

MEASURING CASH CREATION AND FLOW

Hunting for Cash Creation

James P. Weston

Professor of Finance

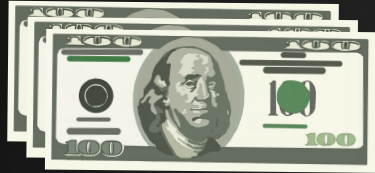
The Jones School, Rice University

HUNTING FOR CASH

► Earnings \neq



► Accruals \neq



► Book value \neq market value

► Accounting cost \neq economic cost

ACCOUNTING EARNINGS

- ▶ You cannot spend earnings
- ▶ Noncash expenses
- ▶ Extraordinary items
- ▶ Balance sheet changes
- ▶ We must find cash flow!

CASH IS KING!

- ▶ Only cash matters in the end
- ▶ Not all cash is paid out
- ▶ Need a measure of cash creation
- ▶ Consistent over time and across firms
- ▶ Free Cash Flow (FCF)

FREE CASH FLOW (FCF)

- ▶ Working capital
- ▶ Depreciation (non-cash)
- ▶ Capital expenditures
- ▶ Asset sales (salvage, terminal)
- ▶ Taxes

FREE CASH FLOW (FCF)

$\text{FCF} = \text{Operating Profit (after tax)}$

– Increase in WC

+ Depreciation

– Capital expenditure

+ After-tax salvage value

SUMMARY

- ▶ NPV, IRR, etc. based on cash
- ▶ Cash creation will drive valuation
- ▶ Measuring FCF is paramount