Free Cash Flow (FCF): Explanation & Examples

Free cash flow (FCF) reflects the amount of cash free for distribution to all stakeholders.

The level of FCF does not always reflect the health of a business or its prospects. For example, a large amount of FCF can be a sign that a company has limited investment opportunities and, hence, limited growth prospects. On the other hand, negative FCF can be an attractive indication that a company has more investment opportunities than it can fund with internal cash flows. Zero FCF could mean that the company generates just enough cash to internally fund its growth opportunities.

There are many ways to calculate free cash flow. Most approaches are short cuts to our more comprehensive approach to the calculation. The formula for FCF can be seen in Figure 1. For more on FCF, see here.

Figure 1: How To Calculate Free Cash Flow

NOPAT – Change In Invested Capital

Or

NOPAT
– Change In Net Working Capital (excludes Excess Cash)
– Change In Fixed Assets
= Free Cash Flow

Sources: New Constructs, LLC and company filings

We've highlighted companies that misrepresent their free cash flow in order to trick investors into believing they are more profitable than they truly are. As we note in our article on ROIC, the FCF calculation is not hard. Getting all the data to ensure the calculation is performed with high integrity numbers is the hard part. We put extraordinary effort into ensuring we use the best possible NOPAT and Invested Capital for FCF calculations.

Free cash flow yield (free cash flow/enterprise value) is a nice ratio to understand profits relative to the value of the business. In our opinion, it is far superior to dividend yield in reflecting cash flows relative to value.

Figure 2 contains the companies with the highest and lowest level of FCF and their FCF yields.

Figure 2: Companies With Most Positive/Negative Free Cash Flow

Ticker	Name	FCF	FCF Yield
	Highest Free Cash Flow		
GE	General Electric	$122,634	44%
AAPL	Apple Inc.	$45,945	10%
RDS.A	Royal Dutch Shell	$32,449	15%
NTT	Nippon Telegraph and Telephone	$31,361	17%
C	Citigroup	$28,605	18%
	Lowest Free Cash Flow		
PBR	Petroleo Brasileiro S.A.	($48,513)	-19%
MDT	Medtronic	($55,638)	-43%
AGN	Allergan	($70,411)	-46%
T	AT&T Inc.	($92,800)	-19%
DB	Deutsche Bank	($129,550)	-451%

Sources: New Constructs, LLC and company filings. Only includes companies with positive NOPAT

Per Figure 2, General Electric has the most free cash flow out of all companies under coverage. See General Electric's historical free cash flow, dating back to 1998, in our model here. You can see that in nine of the past 10 years, General Electric has generated positive free cash flow, totaling to a cumulative $385 billion. Despite the impressive FCF generation, GE earns a Dangerous rating, largely due to its valuation. At its current price, General Electric has a price to economic book value (PEBV) ratio of 2.7. This ratio means the market expects GE's NOPAT to grow by 270% from current levels. The adjustments page in our model shows all the adjustments we make to get NOPAT and Invested Capital right for GE's FCF calculation.

Apple Inc. (AAPL), Royal Dutch Shell (RDS.A), Nippon Telegraph and Telephone (NTT), and Citigroup (C) round out the list of companies that generate the most FCF. Additionally, these companies earn a high free cash flow yield.

Deutsche Bank (DB) generates the least, or most negative, free cash flow of all companies under coverage. You can see DB's free cash flow dating back to 2012 here. In Deutsche Bank's case, the company has generated negative FCF for the past two years. 2015 was affected by a large increase in long-term liabilities, which greatly increased DB's invested capital, but failed to increase profits. The adjustments page in our model shows all the adjustments we make to get NOPAT and Invested Capital right for DB's FCF calculation.

Petroleo Brasileiro (PBR), Medtronic (MDT), Allergan (AGN) and AT&T (T) round out the list of companies generating the least free cash flow.

Our models and calculations are 100% transparent because we want our clients to know how much work we do to ensure we give them the best earnings quality and valuation models in the business.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, style, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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