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The multiplier effect of free cashflow

At Allan Gray, our investment team is required to perform a thorough analysis of companies' financial statements as part of the research to establish the intrinsic value of any company. The intrinsic value of any company can be defined as the value in today's money of all the expected future free cashflows that the company is likely to generate. The research effort would thus include a detailed examination of a company's historic cashflow generation and an assessment of the future cash generating ability of the company.

In general, we place a higher value on companies that can generate superior, sustainable free cashflow over long periods of time. Free cashflow can be described as the cashflow that a company generates in a given period from its operations less the capital expenditure required to sustain the current level of cashflow generation.

Free cashflow = cashflow from operations - maintenance capital expenditure.

Why would an investor want to pay more for free cashflow?

Companies that generate substantial free cashflows have scope to increase returns to investors, either through the payment of dividends or by reinvesting these cashflows into activities or businesses that will generate even more free cashflow in the future.

The multiplier effect

Companies that operate in high-growth industries typically find that the biggest constraint to growth is lack of capital. However, if these companies have established operations that are generating substantial free cashflows, these cashflows can be re-invested in funding or acquiring high-growth businesses that will generate even higher free cashflows in the future.

The MTN example

MTN is a good example of a company that has used its established business in South Africa to invest in growing businesses in the rest of Africa and more recently in the Middle East. The South African operation generated around R400m of free cashflow in its 1998 financial year, four years after its inception. MTN South Africa currently generate in excess of R2.7bn in annual free cashflow and this has enabled the group to expand into the rest of Africa, most notably Nigeria, where it currently generates in excess of R1bn of free cashflow after only four years of operation. The strong cashflow generation of the group has enabled it to assume substantial debt on its balance sheet and acquire high-growth operations, culminating in the recent take-over of Investcom, the Dubai-listed mobile operator with operations in Africa and the Middle East.

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