

FREE CASH FLOW: A NEW MODEL FOR ANALYZING FINANCIAL PERFORMANCE

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ABSTRACT

Free Cash Flow is equal to cash from operations minus Capital Expenditures. FCF represents cash generated by an entity from its operating activities and after deducting reinvestment in non-current assets. Free cash flow is important because it gives opportunities for enhancing shareholder's wealth. Without availability of cash the business entity can't be able to expand production, to develop new products, make acquisitions, buy non-current assets, reduce debts, pay dividend. It is believed that financial analysts mainly focus on earnings rather than 'real' cash inflows. Earnings, some time, can be manipulated by various accounting practices, but it is difficult to show fake cash flows. It is important to mention that negative cash flow is not bad itself, because it may be indication of making large investment by the company in new business opportunities for the purpose of high returns. Free cash flow has a characteristic of volatility so, one can observe free cash flow over a period of few years rather than a single year or a quarter.

KEYWORDS: FCF, EBIT, Operating Cash Flow (OCF); Capital Expenditure (CE).

Introduction

Free Cash Flow (FCF) is a measure of company's financial performance. It is not only indication of financial performance but it can also be useful for analysing the true profitability of an enterprises. Before analysing its usefulness, importance or characteristics it will be better to explain that what is FCF?

Basically it is calculated as 'operating cash flow' minus 'capital expenditures'. FCF represent the availability of cash after meeting out all capital expenditures (e.g. purchases of office equipments, plant and machinery, computers, buildings, furniture and fittings etc.). This available cash can be utilized in expanding production activities, launching new products, make acquisitions, payment of dividends to investors, repayment of debts etc.

Financial Analysts describe the free cash flow as – it is the money left to pay to the investors after meeting all its financial obligations. Free cash flow, as a part of cash flow analysis, has become more important after various incidences of financial frauds. Now the investor has started looking towards the concept of free cash flow, as it is not easy to manipulate as earning per share.

The free cash flow model is an indicator of the financial health of a business enterprise it also helps in analyzing the ability of investing in new business opportunities. The increasing trend in free cash flow over a period of time indicates that right opportunities are being availed by the firms, it may be enjoying growth in the revenue or may managing their assets efficiently. In contrary to this the declining trend may indication of decline in earnings growth, increasing level of debt or may have experience of declining liquidity. But declining trend does not always depict negative performance, it depends how the funds are being utilized and requires more analytical study of financial data.

What is Free Cash Flow and How It is Calculated

Basically free cash flow is an indicator of business health as regards finance and profitability. It is the money which remains after payment of capital expenditure out of operating cash inflows. Though there are several methods for calculating free cash flow but all will generate same answer. Hence the most acceptable method is being explained here:

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Free Cash Flow = OCF – CE

Where:

- OCF = Operating Cash Flow
(i.e. Net Income + Amortization /Depreciation – Changes in Working Capital)
- CE = Capital Expenditures
(i.e. Changes in Operating Assets)

The computation of Free Cash Flow can be presented in tabular form as given below:

Element	Source
EBIT x (1-Tax Rate)	Current Statement of Profit and Loss
+ Depreciation and Amortization	Current Statement of Profit and Loss
-Changes in Working Capital	Previous and current year Balance Sheet: Current Assets and Current Liabilities
-Capital Expenditures	Previous and current year Balance Sheet: Non Current Assets
= Free Cash Flow	

Thus, this can also be presented in the form of formula as follows:

$$FCF = EBIT (1-Tax Rate) + (Depreciation/Amortization) - (Changes In Working Capital) - (Capital Expenditure)$$

When FCF position of a concern is to be analyzed as compared to some past period then its increasing trend will be indication of powerful financial strength. However, too large position of CFC will be the signal of idleness of funds. Negative trend may also be indicator of growth in the business as it may show that the entity is able to invest in good business opportunities. But there is need to analyze the facts in depth to draw right conclusion.

Free Cash Flow Example

Let us take some data of a hypothetical firm for understanding the computation of Free Cash Flow:

- EBIT : Rs 10 Crore
- Tax Rate : 30%
- Depreciation and Amortization : 2 Crore
- Increase in Current Assets : 50 Lac
- Increase in current Liabilities : 10 Lac
- Capital Expenditure : 3 Crore

$$\begin{aligned}
 \text{Free Cash Flow} &= EBIT \times (1-T) + \text{Depreciation and Amortization} - \text{Changes in Working Capital} - \text{Capital Expenditure} \\
 &= 10 \times (1-0.30) + 2 - 0.40 - 3 \\
 &= 7 + 2 - 0.40 - 3 \\
 &= 5.60 \text{ Crore}
 \end{aligned}$$

Importance and Interpretation of Free Cash Flow

- Free Cash Flow is a way of looking at ‘cash flow’ of an entity to see that how much amount is available for distribution among the security holders. Hence, FCF is useful for debt holders, preferred stock holders and equity holders. It is also indicator of financial health of an enterprise in respect of exploring new business opportunities. The more free cash flow also indicates that the company can pay to its creditors and investors easily and can reinvest in its own business activities for expansion.
- The entity which is having healthy free cash flow have sufficient funds to meet their obligations in time and some fund still remain left for other purposes. A business entity with increasing free cash flow is considered to be doing well and having good business opportunities of expansion. In contrary to this a company with decreasing free cash flow may require to restructure the capital requirements.
- An investor looks for the company which is having rapid growth in free cash flow as such company may be having excellent future prospects. Hence, when an investor finds a company with rising free cash flow and its share price undervalued then he can find good investment opportunities in such a company.

- The best use of free cash flow helps in the growth rate of an entity. Again, the growth rate will require more investment in working capital by way of investing in accounts receivables and inventories. In such a situation free cash flow will show declining trend. In contrary to this, if the activities of business are shrinking then some amount of working capital will be converting into cash, as accounts receivables used to pay their amount, and inventories liquidated, consequently the free cash flow will show increasing trend.

Darkness of Free Cash Flow

There may be various circumstances when positive free cash flow of a company may not depict the healthy long-term situation, the same may be caused due to the following situation:

- Reducing or postponing capital expenditure.
- Curtailing scheduled payment of accounts payables.
- Disposing of major assets.
- Entering into agreements for lease arrangements for key assets in place of buying them.
- Avoiding of making huge advertising expenses.
- Forgoing payment of dividend on ordinary shares.
- Allowing heavy cash discount on collection from accounts receivables.

So, while evaluating the free cash flow position of a company an analyst should be aware of the general conditions and financial strategic of the management.

Ratio of Free Cash Flow (FCF) to Operating Cash Flow (OCF)

The ratio of free cash flow to operating cash flow shows the relationship between these two components. As discussed earlier free cash flow is the cash a firm produces through its operations, less the cost of expenditure incurred on assets. The cash flow remaining after this deduction is considered "free" cash flow, which is available with the company for using it in expansion, acquisitions etc. Higher the ratio greater will be the financial health of the company.

This ratio can be presented in the form of formula as follow:

$$\text{FCF to OCF Ratio} = \text{FCF/OCF}$$

Where:

FCF = Free Cash Flow (Operating Cash Flow-Capital Expenditure)

OCF = Operating Cash Flow (Can be observed from Cash Flow Statement)

Suppose, a company's FCF is 64 crore and OCF is 80 crore then FCF to OCF Ratio will show 80% which is a very high beneficial relationship.

A Different View: A different and important view of FCF can also be presented here. If cash dividend is also deducted from OCF along with capital expenditure then it will provide a conservative free cash flow. The financial analysts consider the outflow by way of cash dividends just as critical as capital expenditure. Though in general meeting the members may reduce or denial for payment of dividend, but there is a practice of avoiding such a situation, so normally dividend is paid by the company to maintain trust among the investors. Hence, this view is widely accepted by the financial professionals.

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