Twitter Thread by Intrinsic Compounding

Intrinsic Compounding
@soicfinance

Everything about Free cash Flow Simplified!

What we will talk about in this ■■:

1■What is Free Cash Flow
2■How to calculate Free Cash Flow
3■Types of Free Cash Flow
4■Importance & Limitations of Free Cash Flow

Let's dive in ■■■■



What is Free Cash Flow?

Free cash flow means the cash that is left over after a company pays for its operating expenses and capital expenditures (Capex) like purchasing new machinery, equipment, land & building, etc. and satisfying all its working capital needs.

In simple words, suppose whatever cash that is left with you after you spend your salary or income is known as Free cash flow that you can use for different purposes.

The more FCF a company has, the better it is. Businesses which generate high FCF can:-

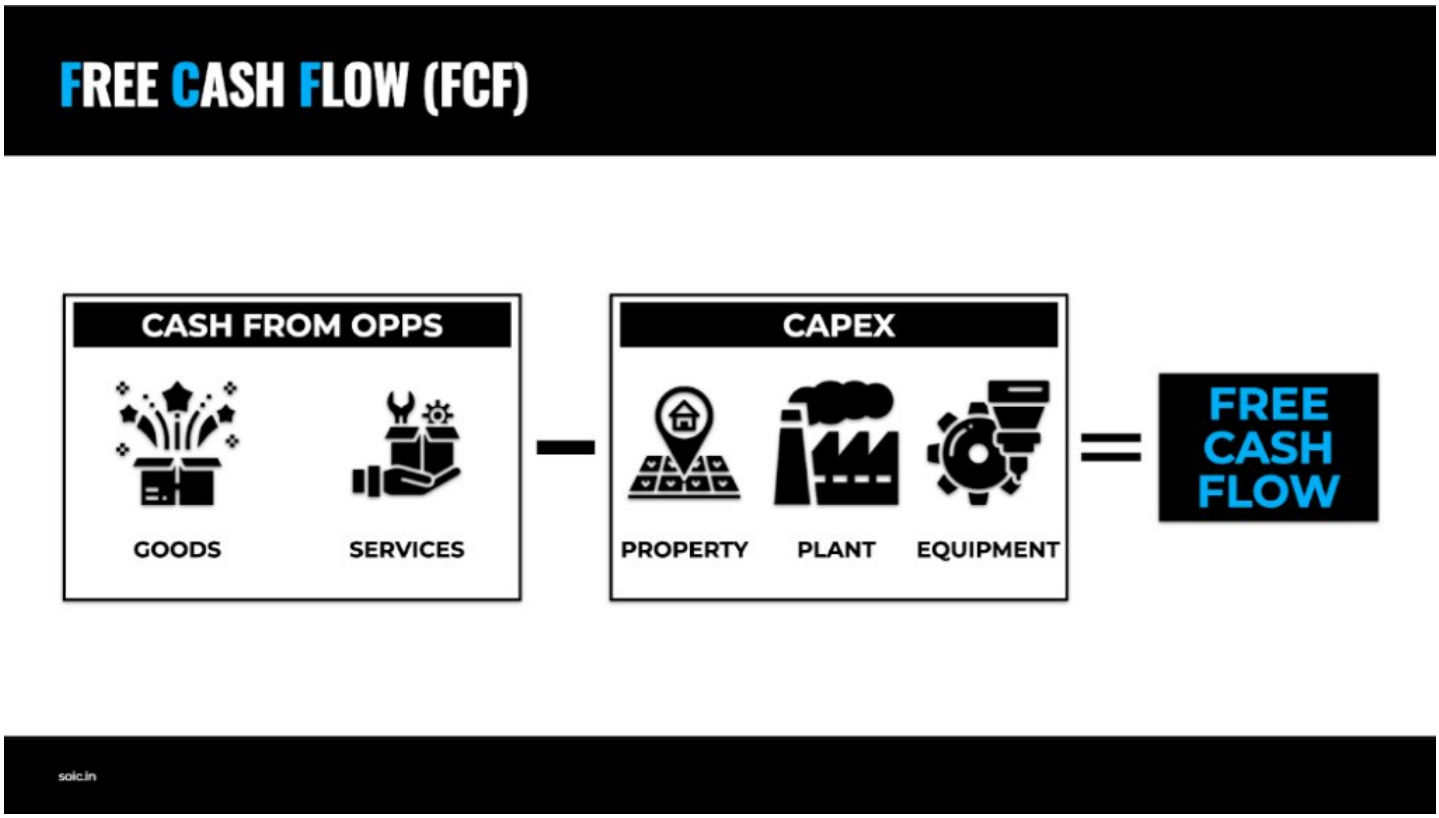
1■Give investors higher dividends
2■Do share buybacks
3■Build a war chest for acquisitions or Capex.
4■Reinvest in the business when opportunity arises with lesser dependence on debt.

How to calculate Free Cash Flow■:

To calculate free cash flow, all you need to do is open the Cash Flow Statement and subtract "Net Capital expenditure" from "net cash from operating activities".

The formula looks like this:

Free cash flow = Net cash from operating activities-Net Capex



Let’s calculate the FCF for Happiest Minds for FY 2021-22:

As we can see from the financials its cash flow from operating activities is 168 cr and its net capital expenditure is = 67Lakhs+3.46cr-(10Lakhs)

=168 Cr-4.03 crores= 163.97 crores is the FCF!

Happiest Minds Technologies Limited
CIN : L72900KA2011PLC057931
Regd. Office:#53/1-4, Hosur Main Road, Madivala (next to Madivala Police Station) Bangalore 560 068, Karnataka, India
Website: www.happiestminds.com , Email: IR@happiestminds.com , Tel: +91 80 6196 0300

Audited Consolidated Statement of Cash Flows for the year ended March 31, 2022

(Rs. in lakhs)

	Year ended March 31, 2022 Refer note	Year ended March 31, 2021 (Audited)
A. Cash flow from operating activities		
Profit before tax	24,585	18,602
Adjustments to reconcile profits before tax to net cash flows:		
Depreciation and amortization expense	3,288	2,274
(Gain)/ loss on disposal of property, plant and equipment, net	(10)	-
Share-based payment expense	300	297
Gain on investments carried at fair value through profit and loss	(368)	(184)
Gain on sale of investments carried at fair value through profit and loss	(1,377)	(671)
Interest income	(636)	(838)
Fair value loss on warrant liability	609	-
Gain on liquidation of subsidiary	-	(82)
Net unrealised foreign exchange loss	404	66
Rent concession	(323)	(302)
Impairment loss on financial assets	189	1,021
Finance costs	995	649
Operating profit before working capital changes	**27,656**	**20,832**
Movements in working capital		
Increase in trade receivables	(4,526)	(511)
Decrease in loans	10	50
Increase in non-financial assets	(1,610)	(279)
Increase in financial assets	(3,078)	(1,429)
Increase/ (decrease) in trade payables	1,489	(644)
Increase/ (decrease) in financial liabilities	1,004	(1,684)
Increase in provisions	58	516
Increase/ (decrease) in contract liabilities	660	(43)
Increase in other non-financial liabilities	496	1,109
Cash generated from operating activities	**22,159**	**17,917**
Income tax paid (net of refunds)	(5,347)	(3,600)
Net cash generated from operating activities (A)	**16,812**	**14,317**
B. Cash flow from investing activities		
Purchase of property, plant and equipment	(67)	(78)
Purchase of intangible assets	(346)	(19)
Proceeds from sale of property, plant and equipment	10	-

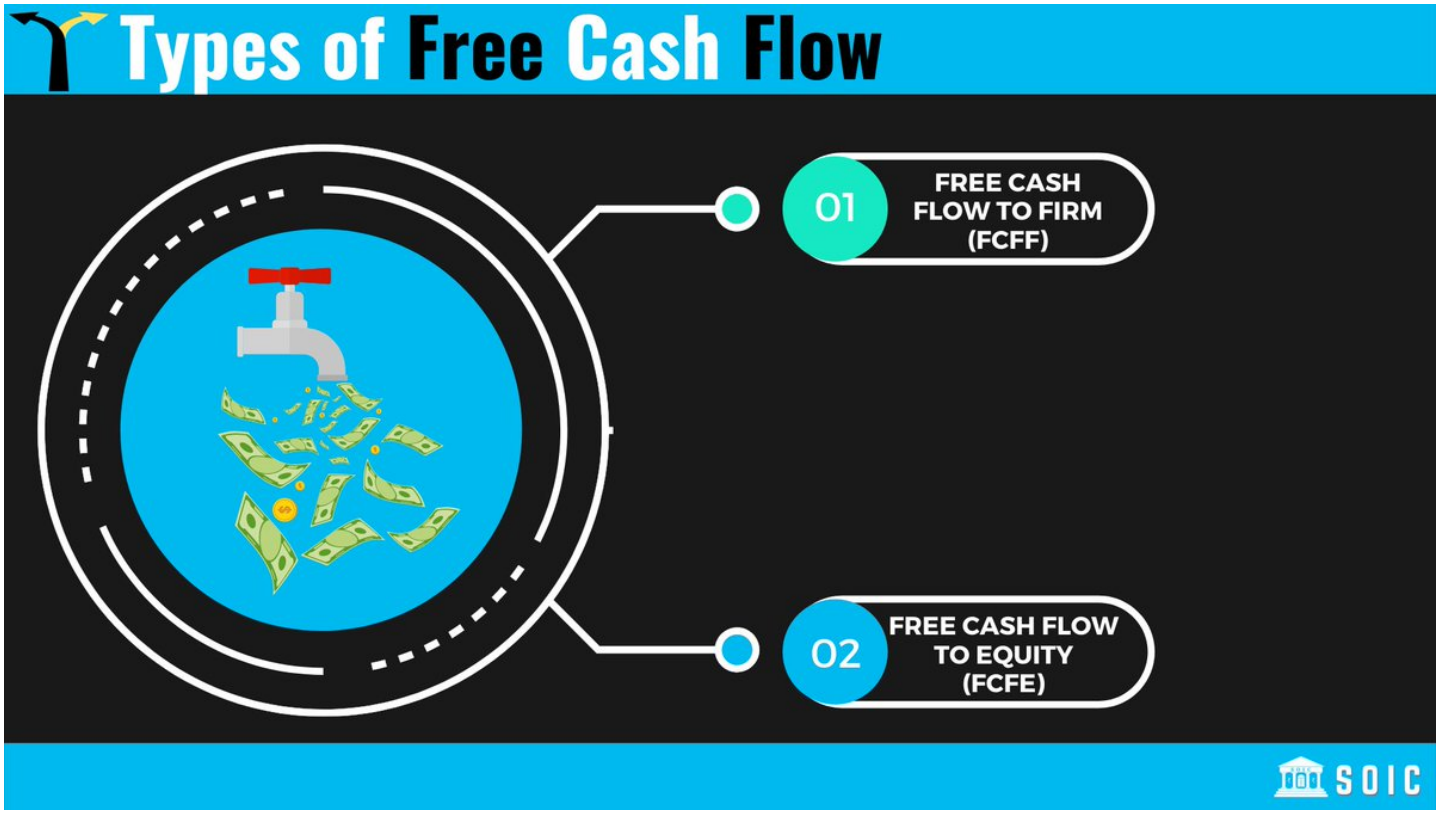
Net Cash Flow from operations

CAPEX

Now, let's look at two types of Free cash flow!

1■Free cash flow to Firm

2■Free cash flow to Equity



Free Cash Flow to the Firm (FCFF):

FCFF is the same FCF which we have discussed above, FCFF means the ability of the business to produce cash after deducting all its capital expenditures which is calculated as CFO - Capex.

Thus, the free cash flow that is left to the Firm



Free Cash Flow to the Equity (FCFE):

Free cash flow to equity (FCFE) is the amount of cash a business generates that is available to be distributed to the company’s equity shareholders as dividends or stock buybacks after all expenses, reinvestments, and debt repayments.

It is also known as Levered Free Cash Flow.

It is calculated as follows:

FCFE = Cash from Operating Activities – Capital Expenditures + Net Debt Issued (Proceeds from borrowings-Repayment of borrowings)

Free Cash Flow to firm vs Free Cash Flow to Equity:-

The main difference between the two is that Free cash flow to firm represents the Cash flow that is available to both the Debt and Equity holders.

FCFE only represents the cash flow that is available to the shareholders!

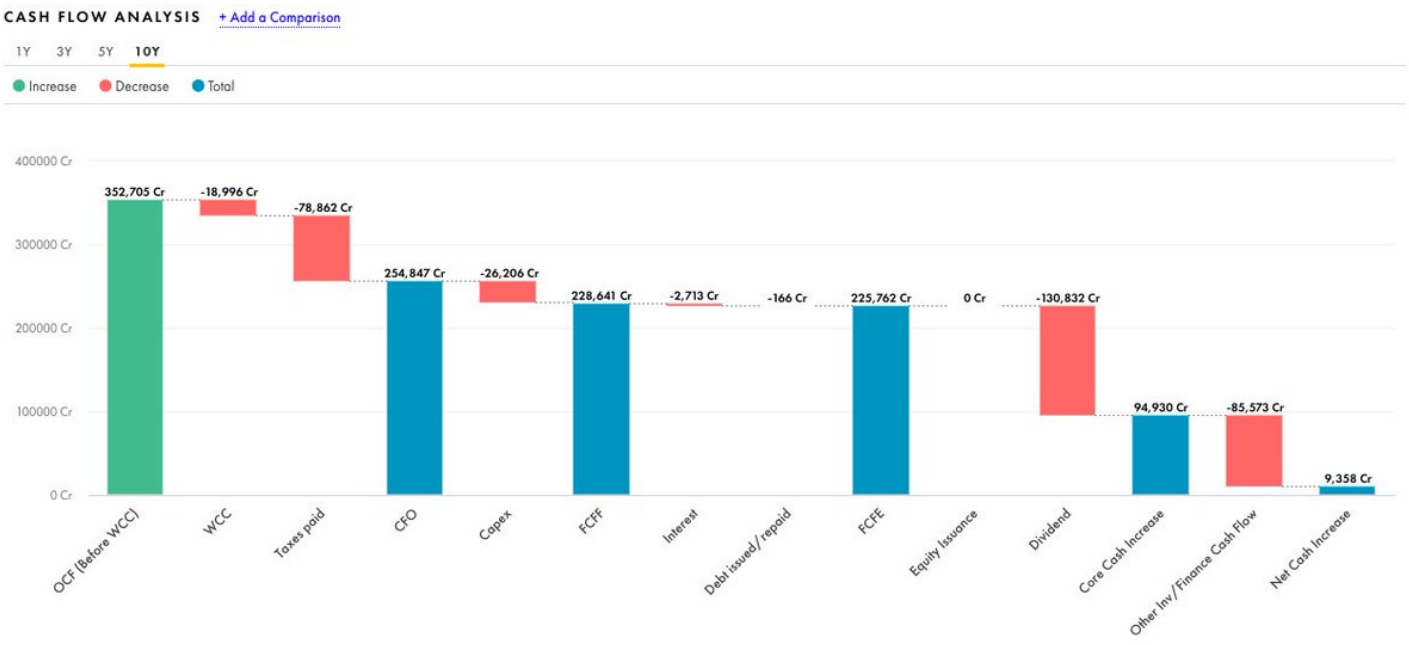
The Importance of Free Cash Flow ■■

Company with high free cash flow can expand, develop new products, have a safety cushion, be in control of its own destiny, can expand without debt and pay dividends etc. Positive free cash flow is indicative of overall business health.

We can check it from the financials of TCS as well, where it is generating high free cash flow because its business is asset light where it doesn't require high Capex. So they are returning this FCF to shareholders via share buyback and dividends.

This is the 10 year cumulative Cash flow statement of TCS. Just look at dividend paid ■■

Out of 2.25 Lakh crores of Cumulative Cash flows generated by TCS, they have paid almost 1.4 Lakh crores of dividend in the last decade. As the business can grow without Capex.
@Tijori1



What are the limitations of Free cash flow?

Low free cash flow is not always indicative of a failing business. Even healthy companies see a dip in free cash flow when they're actively doing Capex for pursuing growth.

Businesses which are into manufacturing or in other areas have to Spend on Capacity expansion in order to grow.

We can see the same from some examples where companies were doing high capex to leverage growth resulting in negative free cash flow for a few years ■■■■

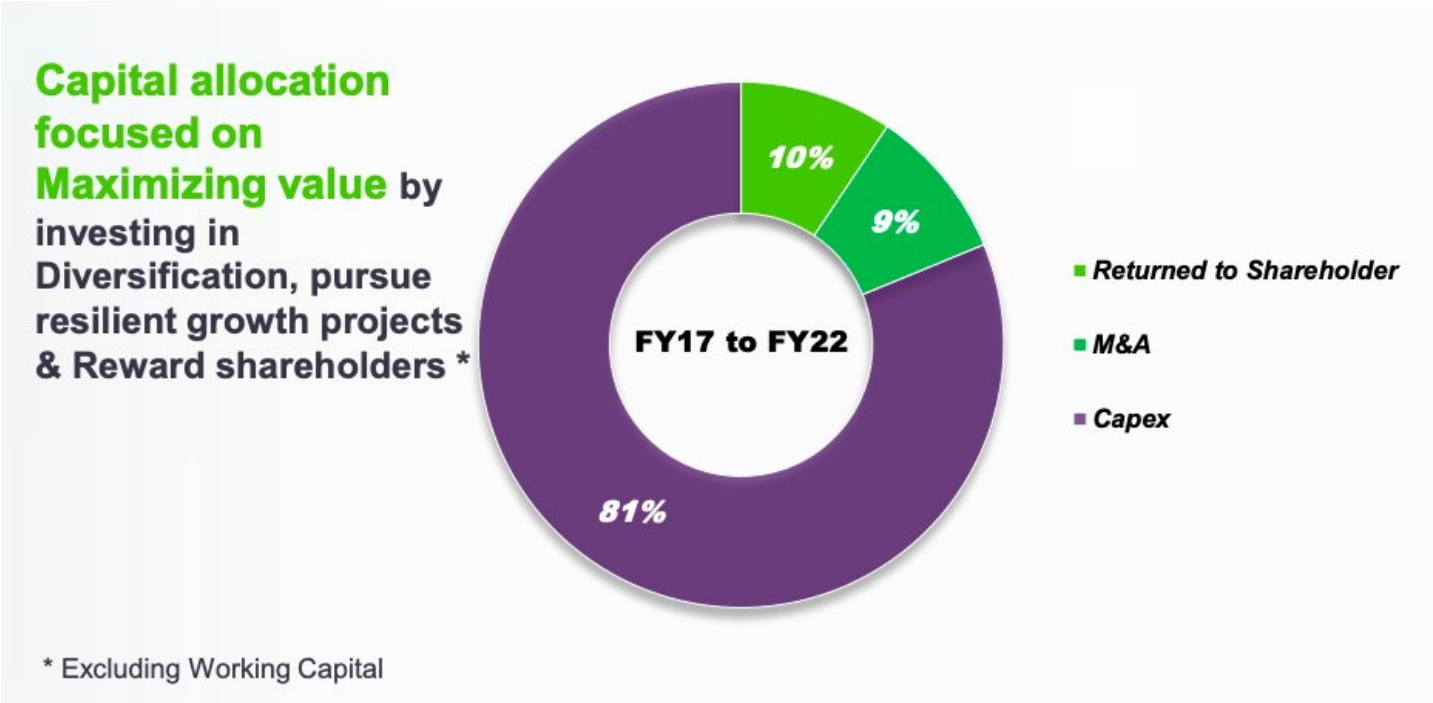
For Example:- Deepak Nitrite Ltd was going through high Capex phase between FY2017 to 2020, during this time they were setting up a Phenol plant resulting in negative free cash flow during this period.

(Credits @Tijori1)

CASH FLOW Standalone **Consolidated**

	MAR 2002	MAR 2003	MAR 2015	MAR 2016	MAR 2017	MAR 2018	MAR 2019	MAR 2020	MAR 2021	SEP 2021
Cash from Operating Activity -	24.50	24.08	108	167	49.01	183	60.27	765	999	942
Profit Before Tax	9.49	12.89	67.29	89.13	135	111	268	806	1,042	1,427
Adjustments	19.50	23.44	72.88	79.83	7.72	101	161	266	238	232
OCF Before Working Capital	28.99	36.26	140	169	142	212	429	1,072	1,280	1,659
Working Capital Changes	-4.26	-9.26	-18.15	17.13	-77.19	-0.92	-312	-109	-44.06	-399
Taxes Paid	-0.24	-2.93	-14.01	-18.81	-16.22	-27.86	-56.08	-198	-236	-317
Cash from Investing Activity +	-11.47	-12.11	-89.12	-169	-353	-525	-163	-428	-396	-468
Cash from Financing Activity +	-13.29	-9.51	-22.28	4.33	305	345	95.81	-338	-596	-451
Net Cash Flow	-0.26	2.46	-3.40	2.23	1.07	3.59	-6.47	-0.82	6.75	23.03
Opening Cash & Cash Equivalents	1.45	1.20	6.46	3.06	4.77	5.84	9.43	2.96	2.14	–
Effect of FX	–	–	–	–	–	–	–	–	–	–
Closing Cash & Cash Equivalents	1.20	3.66	3.06	5.29	5.84	9.43	2.96	2.14	8.89	–
Net Capex (est)	10.25	11.10	89.84	86.50	241	621	254	416	209	230
Free Cash Flow (est)	14.25	12.98	18.16	80.77	-192	-438	-194	349	790	712

Even in Laurus Labs case the company has spent nearly 81% of the cash flows it has generated in Capex over the last 5 years, thereby resulting in lower free cash flows but super fast Earnings growth:



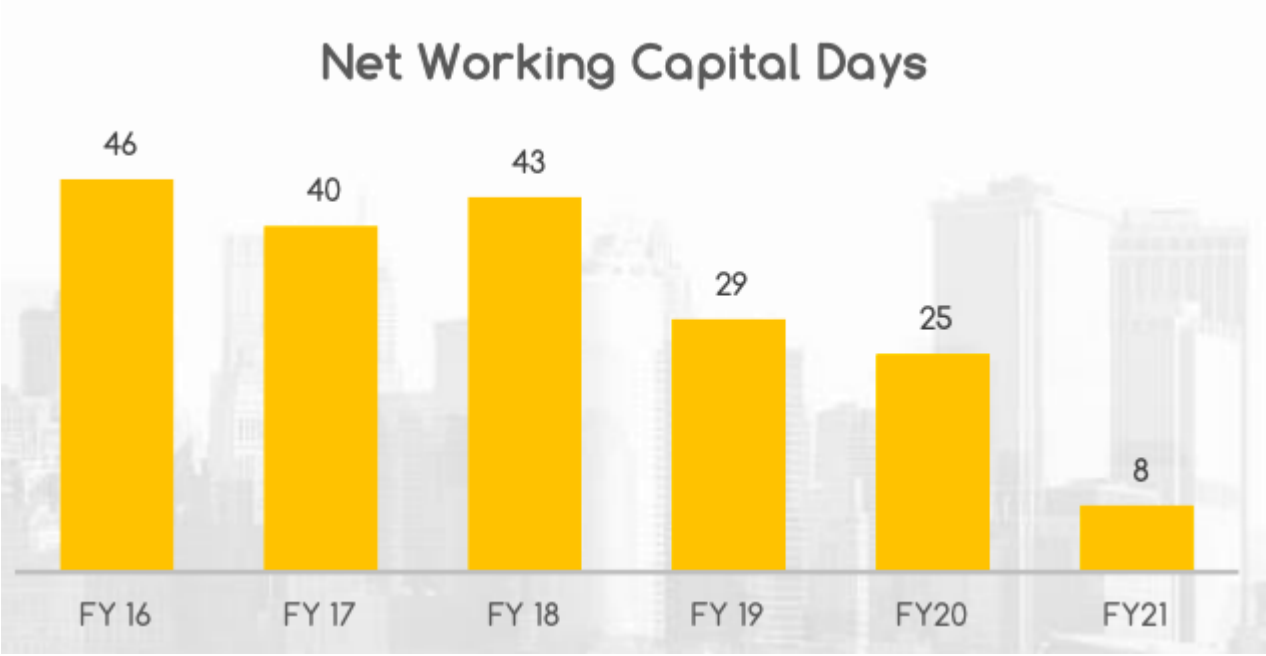
Finally, lets learn an extremely important concept.

Linking the concept of change in working capital and its impact on Free Cash Flow. Those who understand can make a killing if they see working capital improving in a company.

Example:- APL Apollo

In FY 2020 they switched to a cash and carry model from normal credit period business of 20 days which resulted in the reduction in net working capital days from 25 to 8 in FY 2021.

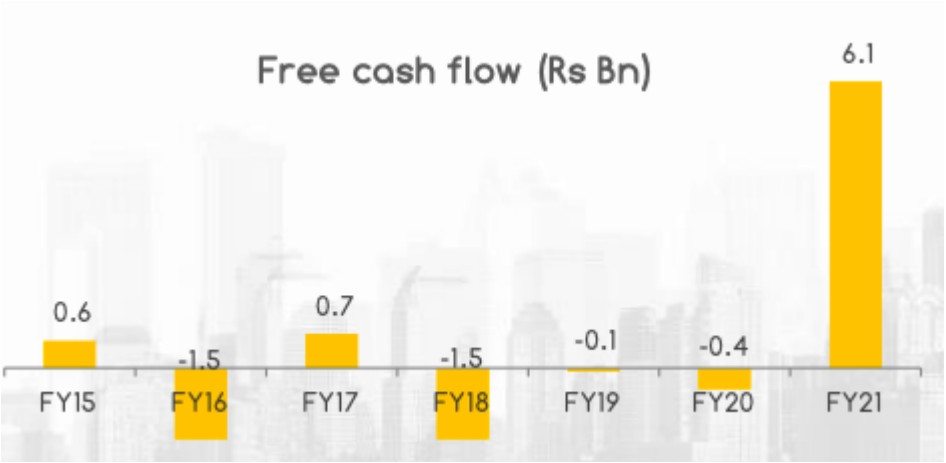
Just look at the working capital days:-



Improvement in working capital led to two major changes:-

1. Massive deleveraging as lesser working capital loans were required to run the business.

2. Generation of solid free cash flow that can be paid out dividends or be used for Capacity expansion through internal accruals.



Let's look at peers within the sae industry and how generation of Free Cash Flow is impacting the valuations of all these companies.

If we look at the 10 Years cumulative cash flow of the companies, it is as follows:

Look at the Working capital and this where Page wins!!

10 Years Cumulative Cash Flow





Company	10 Yr Cum CFO	10 yr Cum FCF	10 yr Cum Working Capital changes	CFO to FCF %	Valuations (P/E ratio)
Page Industries	3296 cr	2828 cr	54 cr	85.80%	110.32 Times
Dollar Industries	311 cr	100 cr	(492 cr)	32.15%	25.26 Times
Rupa & Company	693 cr	469 cr	(506 cr)	67.67%	20.55 Times
Lux Industries	761 cr	444 cr	(657 cr)	58.34%	19.50 Times

SOIC

If you loved the thread and understood the concept of Free cash flow, then retweet to educate maximum investors.

Thank you for reading!



Apart from this, I am doing a detailed Webinar on Valuations on 22nd of May in which I will discuss multiple ways to value a business with detailed case studies :)

Link to register ■: https://t.co/fTr7JYgszn

