Headline: **Cash flow is King**

Source: **DSIJ** | Date: 11 November, 2019

Special Report

Identifying quality stocks that can beat Sensex returns is a material discovery, practically for any investor. While doing so, most investors undermine the importance of cash flow from operations of companies. **Geyatee Despande**, while highlighting the importance of focusing on cash flows from operation, explains how the higher cash flows from operations translate into higher profits, thus rewarding investors eventually.

With market sentiment becoming more bullish as we head into the end of CY2019, investors are more excited about prospects today than they were throughout the year. Investors are not to be blamed as the global markets are supportive and there seem to be opportunities galore in markets today to beat the Sensex. As we head into 2020 the big question still remains – which set of stocks will outperform the Sensex? What strategy may work for 2020 without being sector specific?

With improving market sentiment, it is important that we focus on the momentum strategy for beating the index. Momentum strategy works best in bullish market set ups and when broader markets gather steam. The question however still remains "How to pick quality stocks (good fundamentals) when the market sentiment is positive or improving?"

Says Tushar Deshmukh, "I have noticed that I often get lost when markets suddenly change in terms of sentiment and broader markets start chipping in. Most of the times I do not know where (which stock) to buy when market sentiment improves. Stock selection is very difficult to make even when I am convinced that market is going to deliver positive returns over one odd year." Tushar has been an investor for over a decade now.

Indeed, most of the time, investors do not have a strategy of stock selection in place that suits the prevailing market condition. However, it can be extremely profitable to be prepared in advance as investors can then encash the bullish market sentiments optimally. Stock selection strategy needs to be in place- that's all!

Assuming a bullish market sentiment to prevail, a momentum strategy that focuses on high growth stocks may sound like the most logical equity strategy that needs to be adopted, in order to beat the Sensex. While doing so investors also have to not ignore the quality component in the stock. In other

Cash flow statement shows inflow and outflow of cash and cash equivalents from various activities of a company during a specific period under the main heads i.e., operating activities, investing activities and financing activities.

> **If I had to run a company on three measures, those measures would be customer satisfaction, employee satisfaction and cash flow.**
>
> \- Jack Welch

> **Entrepreneurs believe that profit is what matters most in a new enterprise. But profit is secondary. Cash flow matters most.**
>
> \- Peter Drucker

words, the strategy that can work in current market situation seems to be focusing on high growth momentum stocks that reflect strong fundamentals.

Operating cash flows and net income as quality parameter

While analysing stocks how much weightage do we as investors give to operating cash flows and its excess over net income? Very little is the most likely answer.

When scanning opportunities, it could prove to be profitable to focus on those stocks that are generating higher operating cash flows. Before we hunt for opportunities by focusing on operating cash flows, we need to understand what exactly is operating cash flow how studying the cash flows can help us identify quality stocks.

Operating cash flow (OCF) is nothing but the amount of cash generated by the regular operating activities of a business within a specific time period for e.g., one fiscal year. OCF is calculated simply by adding non-cash items to the net income and adjusting for changes in net working capital. No financial analysis of any company is complete without observing OCF in conjunction with net income, free cash flow (FCF), and other financial metrics

Operating Cash Flow = **Net Income** + **Non Cash Expenses** + **Increase in Working Capital**

Ishan Shah

AVP - Content & Research, QuantInsti

Higher cash flows facilitate the availability of additional capital that can be redeployed into the business. This supports growth without pressurising the balance sheet. Such liquidity when corresponding to a high growth phase in the economic cycle is particularly beneficial in tapping many potential growth avenues/opportunities. For investors who are equipped with quantitative tools & techniques, it is easy to filter out companies by applying various statistical tests to identify the right stocks and invest in them. Such strategies when employed have a high likelihood to outperform the returns of the benchmark index by a decent margin and with a low volatility quotient. We have seen some of the strategies generating a CAGR of 15%+ in the past three years.

> Never take your eyes off the cash flow because it's the lifeblood of business.
>
> - Richard Branson

> The more a business owner knows about their cash flow, the more empowered they become.
>
> - Nick Chandi, PayPie CEO

> We were always focused on our P&L statement. Cash flow was not a regularly discussed topic. It was as if we were driving along, watching only the speedometer, when in fact we were running out of gas.
>
> - Michael Dell

Empirical evidence: -

To check if high growth companies with higher operating cash flows than the net income beat the Sensex, we identified the historical performance of such companies.

List of high growth companies with higher operational cash flows than net profits: -

Company	Compounded Profit Growth		Compounded Sales Growth		Stock Price CAGR		
	3 Year	5 Year	3 Year	5 Year	1 Year	3 Year	5 Year
Trident	14.56	12.65	12.51	6.32	-5.04	0.94	13.92
PNC Infratech	9.81	33.81	15.42	21.87	25.07	11.69	NA
Bombay Burmah	32.06	35.7	9.24	9.46	-7.13	25.90	35.92
Godrej Consumer Products	26.12	23.34	6.98	6.30	1.12	11.10	17.79
HUL	14.11	11.54	6.89	6.10	33.77	37.27	24.00
Deepak Nitrate	26.52	9.07	8.98	12.03	41.41	44.30	35.88
Hatsun Agro	26.52	9.07	14.01	14.48	-1.98	20.55	22
Heidelberg Cement	84.90	49.4	11.84	8.94	27.95	8.23	15.62
Inox Leisure	19.14	30.05	10.23	5.05	65.56	12.87	15
JMC Projects	46.63	51.96	11.39	13.81	19.75	25.42	30.15
Linde India	23.14	-8.62	10.29	7.13	35.30	13.44	6.24
					21	19.25	21.6
All Figures in %				SENSEX	18	13	8

If we consider only those stocks that have consistently enjoyed higher operating cash flow when compared to net income for the past five years, market capitalisation of more than Rs 1,000 crore and profit CAGR for last five being close to 10 per cent, we find that the outperformance is visible in these set of stocks if we consider the average performances.

On an average the set of stocks that qualify on the above said parameters have delivered 21 per cent, 19 per cent (annualised) and 21.60 per cent (annualised) in one year, three years and five years respectively.

This is when the Sensex has inched up by 18 per cent in one year, 13 per cent in three years on an annualised basis and 8 per cent in five years on an annualised based. This additional return is what can create wealth for investors in the long run.

Rama Ratnam

Director and Head of Products
Centrum International Services Pte. Ltd.

Companies with capability to generate higher and consistent free cash flows when compared to peers within an industry will outperform. Investors should lay due emphasis on free cash flows of companies irrespective of income or total return investment bias.

The following are the reasons for the same:

- Free cash flow is a powerful prognosticator of dividend sustainability and stock price returns
- Stocks selected based on high free cash flows criteria tend to deliver high dividend yield and perform better in the long run (if we cannot deep dive in the DCF modelling and cash flow forecasting this can be a good proxy)
- Replacing earnings with cash flows is a better idea to implement to predict stock returns
- Some ratios that aid better stock selection are FCF/Asset and Enterprise Value/FCF. These are better metrics to consider vis-a-vis ROA, PE multiples or EV/EBIDTA

Free cash flow does not suffer from the pitfalls of accrual-based earnings measures.

Conclusion

With Sensex touching all time highs and promising to inch upwards on attractive equity yields in a low interest rate environment, the positive outlook for market can reduce a lot of uncertainty in Investors' minds. What aids bullishness in equity markets is also the fact that the oil prices and commodity prices are expected to remain subdued in the coming year. The government is finally making the right noises and promises minimal interference in business. This may go a long way into strengthening Indian equities.

To beat the Sensex is no mean task and without a focused approach the task of beating the Sensex gets even more difficult. The way to beat the Sensex this season can be to focus on high growth stocks showing momentum in stock prices and reflecting higher operating cash flows when compared to net income.

Free cash flows can provide deeper insights into a company's prospects. Higher free cash flows would suggest better growth prospects for the company. This is the exact reason why such high growth stocks with higher cash flows should be preferred for portfolio investing. Higher cash flows allow the company to develop new products, make acquisitions, pay dividends and reduce debts. To take optimal economic decisions one needs to evaluate the ability of an enterprise to generate cash and cash equivalents which is provided by the cash flow statement.

Hence a closer look into the cash flow statements is essential for investors.