

*Cash Cows Growth Series*

# Why Free Cash Flow Margin



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# A Key Indicator of Growth Companies

- 1 Growth investing is a complex and multifaceted strategy, in which there is rarely a one-size-fits-all approach.
- 2 Free Cash Flow (FCF) is vital for financing business growth, investing in research and development, and pursuing innovation. Companies that consistently generate positive FCF may fund their expansion plans without relying heavily on external financing, making them more self-sustainable.
- 3 A high **FCF Margin** suggests that a company is efficient at converting its revenue into cash flow.
- 4 By prioritizing companies with robust FCF margins, investors position themselves to capitalize on the financial strength and the growth potential of these firms.

## Understanding Free Cash Flow

### Free Cash Flow

**Free cash flow** is the cash remaining after a company has paid:



Expenses



Interest



Taxes



Long-Term Investments

**Free cash flow** can be used to drive business growth:



Buy back stock



Participate in mergers/acquisitions



Research and Development



Marketing "Brand Awareness"



Geographic Expansion

### What is Free Cash Flow Margin?

$$FCF \text{ Margin} = \frac{FCF}{Sales}$$

**Free cash flow margin:** (FCF/Sales) measures a company's total free cash flow relative to its sales.

**Sales:** a company's revenue earned from the sales of products or services.

### Why do we like FCF Margin?

FCF is the funding source for growth.

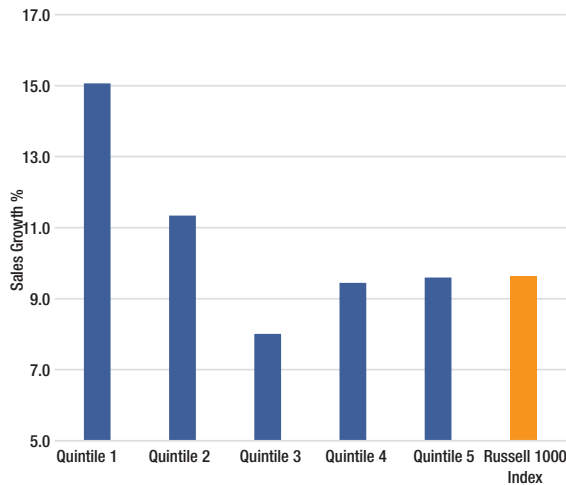
- Free cash flow is the internally sourced capital.
- FCF can be strategically allocated to endeavors such as research and development, advertising, and marketing, which are instrumental in driving business expansion and growth.
- The FCF production indicated by high FCF margin highlights a company's ability to self-finance its growth initiatives, aligning it with better growth potential.

# Why is FCF Margin Growth Oriented?

Growth stocks are typically associated with revenue growth.

The first quintile high FCF margin producers have delivered faster historic sales growth than the rest of the universe.

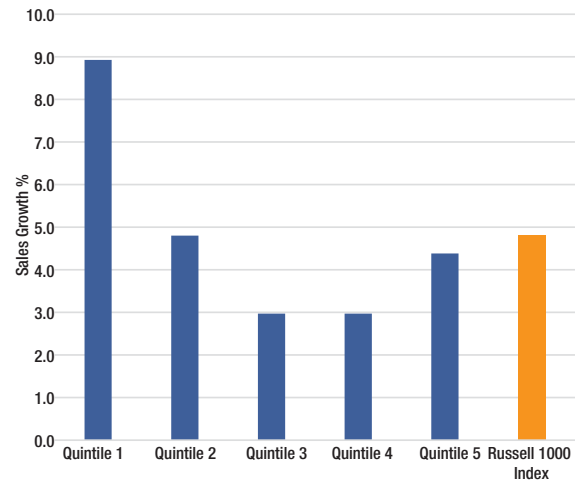
## Trailing 3-Year Sales Growth by FCF Margin (Median) as of 12/31/2023



Source: FactSet, Pacer Advisors, Russell 1000 Index

The first quintile high FCF margin companies are expected to surpass the rest of the market in terms of revenue growth over the next two years.

## Forward 2-Year Sales Growth Estimate by FCF Margin (Median) as of 12/31/2023



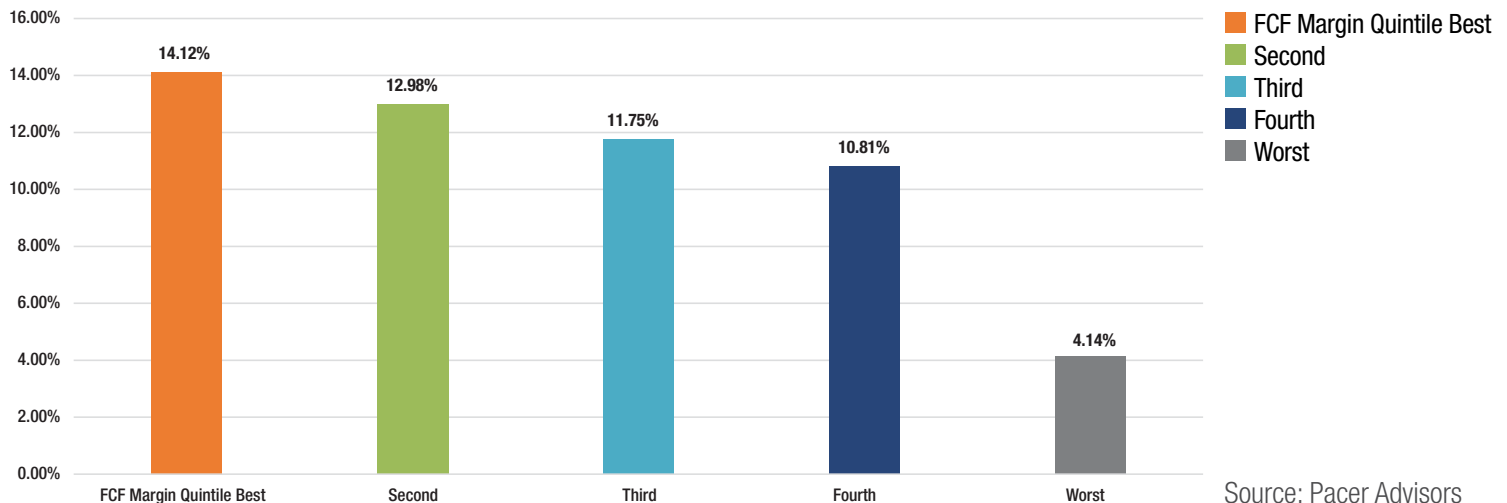
Source: FactSet, Pacer Advisors, Russell 1000 Index

## FCF margin has emerged as a pivotal factor for identifying growth opportunities.

The historical performance data strongly supports the notion that using FCF margin has led to higher returns. The top quintile of FCF margin large cap companies outperform the lower quintiles across different historical time frames. Companies with the weakest profitability, as indicated by lower FCF margins, consistently lag the broader large-cap universe.

## Annualized Returns, Stocks in Russell 1000 Index by FCF Margin Quintiles

12/31/1991 - 12/31/2023



Source: Pacer Advisors

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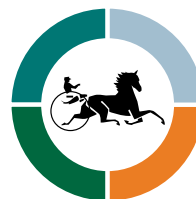
**Russell 1000 Index** is a market-capitalization weighted index representing the top 1000 large-cap stocks in the Russell 3000 Index.

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