



A Better Measure of Financial Health in an Uncertain World

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January 29, 2008

In ascertaining the fundamental and intrinsic value of a business, it is important to focus on a company's cash flow generation potential and cash position. The vast majority of professional investors and sell-side analysts tend to focus almost entirely on projected future "operating earnings" to make valuation judgments and formulate investment opinion. There are significant differences between net income and cash flow that should be considered when analyzing a company's future prospects and empirical value. In our view, future free cash flow truly available to shareholders is the most important determinant in arriving at the real value of a business.

Why is cash so important? Using a biological analogy, cash is the lifeblood flowing throughout a business that provides the nourishment essential for sustaining life and future prosperity. Even a temporary shortage of cash can signal the sudden demise of a company. Not surprisingly and by a wide margin, the leading cause of business failure is due to cash insufficiency. An abundance of cash and cash flow can provide a company with a distinct competitive advantage as a result of the operating flexibility that comes with a deep liquid pocket. Cash rich companies can quickly pursue opportunities in a rapidly evolving world that cash poor companies may not. This becomes particularly evident in today's challenging economic and tight credit environment. Nevertheless, many investors choose to focus on other measures of profitability.

Net Income, the standard by which companies periodically report their level of profitability, is not the ideal barometer of a company's true financial health. The general feeling is that accounting standards, while useful and important, do not present a meaningful picture of a company's prospects and tend to distort underlying trends. Professional investors and analysts tend not to rely on accounting standards based measures of profitability such as *Net Income*. In treating with perceived shortcomings in accounting standards, the investor community has come to rely on another profitability measure commonly referred to as "*Operating Earnings*". In an effort to better meet the needs of investors or burnish the results, companies have begun to prominently report, as supplemental information, financial results on an operating earnings or "pro forma" basis. In general, Operating Earnings is arrived at by excluding non-recurring items of revenue and expense from standards-based Net Income to arrive at a more normalized level of profitability. Items commonly excluded from Net Income to arrive at Operating Earnings encompass extraordinary and unusual items such as retroactive accounting changes, charges associated with corporate restructurings, mergers and acquisitions; significant litigation-related income and expenses, and one-time gains or losses on dispositions of company assets. The pro forma earnings often eliminate amortization of intangibles as well. The use of operating earnings makes it easier for an analyst to interpret historical financial trends without the noise of unusual, one-time events. Historical financial trends can then be used more meaningfully to project future profitability trends.

While an improvement over Net Income, Operating Earnings have pitfalls. For example, focusing on Operating Earnings is not always helpful in distinguishing the future prospects and related risks of a company with high fixed capital intensity and debt leverage, like Carnival Cruise Lines, from one with low capital intensity and virtually no debt, such as Automatic Data Processing. Pro forma earnings may also overstate the real ongoing profit contributions of acquired companies by ignoring the cost of carrying intangible assets. This is particularly true when companies are serial acquirers that are willing to pay inflated prices for other companies leading to large amounts of intangible assets hitting their books and whose associated amortization expense is excluded under “pro forma” reporting. A striking example of this situation is Worldcom. An obscure telecom company, Worldcom embarked on a \$60 billion acquisition spending spree, acquiring 65 companies in six years. The spree culminated with the 1997 acquisition of MCI. Worldcom suddenly emerged as the second largest telecom company in the US. Their liberal use of pro forma reporting dramatically muted the drag from these acquisitions providing the investor community with the illusion of rapidly rising earnings which spurred a rapid rise in their stock price. With reliance on their high stock price as acquisition currency, Worldcom made an attempt to acquire Sprint. When that failed, the flaws in their financial reporting became apparent and set them on an irreversible course for bankruptcy.

In order to get to a truer picture of a company’s health and its prospects, a growing subset of investors is utilizing a measure called “Free Cash Flow”. Free Cash Flow is calculated by deducting “Capital Expenditures” from “Net Cash Flows Provided by Operating Activities”. These measures can quickly be gleaned from a company’s financial statements. When one considers that Carnival pays upwards of \$500 million each for a modern cruise ship, the Free Cash Flow outlook for a company that provides pleasure cruises is quite different from one that provides a payroll processing service, though both companies could exhibit comparable Operating Earnings growth.

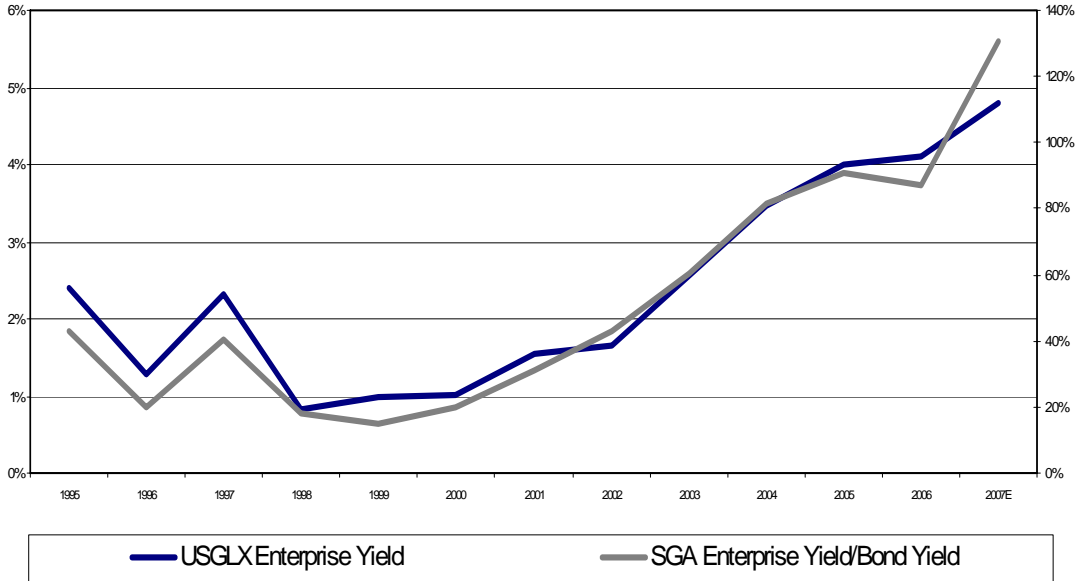
While the use of “Free Cash Flow” in investment analysis is an advance over “Operating Earnings”, “Free Cash Flow” also has its shortcomings as it does not take into account significant items that would impact a company’s future prospects. For example, a company may need to make acquisitions in order to maintain its growth rate or market position. A company like Sysco (the leading food distributor) made numerous acquisitions of smaller distributors which helped the company maintain its attractive growth rate for decades. Another example of an item not reflected in Free Cash Flow is the obligation to fund an under funded pension plan. Recently UPS reached a settlement with the Teamsters to contribute a lump sum payment of \$6 billion to fund a massively under funded pension plan run by the union. As this was not a UPS sponsored pension plan but rather a union plan, the pension liability was not reflected on the books of UPS. With shortcomings evident in utilizing financial measures such as “Net Income”, “Operating Earnings”, “Pro Forma Income” and “Free Cash Flow” to properly assess the value of a business, there must be a better measure. There is and I will get to it - - - shortly.

From the perspective of a prudent investor that might own the entire company, the key question is “How much cash can be withdrawn from the business on an annual basis without impairing the growth prospects or competitive position of that business?” I’m confident Warren Buffet has focused on the answer to this very question before signing off on any acquisitions made by Berkshire Hathaway, the highly successful investment company he founded and leads. In reflecting on Buffet’s prior investments in Coca-Cola, Dairy Queen and See’s Candy Shop, he was undoubtedly focused on the amount of cash that could be reliably repatriated to Berkshire over time. The fact that these companies make soda pop, milk shakes and chocolate is probably of little consequence to Mr. Buffet, though he does have a reputation for having a sweet tooth.

If one believes that investing is mostly about growing capital reliably over time and that the fruits of that investment take the form of future cash payments that are ultimately repatriated to the investor, then it stands to reason that assessing the underlying future cash flow prospects of a business is the most reliable predictor of future value. If it is agreed that assessing future cash flow is important, then the challenge for an analyst is to arrive at a cash flow metric that is both relevant and readily ascertainable. At my firm, we met the challenge by converting “operating earnings” to what we internally refer to as CFATS (Cash Flow Available to Shareholders). Conceptually, CFATS is the total annual amount of cash a business owner could comfortably withdraw from the company without impairing the long-term growth prospects of that business.

The conversion to CFATS involves starting with Operating Earnings, adding back non-cash expenses such as Depreciation, Amortization and Stock-Based Compensation; then subtracting cash outflows which are generally capitalized assets such as Capital Expenditures, Acquisitions (only if necessary to maintain the growth rate of the business) and if applicable, any other cash payments necessary to properly fund the business (such as an under funded pension plan). After arriving at annual CFATS figures for companies, we relate those to annual Operating Earnings. We internally refer to this ratio of CFATS to Operating Earnings as the CE Ratio (Cash to Earnings Ratio). The CE Ratio is useful in getting a sense for how efficient a business is in converting earnings to usable cash flow. In our view, a high CE ratio (such as 100% for Procter & Gamble) bodes well for a company’s future prospects. In calculating intrinsic value for a company, we utilize annual projected CFATS (in lieu of net income) in our ten year discounting methodology. We also incorporate CFATS in a short-hand valuation ratio we call Enterprise Yield (CFATS divided by a company’s market capitalization). Enterprise Yield can then be compared to the yield on a long duration, risk free alternative such as the ten year US Treasury bond.

CHART 1
Portfolio Is Attractively Priced on Cash Basis



It is worth pointing out that as of year end, the enthusiasm we share about the outlook for our portfolios comes in part from the fact that the weighted average Projected Enterprise Yield on our current investment portfolio is 4.0% compared to the 4.2% yield to maturity on the 10 year US Treasury. In recent weeks, the ten year bond rate has dropped meaningfully to 3.7%, resulting in a 133% relative ratio at the end of January as shown in Chart 1 above. In historical terms, having an Enterprise Yield that is around 100% of the US Treasury Yield is unprecedented, as we have pointed out repeatedly in recent quarters.

The normalized relationship is about 60% for our large cap, quality growth style of investing. The weighted average CFATS in our current portfolio is projected to attain compounded annual growth at a low double digit rate over the next ten years. Should our projections prove to be accurate, our portfolio weighted CFATS should grow by a factor of 3 times over the next ten years. This would imply an Enterprise Yield of 12% by 2017, assuming today's market entry point is held static for ten years, a very compelling return compared to the current ten year US Treasury's yield. Should the relationship of the Enterprise Yield return to its normalized historical relationship to the Treasury Yield of 60% (even discounting for the recent sharp drop in the 10 year note), then the ten year implied annualized investment return for our current portfolio would be in the high teens, a very compelling proposition indeed.

In summary, in our view it would be prudent for long-term investors to focus on a company's cash flow and cash position, particularly at times when there is great uncertainty in the market place. Also, it is more appropriate and relevant to use projected CFATS as opposed to projected operating earnings in discounting methodologies used to arrive at a company's intrinsic value. Finally, by this measure, high quality, cash rich, sustainable growth companies are now selling at very low valuations, presenting a wonderful opportunity for investors as shown in Chart 2 below. While it is encouraging to see that in the past few months, the market seems to have begun to recognize this opportunity, the upside potential in this category remains outstanding.

CHART 2
High Quality, Cash Rich, Sustainable Growth

<u>Top Ten Holdings</u>	<u>Quality Rating</u>	<u>Projected Enterprise Yield</u>	<u>EPS Growth 3-Year</u>	<u>Current P/E Ratio</u>
ADP	A+	5.0%	10%	16.9
Coca-Cola	B+	4.8%	11%	18.6
GE	A+	6.0%	12%	14.1
Genzyme	B+	3.4%	18%	18.7
Medtronic	A-	5.6%	15%	15.9
Microsoft	B+	5.5%	14%	15.3
PepsiCo	A+	4.5%	11%	17.6
P&G	A	5.7%	11%	17.5
Staples	B+	6.6%	15%	14.2
State Street	A	5.9%	14%	15.1
Top 10 Average	A-	5.3%	13%	16.4