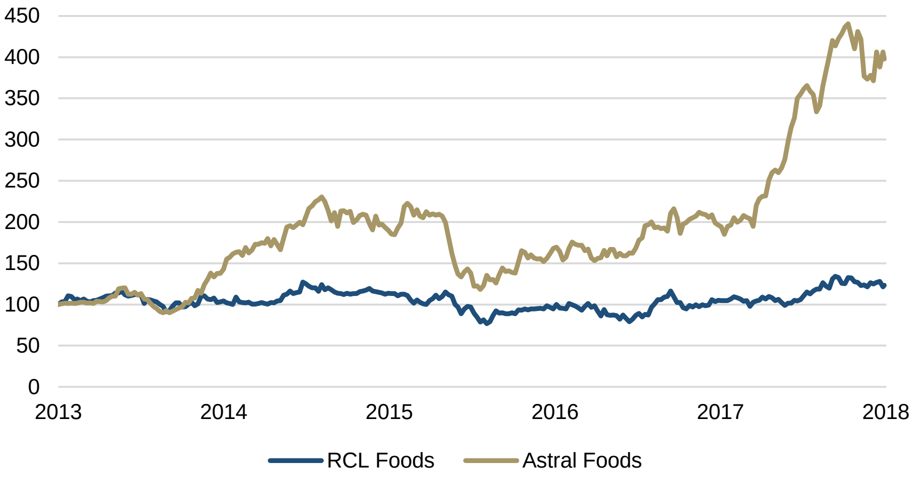
Source: Credit Suisse HOLT, Thomson Reuters, BlueAlpha Research

Over the period, RCL had cumulative Net Income of R1.3 billion, which sounds great at first glance. Furthermore, when you add back Non Cash Charges, they earned a collective R7.6 billion – even better. However, over the same period, they spent a cumulative R13.6 billion on both Working Capital and CapEx, which as per our equation, is deducted to arrive at FCF. This resulted in negative FCF of R6 billion – which exposes the problem with only looking at EPS – a company with what looks like great earnings, can actually have a large shortfall of actual cash.

Why is it important?

In the long run, this shortfall is unsustainable, as the company must keep borrowing to fill the void. In RCL's case, they funded their shortfall with R2 billion in new debt and the balance in new equity issuance, diluting the existing shareholding. The consequence of this has been that their share price has basically gone nowhere in 5 years, while peers have performed very well - some even doubling their share price over the same period.

Figure 2: RCL's share price vs. Astral Foods (indexed to 100)



Source: Bloomberg

As you can see, RCL's share price has pretty much gone nowhere in 5 years, justified mainly by unsustainable capital raising. Had you only looked at EPS, the company would have looked financially strong and perhaps at an attractive entry point. By doing a little digging, a very different picture emerges. While FCF is not the answer to everything, it is certainly a very useful tool in gaining a better understanding of a company's operating environment. It therefore pays off to reconcile back to cash in the bank – after all, **cash really is king**.