Financial Statement Analysis

Session 3

Cash Flow Statement

Introduction to your speaker

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    - Exempt Fund Manager under the MAS regime
  - 10 years of investment experience
    - Singapore and Hong Kong

Off-Balance Sheet Items (from previous session)

- Sale-Leaseback Transactions
  - Financial Engineering
    - Asset+Loan converted to off-balance sheet lease
    - Typically match Weak Sellers with Dumb Buyers
  - Portrayed as Win-Win, Actually Lose-Lose
    - Seller gets cash, buyer gets income
    - Seller pays too much in rent, buyer pays too much for the asset
    - Downturn: seller defaults and buyer suffers asset impairment
- Contingent Liabilities
  - 3rd party guarantees (e.g. Ezra guarantees for EOC loans)
  - Lawsuits (where damages are unknown)
  - Contracted expenditures (e.g. agreements to buy raw materials)
  - Minimum lease payments (e.g. shop rental agreements)

The Cash Flow Statement

- Like an Income Statement, tracks changes over time
- Before / After Concept of Cash Balance
- Key Categories
  - Non Cash Items
  - Interest & Taxes
  - Changes in Working Capital
  - Investing Cash Flows
  - Financing Cash Flows

Non-Cash Items

- Non-Cash does not mean Non-Economic!
  - Physical assets wear out or become obsolete
  - Unrealized gains/losses CAN be realized
- Depreciation & Amortization
  - Plant, Property & Equipment (PPE), Intangibles (Patents, Trademarks etc)
- Impairments
  - Assets suffer material decline in value (PPE, AR, Intangibles etc)
- Unrealized gains/losses
  - Fair value changes (investment property, stocks, bonds etc.)
  - Foreign exchange (forward contracts, translation changes)
- Share-based payment
  - Compensation to key staff
- Question: Why are share-based payments considered an expense when the company RECEIVES cash from the exercise of options?

Interest & Taxes

- Interest
  - Received on bank balances
  - Paid on bank loans
    - Interest charged in P&L may not match payment in Cash Flow
- Taxes
  - Refunds (rebates, concessions)
  - Paid
    - Tax charged in P&L may not match payment in Cash Flow
- Question: Why / When is there a mismatch between the income statement versus the actual payments?

Changes in Working Capital

- Tracks changes in Working Capital (WC)
  - Trade / Account Receivables (AR)
  - Inventories (Inv)
  - Trade / Account Payables (AP)
- WC = AR + Inv - AP
- Net Change in WC = Current WC – Previous WC
- Working Capital correlates to business activity
  - Growth consumes WC
  - Contraction releases WC
  - Steady state means no change in WC

Investing Cash Flows

- Purchase of Plant, Property & Equipment (PPE)
  - Replacement and Repair
  - Expansion
- Disposal of PPE
  - Usually not material unless Vessels / Buildings
- Investment into Joint Ventures & Associates
  - These entities will in turn spend on PPE
- Question: What about loans to JVs and Associates?

Financing Cash Flows

- Loans
  - New Loans (inflow)
  - Repayment (outflow)
- Dividends
  - Paid (outflow)
- Shares
  - Issuance (inflow)
  - Buy-back (outflow)

Free Cash Flow (FCF)

- Excess cash available to the owners
- FCF = Net Profit After Tax (NPAT) adjusted for…
  - Depreciation & Amortization (D&A)
  - Capital Expenditure (Capex)
  - Working Capital Changes (WCC)
- FCF = NPAT + D&A – Capex + WCC
- FCF during:
  - Steady state: FCF = NPAT (Capex = D&A, WCC =0)
  - Expansion: FCF < NPAT (Capex > D&A, WCC < 0)
  - Contraction: FCF > NPAT (Capex < D&A, WCC > 0)

Earnings before Interest, Tax, Depreciation & Amortization (EBITDA)

- Similar to FCF in concept, with adjustments
  - Interest, Tax, Depreciation & Amortization added back
- Useful when comparing companies across:
  - Countries (different tax rates)
  - Capital structures (different interest costs)
  - Accounting policies (different depreciation charges)
- Often used by Private Equity (PE) firms
  - PE firms control the company so they can choose the capital structure, do tax planning etc.
- Question: Should passive minority investors use EBITDA? Why or why not?

Dividends

- Declared from Profits, Paid from Cash
  - Accounting charge against accumulated profits
  - Payment from cash balance
- If FCF < 0, dividends are being funded by:
  - Cash Reserves
  - Increased Debt
  - Asset sales
  - Share sales
- Question: why pay dividends if FCF < 0?

Cash Consumers vs. Cash Generators

- Consumers
  - Business can use unlimited amounts of capital
    - Property Development
    - Steelmaking
    - Shipping
    - Wafer Foundries
- Generators
  - Business cannot use all the cash generated
    - Professional Services
    - Investment Property
    - Retail & Distribution
- Question: Why invest into a cash consuming business?