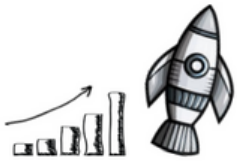

Free Cash Flow

Free cash flow (FCF) is the amount of cash a company can generate after paying its operating expenses and capital expenditures. Free cash flow is essential because it shows the investor how good the company is at generating cash and if the company has enough cash to distribute a dividend or buy back shares. There are a few ways to calculate cash flow, but for simplicity, we will use operating cash flow in our method. Let's use an example of a theoretical company called ABC Inc. ABC Inc. has $2 million in cash flow from operating activities and $1 million in capital expenditures. ABC Inc. will have a free cash flow of $1 million.

We know that ABC Inc. will be able to execute specific goals. Depending on their goals, they may be able to deliver a dividend to shareholders, buy back shares, pay back the debt they owe, or shore up other operations. As investors, we know that growth in free cash flow is often an indication of increased earnings. With those goals and benefits in mind, we must understand that declining free cash flow is not necessarily bad. Let's say ABC Inc. is paying back money to its suppliers faster than usual and collecting money from its customers simultaneously- their free cash flow will likely decrease. We know paying back suppliers faster is good, but a decrease in free cash flow may scare investors. Investors need to understand the mechanics of free cash flow and read management's plans to understand the impacts of free cash flow. Free cash flow can be on a per-share basis. For example, if ABC Inc. has 1 million shares outstanding and $1,000,000 in free cash flow, we would know the FCF per share is $1. We can compare this to the market price to understand the valuation of the business.

When looking at FCF, it's important to understand how much of the capital expenditures are maintenance capital expenditures versus growth capital expenditures. If a company is investing aggressively, its current FCF may be low because growth capital expenditures are high. But if those growth expenditures are done well, it might mean that FCF in the future will grow and be much higher than it is today. And on the other hand, for a business that has no growth prospects, FCF may be high today but be on the road to decline in the years ahead. So, it's good to count the cash and look at FCF for a business, but it's also important to try and understand the trend in FCF going forward.