

free cash flow in real terms. Yet the consequences for value creation are not immediately evident from common financial performance indicators, such as operating margin and return on capital. The problem is that accounting doesn't handle inflation very well: depreciation and amortization tables were built for low-inflation times.

Consider the following example: the (illustrative) financials of a company that started out in year one and two with stable sales, at a constant operating margin (EBITA/sales) of 10 percent, and a constant ROIC of 10 percent. As a result, its free cash flow (FCF) is \$100 per year. Projecting unchanged cash flows into perpetuity and using a cost of capital of 10 percent represents a company value of \$1,000. However, to remain stable in real terms, the

company's free cash flows must keep pace with inflation (Exhibit 1).

Financial professionals will spot the challenge: net property, plant, and equipment (NPPE) and depreciation are based on historical purchase prices and, during high-inflation times, increase at much lower rates than they do in periods of lower inflation.³ If a company can't fully pass on these expenses, free cash will suffer. Merely treading water on operating margins means that a company drifts backward; to keep up, it needs to (in this example) grow margins and returns on capital at 11.1 percent and 12.3 percent, respectively. That impressive feat merely ensures that free cash flow grows at 10 percent and stays constant in real terms.

Exhibit 1

When inflation is persistently high, free cash flow is a better indicator of performance than EBITA or ROIC.

Company key performance metrics, inflation adjusted, illustrative

	Year 1	Year 2	Year 3	Year 4	Year 16	Year 17
Sales, \$	1,000	1,100	1,210	1,331	4,177	4,595
EBITDA, \$	225	248	272	299	940	1,034
Depreciation, \$	-125	-125	-126	-128	-265	-291
EBITA, \$	100	123	146	171	675	743
Gross property, plant, and equipment, \$	1,875	1,888	1,914	1,955	4,369	4,806
Cumulative depreciation, \$	-875	-875	-876	-878	-1,537	-1,691
Invested capital, \$	1,000	1,013	1,038	1,077	2,832	3,115
EBITDA, \$	225	248	272	299	940	1,034
Capital expenditures, \$	-125	-138	-151	-166	-522	-574
Free cash flow, \$	100	110	121	133	418	460
EBITA growth, %	0.0	22.5	19.5	17.4	10.1	10.0
EBITA/sales, %	10.0	11.1	12.1	12.9	16.2	16.2
ROIC, %	10.0	12.3	14.5	16.6	26.2	26.2
Free-cash-flow growth, %		10.0	10.0	10.0	10.0	10.0

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³ NPPE and depreciation will only gradually reflect inflation over the next years when assets are replaced at higher prices. In this example, the NPPE asset base is in steady state with a lifetime of 15 years.