

PART ONE

Defining Free Cash Flow and Shareholder Yield

Free Cash Flow

As a boy growing up in the 1950s, I was fascinated by the stock market. In the small Ohio town of my youth, my pals and I would cut lawns and trim hedges to earn spending money, but it seemed to me that the stock market provided an easier way to turn a profit. So, lured by the call of Wall Street, we devoured “How To” books on investing. Most of these books offered useless get-rich-quick schemes, variations of which can still be seen today on late night TV. There was no end to the bizarre trading techniques advocated by these authors; they touted stocks beginning with “x,” ending with “x,” stocks with no vowels. You name it, there was a book on it. In the more serious books, however, there was one variable that everyone seemed to agree on: That variable was *earnings*.

In the course of our studies, my friends and I learned everything we could about earnings and why they were endowed with the power to drive stock prices. We discovered that earnings represented the amount of revenues left over to the investor after all expenses were accounted for. If a company grew earnings, the company itself would become more valuable and this would be reflected in a higher share price. We also learned that, in order to arrive at a calculation of earnings, one needed

to follow the rules of accounting. At the time, accounting was seen as a sort of divining rod that properly separated assets from expenses, actual revenues from contingent revenues, and liabilities from real shareholder capital. In other words, there were few who questioned the concept of earnings or the accounting processes from which they were derived. And my friends and I were no exception.

Time passed, however, and my boyhood interest in the stock market developed into a career on Wall Street. In my very early days as a security analyst, earnings were still considered the most significant driver of stock prices. In fact, my first college textbook on the subject, *Security Analysis: Principles and Techniques* by Graham and Dodd (McGraw-Hill, 1962), centered its analysis almost completely on earnings. The discussion of cash flow was confined to 8 pages of a 723-page book!

As a result of this singular focus on earnings, most of us who studied or worked in the investment field during those years believed that the “fundamental analysis” of a company was all about the bottom line. However, in most MBA programs, there was a quiet revolution taking place that subsequently led to an explosion of novel ideas in finance that would turn the traditional earnings paradigm on its head. This revolution would not only change the investment industry as a whole, but would also completely transform my own approach to security selection.

This new financial outlook was based on the notion of *cash flow*. Specifically, there was a growing belief among investors and analysts that cash flow—not earnings—was the true determinant of investment value. In fact, the seeds of this idea had been sown several decades earlier when, in 1938, John Burr Williams’s *The Theory of Investment Value* established the concept of “present value” in comparing investment opportunities. In doing so, he acknowledged the primacy of cash flow by de-

scribing “the investment value of a stock as the present worth of all dividends.”¹ Now, a new generation of investors and analysts were expanding on Burr’s ideas with the goal of developing fresh insights into the power of a cash flow-focused valuation methodology.

But these insights, however revolutionary, were not immediately embraced by the investment community. Because the cash flow philosophy flew in the face of those who continued to subscribe to the accounting/earnings paradigm, a gap was created between the traditional model of equity analysis and the model suggested by these new findings. For cash flow to gain widespread acceptance as a singularly valuable investment metric, it would take an event of great relevance to the investment community. It wasn’t until 1984 that just such an event occurred: an event that would transform the common perceptions of what determines investment value and stock prices.

In 1984, a little-known private equity company called W.E.S.Ray (founded by Bill Simon, a former secretary of the U.S. Treasury, and Ray Chambers, an accountant) bought a company called Gibson Greeting Cards. Before being purchased by W.E.S.Ray, Gibson had already been the target of several acquirers. In 1964, Gibson had been acquired by CIT Financial Corporation, which was acquired in turn by RCA in 1980. Soon after its acquisition of CIT, however, RCA shifted its strategic focus to its collection of core businesses, which included names such as NBC, Hertz, and several high-profile electronics and communications companies. As a result, RCA decided to sell Gibson Greeting Cards, one of its noncore subsidiaries, to W.E.S.Ray Corporation for \$81 million.

At the time, many observers on Wall Street thought W.E.S.Ray’s purchase of Gibson was an ill-considered move. Even though Gibson was the third largest greeting card company in the United States with sales of \$304 million, the company did not fit the model of what popular consensus deemed

an exciting investment. Most of the investment community still adhered to the accounting methodology put forth by Graham and Dodd and, according to their earnings-based criteria, Gibson offered few indications of investment worthiness; there was nothing “flashy” about the company’s financial composition, growth potential, or strategic capabilities. But to those who had discovered the value of the free cash flow philosophy, Bill Simon and Ray Chambers among them, Gibson could not have been a more attractive investment opportunity.

In Gibson, W.E.S.Ray discovered a set of characteristics that have since become the holy grail of every free cash flow pundit. Specifically, W.E.S.Ray found that Gibson possessed:

- A stable revenue base that could take on a significant amount of leverage, and
- The ability to consistently generate high levels of free cash flow that could cover the cost of the acquirer’s debt and still allow the firm to grow.

With these characteristics in mind, W.E.S.Ray structured its acquisition of Gibson in the following manner: W.E.S.Ray gave Gibson management 20 percent of the company and, along with management, Simon and Chambers put \$1 million toward the \$81 million purchase price. The remaining \$80 million was provided by various borrowings, including a \$40 million loan from General Electric Credit Corporation and a \$13 million loan from Barclays American Business Credit. To finance the rest of the purchase price, Gibson sold and then leased back its three major manufacturing and distribution facilities. Then, 18 months after the acquisition, W.E.S.Ray floated a public offering of 10 million Gibson shares at \$27.50 per share. As a result of the cash generated by this offering, W.E.S.Ray realized a final payoff of \$66 million on an investment of about two-thirds of a million dollars. In other words, W.E.S.Ray’s return was nearly 100 times its initial equity investment. As for the

\$80 million in debt, the newly public Gibson was now responsible for using its own free cash flow to repay these loans.

With the Gibson acquisition, Simon and Chambers had achieved something truly remarkable. In essence, they had acquired a company with the company's own assets, and then pocketed a fair portion of the proceeds when the company was taken public. Investors, especially those who had previously ignored the importance of free cash flow, could not help but take notice.

The key to W.E.S.Ray's success was its steadfast application of the cash flow model. Whereas traditional accounting metrics might have assigned Gibson to the dustbin, W.E.S.Ray understood that the company's solid cash flow characteristics made it an extremely worthwhile investment. By using Gibson's free cash generation to its advantage, W.E.S.Ray realized an incredible profit from an acquisition that no one else was smart enough to make.

The story of W.E.S.Ray and Gibson was important to me as an equity analyst and investment manager, and transformative for the investment community as a whole, because it brought to life the very concepts that had revolutionized and divided the field of academic finance decades earlier. Now, these concepts—which had all either asserted or implied the value of free cash flow-based investment metrics—had finally become practice. With W.E.S.Ray's acquisition of Gibson, financial insights crowded out the accounting models that had once held all but unquestioned sway over Wall Street. Instead of merely focusing on earnings, the Gibson story showed us that so much more was at stake in our evaluations of publicly traded companies. Cash flow, specifically, was the metric that would soon change the face of investing.

Today, there are few people in finance—or in any other vocation or field of study, for that matter—who would dispute the importance of cash. Entire civilizations, philosophies, and social orders have been created or destroyed with the goal of harnessing the power of cash. Capitalism, for example, is

perhaps the most efficient process yet devised that allows both individuals and organizations to gain access to and control over cash and other forms of liquid capital. As the old cliché goes, cash is king.

Within the current investment landscape, cash—in the form of *free cash flow*—enjoys growing popularity as a key metric for investment managers, largely as a result of the lesson provided by W.E.S. Ray and Gibson Greeting Cards and the thousands of similar transactions that followed it. In terms of both security selection and the evaluation of business management, free cash flow provides the most meaningful gauge of a company's financial and operational health, and the most robust indication of share price performance.

We start this book with a discussion of free cash flow because of its essential place in the toolkit of the informed investor. But we are also using the concept of free cash flow as our jumping-off point because it is the cornerstone of this book's central investment thesis: Shareholder Yield. The rest of this chapter is dedicated to clarifying and expanding our definition of free cash flow with an eye toward the introduction of the Shareholder Yield philosophy.

Free Cash Flow—A Working Definition

In this book, the term *free cash flow* has very specific connotations that differentiate it from the more generalized concepts of “cash” and “cash flow.”* Professor Enrique R. Arzac, in his

*We can also build a definition of free cash flow by aggregating the following components: cash dividends, stock repurchases, increase in the cash balance and marketable securities, debt reduction, and interest payments. With regard to capital expenditures, one can determine that acquisitions, reinvestment in capital projects, and expansionary investments net of disposals are needed to

book *Valuation for Mergers, Buyouts, and Restructuring*, presents the demarcations between these separate, yet related, ideas in the following manner:

Why do we find it necessary to refer to a cash flow that is “free”? In practice, the term cash flow has many uses. For example, accountants define the cash flow of a company as the sum of net income plus depreciation and other non-cash items that are subtracted in computing net income. However, that cash flow is not available for distribution to investors when the firm plans to reinvest all or part of it to replace equipment and finance future growth. Free cash flow is the cash available for distribution to investors after all planned capital investments and taxes.²

A similar definition is provided by George Christy in *Free Cash Flow: A Two-Hour Primer for Management and the Board*: “Free Cash Flow = Revenues MINUS cash expenses PLUS non-revenue cash receipts PLUS or MINUS cash changes in working capital MINUS capital expenditures.”³ He goes on to say that the “‘free’ in free cash flow means that, after the company funds cash expenses and the changes in receivables, inventories, and fixed assets required to generate the revenues, the remaining cash flow is ‘free’ to be used for whatever management decides is best for the company.”

In other words, free cash flow is a specialized concept that allows us to determine the true amount of cash available for immediate, discretionary, strategic use by a business. It is

support the production of free cash flows. However, managing capital expenditures to reduce those investments that do not meet the cost of capital will increase free cash flows. With regard to interest payments, they are excluded from this definition because they are not discretionary, even though they are technically part of the free cash flow assignable to both debt and equity investors.

important to note that the definition of free cash flow used in this book (and in the books by Arzac and Christy) is not the same as the concept of cash flow as determined under generally accepted accounting principles (GAAP) accounting. While the GAAP version of cash flow may attempt to arrive at a number that approximates a business' available cash, it is "nothing more than a reconciliation of the change in the balance of the 'Cash and Cash Equivalents' account to the changes in the other balance sheet accounts (and indirectly to the numbers in the income statement)." For investors, analysts, and managers, this is problematic because "both the GAAP balance sheet and income statement are riddled with accruals, some of which are disclosed and some of which are not disclosed." Free cash flow, however, avoids these unfortunate opacities because it "captures all cash flows in and out of the company, is not distorted by accrual items, and includes changes in working capital and capital investments."⁴

In the next section, we take a closer look at why traditional GAAP accounting is an inadequate investment and management tool, and why free cash flow provides a more effective way to gauge financial performance.

Free Cash Flow versus Earnings and the Price/Earnings Ratio—A Comparative Approach

The increasing importance and effectiveness of free cash flow is placed in particularly high relief when compared to other popular investment metrics—specifically, earnings and its derivative, the price/earnings ratio (P/E).

Why has cash flow eclipsed earnings and P/Es as the most useful benchmark for security selection and business management? Much of the answer lies in accounting: the process by which a company represents its financial composition.

Earnings, as defined by the accountant, are the residual of the application of GAAP applied to the recognition of “revenues” less related “costs.” As such, earnings are intended to fairly represent the period-to-period performance of the company under review. However, over the past 20 years, GAAP standards have become less and less informative relative to the true financial health of a business. Although the GAAP system can certainly be credited for seeking to enforce a greater level of accountability and standardization within corporate financial reporting, the beneficial intentions of this process have become increasingly obfuscated. In fact, GAAP standards have grown so intricate and complex that their utilization is fraught with serious pitfalls for both management and investors. At over 10,000 pages long, GAAP is dense and convoluted and has resulted in the need for countless financial restatements and corrections.⁵ As a result, the notion of earnings—resulting product of GAAP calculations—has become as ineffectual as the system from which it is derived. To put it in colloquial terms, accounting is like a bathing suit: it reveals a lot, but what it doesn’t reveal is essential.

To better illustrate this point, let’s turn to a well-known case study. In 1993, Jack Treynor, former editor of the *Financial Analysts Journal* and one of the truly great minds in finance, published *The Feathered Feast*, an investigation into how the concept of earnings can be a dangerously deceptive misrepresentation of a company’s financial realities.⁶ In this case study, a hapless portfolio manager for the Amalgamated Iceman’s Pension Fund was lured into purchasing shares of Feathered Feast, Inc. (FF), a rapidly growing fast-food chain specializing in fried chicken. The investment in FF appeared to make a great deal of sense based on the past, present, and estimated earnings growth evident on the company’s income statement. According to GAAP calculations, FF’s earnings had grown by 10 percent per year from 1987 to 1990, and predictions of

near-term future growth were said to be conservative at 12 percent. As a result, it came as a great surprise to investors when, in 1992, FF began to default on some of its lease contracts for retail sites. Soon, the company was unable to cover corporate overhead costs and resorted to auctioning off its assets for scrap metal.

In *The Feathered Feast*, the basic question posed by Treynor is this: How can a company with such exemplary earnings growth turn out to be such a remarkably poor investment? The answer, as it turns out, is not simply a function of the *idea* of earnings, but also the *process* by which this idea is formulated. And what, precisely, is this process? Once again, it's called accounting.

For our purposes, let's say that the world is divided into two types of individuals—the accountant and the investor. The accountant and the investor are at opposite ends of the financial valuation spectrum. The accountant has two objectives. The first is to fairly represent the state of the business at a point in time, which is done via the balance sheet. The second objective is to record the receipts and expenses to show profits or losses, which is done via the income statement. Conversely, the investor's objective is to use the accountant's data and the principles of finance to create a fair market value for a company. The investor does this by discounting future expected cash flows with an assumed appropriate discount rate. At the heart of the investor's assumption is the expected stream of cash flows to be derived from the net assets owned by the entity.

In other words, the investor is focused on cash flows while the accountant is focused on earnings. Because of this, the accountant is vulnerable to the many pitfalls and distortions caused by the presence of misleading accrual items within GAAP-derived financial statements. In the case of the Feathered Feast, the most misleading of these accruals took the form of depreciation.

Depreciation, in the eyes of the accountant, is represented by an annual charge against an asset's purchase price in order to reflect the decline in the value of that asset. The shortcomings of this method become clear when we realize how much variation and subjectivity are involved in judging how quickly or slowly an asset's value will decline.

Airplanes, for instance, are assets that were once commonly thought to have "useful" lives of 10 to 15 years per accounting conventions. However, after 40 years, many airplanes are still flying. Energy pipelines are another good example. There is an annual depreciation charge to the expected life of a pipeline, but do we really believe this pipeline is worth less on an annual basis when astute buyers are actually paying more and more for each additional mile of pipeline every year? By the same token, what is implied when a manufacturing firm builds a new plant with an estimated life of 30 years only to learn a year later that the widgets it was to produce have become technologically obsolete? In this case, should not the depreciation rate be 100 percent?

In fact, the accountant's miscalculation of the fair value of assets is the key to solving the conundrum presented in *The Feathered Feast*. To arrive at FF's projected earnings, the accountant had to apply an assumed rate of depreciation: a process that, as demonstrated in the prior paragraph, is an inexact science at best. It is not surprising, therefore, that in Treynor's case study the accountant's analysis of the value of FF's assets was wildly inconsistent with the economic reality. This is because the changing value of the assets (FF's retail structures) did not match the assets' ability to generate earnings over time. On FF's income statement, accountants had depreciated FF's retail structures on a 12-year basis. However, these structures actually became obsolete in only 5 years. Therefore, with the hindsight of this accelerated depreciation, historical earnings growth for FF was actually *negative*. Put another way, FF shares

only appeared to be a good investment when the annual estimated depreciation charge (on a 12-year outlook) was low enough to keep earnings in the black. But, as soon as accurate depreciation numbers were available in hindsight (on a 5-year outlook), the company's true financial weakness was revealed. Tables 1.1 and 1.2 show the remarkable disparity between these two different outcomes. Specifically, estimated net income changes from a positive \$85 million under the accountant's approach (Table 1.1) to a negative \$82 million under the investor's approach (Table 1.2).

In light of this miscalculation on the part of the accounting model, is it possible to trust the concept of earnings or the accounting methodology from which earnings are derived? Sadly, the answer is no.

Thankfully, finance—the methodology employed by investors—offers an alternative, and more realistic, concept of an asset's value and longevity. This concept is based on the present value principle, as first asserted by John Burr Williams. This principle says that there is a stream of benefits (cash flows) derived from the purchase of an asset, and the asset's

TABLE 1.1 Foresight Depreciation and Profit Analysis for Feathered Feast
(\$ in millions)

	1987	1988	1989	1990	1991 (est.)
Net income (after taxes)	58	64	71	78	85
Net income plus depreciation	100	110	121	133	146
Dividends	50	55	60	67	73
Capital investment	—	50	55	60	67
Gross plant	500	550	605	665	732
Dividends/Net income	0.86	0.86	0.85	0.86	0.86

Source: Financial Analysts Journal.

TABLE 1.2 Hindsight Depreciation and Profit Analysis for Feathered Feast
(\$ in millions)

	1987	1988	1989	1990	1991 (est.)
Gross plant	500	550	605	665	732
New investment	—	50	55	60	67
Restated depreciation	100	112	131	161	228
Net plant	400	338	262	161	0
Net income (after taxes plus depreciation)	100	110	121	133	146
Depreciation	100	112	131	161	228
Net income	0	(2)	(10)	(28)	(82)

Source: *Financial Analysts Journal*.

present value is determined by discounting this value by the firm's cost of capital.

To illustrate the difference between these two approaches to asset valuation, let's return to the airplane example. Recall that, under the accountant's approach, an airplane has a fixed life. However, under the investor's approach, the useful life of the airplane can vary greatly and, in some cases, be nearly infinite. Needless to say, these two approaches can result in wildly different values for the exact same company asset.

This is the reason the concept of earnings and, by extension, the concept of book value are often worthless tools for investors. Earnings and book value reflect the accountant's flawed concept of depreciation, as well as various other questionable accruals, and generally bear no relation to the true time value of the cash flows generated by an asset as reflected in the public securities markets.

Furthermore, there is no cost of capital within the accountant's methodology, even though cost of capital is incredibly relevant to finance. Why are investors correct in incorporating

cost of capital into their calculations? Because the annual depreciation of an asset should not be immune to changes in interest rates, nor should depreciation be the same in an 8 percent interest rate environment as in a 4 percent interest rate environment. Simply put, the accounting approach ignores these critical details, while the finance approach incorporates them via the use of cash flow and the cost of capital.

From this discussion, we see that accounting clings to a method of asset valuation that is largely based on subjective and often quantitatively unsupportable assumptions. Therefore, it is clear that, for this and a host of other reasons, the concept of earnings is an accounting construction that is often of little use to investors and finance professionals. By extension, through the transference of the annual income number to retained earnings, the concept of book value (BV) is similarly erroneous.

If we follow this logic, it becomes clear that the popular valuation ratios derived from these accounting concepts—P/E and price to book value (P/BV)—also serve a questionable purpose. At the most basic level, P/E and P/BV are ineffective metrics for the simple fact of their flawed denominators. However, these ratios are additionally misleading because they attempt to combine accounting and finance: two philosophies that, as we have already learned, subscribe to radically different and fundamentally unblendable valuation methodologies.

A security's price reflects a concept based in finance (the present value of future streams of cash flows), while the concepts of earnings and book value are the products of accounting theory. To illustrate the dangers of mixing finance (a security's price) with accounting (earnings and book value), one need only refer back to the *Feathered Feast*. Before its collapse in 1992, FF stock had a remarkably high P/E ratio of 40, which seemed to indicate a level of confidence about its growth prospects and its investment worthiness. As we now

know, this indication proved false and it is easy to see how the weak conceptual underpinnings of the P/E ratio are to blame.

For another example of why P/E and P/BV are not effective or accurate metrics, consider what happens when a company repurchases its stock at a price above its book value per share. The accounting treatment for this repurchase would result in a debit to Treasury stock and a credit to cash on the company's books. Treasury stock is a reduction from stockholders equity, so this transaction has the effect of lowering the firm's book value and therefore increasing its P/BV ratio, assuming no change in the market price of the company's public stock. It also has the effect of raising its "Return on Equity," because the numerator (earnings) has remained unchanged while shareholder equity has been reduced.

This situation becomes problematic when we recognize that some investment industry consultants use P/E and P/BV ratios as the sole means of differentiating "value" companies from "growth" companies. Value companies are defined as such because they have low P/Es and low P/BVs, whereas growth companies have high P/Es and high P/BVs. In reality, however, the actual characteristics of value and growth more often than not have nothing to do with these artificial descriptions. For example, from the previous discussion of what happens to P/E and P/BV during a share repurchase scenario, it is clear that a company could switch from the value category to the growth category by sheer virtue of the frequency and magnitude of its share buyback program. In other words, a "value" company could become a "growth" company, and vice versa, not through a fundamental change in the company's financial or operational characteristics, but rather through a mere reshuffling of its assets and shareholders equity components.

The main point of the past several pages is that accounting is a contrived language that often provides misleading criteria for investment decisions and investment style categorizations.

Accounting-related concepts such as earnings and P/E communicate little to an investor about the true profitability of the business, let alone a proper valuation for it. However, we can look to finance to provide superior insight into the true characteristics of an investment opportunity. This superior insight takes the form of free cash flow and its various applications.

Today, there are myriad examples of the manner in which the investment community has adopted the finance-derived concept of free cash flow as the gold standard for capital allocations. It is the rare Wall Street research report these days that does not mention cash flow and the valuation metrics that incorporate it. In addition, leveraged buyout (LBO) firms and private equity (PE) funds focus almost exclusively on cash flow as the measure of value creation. Because so many of these LBO/PE acquisitions involve placing a great deal of debt on the target company's books, the target company must be able to generate the cash flow necessary to service this new debt and to allow the acquirers to realize a profit. (Recall the example of Gibson Greeting Cards from earlier in the chapter.) For this reason, LBO and PE investors use a free cash flow model when evaluating takeover prospects. The success of this strategy is underscored when we consider that, in 2005, the net amount of capital raised by global private equity funds was \$272 billion, nearly double the level from the prior year.⁷ As of September 2006, this number increased to over \$400 billion. In our view, this evidence of the growing popularity of private equity investing also indicates the heightened relevance of the cash flow metrics these funds are known to employ.

There are also many recent books and articles that support the use of free cash flow benchmarks for both investors and managers. Two of these books stand out in particular, both of which have already been cited in this chapter. *Free Cash Flow*, by George Christy is an excellent synopsis of how and why management teams should use the free cash flow model to cre-

ate shareholder value. In Christy's words: "maximizing free cash flow maximizes a company's options and opportunities."⁸

The second book is *Valuation for Mergers, Buyouts, and Restructuring* by Enrique Arzac. Arzac, a professor of Finance at Columbia University's Graduate School of Business, provides an in-depth examination of the complexities involved in determining valuations for business units that generate cash flow. This book demystifies the entire subject of valuation and provides a level of granularity uncommon to most textbooks on this topic. At the core of Arzac's argument is the notion that—in the game of mergers and acquisitions, restructurings and common share ownerships—buyers pay for cash flow, not earnings.

In addition, both Arzac and Christy point out that GAAP accounting, the process by which earnings are derived, was never intended to be a management tool. Instead of GAAP, free cash flow metrics should be used to evaluate performance. Free cash flow offers a superior method because it incorporates the company's entire value chain (revenues, margins, working capital requirements, and capital expenditures) into one formula. In presenting this argument, Arzac and Christy align themselves with the pioneers of the free cash flow philosophy, which concluded long ago that a company's stock price is determined by the stock market's assessment of the firm's expected cash flows, not its historical earnings or GAAP earnings.

It seems clear that the investment community has already begun to embrace the idea of free cash flow as the stock market's most compelling and effective valuation benchmark. Similarly, we believe that investors and managers are ready to jettison the outdated system of traditional management accounting principles in favor of the superior insights offered by finance-derived cash flow metrics. The next section begins to specify the manner in which these metrics can be employed by

the investment community within the framework of Shareholder Yield.

The Five Possible Uses of Free Cash Flow— An Introduction to Shareholder Yield

In addition to being the most useful metric for investors, free cash flow is also the metric that enables a company's management team to review and select the best possible options for the generation of shareholder value in light of the firm's cost of capital. Therefore, when engaged in the process of security selection, it is necessary for investors to look not only at the quantity and quality of a company's free cash flow, but also the manner in which this free cash flow is deployed by management.

From the perspective of a company's management team, there are only five possible uses of free cash flow:

1. Cash dividends
2. Stock repurchases
3. Debt reduction
4. Acquisitions
5. Reinvestment in company capital projects

Every conceivable option for the allocation of a dollar of free cash flow use falls into one of these five applications. Often, management will employ some of each, but we see a distinction between the first three uses and the latter two. We believe that, unless the return on incremental capital is superior to the firm's average cost of capital, there is little point in pursuing option 4 (making acquisitions) or option 5 (reinvesting in the business beyond maintenance capital expenditures).

So, when and if acquisitions and reinvestments fail to generate sufficient returns, free cash flow should be returned to

shareholders via one of the first three options. These first three possible uses of free cash flow (cash dividends, stock repurchases, and debt reduction) are all effectively dividends payable to shareholders. Therefore, we refer to these three options collectively as Shareholder Yield.

The concept of Shareholder Yield plays a key role in the pages that follow. As we move on to a more comprehensive analysis of these three cash flow deployment options, it is our hope that this first chapter has set the stage for the discussion that will follow. So far, we have endeavored to use the “accounting versus finance” dichotomy to explain why P/Es (the products of accounting) are out and free cash flows (the products of finance) are in. Similarly, we have used free cash flow to derive the components of Shareholder Yield: a concept that is not only crucial to our investment framework but absolutely necessary for informed stock selection. In the next chapter, we explore the notion of Shareholder Yield more fully in order to further strengthen the case for this application of the free cash flow deployment philosophy.

