

Free Cash Flow Yield: The Best Fundamental Indicator

[Hans Wagner](#)

When evaluating stocks, most investors are familiar with fundamental indicators such as the [price-to-earnings ratio \(P/E\)](#), [book value](#), [price-to-book \(P/B\)](#), and the [PEG ratio](#). In addition, investors who recognize the importance of cash generation use the company's cash flow statements when analyzing its [fundamentals](#). They recognize these statements offer a better representation of the company's operations.

However, very few people look at how much [free cash flow \(FCF\)](#) is available vis-à-vis the [value](#) of the company. Called the [free cash flow yield](#), it's a better indicator than the P/E ratio. (For a primer, refer to "[What Is a Cash Flow Statement?](#)")

Free Cash Flow

Cash in the bank is what every company strives to achieve. Investors are interested in what cash the company has in its bank accounts, as these numbers show the truth of a company's performance. It is more difficult to hide financial misdeeds and management adjustments in the cash flow statement.

Cash flow is the measure of cash into and out of a company's bank accounts. Free cash flow, a subset of cash flow, is the amount of cash left over after the company has paid all its expenses and capital expenditures (funds reinvested into the company).

You can quickly calculate the free cash flow of a company from the [cash flow statement](#). Start with the total from the cash generated from operations. Next, find the amount for capital expenditures in the "cash flow from [investing](#)" section. Then subtract the capital expenditures number from the total cash generated from operations to derive free cash flow (FCF). (For an example, see "[How Do You Calculate Free Cash Flow?](#)")

When free cash flow is positive, it indicates the company is generating more cash than is used to run the business and reinvest to grow the business. It's fully capable of supporting itself, and there is plenty of potential for further growth. A negative free cash flow number indicates the company is not able to generate sufficient cash to support the business. However, many [small businesses](#) do not have positive free cash flow as they are investing heavily to rapidly grow their venture.

Free cash flow is similar to earnings for a company without the more arbitrary adjustments made in the [income statement](#). As a result, you can use free cash flow to help measure the performance of a company in a similar way to looking at the [net income](#) line. (Free cash flow is not the same as [net cash flow](#), however.)

Free cash flow is the amount of cash that is available for stockholders once all expenses are extracted from the total revenue. The net cash flow is the amount of profit the company has with the expenses that it pays currently, excluding [long-term debts](#) or [bills](#). A company that has a positive net cash flow is meeting operating expenses at the current time, but not long-term expenses, so it is not always an accurate measurement of the company's progress or success.)

The P/E ratio measures how much annual net income is available per [common share](#). However, the cash flow statement is a better measure of the performance of a company than the income statement. (For a complete list and discussion of all the major ratios in [financial analysis](#), be sure to check out our [Financial Ratios Tutorial](#).)

Free Cash Flow Yield

Is there a comparable measurement tool to the P/E ratio that uses the cash flow statement? Happily, yes. We can use the free cash flow number and divide it by the value of the company as a more reliable indicator. Called the free cash flow yield, this gives investors another way to assess the value of a company that is comparable to the P/E ratio. Since this measure uses free cash flow, the free cash flow yield provides a better measure of a company's performance.

The most common way to calculate free cash flow yield is to use [market capitalization](#) as the divisor. Market [capitalization](#) is widely available, making it easy to determine. The formula is as follows:

$$\text{Free Cash Flow Yield} = \frac{\text{Free Cash Flow}}{\text{Market Capitalization}}$$

Another way to calculate free cash flow yield is to use [enterprise value](#) as the divisor. To many, enterprise value is a more accurate measure of the

value of a firm, as it includes the debt, value of preferred shares and [minority interest](#), but minus cash and cash equivalents. The formula is as follows:

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

Both methods are valuable tools for investors. Use of market capitalization is comparable to the P/E ratio. Enterprise value provides a way to compare companies across different industries and companies with various [capital structures](#). To make the comparison to the P/E ratio easier, some investors invert the free cash flow yield, creating a ratio of either market capitalization or enterprise value to free cash flow.

Using Free Cash Flow Yield

As an example, the table below shows the free cash flow yield for four [large-cap](#) companies and their P/E ratios in the middle of 2009. Apple ([AAPL](#)) sported a high trailing P/E ratio, thanks to the company's high growth expectations. General Electric ([GE](#)) had a trailing P/E ratio that reflected a slower growth scenario. Comparing Apple's and GE's free cash flow yield using market capitalization indicated that GE offered more attractive potential at this time. The primary reason for this difference was the large amount of debt that GE carried on its books, primarily from its financial unit. Apple was essentially debt-free. When you substituted market capitalization with the enterprise value as the divisor, Apple became a better choice.

Comparing the four companies listed below indicates that Cisco was positioned to perform well with the highest free cash flow yield, based on enterprise value. Lastly, although Fluor had a low P/E ratio, it did look as attractive after taking into consideration its low FCF yield.

Free Cash Flow Yield Comparison (\$000)				
Free Cash Flow Yield Calculations (ttm)	Apple (AAPL) as of 27-June-2009	Fluor (FLR) as of 30-June-2009	Cisco (CSCO) as of 25-July-2009	General Electric (GE) as of 30-June-2009
Total Cash flow from Operating Activities	\$11,344,000	\$649,484	\$9,897,000	\$36,064,000
Capital Expenditures	\$1,088,000	\$293,107	\$1,005,000	\$12,405,000
Free Cash Flow	\$10,256,000	\$356,377	\$8,892,000	\$23,659,000
Market Capitalization (21-Sep-2009)	\$164,600,000	\$9,920,000	\$136,920,000	\$177,570,000
Free Cash Flow Yield using Market Cap	6.23%	3.59%	6.49%	13.32%
Free Cash Flow Ratio using Market Cap	16.05	27.84	15.40	7.51
Enterprise Value (21-Sep-2009)	\$141,520,000	\$8,110,000	\$110,770,000	\$637,090,000
Free Cash Flow Yield using Enterprise Value	7.25%	4.39%	8.03%	3.71%
Free Cash Flow Ratio using Enterprise Value	13.80	22.76	12.46	26.93
Trailing PE Ratio (21-Sep-2009)	32	13.4	22.6	13
Forward PE Ratio (21-Sep-2009)	26.7	15.5	15.6	18.4

Liability Adjusted Cash Flow Yield

Though not commonly used in company valuation, [liability adjusted cash flow yield \(LACFY\)](#) is a variation. This is a fundamental analysis calculation that compares a company's long-term free cash flow to its outstanding liabilities over the same period. Liability adjusted cash flow yield can be used to determine how long it will take for a buyout to become profitable or how a company is valued. It is calculated as follows:

Average Free Cash Flow

$[(\text{Outstanding Shares} + \text{Options} + \text{Warrants}) \times (\text{Per Share Price}) - \text{Liabilities}] - [\text{Current Assets} - \text{Inventory}]$ is not commonly used in company valuation.

To see whether an investment is worthwhile, an analyst may look at ten years worth of data in a LACFY calculation and compare that to the yield on a 10-year Treasury note. The smaller the difference between LACFY and the Treasury yield, the less desirable an investment is.

The Bottom Line

Free cash flow yield offers investors or [stockholders](#) a better measure of a

company's fundamental performance than the widely used P/E ratio. Investors who wish to employ the best fundamental indicator should add free cash flow yield to their repertoire of financial measures. You should not depend on just one measure, of course. However, the free cash flow amount is one of the most accurate ways to gauge a company's financial condition.

For additional related reading, check out "[Analyze Cash Flow the Easy Way](#)" and "[Free Cash Flow: Free, But Not Always Easy.](#)"