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Forget Free Cash Flow...

...as a period performance measure

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What do Avery Dennison, Boston Scientific, Hasbro, and Pitney Bowes have in common? Each uses Free Cash Flow (FCF) for executive incentives[1] to "align pay with shareholders". More and more, companies use FCF, a measure of operating profit after tax, capital expenditures and other investments in the business, to measure period performance and this may have disastrous long term implications.

The rationale is logical - FCF is used in discounted cash flow analysis and it recognizes capital spending. However, FCF is flawed for period performance because it front loads the charge for the entire investment into one year, requiring an immediate full payback. Then beyond that first year, the investments appear free, having already been "expensed" in FCF.

Free Cash Flow remains appropriate for investment analysis when discounted over the life of a project (e.g., Net Present Value) but is unsuitable for evaluating period performance.

Seeking to maximize period FCF risks "quick wins" through the deferral or avoidance of investment rather than the more difficult but enduring paths of increasing revenue, improving asset utilization and/or expanding margins. Over time, companies that maximize period FCF often find themselves under-investing in and more likely to experience low growth and erosion of competitive advantages.

Free Cash Flow Yield

Recently, some analysts, investors and companies have emphasized Free Cash Flow Yield as a better measure of shareholder return. This further clouds the picture and provides counterproductive signals. Consider a company that is expected to make a desirable $200 MM investment, but they cancel it to increase FCF. Investors react negatively reducing the market capitalization. The higher numerator and lower denominator improve FCF yield in two ways, but is this a wise decision?

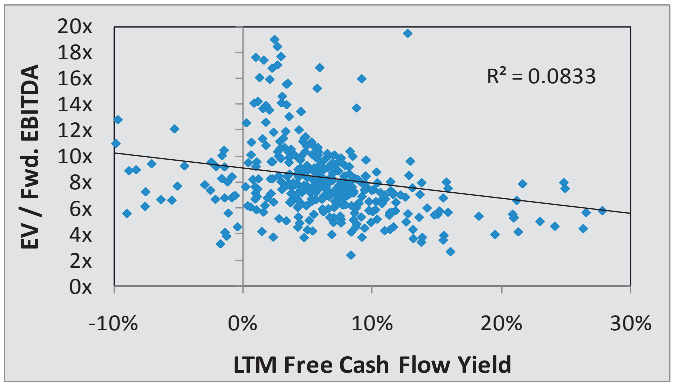
No! In this instance, investors bid up the share price as they anticipated the investment to create value despite a short term FCF decline. The share price declined when the investment was cancelled, but if FCF were used for performance measurement, bonuses may have increased.

Such a large transparent "cause and effect" example is not the norm. What is more common is a systematic underinvestment in the business via a myriad of small decisions as management focuses on maximizing period FCF and FCF Yield. Often even high return businesses don't invest enough to protect current FCF.

What Investors Say vs. What They Do

It is easy to see how executives turn to FCF as a period measure given what investors say. Popular investor/investing websites are packed with commentary like *"FCF presents the truest sense of shareholder return"* and *"FCF Yield provides a good sense of a business' ongoing return on investment."*

So shouldn't FCF and FCF Yield be a focus of management? We subscribe to the Margret Mead axiom that "what people say, what people do and what people say they do are entirely different things." Rather than listening to what investors say, it is more important to look at what they actually do. Our equity capital market research shows that there is no statistical relationship between FCF Yield and market valuation.



Although the poor statistical fit renders this relationship useless, it is interesting that the slope is downward. The highest FCF Yield companies have low EBITDA multiples and, anecdotally, it seems the high FCF yields are achieved by harvesting assets and effectively running the business down over time. For most companies, using FCF of FCF Yield in incentives may encourage behaviors that drive down the share price. Perhaps more important than multiples, the companies with the highest median long term total shareholder returns (5 year TSR) consistently have the lowest 5 year average FCF Yields (Quartile 1).

Quartile		I	II	III	IV
2008	FCF Yield	3.1%	3.7%	4.6%	4.3%
	5 Year TSR	394%	141%	69%	1%
2009	FCF Yield	4.2%	4.4%	4.7%	5.3%
	5 Year TSR	102%	35%	-7%	-47%
2010	FCF Yield	3.8%	4.9%	5.5%	6.5%
	5 Year TSR	121%	41%	8%	-29%

Investors appear to recognize the value of good investments even when they reduce current FCF, despite what they "say".

Conclusion

It's often said "What gets measured gets managed" so companies that aim to maximize period FCF are more likely to under invest and become competitively disadvantaged over time.

Management should select performance measures that align with the interests of shareholders, are consistent across management processes, and encourage managers to behave more like long term committed owners.

Fortuna Advisors developed a simple and accurate shareholder value metric called Residual Cash Earnings (RCE) that mitigates the pitfalls of FCF by spreading the recognition of value out more smoothly over the life of the investment, all in "one key internal measure" that:

- Demonstrates a strong empirical relationship with long term shareholder value.
- Encourages the right accountability for capital to balance the growth and return trade-off.
- Simplifies, aligns and improves all financial management and decision making processes.

See "Postmodern Corporate Finance", in the Spring 2010 Morgan Stanley *Journal of Applied Corporate Finance* for more on RCE.

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[1] Companies identified based on recent SEC Proxy Filings

[2] Graphics based on Fortuna Advisors analysis using CapitalIQ data using the S&P 500. TSR's are five year compound returns ending in the year noted.