

# Profit is an opinion,

While many focus on Net Income, seasoned financial analysts know the true value of a firm lies in its ability to generate cash.

# Cash is a fact.

This guide is your file on the case. We will move from the ambiguity of accrual accounting to the certainty of cash. We will investigate the critical clues—Net Working Capital, Operating Cash Flow, and Free Cash Flow—to uncover the undeniable financial truth.





# The First Clue: A Firm's Lifeblood is its Net Working Capital

Net Working Capital (NWC) represents the short-term liquidity of a firm. It's the essential buffer between what a company owns and what it owes in the short term.



$$\text{NWC} = \text{Current Assets} - \text{Current Liabilities}$$



# The Real Evidence Lies in the *Change* in NWC.

In finance, the absolute level of NWC is less important than its change from one period to the next. As a firm grows, it invests in inventory and extends credit to customers. This “ties up” cash.



An **outflow** of cash.

Cash Usage.

The firm spent cash to increase its short-term assets (e.g., bought more inventory).



An **inflow** of cash.

Cash Source.

The firm freed up cash by reducing its investment in current assets.

Key Takeaway: Understanding this cash movement is fundamental to calculating the true cash flow of the firm.



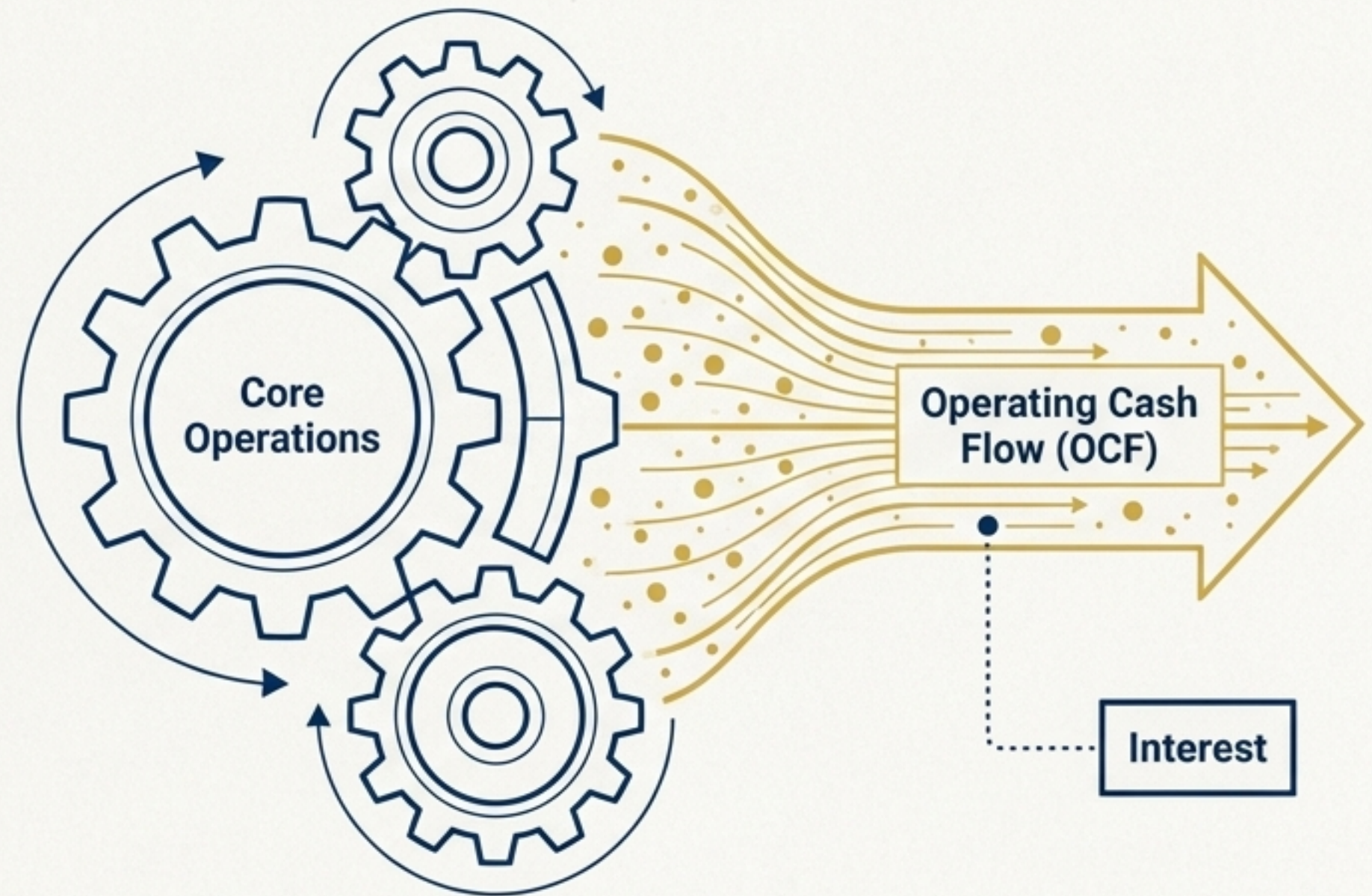
# Examining the Core Engine: Operating Cash Flow (OCF)

## Definition

OCF is the cash generated by a firm's day-to-day business activities. It measures the **cash profitability of a company's primary products or services** *before* considering any financing decisions.

## Key Distinction

To get a **pure measure of operational performance**, we calculate OCF *before* accounting for interest payments. Interest is a financing expense, not an operating one. We are isolating the engine from the fuel source.





# The OCF Calculation: Following the Cash Evidence.

Let's analyze the case file for a sample firm.

EBIT (Earnings Before Interest & Taxes)

**\$219M**

Operating profit, our starting point.

+ Add Back Depreciation

**+\$90M**

This was an accounting expense, but  
no cash actually left the building.

– Subtract Current Taxes

**-\$71M**

This is the actual cash paid to the government.

= Equals Operating Cash Flow

**\$238M**

The true cash output from the core engine.



# Two Lenses to View the Same Truth: Accounting vs. Finance

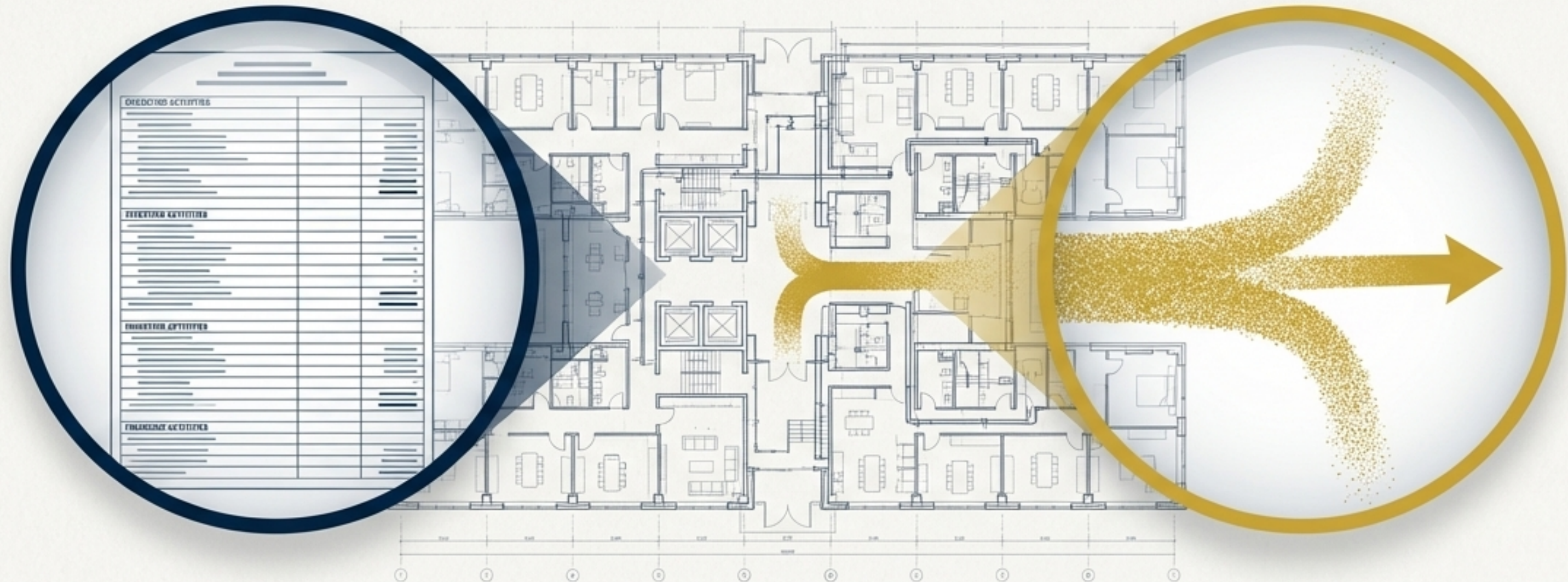
While our goal is to find the total cash available to investors, it's important to understand the official "Statement of Cash Flows" used by accountants. They are two different perspectives on the same underlying reality.

## The Accountant's View (Statement of Cash Flows)

A formal report that reconciles Net Income with the change in the cash balance. It is structured and rule-based.

## The Finance View (Free Cash Flow)

An analytical tool focused on a single question: How much cash is the business generating that is *free* to be distributed to its capital providers?





# The Official Ledger: Deconstructing the Statement of Cash Flows.

This statement is always divided into three distinct sections to track where cash is coming from and where it is going.



## 1. Cash Flow from Operating Activities

\*Starts with Net Income\* and adjusts for non-cash items (like Depreciation) and changes in working capital (e.g., an increase in inventory is a use of cash).



## 2. Cash Flow from Investing Activities

Reflects investment in long-term health. Includes acquisition of fixed assets (a cash outflow) and sale of fixed assets (a cash inflow).



## 3. Cash Flow from Financing Activities

Tracks money between the firm and its owners/creditors. Includes paying dividends (outflow), retiring debt (outflow), or issuing new stock (inflow).



# The Investigator's Prize: Unlocking Free Cash Flow (FCF).

**Definition:** Free Cash Flow is the single most important metric for valuation. It is the cash that is 'free' to be distributed to investors because it isn't needed for day-to-day operations or reinvestment in the business.



**What it represents:** FCF is the cash remaining after the company has paid for everything it needs to maintain and grow its asset base.

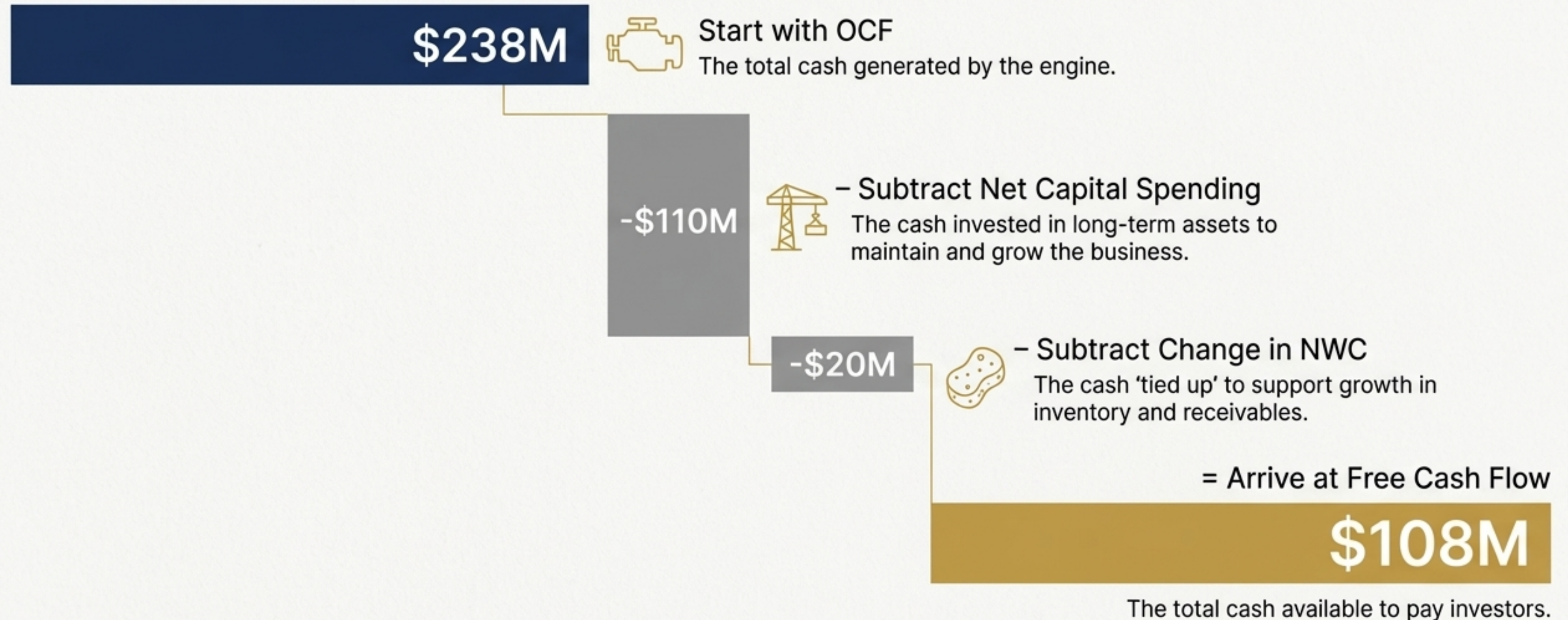
The cash has already been used for:

- Operating Expenses (covered in OCF).
- Capital Spending (new equipment/buildings).
- Net Working Capital (stocking the shelves).



# The Path to Free Cash Flow

**Free Cash Flow** = Operating Cash Flow – Net Capital Spending – Change in Net Working Capital





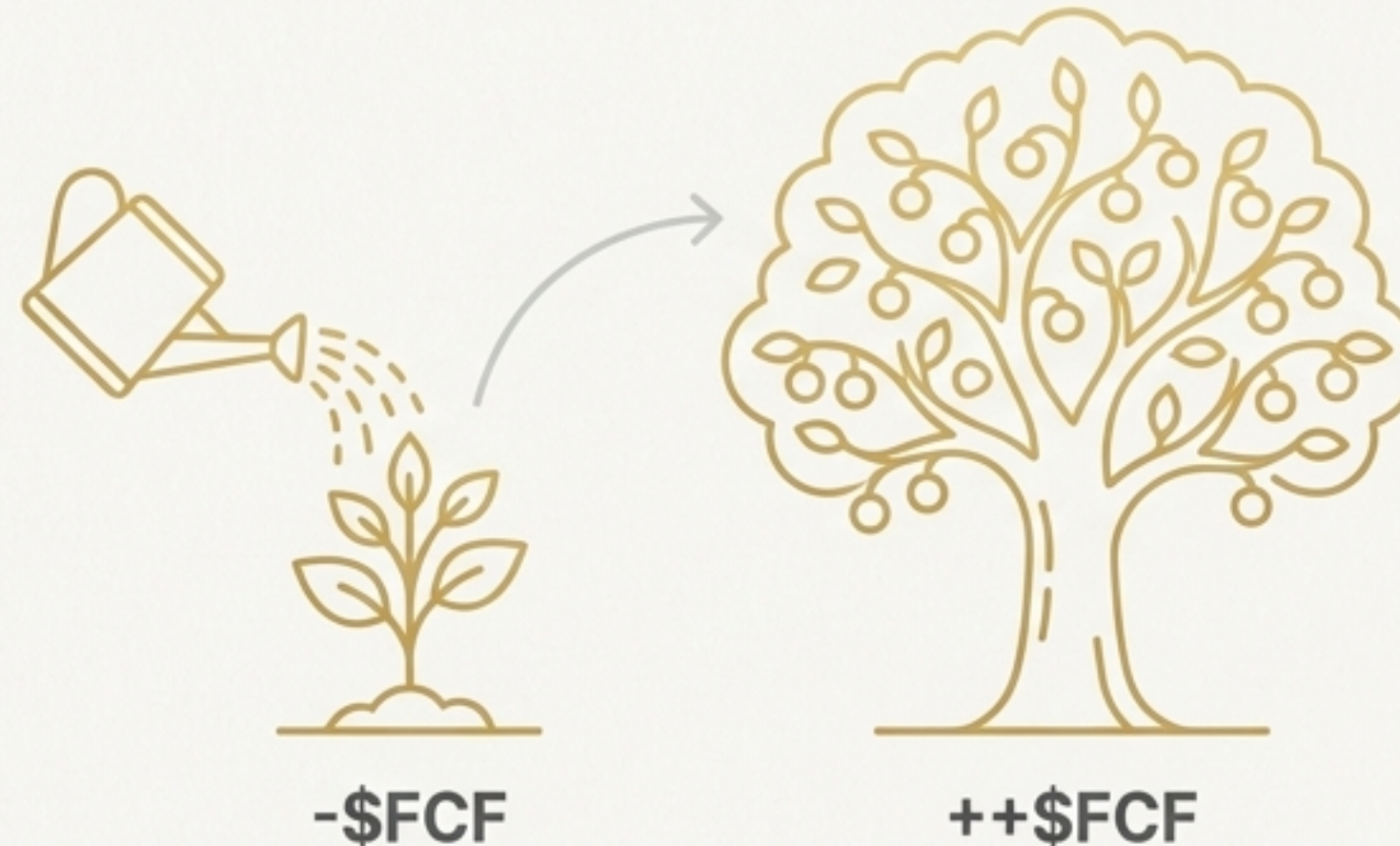
# A Plot Twist: When Negative Free Cash Flow is a Good Sign

## The Misconception

- It is common to assume that negative FCF is a sign of a failing business.

## The Reality

- Rapidly growing firms often have negative Free Cash Flow. This is not necessarily a bad sign.



## Why?

- It often means the firm is investing heavily in its future.
- The cash is being used to aggressively purchase fixed assets (Capital Spending) and build up inventory (NWC) to support massive future growth.

## The Key

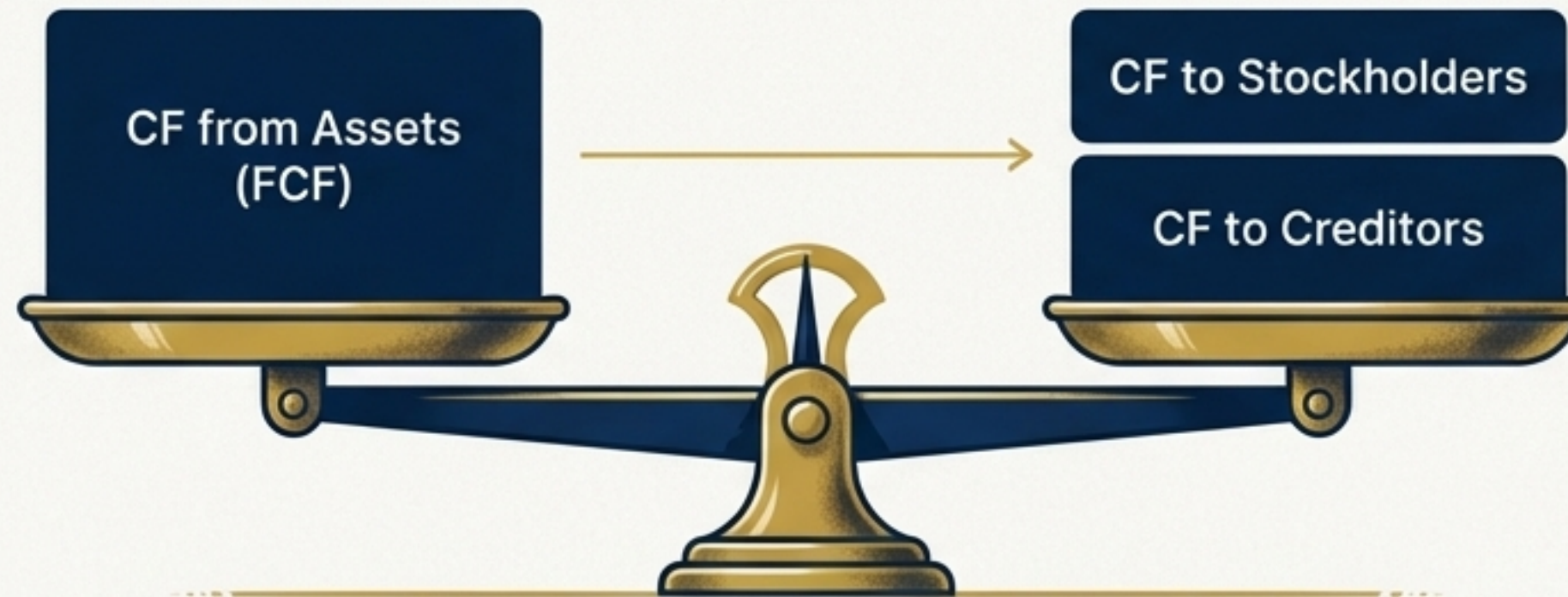
- The expectation is that these investments will lead to substantial positive cash flows down the road.



# The Grand Reveal: The Cash Flow Identity

**The Golden Rule of Finance:** One of the most powerful concepts in corporate finance is the Cash Flow Identity. It is an infallible check on our work.

**The Statement:** It states that the cash flow generated from the firm's assets must *equal* the cash flow paid to the firm's creditors and its stockholders.



$$\text{Cash Flow from Assets (CF(A))} = \text{Cash Flow to Creditors (CF(B))} \\ + \text{Cash Flow to Stockholders (CF(S))}$$

In simpler terms: Every dollar generated must be accounted for. It either goes to lenders or it goes to owners.



# Following the Money, Part 1: Cash Flow to Creditors

**Who are the creditors?** These are the bondholders and lenders who provided debt capital to the firm.

**What do they receive?** Creditors are paid “Debt Service.” This is the interest they are owed, plus any repayment of the principal amount they originally lent.

**The Calculation:**

**Cash Flow to Creditors (CF(B)) = Interest Paid – Net New Borrowing**

We start with the total interest paid out. We then subtract any *new* cash the firm brought in by taking on more debt.





# Following the Money, Part 2: Cash Flow to Stockholders.

## Who are the stockholders?

These are the equity investors—the owners of the company.

## What do they receive?

Stockholders receive cash through dividends and stock repurchases.

## The Calculation:

**Cash Flow to Stockholders (CF(S)) =  
Dividends Paid – Net New Equity Raised**

We start with cash paid out as dividends. We then subtract any *new* cash the firm received by selling new shares of stock.





# Case Closed: The Core Principles of Cash Flow

## 1. Cash Flow $\neq$ Net Income

The investigation proves that Net Income is an opinion, clouded by non-cash items and accounting rules. True cash flow accounts for real investments in capital and working capital.

## 2. Growth Requires Cash

Growing firms must 'spend' cash to fund higher levels of inventory and receivables. The Change in NWC is a critical use of cash that must be tracked.

## 3. The Identity Must Always Balance

Every dollar of cash generated by the assets must be paid out to the providers of capital (debt and equity) or reinvested in the firm. There are no other options. This is the undeniable truth.

