

*Cash Cows Series:*

# Free Cash Flow as a Proven Measurement of Quality



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# A Source for Growing Wealth

- 1 The goal of most investors is to achieve **financial security**. High free cash flow is an indicator of a company's financial strength.
- 2 **Positive free cash flow** indicates a company is generating more cash than it needs to run the business and can invest in growth opportunities.
- 3 Companies generating **high free cash flow yields** have the ability to grow dividends over time and produce better earnings.
- 4 Using strategies that are **constantly re-evaluating and rebalancing** is the key to owning quality companies generating high free cash flow.

**P/E (Price to Earnings) ratio** is share price divided by the last twelve months earnings per share.

<sup>(1)</sup>Includes multiples based on forecast operation income and net income.

<sup>(2)</sup>EBITDA - Earnings before interest, taxes, depreciation, and amortization.

<sup>(3)</sup>Includes multiples based on free cash flow to equity and free cash flow to firm.

<sup>(4)</sup>Includes multiples based on trailing operating income and net income.

## Understanding the Terms

### 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:



Buy back stock



Pay dividends



Participate in mergers/acquisitions

### Free Cash Flow Yield

**Free cash flow yield = (FCFY)**

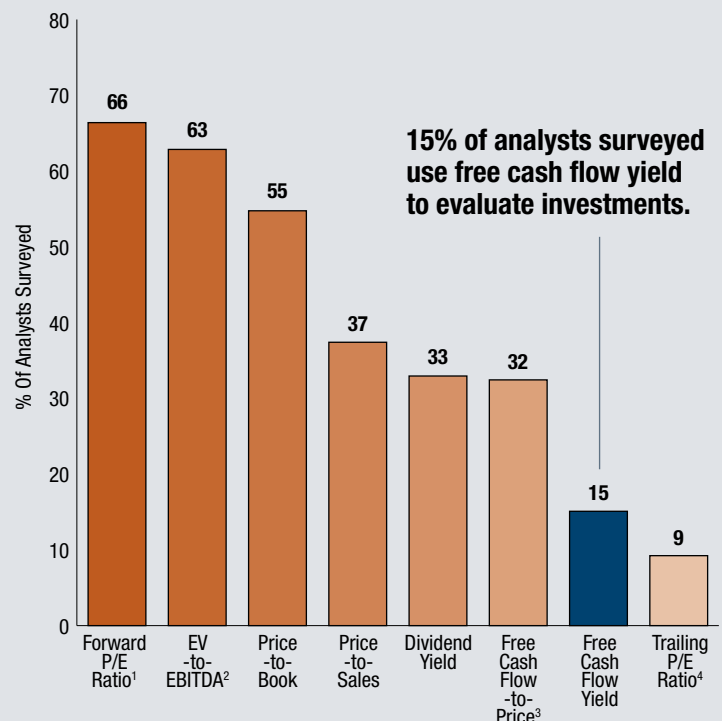
**Free Cash Flow**  

$$\frac{\text{Free Cash Flow}}{\text{Enterprise Value}}$$
*(Market Cap + Debt - Cash)*

**Free cash flow yield can determine an investor's payback period:** Higher free cash flow yield = shorter payback period

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

### "Equity Valuation: A Survey of Professional Practice."

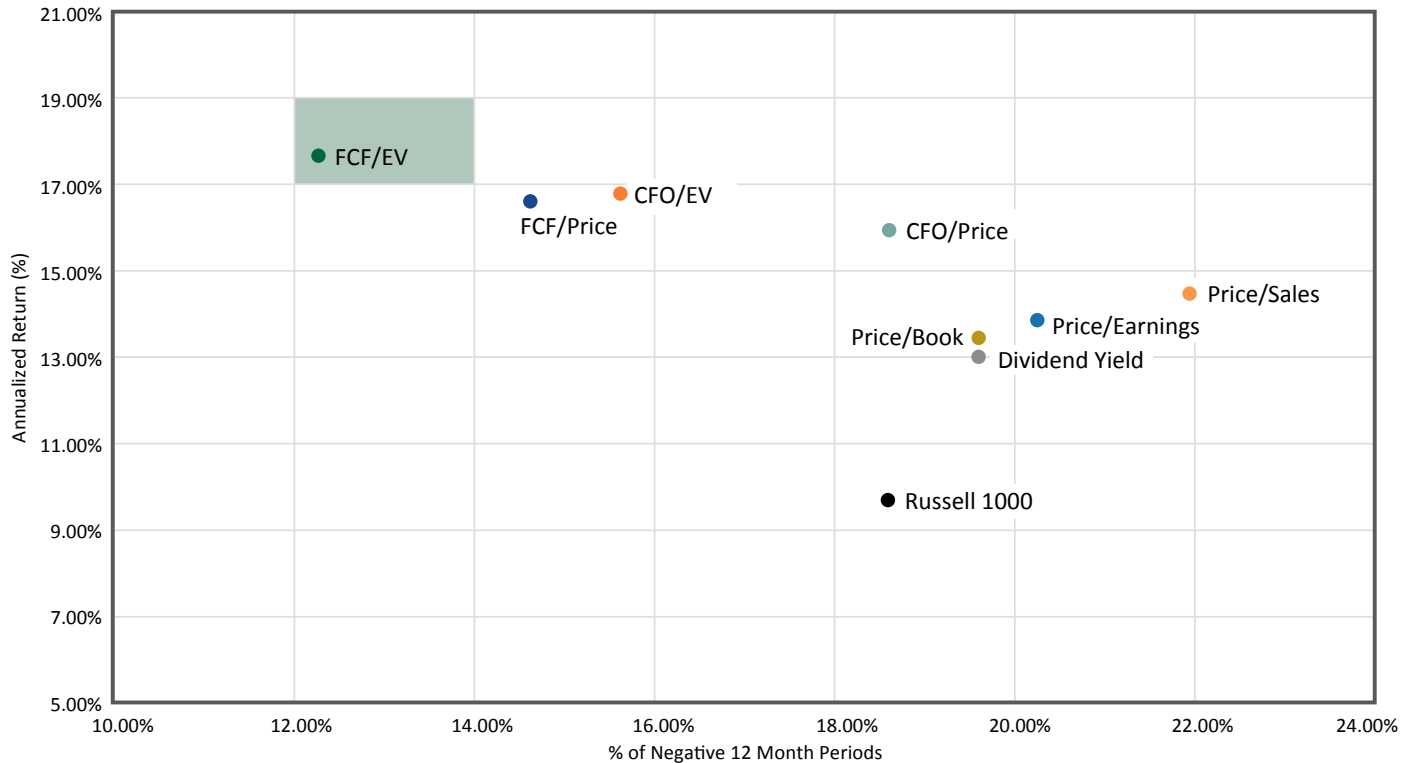


Source: Pinto, J., Robinson, T., and John D. Stowe, 2015, CFA Institute.

## Free Cash Flow Yield Is an Important Valuation Metric

In the chart below, free cash flow yield has the highest return with the fewest periods of negative trailing twelve month returns.

### Valuation Metrics (12 Month Rolling) 12/31/1991 - 12/31/2017



#### Chart Key:

**FCF/EV:** Free Cash Flow/Enterprise Value

**CFO/Price:** Cash Flow From Operations/Price

**FCF/Price:** Free Cash Flow/Price

**CFO/Price:** Cash Flow From Operations/Price

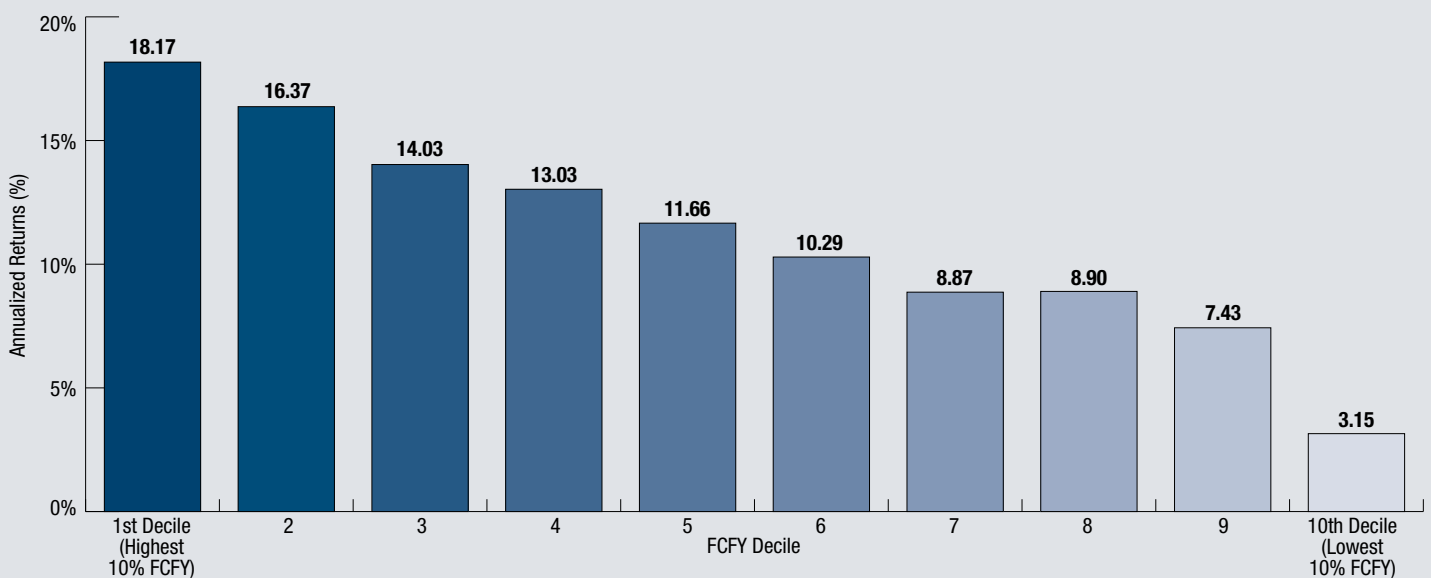
**Price/Book:** Price/Book Value

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

## Free Cash Flow Yield Outperforms Over Time

In the chart below, companies with the highest FCFY (1st Decile) outperform companies with the lowest FCFY (10th Decile) over time.

### Russell 1000 by Free Cash Flow Yield 12/31/1991 - 12/31/2017



Source: FactSet. Data is composed of the Russell 1000 Index excluding financials. Each decile is composed of approximately 85 stocks (10%) based on free cash flow yield, equal weighted.

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## Pacer Cash Cows Index<sup>SM</sup> ETF Series



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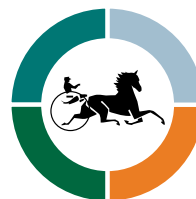
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