

CASH IS KING

by Alexander Davidson
author of
"How to win in a
Volatile Stock Market"

Market professionals are making fortunes buying stocks at bargain prices and holding these until the market sends the share price soaring. But how do they spot the bargains in the first place?

As I explain in my new book "How to Win in a Volatile Stock Market", a little ratio analysis helps. Earnings-related valuation is useful, but an understanding of the company's cash position is crucial.

The usual way in which beginners value a company is by the Price Earnings Ratio (PER). This represents the share price, divided by current or prospective earnings per share. Earnings per share, however, is derived from after tax profits that are typically manipulated, and this will distort the PER.

There are many ways in which the distortion process happens. Tax payable in a given year can often be changed. Expenses can be smoothed. If the depreciation period for assets is lengthened, the percentage write-off of depreciation to the profit and loss account will be proportionately less in any given year, which enhances profits.

Undoubtedly, profits are opinion. In contrast, cash is fact. This is because you cannot disguise or alter how much hard cash a company has.

SO HOW DO YOU MEASURE CASH FLOW?

Let me introduce you to a very useful little ratio. This is to divide cash flow per share by earnings per share. You can obtain these figures from the company's financial statements, or the reference book REFS calculates the ratio for you. If the result is more than one, you will have pinpointed likely value in the underlying company. It is quite rare that cash flow is higher than earnings.

If you are valuing telecoms (or other capital intensive) companies, there is another ratio in vogue. This is enterprise value (market capitalization plus debt less cash) or EV, divided by earnings before interest, tax, depreciation and amortisation (EBITDA). The ratio conveniently ignores interest payments for these companies' huge borrowings. It is essentially a cash flow-related ratio, which is very useful, although not formally recognised by accountants. As telecoms companies often do not have positive earnings, there are no earnings per share, and so no effective PE ratio.

With Internet companies – the recent darlings of the stock market – various valuation methods are in use including sales per share, and eyeballs (visitors to the web site) per share, both of which measure turnover rather than cash flow. But as recent Internet company failures such as online

clothes retailer Boo.com will testify, lack of cash can close down a company.

Ultimately for this reason, if you are buying a company that operates in the new economy, it is crucial not to ignore cash flow. This is so, even if the market values the company on the basis of the business model, of market share, or something else far removed from cash. Let me give you an example. In November 1999, I recommended that readers of Vanguard Investor, a high-tech tip sheet for which I was writing, should buy shares in Geo Interactive Media, an Israeli broadband company quoted on the London Stock Exchange, at 300p.

The attraction of the company was certainly not its profits or its track record, neither of which were much. It was its business model, and the fact that it was a leader in the field of streaming technology, which speeds up the transfer of so-called rich media, mainly video and sound material, via the internet. But I also checked out the company's cash situation. Geo Interactive was spending US\$1.2m a month on a basis of US\$21m net cash. At that rate, its cash burn would last until the end of 2000.

However, plenty of cash-enhancing deals lay ahead, and Geo Interactive's prediction that it would soon be cash-positive seemed plausible. Sure enough, in October 2000, the company reported that it had net cash of US\$381m, partly as a result of an acquisition strategy in the first half of this year – taking full control of Orca Interactive and Zapex Research – that enhanced cash flow. In the year since I had recommended the stock, it had risen in value from 300p to 1400p.

DISCOUNTED CASH FLOW ANALYSIS (DCF)

The big advantage of DCF analysis is that it values a company according to the one item that cannot be fudged, its cash. It is always worth checking cash flows, present or prospective, against earnings-related valuations for the equivalent period, as they may tell a different story. In addition, DCF analysis has an advantage in that it measures the time value of money. This translates prospective cash flows into present value.

If you are to conduct your own DCF analysis, you must first find the net operating cash flow (NOCF). This involves taking the company's earnings before interest and tax (EBIT). Deduct



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from this corporation tax paid and capital expenditure. Add depreciation and amortisation, which do not represent a movement of cash outside the company. Then add or subtract the overall change in working capital, including movements in stock, in debtors and creditors, and in cash or cash equivalents.

The result is the NOCF for this year. You should also calculate this for future years. This way, you will gain a picture of the likely future financial performance in terms of cash availability, as opposed to the less reliable measure of earnings. Obviously, cash available next year is worth less in present day terms than if it was available this year, due to inflation.

In addition, cash flow will continue into the future, beyond the say five or ten years over which the discounted cash flows are spread. The cash flows covering the period beyond are known as the terminal value, and, without evidence to the contrary, are assumed to extend into infinity. Present and future cash flows and terminal value combined make up a company's present value.

The DCF method is not perfect. In discounting future cash flows, you will not necessarily come up with an accurate net present value. The accuracy will depend both on how reliable are the forecasts used for NOCF, and how many years are included in the DCF analysis. Also crucial is the rate at which you discount the cash flows. The larger this is, the smaller is the net present value of future cash flows. The discount rate - also known as required rate of return - can be compared with the same figure for other investment proposals.

HOW DO YOU SELECT AN APPROPRIATE DISCOUNT RATE (OR REQUIRED RATE OF RETURN)?

One way is to use the same rate as comparable companies use. However, this method has proved unreliable because it is hard to make accurate comparisons. A more reliable method - widely used by professional investors - is to use the company's weighted average cost of capital (WACC) as the discount rate. So what is the WACC?

Generally, companies raise their capital through equity or debt. The WACC represents the cost of capital to the company weighted in terms of debt and equity. We can break down the WACC into its two components. First, the cost of debt is the current yield to maturity on the company's bonds. Second, the cost of equity is commonly measured by the Capital Asset Pricing Model (CAPM - pronounced CAPEM).

The CAPM is widely used but controversial. It assumes that investors should be rewarded for acquiring investments that carry a larger amount of "market" risk that cannot be diversified away. A share's market risk is measured by beta, which is a historical figure and therefore not always reliable. Therefore, a portfolio of high beta stocks does not always outperform one of low beta stocks, although it has been argued that beta works better over a period (decades rather than years) or at times of major share price fluctuation such as during a market crash.

With the unreliability of the CAPM contributing to uncertainty about what is the right discount rate, many analysts plot a range of DCF models using several discount rates. This way, they can present some alternatives. Even then, some analysts abuse DCF analysis to paint an over-optimistic picture of a favoured company's prospects, or the reverse for those of its competitors.

The message is clear. DCF analysis is valuable, but do not rely only on this - or any other valuation method - when you are valuing a company. Also be aware of valuation methods specific to sectors. For property companies, investment trusts and insurance companies, DCF is less relevant than net asset value per share. In the case of biotechnology or pharmaceutical companies, check out the research & development expenditure.

For Internet companies, check the strength of the business model, and whether it is unique and properly patented. This can be more important than their cash flow at an early stage, as it will take time to get contracts with business partners and clients. If you want to find out more about valuing companies, read my new book, in which I provide my e-mail address in case you have queries.



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