The Power of Free Cash Flow Yield

– Michael Mack, Portfolio Manager

Valuation metrics offer investors a simple way to assess a company's worth by looking at its sales, earnings and cash flow. These metrics compare the company's value to the market's assessment of the company to determine if an investment is attractive. Let's take a look at the most commonly used valuations and explore why we believe free cash flow yield is the most valuable of them all.

A wide variety of valuations

There are many valuation metrics for investors to use. So which is best? Let's look at some of the common ones listed to the right. With the exception of free cash flow yield, a lower ratio indicates a more attractive investment. For example, a company with a share price of $29 and $1.80 in earnings per share over the last 12 months would have a price to earnings ratio (P/E) of 16.11. This company would be a more attractive investment than a company with a P/E of 18.86 ($33 share price and $1.75 earnings per share).

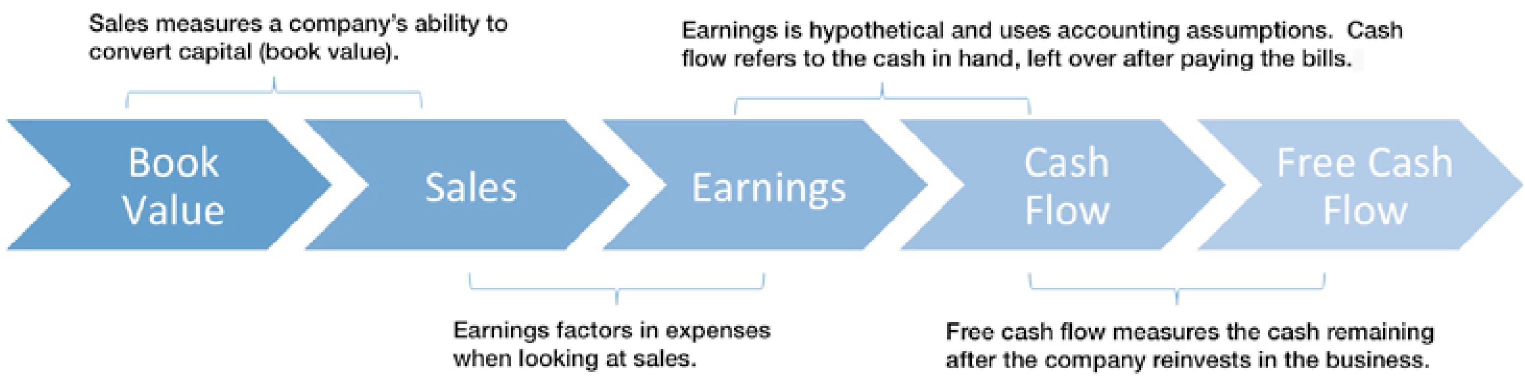
The flow of information

Putting aside the definitions, what do each of these metrics mean and what do they tell investors? Are all metrics created equal? According to Warren Buffett, they are not.

Common Valuation Ratio	How Ratio Is Calculated
Price to Book	**Price per Share** / **Book Value per Share** (Assets – Liabilities)
Price to Sales	**Price per Share** / **Sales per Share**
Price to Earnings	**Price per Share** / **Earnings per Share**
Price to Cash Flow	**Price per Share** / **Cash Flow per Share**
Price to Free Cash Flow	**Price per Share** / **Free Cash Flow** (Cash – capital expenditures)
Free Cash Flow Yield	**Free Cash Flow** / **Enterprise Value** (Market Cap + Debt – Cash)

> **"Common yardsticks such as dividend yield, the ratio of price to earnings or to book value, and even growth rates have nothing to do with valuation except to the extent they provide clues to the amount and timing of cash flows into and from the business."**
> *– Warren Buffett's 2000 Annual Letter*

As Buffett notes, free cash flow is the most important metric and other assessments merely serve as a guide to help determine free cash flow. The diagram below shows that each of these valuations builds on the information from the ones before, starting with book value and ultimately providing the most important and useful metric, free cash flow.



More on Free Cash Flow

Now that we've established that free cash flow offers us the most insight of the available measures, let's take a closer look at what it is, what it's used for and why it's important to investors.

FREE CASH FLOW

What is Free Cash Flow?

The cash remaining after the company has paid:

- Expenses
- Interest
- Taxes
- Long-Term Investments

Free Cash Flow can be used to buy back stock, pay dividends, or participate in mergers and acquisition.

What is Free Cash Flow Yield?

$$\frac{\text{Free Cash Flow}}{\text{Enterprise Value}}$$

(Market Cap + Debt - Cash)

Gauging a Company's Health

Positive free cash flow indicates a company is generating more cash than it needs to run the business and can invest in growth opportunities.

Free Cash flow (FCF) yield can determine an investor's payback period. The higher FCF yield, the lower the payback period.

FCF yield	1%	2%	5%	10%
Years to pay back all debt and equity holders	100 years	50 years	20 years	10 years

Attributes of Free Cash Flow Producing Companies

Productive

Generate more cash flow than they need to spend. Require less capital and are able to grow without external financing

Reliable

A company's free cash flow is a more sturdy measure of profitability than earnings, which are subject to manipulation and accounting assumptions.

Self Sufficient

Less reliant on the capital markets for financing. Companies in need of cash often issue stock, diluting shareholders.

Impact on a Portfolio

The below chart shows how a portfolio built on each of these metrics performed since December 31, 1991. Free cash flow yield (free cash flow/enterprise value) offered the investor the highest return and the fewest periods of negative returns. Going forward, there is no way to be sure that free cash flow yield will continue to provide the best returns. In fact, there have been market cycles where companies with high free cash flow yields have underperformed. Nevertheless, we believe there is a compelling reason to invest using free cash flow yield.

Valuation Metrics (12/31/1991 – 12/31/2019)

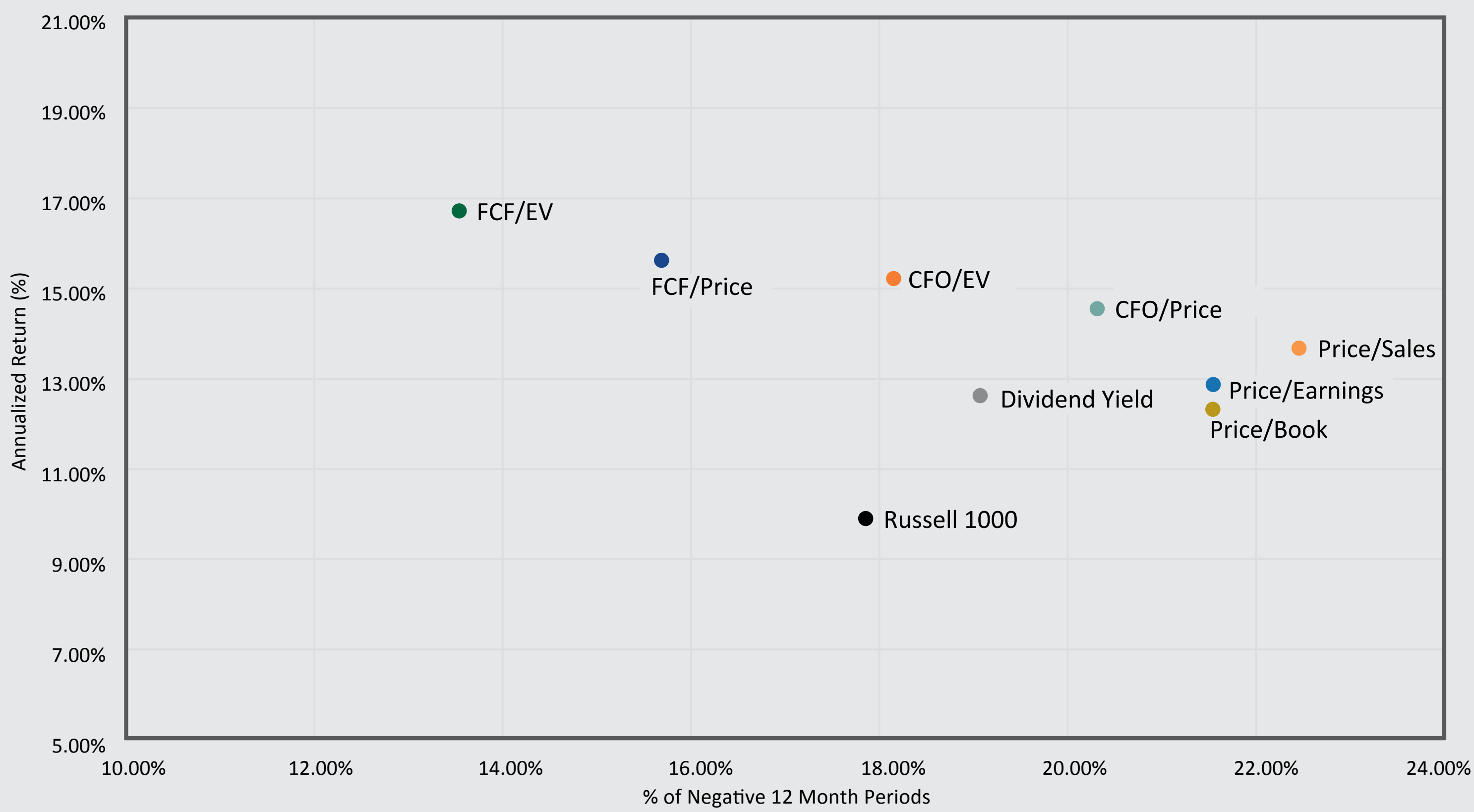


Chart Key:
FCF/EV: Free Cash Flow/Enterprise Value
CFO/EV: Cash From Operations/Enterprise Value
FCF/Price: Free Cash Flow/Price
CFO/Price: Cash From Operations/Price
Book/Price: Book Value/Price

Source: FactSet.
Data calculated based on the top 100 companies in the Russell 1000 Index for each valuation metric.

How to Invest in High Free Cash Flow Yield

So now that we've established that free cash flow yield is an important metric to consider, how can you use it? The Pacer Cash Cows Index® Series uses a free cash flow yield screen to invest in 100 companies from various indexes. These ETFs aim to provide a continuous stream of income and/or capital appreciation over time.

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