

College of Business Book Review by David Coffee

Title: “Free Cash Flow: Seeing Through the Accounting Fog Machine to Find Great Stocks”

Author: George C. Christy

Publisher: John Wiley & Sons, Inc.

Length: 181 pages

Price: \$49.95 (Amazon.Com \$32.97)

Reading time: 10 hours

Reading rating: 6 (1 = very difficult; 10 = very easy)

Overall rating: 3 (1 = average; 4 = outstanding)

This book is about the art of using cash flow analysis to determine the fundamental value of a company in order to identify good stock investments. The book is not appropriate as an introduction to equity investing. It is written for experienced investors with a basic understanding of the concepts embedded in accrual accounting and the conflicting relationship net income measurements based on generally accepted accounting principles (GAAP) can have with cash flows. While the focus of the book is narrow and somewhat intense, the author offers a surprising number of key insights which can be very useful to anyone investing in the stock market. These insights may very well make this book worth reading even if you lack a technical financial and accounting background.

While the typical “how to invest” books are written by professional investors or academics in finance, the author, George C. Christy, is neither. Mr. Christy, most recently the treasurer of a public company, was for 30 years a corporate banker in Chicago, Tokyo, and Los Angeles. His perspective is based on his banking experience. Because bank loans are “repaid by cash flow, not GAAP earnings” the author learned early on how to analyze cash flow. After his banking work, he was a consultant at one of the country’s largest investor relations firms, writing clients’ earnings press releases, annual reports and corporate profiles. He helped client CEOs and CFOs prepare for quarterly earnings conference calls and presentations. His career has given him an insider’s perspective of how CEOs and CFOs manage public disclosures and relations with the street. This book is an insider’s perspective on cash flow investing which is very different than that of the typical money manager.

In this book, Christy characterizes accrual accounting as “the accounting fog machine,” and is critical of the complex array of estimates and assumptions required to generate periodic earnings measurements. He makes a case for using cash flows as a better measure of economic performance. The importance of cash flows to valuation models is not new, as most valuation models project future cash flows and discount them back to their present value.

The concept of measuring “free cash flows” and using this metric as a basis of economic performance is, as the author points out, widely recognized in the financial community. Unfortunately, there are several different definitions of free cash flow. Charles Schwab’s Schwab Equity Ratings (SER) defines free cash flow as accrual net income

plus depreciation and minus capital expenditures and dividends. Others define it as simply cash flows from operations or cash flows from operations less capital expenditures. Christy's definition is essentially the latter. But the really important contribution of his book, is not his particular definition of free cash flows but his observations and insight into the importance of how the free cash flows are disposed of and how this disposal impacts firm valuation and investor returns.

Christy considers all corporate strategies as falling into one of five possible disposals of free cash flows: (1) cash dividends; (2) share repurchases; (3) debt pay downs; (4) new capital projects; and (5) acquisitions. It is the disposal of the cash just as much as the generation of the cash which signals good stocks and bad stocks. This point is important and in the reviewers opinion, is the key contribution of this book. It certainly made me think about issues which I have been overlooking in my own valuation models and portfolio selections.

For example, suppose a company is using cash flow for acquisitions. Christy contends that acquisitions made outside the buyers core business signal that management thinks its core business offers less than acceptable prospects and that time spent in the acquisition process is time not spent on the core business. Plus acquisitions often are accretive to accrual based earnings per share because goodwill is no longer amortized, but may not be accretive to free cash flow per share.

Or suppose a company deploys free cash flows by making share repurchases. The book discusses six types of stock buybacks, one of which is referred to as "delusional buybacks." These are done by companies with negative cash flows and result in investors owning a larger share of a company's negative cash flow! Does this spark your interest? Read the book to learn about "nonbuybacks, bonus buybacks, defensive buybacks, front door buybacks and investor buybacks." Only investor buybacks are good for valuation.

You may visit the author's web site at www.OakdaleAdvisors.com. You can find two downloadable Excel files used in the book at www.wiley.com/go/christy. If you are a serious equity investor with an analytic perspective, you may find the book to be a refreshing approach to stock selection.

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