

Fixed Income Insight

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Executive Summary: Free Cash Flow

Free Cash Flow's Increased Emphasis in Corporate Bond Research

FCF (free cash flow) has gained stature as EBITDA (earnings before interest, taxes, depreciation and amortization) has fallen, thanks to remarkable corporate failures that EBITDA failed to pick up—failures that FCF may have detected. Enron moved costs off the balance sheet and it has been alleged that management at WorldCom intentionally manipulated EBITDA to trick investors.

EBITDA and FCF differ in two major ways:

- ▶ Unlike EBITDA, FCF deducts taxes, interest and working capital changes, and unavoidable cash outflows.
- ▶ Unlike EBITDA, FCF deducts capital expenditures, the cash equivalent of depreciation. Additionally, while EBITDA comes totally from the income statement, FCF is focused on the statement of cash flows.

In theory, FCF represents the net cash inflow to an enterprise for discretionary uses, such as debt reduction or share repurchase.

Various versions make for robust use, including FCFE (FCF for equity) and FCFD (FCF for debt-holders). FCF incorporated with industry life-cycle analysis makes it possible to readily determine whether cash flow is where it should be. A start-up company would not be expected to be FCF positive; however, negative FCF in a mature industry would prompt an analytical judgment call as to whether the negative FCF is justified. In a mature industry, we believe negative FCF is the quantitative sign of overcapacity, a recent common affliction of telecom, autos and utilities.

For a full report on James Butler's commentary regarding the increased emphasis on Free Cash Flow, contact your McDonnell Investment Management representative or call Therese Koch, Manager of Marketing Communications, at (630) 684-8600.

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