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Fall 2019

It's all about Cash Flow

The last newsletter covered, briefly, some of the key principles that we rely on in valuing businesses. In this newsletter I'd like to highlight one of the principles – focus on cash flows, not profits – and expand on it.

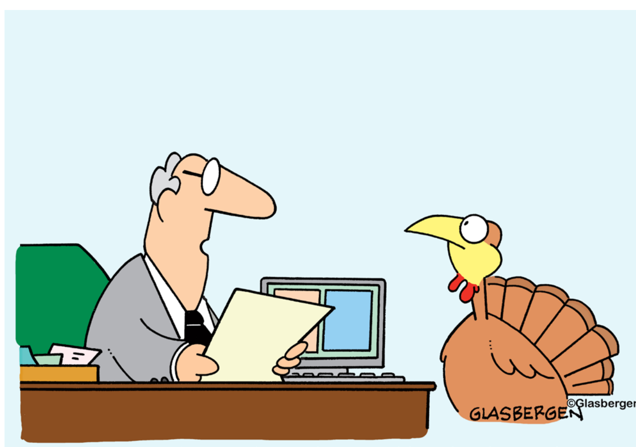
When stock market analysts talked about a company's valuation many years ago, they often referred to its price/earnings ratio. Analysts would also refer to dividend capitalization models used to value a business, meaning its value was tied to the level of dividends the company issued (almost like a bond). As more people came to accept shareholder-value-creation principles, they recognized that earnings or dividends are only part of the story. To truly understand how a company is doing, we need to look at its cash flow.

As a company grows it will need to fund more accounts receivable and inventory which uses up some cash flow. A growing company will also have to buy/replace equipment in order to continue producing products. As long as the company remains stable, cash used to fund working capital will remain tied up and equipment will need to be purchased/replaced.

Please note that the way I've defined cash flow is the cash flow available to all providers of capital (both debt and equity). This is the most appropriate way to look at cash flow for valuation purposes, and it is often referred to as cash flow to invested capital. If you want to read more about invested capital please see my newsletters from Fall 2013 and Spring 2014.

What is it?

To calculate cash flow, we start with earnings before interest expense and adjust it for income taxes. Then we add back items like depreciation and amortization because they don't reflect the actual use of cash. But we deduct capital expenditures because they do reflect the use of cash. Then we have to adjust for changes in working capital, which includes items like accounts receivable and inventory, net of accounts payable and accrued liabilities.



"I advise my clients to invest in something they know about. You should invest in a company that makes roasting pans."

Why is it Important?

When we hear conversations about a company's performance we often hear about sales or profits. Those are important measures, but on their own they can mask poor performance by a management team. As an example, let's say a company's sales increased by 25% in one year. That sounds pretty impressive, right? But what if I told you they had to spend $2 million on a new piece of equipment to generate those sales, and they had to buy a large amount of

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I wish you a safe and happy **Thanksgiving Day.**

inventory to make sure they could produce the products. Now we have more information about the management team's decisions. We can look at the effect on cash flow and consider whether they are improving the value of the company or not.

Cash flow is important because it is the most complete measure of a company's ability to create value for its shareholders. It is theoretically correct, and it is consistent with good management principles. Cash flow respects the role of both the balance sheet and the income statement in creating (or destroying) value. Cash flow also holds management to account for their total performance. Managers should not be judged solely by sales and profits, but also by the amount of assets they need to generate sales and profits. When we look at cash flow it also gives us a better picture of the management team's strategy, and what challenges may await them in the future.

The old saying is that you can't buy bread with profits – you buy it with cash. When we focus on cash flow, we are paying attention to a critical factor in the valuation of a business.

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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- **Assisting with the acquisition or sale of a business, business unit or product line**
- **Assisting with corporate performance measurements**
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