For professional investors

ROBECO
The Investment Engineers

Cash is a fact, earnings is an opinion

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Contents

Intro

- To get the best estimate of how a company is doing, our Global Equity analysts look at free cash flow rather than earnings. Earnings can be 'managed' in the balance sheet, cash is what it is.

- In this paper we will explain the difference between earnings and cash. We will show why we are convinced that free cash flow yield is an effective discriminating factor when identifying the stocks with the best promise of outperformance.

Robeco's Global Equity team uses free cash flow to screen the universe for the most attractive investment candidates for further fundamental analysis. There are many reasons to use free cash flow as one of the main variables for this screen. Firstly, being able to generate free cash flow is an enviable quality of a company and an indication of a viable business. If the company runs a cash deficit on its activities over a period of time, it will sooner or later require external funding. Secondly, a company uses capital expenditure to attain its growth and margin ambitions. If less capital expenditure is needed to attain the same growth and margin targets this is a good thing. The management of the company is using the scarce resources in an efficient manner to create value for shareholders. Thirdly, the amount that remains after operating expenses and taxes can be freely used to pay interest on debt, pay down debt, acquire assets, pay dividends or buy back stock. All with the promise of increasing the value for the shareholders.

In this paper, we will first present the concept of free cash flow. What definition do we use, how do we calculate free cash flow? In the appendix we will give a more detailed description of the accounting concept of cash flow. Then we will discuss the research on the topic. Does the selection of stocks on the basis of free cash flow lead to the promise of outperformance? Subsequently, we will touch on some cases where cash flow can be managed towards a favorable outcome in the short term, but have doubtful sustainability in the long term. Finally, we will discuss the advantage of focusing on cash rather than earnings. Cash is a fact, earnings is an opinion.

The concept of free cash flow

There are three types of cash flow: cash flow from operating, investing and financing activities. We will explain them and show why earnings is not the same as cash.

We believe that free cash flow gives an accurate insight into a company's ability to generate cash and real profits.

When looking at the cash flow statement of an individual company one often sees three categories of cash flow: operating, investing and financing. What is the cash that results from operating the existing assets? What is the cash deployed in investments? And how is that financed?

Table 1. Cash flow statement

Cash flow from operating activities	
	Revenues
-/-	Cost of goods sold
-/-	Selling, general & administrative expenses
	Operating income (EBIT)
-/+	Additions/ reductions in working capital
-/-	Tax payable
Cash flow from investing activities	
-/+	Purchases and sales of assets
-/+	Acquisition and divestments
Cash flow from financing activities	
-/+	Interest paid or received
-/+	Repayment or issuing of loans
-/+	Dividends paid or received
-/+	Share buyback or issuance
Increase/ decrease in cash position	

Source: Robeco

Cash flow from operating activities | The starting point for cash flow from operating activities are a company's revenues. When we deduct the cost of goods sold (Cogs) from the revenues, we obtain the gross profit. Note that the Cogs do include direct labor costs, depreciation and amortization. Gross profit minus the selling, general & administrative (SG&A) expenses gives the operating income or EBIT (earnings before interest and tax). Subsequently, we consider the additions to the working capital. If a company has added to the working capital, it has made an extra investment in the operating business. When we deduct these additions and taxes payable from operating income, we arrive at the cash flow from operating activities

Operating cash flow focuses on cash inflows and outflows related to a company's main business activities, such as selling and purchasing inventory, providing services and paying salaries and taxes.

Cash flow from investing activities | Cash flow from investing has to do with the purchase or sale of capital goods. This can take any form, ranging from buildings, factories and equipment to software or the acquisition of another company. For investing activities one can make a distinction between capital expenditure (capex) for maintenance purposes or for growth purposes. Maintenance capex is spent to maintain the existing cash flow generation capacity of the company, while growth capex is spent to generate new sources of cash flow. One can estimate maintenance capex by equating it with depreciation. By doing so one can better compare companies with a high growth profile with companies with a low growth profile. Even better is to make your own estimation. Take the easy example of a pipeline company that depreciates its assets over an economic life of 20 years. In this case the actual maintenance capex is much lower than the depreciation.

Cash flow from financing activities | Finally, the cash flow from financing activities is related to the acquisition of the money needed to finance it all: interest paid or received; dividend paid or received; loans issued or repaid; shares issued or buybacks.

Free cash flow | Cash flow is the net amount of cash and cash-equivalents moving into and out of a business. Positive cash flow indicates that a company's cash balances or liquid assets are increasing. This enables the company to internally fund investments in its business, to pay off its debts or return money to shareholders. The cash can also provide a buffer against future financial challenges. For example, semiconductor companies that operate in a cyclical environment tend to have higher cash balances to provide for darker days.

Free cash flow (FCF) is a measure of a company's financial performance, calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able to generate after spending the money required to maintain or expand its asset base. FCF is important because it allows a company to pursue opportunities that enhance shareholder value.

FCF = EBIT (1-tax rate) + (depreciation) + (amortization) - (change in net working capital) - (capital expenditure)

Earnings are not the same as cash | A lot of investors focus on the earnings development, which may give a different picture than the cash flow development. Net earnings or net income include accounts receivable and other items for which payment has not actually been received. Items that have not yet been paid for are not included in cash flow.

'Earnings are not the same as cash'

Under accrual accounting, expenses are matched with the related revenues and/or are reported when the expenses occur, not when the cash is paid. The result of accrual accounting is an income statement that measures a company's profitability rather than the cash movements resulting from operations, investments or the financing of the company’s activities. The accrual accounting method allows companies to count credit as part of a company's income. ‘Accounts receivable’ appear as line items in the assets part of a company's balance sheet, but do not represent completed transactions for which payment has been received. They do not, therefore, count as cash.

We look at operating cash flow as the distinguishing factor. If a company were to sell operational assets for cash, this cash is not part of our free cash flow definition. Selling operating assets that make money will lower future operating cash flow.

We believe that free cash flow gives a better insight into a company’s ability to generate cash and real profits. In analyzing and forecasting it is important not to restrict oneself to one year. Free cash flow that is negative in one year can still turn positive if a large investment is made that will raise future cash flow and generate a high return.

Academic research on cash flow

The landmark study that drew attention to the importance of distinguishing between reported earnings and the cash generated by a firm was done by Sloan (1996). Later research by Bernstein shows that free cash flow yield is a strong variable to forecast outperformance. This research is confirmed by Robeco Quantitative Research.

Cash flow was already included in the research articles that followed or coincided with the famous Fama & French research article 'Cross-section of Expected Stock Returns" of 1992. In the early 1990s, studies focused on the value premium, where Cash Flow to Price (CF/P) was one of the factors being researched (e.g. by Chan et al (1991). In the mid-1990s research by Lakonishok, Shleifer and Vishny (1994) found that the Cash Flow/Price ratio beat the Price/Earnings ratio in terms of efficacy.

The landmark study that drew attention to the importance of distinguishing between reported earnings and the cash generated by a firm was done by Sloan (1996). According to Sloan, the market failed to make this distinction and this was key to finding overvalued and undervalued firms. Sloan showed that investors did not distinguish between accruals and the cash components of earnings. A portfolio that went long stocks with higher levels of the cash component, and short the stocks with high levels of accruals was able to generate a superior return.

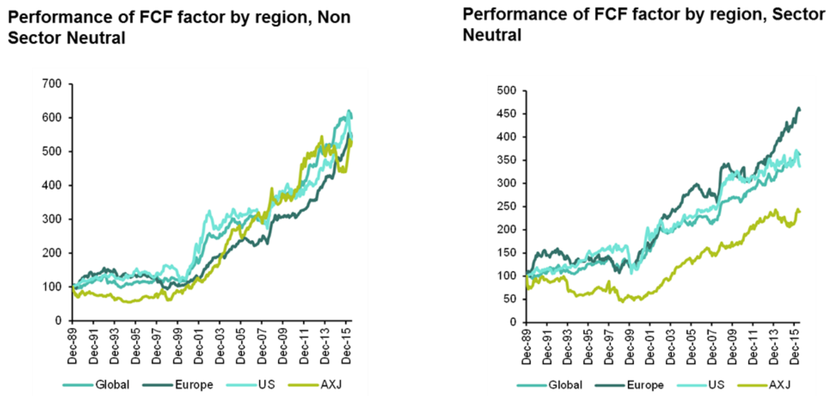
More studies followed, both on the 'accruals anomaly', and on free cash flow indicators as a guide to the firm's future performance. For instance, Hackel et al (2000) found that a combination of trailing free cash flow and upper bounds for free cash flow multiples formed the basis of an effective long-only stock selection strategy which beat size- and beta-adjusted market portfolios in the US.

Most studies – of which, interestingly, there have been relatively few - found that FCF indicators - which are harder for firms to manage than earnings - had significant predictive ability in forecasting stock returns.

Bernstein: Free cash flow is king | Internal research at Robeco also confirmed the forecasting capabilities of FCF yield. And these studies are confirmed by Bernstein research, that hailed free cash flow in a recent study called 'Free Cash Flow is King'.

In this Bernstein study, free cash flow was defined as Net Operating Cash Flow less Capital Expenditure. The universe for the study consisted of the 500 largest stocks in the MSCI All Countries World Index, starting in 1990 until the beginning of 2016. The portfolio was constructed by going long the top quintile of stocks ranked by the (trailing) free cash flow yield (FCFY) and short the bottom quintile. The study was conducted on a global basis, but also on a regional basis for Europe, US and the Pacific. The portfolios were rebalanced quarterly. FCF yield was looked at from both a sector neutral and a non-sector neutral basis. The outcome of the study was impressive, to quote Bernstein. The FCFY factor generated average annualized excess returns of 7% per year in the non-sector neutral version and 5% in the sector neutral version.

Figure 1 | Performance of free cash flow factor by region

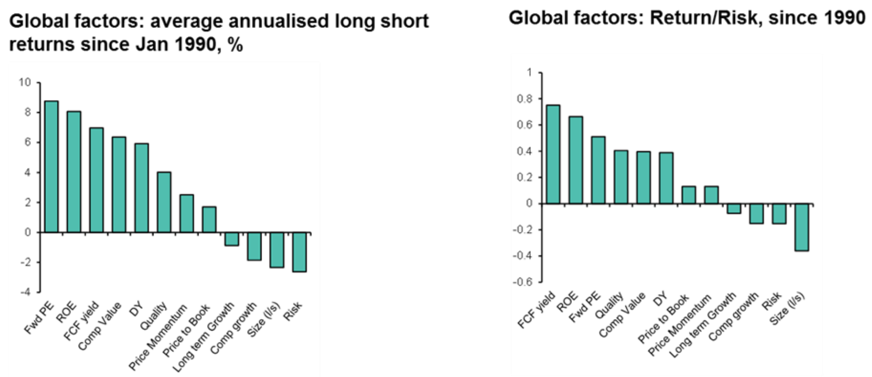


Source: IBES, Factset, Bernstein analysis

An important aspect to mention is that financials were excluded, as well as auto companies (because of their large financial lease portfolios). In the Robeco studies the financial sector was also excluded. We did use other factors (based on other value metrics) to rank the financial universe.

Compared with other factors, FCF Yield also shows good results in the Bernstein study, especially when taking in to account volatility.

Figure 2 | Global factors, return and risk



Source: IBES, Factset, Bernstein analysis

Note that the other value variables - Forward Price/Earnings, Composite Value, Dividend Yield and Price to Book – are all tested on a universe including financials, while the FCF yield test excludes financials from the universe. When comparing apples with apples and also excluding financials for the other variables, the FCF yield results in terms of information ratio improve compared with the other variables.

Table 2. FCF yield factor by region: return/risk since 1990

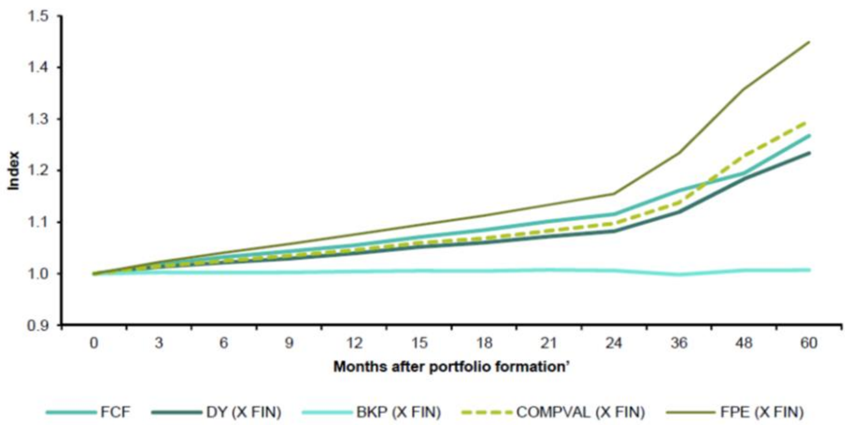
	Non sector neutral				Sector neutral			
	Global	Europe	US	AXJ	Global	Europe	US	AXJ
Average annualized return	7.0	6.6	6.5	6.5	5.0	5.9	4.7	3.3
Annualized volatility	9.3	9.4	11.1	14.1	8.1	9.6	10.2	15.1
Return/risk	0.75	0.70	0.59	0.46	0.62	0.61	0.46	0.22

Source: IBES, Factset, Bernstein analysis

'Research shows that FCF yield is a promising factor for creating alpha'

When looking at the investment horizon or the holding period of the strategy, Bernstein finds that free cash flow yield has better cumulative long-short returns than all other value factors apart from forward P/E on all investment horizons up to three years. Figure 3 shows the results. Cumulative long-short returns are indexed to 1 at the time of portfolio formation.

Figure 3 | Performance of value factors over different investment horizons



Source: IBES, Factset, Berstein analysis

The research done by Bernstein therefore shows that FCF yield is a strong variable to forecast outperformance. This research is confirmed by Robeco Quantitative Research.

Taking a deeper dive

Our analysts are very much aware of the possibilities of earnings 'management'. To detect earnings management there is one overriding principle: Cash is a fact, earnings are an opinion.

To get the best estimate of what the company is making, we use a cash metric rather than an earnings based metric.

In our Global Equities investment process, the FCF yield is only the beginning as it is part of a first screening. This first screening is done to generate ideas for the portfolio. The portfolio manager and the analyst discuss these ideas and subsequently set the research agenda.

In a subsequent stage, our fundamental equity analysts take a deeper dive when making the investment case. They take a second look at the accounting to check whether the historical FCF generation was at a sustainable level or substantially impacted by short-term and/or one-time factors.

Examples of such occasions are:

1. Timing of operating activities. The company can increase sales and cash flow by selling products at a discount. An increase in sales for this purpose can be detected in a decrease in gross margin (because of discounts) or a decrease in inventory days.
2. Underinvestment. A company can decide to reduce capital expenditure to improve earnings and free cash flow. To track whether the company is not underinvesting, one can look at various measures over time: capex to sales; capex to depreciation (if available, an even better metric would be to track maintenance capex to depreciation) and the book value of Property, Plant & Equipment (PP&E) versus the historical cost price of PP&E.
3. Difference in calendar weeks. It can make a big difference for a year over year cash flow comparison if the number of days in a company's fiscal calendar year varies from one year to another.

Preference of cash flow metrics to earnings metrics | The analysts are very much aware of the possibilities of earnings management. Earnings management can be defined as using the flexibility within accounting to manage the measurement and presentation of the accounts so that they serve the interest of preparers.

Earnings management can be done in several ways: increasing income or decreasing expenses, or overstating assets or understating liabilities. Here we will discuss some examples of earnings management and ways to detect them:

1. Premature income recognition: the company recognizes revenues before the services and products are actually delivered to the customers. It's important to know what to look for in the accounts and ask for explanations by management or investor relations. An indication can be whether the amount of account receivable days has increased or any deferred revenues have been booked over the accounting period.
2. Fair value accounting. There are several ways to determine the price of an asset or liability at fair value. Fair value estimates can be done at three levels. Pricing at level 1 means there is a quoted market price for the asset or liability; pricing at level 2 means

> 'Earnings management uses the flexibility in the accounting framework. It can be misleading but is not illegal'

that the asset or liability is not quoted, but the price can be implied from other comparable assets with the same volatility characteristics; pricing at level 3 means there is no price nor a comparable alternative, so the price is determined by the discretionary assumptions from management. It's important to find out whether the company applies pricing at level 3 for value accounting. Note that restating the fair value of an asset or liability also influences the income statement. Upward revaluation of assets can increase earnings, downward revaluations of liabilities can also increase earnings.

3. Capitalizing practices. To improve earnings (and especially Earnings Before Interest, Taxes Depreciation and Amortization – EBITDA) a company that previously expensed costs (like software development or other IT costs) starts capitalizing these costs. Questions to ask are: Has the company changed its accounting policies? Are there unexplained jumps in the EBITDA margin?
4. Cookie jar accounting. To smooth earnings a company creates provisions in periods of strong earnings and releases them when earnings are low. Where to look for in the accounts? Are the additions and releases to provisions volatile?
5. Timing of operating activities. To realize promised sales and earnings targets, a company can increase production just before year end to increase earnings. Or the company can increase sales/earnings by selling products at a discount. An increase in production for this purpose can be reflected in a higher gross margin (more production over the same fixed costs) and an increase in inventory days. An increase in sales for this purpose can be detected in a decrease in gross margin (because of discounts) or a decrease in inventory days.
6. Acquisition accounting. Is the amount of goodwill recognized fair? A company can overstate the amount of goodwill when acquiring another company. Goodwill is subject to impairment testing and thus subjective. By valuing goodwill and fixed assets low, the amount of depreciation is lowered and earnings are higher.

There are many more possibilities for a company to manage earnings. Let's illustrate this with the example of a company that used some of these techniques to manage its earnings. Company X constructed a deal to buy coal over the coming 20 years at a discount to the market price of coal. For the early years of the contract there was a market price, for the outer years management had to make a fair value assumption for the coal. There was value in the contract because the coal was bought at a discount. This value was put on the balance sheet and made its way via the income statement into retained earnings and consequently into the equity of the company. With the contract the company beefed up earnings and equity, based on level 3 fair value accounting.

In the balance sheet of the company we saw a steady increase in the fair value of commodity contracts on the balance sheet over time. The company reported a steady net profit figure over these years , while operating cash flows were erratic and clearly lagged behind earnings.

'To get the best estimate of how a company performs, use a cash metric rather than an earnings based metric'

Conclusion | To detect earnings management there is one overriding principle: Cash is a fact, earnings are an opinion. To get the best estimate of what the company is making use a cash metric rather than an earnings based metric. When using a cash metric, free cash flow yield is an effective discriminating factor in ranking stocks with the best promise of outperformance.

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Appendix

Cash Flow from Operating Activities

Operating cash flow focuses on cash inflows and outflows related to a company's main business activities, such as selling and purchasing inventory, providing services and paying salaries and taxes.

Revenues

Operating income stands for Earnings Before Interest and Taxes (EBIT). EBIT starts with the company's revenues. Revenues are defined as the gross inflow of economic benefits (cash, receivables, other assets arising from the ordinary operating activities of an entity). Examples are the sale of goods in the case of a manufacturing company, the rendering of services by a consultancy firm, etc.

These revenues are to be measured at fair value. Fair value is defined by IFRS as the price that is received to sell a product or service in an orderly transaction between knowledgeable willing buyers and sellers. If you sell a noncurrent asset the receipts are not counted as revenues, nor are unrealized gains or upward valuations of financial instruments.

When should revenues be recognized in the accounts? There are several criteria for identifying the critical event of recognizing revenue on the sale of goods:

1. Performance criteria: risks and rewards have been transferred from the seller to the buyer and the seller no longer has control over the goods sold.
2. Collectability criterion: collection of payment is reasonably assured.
3. Measurability criteria: the amount of revenue can be reasonably measured and the cost of earning the revenue can be reasonably measured.

Revenues can be deferred or accrued. Deferred revenue or deferred income is cash received on the proceeds from a delivery of goods and services from a counterpart, where the goods and services are delivered in a later accounting period. The deferred revenue is put on the balance sheet. In this later accounting period the revenue is recognized and the deferred revenue on the balance sheet is reduced. Accrued revenues work the other way round. The goods and services are delivered now, while the cash is received in a later accounting period.

Revenue recognition has a limited impact on cash flows as the earnings effect is offset by a movement in deferred/ accrued revenues on the balance sheet, taken in working capital movements.

Operating Income (EBIT)
Deducting the Cost Of Goods Sold (COGS) from the revenues results in the gross profit. Note that the COGS do include direct labor costs. Gross profit minus the Selling, General & Administrative (SG&A) expenses gives the EBIT.

Changes in Working Capital
Working capital is defined as current assets minus current liabilities. Current assets include accounts receivable and inventory. Current liabilities include accounts payable. An increase in net working capital can be achieved by increasing receivables or other current assets or decreasing payables by paying off short-term creditors. The working capital cycle is the time it takes to turn working capital in to cash. For example, a company that pays its suppliers in 30 days but takes 30 days to collect its receivables has a working capital cycle of 30 days. These 30 days have to financed, most often by a bank loan and the cost of this loans reduces the company's profitability. If the incoming and outgoing payments balance this reduces the working capital outlay, thereby increasing the free cash flow of the company.

Tax Payable
Interest can be deducted from income before the statutory tax rate is applied. This is called the tax shield for interest: a reduction in taxable income by claiming an allowable deduction for interest payments.

There is a difference in the way profit is taxed for accounting purposes and for tax purposes. For accounting purposes we use the terminology 'accounting profit before taxes' and in the income statement a 'tax expense' will be recorded. For tax purposes we use the term 'taxable profit' and resulting 'current taxes' (also known as tax payable) will be paid to the tax authorities. To complicate matters further the differences in tax can either be of a permanent or of a temporary nature.

For example, a fine given for LIBOR manipulation is deemed not to be tax deductible and as such of permanent nature. And tax credits for innovation or costs related to implementing environmental technology are also of a permanent nature. The possibility to accelerate depreciation is of a temporary nature.

If taxation is of a permanent nature, such as tax credits for innovation, this lowers the statutory tax amount to an effective tax amount. In the income statement we see the 'tax expense' which equals accounting profit before tax, after permanent differences, times the statutory tax rate.

Temporary differences, such as accelerated depreciation, will reverse over time. For that purpose the difference between 'tax expense' and 'current tax' is recorded as a Deferred Tax

Liability (DTL) and/or a Deferred Tax Asset (DTA) on the balance sheet. For example, when an entity within the company makes a negative taxable profit, the current tax payable is put at zero, while at the same time taxable losses can be carried forward in a Deferred Tax Asset (DTA) to offset future taxable profits. For example, banks like Citi still carry a large DTA on their balance sheet resulting from losses in the Financial Crisis which can be used to offset future taxable profits.

The 'tax expense' is what is recorded in the income statement, the tax payable is the cash amount that the company actually pays in tax.

Cash Flow from Investing Activities

Cash flow from investing has to do with the purchase of new capital goods or sales of existing ones. Capital expenditures, or Capex, are funds used by a company to acquire or upgrade fixed assets such as property, industrial buildings or equipment. It is often used to undertake new projects or investments. This type of outlay is also made by companies to maintain or increase the scope of their operations. These expenditures can include everything from purchasing a piece of equipment, building a brand new factory, or buying ERP software to support the logistics of the company.

In terms of accounting, an expense is considered to be a capital expenditure when the asset is a newly purchased capital asset that improves the useful life of an existing capital asset. If an expense is a capital expenditure, it needs to be capitalized. This requires the company to spread the cost of the expenditure (the fixed cost) over the useful life of the asset. If, however, the expense is one that maintains the asset at its current condition, the cost is deducted fully in the year of the expense.

The purchase of new capital goods can also be done by acquiring other companies. For acquisition accounting there are two methods of which one is rarely used and not allowed under US GAAP or IFRS. This is the pooling or merging method, where all line items in the balance sheet, income statement and cash flow statement are added together.

The relevant method is purchase accounting. Purchase accounting is where company A buys the equity of company B. The amount that company A pays for the equity of company B minus the fair value of company B at the time of the acquisition is recognized as goodwill on the balance sheet of company A. Company A starts measuring all the assets/liabilities of company B and comes up with a fair value for company B. This fair value assessment can lead to upward adjustment of the fair value. Only identifiable assets can be restated. Identifiable means that you can sell these assets. You can sell Intellectual Property (IP) but you cannot sell persons, relationships, cost or revenue synergies.

Goodwill is the difference between the price paid and the newly assessed fair value. Goodwill reflects the future economic benefits resulting from the acquisition that cannot be allocated to identifiable assets or liabilities. Goodwill is capitalized on the balance sheet of the acquirer and is classified as a long-term intangible asset. Goodwill is subject to a mandatory annual impairment test: is the amount of goodwill still a good reflection of future economic benefits?

Goodwill cannot be amortized under IFRS. Intellectual Property can be amortized with a normal depreciation schedule.

Cash flow from Financing Activities

Finally, the cash flow from financing activities is related to the acquisition of the money to finance it all: interest paid or received; dividend paid or received; loans issued or repaid; shares issued or buybacks.

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