Forbes
Beyond the Balance Sheet

Good Cap-Ex, Bad Cap-Ex

There's a world of difference between capital expenditures that expand a business and those that merely maintain the status quo.

By Jack Gage

THE "CASH IS KING" PHILOSOPHY HAS ATTRACTED quite a following on Wall Street. In this approach you focus not on a company's earnings but on its cash flow from operations, equal to the sum of earnings and depreciation and amortization, plus or minus changes in working capital items (like inventory or payables) that help or hurt a company's checking account balance. Take cash flow from operations and subtract capital expenditures to get free cash flow. This is what Warren Buffett calls "owner's cash." A company trading at a low multiple of owner's cash is probably a bargain.

There's one big weakness in picking stocks in this fashion—it doesn't do justice to growth companies. A fast-growing outfit might be plowing all its cash flow into expansion, leaving nothing for dividends, and still be a terrific investment. There ought to be some way to distinguish a cement company that has no free cash because it consumes all its cash replacing worn-out machinery, from a retailer gobbling all its cash on new locations.

In this, the seventh in our Beyond the Balance Sheet series, we aim to separate the cement companies from the Wal-Marts. There is no perfect way to do this because companies do not report—and often don't know—how much of their capital spending generates growth and how much merely maintains the status quo. As a rough measure of how much cap-ex is growth-related, we look at growth in revenue and at the historical relationship between revenue and fixed assets. If $1 of property, plant and equipment supports $3 of revenue, then a $300 million revenue gain calls for $100 million of new PP&E. This part of cap-ex is growth cap-ex. Anything else is (we presume) maintenance cap-ex. Only the maintenance cap-ex is subtracted from cash flow to get "adjusted free cash flow."

Last year Wal-Mart spent $13 billion on capital outlays, leaving $3.7 billion of free cash flow when calculated the traditional way. The company's market value is 56 times this number. But when we credit the company for expansion cap-ex, we find a far more reasonable multiple: 18 times adjusted free cash flow of $11.3 billion. DuPont lands at the other end of the spectrum. As traditionally calculated, its price/free cash ratio is 21. By our method it's 26. After factoring in a decline in DuPont's sales the company's free cash flow fell from $2 billion to $1.6 billion.

Not all sales gains, to be sure, come from adding store fixtures or machinery to the business. A company may be doing no more than enjoying price gains from an existing book of customers. But still there is a rough justice in our adjusted free cash figures. Wal-Mart's success is due in part to same-store sales gains, for which it should get credit one way or another in a free cash flow analysis. The BlackBerrys sold by Research In Motion are so popular that it has enjoyed a sales burst while feeding its capital account with an eyedropper. In our analysis RIM gets credited with a negative number for maintenance cap-ex. That is an artificial result but not an unfair one. If RIM can keep up this kind of growth (not a sure thing, given new competition from Motorola), then it's a bargain even at its current steep price.

Whole Foods is another winner. A year ago it was trading at 57 times free cash flow when conventionally calculated. That would be expensive for a tech stock, let alone a supermarket chain. But a lot of its cap-ex was for expansion. Adjusted, the ratio was 39. The stock was not overpriced; it has since climbed 42%.

In the table, which uses more recent results, Whole Foods' price to adjusted free cash falls all the way to 16. Like Costco, Home Depot and others, Whole Foods gets credit not just for adding outlets but also for wringing more revenue from existing assets. Either the customers are buying more food when they go in the store or they are more oblivious to price hikes on the organic chicken. Either way, shareholders are sitting pretty. ■

STICKER SHOCK

These companies became more expensive when we differentiated between expansion and maintenance capital expenditures. They suffer from declining revenue and high PP&E relative to sales, resulting in less free cash flow.

Top 5 Premiums

Company/business	Adjusted P/FCF[1]	Unadjusted P/FCF[2]	Recent price	52-week high	P/E	Sales ($bil)	Market cap ($bil)
Bunge/agribusiness	44	27	$58.10	$67.99	13	$24.1	$6.5
E.I. du Pont de Nemours/chemicals and plastics	26	21	42.24	54.90	16	26.7	42.0
Electronic Data Systems/computer services	51	40	22.58	23.95	NM	20.4	11.7
Mylan Laboratories/biotechnology	167	59	17.80	20.03	29	1.2	3.9
Synopsys/software	17	11	17.39	21.30	36	1.0	2.5

[1]Operating cash flow minus capital expenditures. [2]Operating cash flow less maintenance capital expenditures (total capital expenditures minus the five-year average ratio of gross property, plant and equipment to sales applied to the one-year change in sales).
Sources: Reuters Fundamentals via FactSet Research Systems; company financials.

DUPONT
It will take more than a new paint job for the chemicals and plastics maker to trim the overcapacity it has endured during the past five years.

BUNGE
Operating profits for the $24 billion (sales) food and fertilizer company were down 11% during the first six months of 2005 because of poor crop quality in eastern Europe, higher energy costs and a drought in southern Brazil.

BUNGE: GETTY IMAGES

CHEAPER BY THE NUMBERS

Our screen of U.S.-traded companies with a market value over $2 billion produced 25 stocks to buy and 5 to shed when comparing traditional and refined price with free cash flow multiples. The companies below trade at more than a 25% discount to traditional multiples.

Top 25 Discounts

Company/business	Adjusted P/FCF[1]	Unadjusted P/FCF[2]	Recent price	52-week high	P/E	Sales ($bil)	Market cap ($bil)
Abercrombie & Fitch/specialty retailing	21	32	$63.66	$74.10	27	$2.0	$5.5
Advance Auto Parts/specialty retailing	22	38	68.73	71.59	24	3.9	4.9
Amgen/biotechnology	21	30	80.40	84.02	36	11.6	99.0
Anheuser-Busch/alcoholic beverages	17	23	44.30	53.16	16	15.0	34.4
Apple Computer/computer hardware	24	47	42.65	45.44	34	12.6	35.3
Baker Hughes/oil services & equipment	18	44	58.16	58.72	27	6.6	19.8
Carnival/cruise lines	7	35	52.20	58.98	20	10.1	42.7
Costco Wholesale/specialty retailing	12	26	43.30	50.46	20	51.4	20.8
Dollar General/discount retailing	23	84	19.25	22.80	18	7.9	6.3
Eli Lilly/pharmaceuticals	30	46	53.10	67.30	47	14.1	60.2
FedEx/shipping	5	29	84.65	101.87	18	29.4	25.6
Gillette[3]/specialty retailing	22	37	52.40	54.33	28	11.2	52.3
Harrah's Entertainment/gaming	8	28	72.99	79.69	24	5.0	9.0
Home Depot/specialty retailing	17	32	40.59	44.30	17	74.5	87.3
Manpower/business services	15	25	46.45	49.95	17	15.8	4.0
Motorola/communications equipment	6	23	21.65	22.11	19	33.3	53.3
Paccar/auto manufacturing	21	68	70.56	81.42	12	13.0	12.1
Pentair/conglomerates	10	32	39.55	46.47	23	2.8	4.0
Research In Motion/communications equipment	27	65	68.91	103.56	45	1.5	13.1
Starbucks/restaurants	19	61	50.99	64.26	42	6.2	19.9
Texas Instruments/semiconductors	13	25	31.53	32.86	26	12.6	51.2
Urban Outfitters/specialty retailing	29	84	56.04	62.96	45	0.9	4.6
Wal-Mart Stores/discount retailing	18	56	49.15	57.89	20	291.4	205.5
Walt Disney/broadcasting	16	42	25.41	29.99	20	31.5	52.9
Whole Foods/supermarkets	16	84	132.82	139.69	53	4.5	8.9

[1]Operating cash flow minus capital expenditures. [2]Operating cash flow less maintenance capital expenditures (total capital expenditures minus the five-year average ratio of gross property, plant and equipment to sales applied to the one-year change in sales). [3]Acquisition by Procter & Gamble pending.
Sources: Reuters Fundamentals via FactSet Research Systems; company financials.

RESEARCH IN MOTION

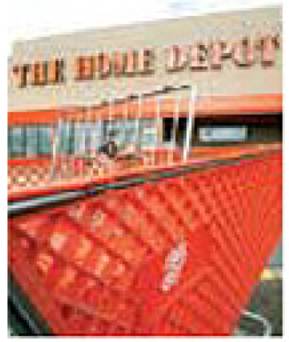
Expansion isn't limited to square footage. BlackBerry demand led to RIM's 60% workforce increase in 2004.

IBM

It doesn't require a ThinkPad to know it takes money to make money. The computer maker's seven-day improvement in its cash cycle makes plowing money into R&D more affordable *(see below)*.

STARBUCKS

From the company that brought you the $7 latte, more than 600 new stores in 2004 helped deliver a double shot to earnings and 22% sales growth so far in 2005.



HOME DEPOT

Discounts in the stores are nice, but it's the $6.7 billion in stock buybacks over the last two years that has made shareholders happy.

CAPITAL AT WORK

We asked the experts at RateFinancials of New York City (www.ratefinancials.com) to identify those companies whose cash cycles improved and deteriorated the most during the last six months. A barometer for how well a company uses its working capital, the cash cycle is a critical component of operating cash flow, measuring how quickly a company collects its receivables, extends its payables and turns over inventory.

CASH CYCLE[1] IMPROVEMENT	CASH CYCLE[1] EROSION
AutoZone 16 DAYS	SafeNet 32 DAYS
IBM 7 DAYS	Hasbro 20 DAYS
Walt Disney 5 DAYS	Siebel Systems 15 DAYS
Paychex 4 DAYS	Cendant 10 DAYS
Costco 2 DAYS	Goodyear 6 DAYS

[1]Accounts receivable days outstanding, plus inventory days, minus payable days. *Source: RateFinancials.*

HOME DEPOT: TIM BOYLE / GETTY IMAGES; STARBUCKS: MIKE CLARK / AFP / GETTY IMAGES