



# The Role of Cash Flows in Value Investing

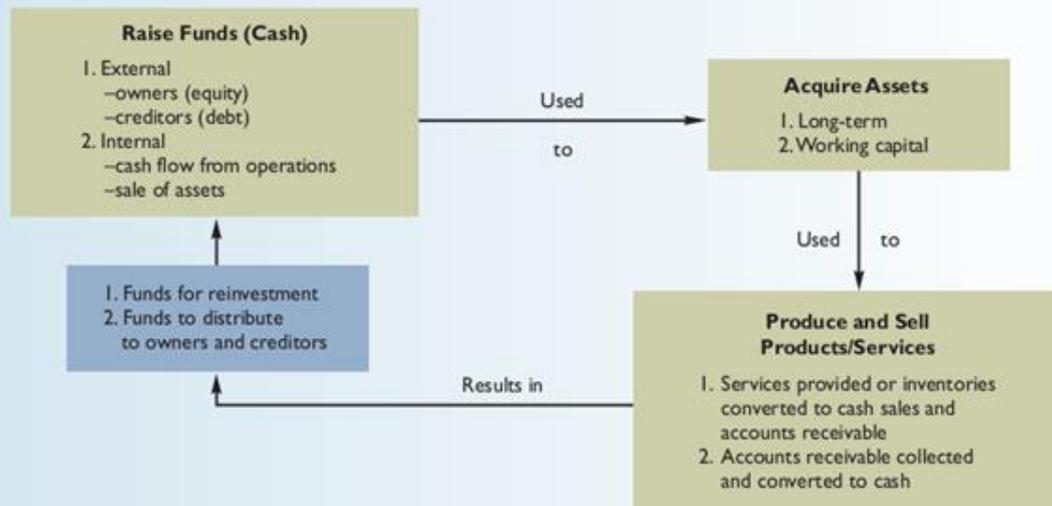
## What It Means to Value Invest

To be a successful value investor, one must know to make an investment when the price of something is under its true value (intrinsic value) in the marketplace and know how long to hold on to that investment or when to sell the investment, once the marketplace recognizes and subsequently offers what the investment is truly worth. This buy low sell high concept might seem simple but, with thousands of professional analyst employed all over the world and millions of amateur investors, all working to beat the market; finding undervalued investments can be a tall order!

Though value investing is hard (If it was not, we would all be Warren Buffet), it is not impossible. The main reason people fail at value investing is because they have no idea of how cash flows work. Most investors focus on accounting data which is historical in nature and thus, is inadequate at accurately representing the actual cash a firm has on hand or the net present value of long-term capital investments. Also, the inconsistency inherent within GAAP requirements, as well as, the differences in how companies report their income, makes for inconsistency in the analysis of traditional financial ratios. Like the old saying goes, “Cash is king”, explaining why some of the world’s most successful value investors focus on cash and assets when deciding to invest. Below I have added a snippet of the text *Contemporary Financial Management* by Moyer, McGuigan & Rao to help explain the Cash Flow Generation Process. I hope you enjoy!

▲ FIGURE 4.2

**A Firm's Cash Flow Generation Process**



## The Cash Flow Generation Process

Financial managers are concerned primarily with raising funds (cash) for use by the firm and investing those funds in assets that can be converted into a stream of cash flows accruing to the firm and its owners. If the value today of the stream of cash flows generated by the assets of a firm exceeds the cost of those assets, the investments undertaken by the firm add value to the firm. When financial managers perform this primary function of acquiring funds and directing the investment of those funds into value maximizing projects, they must balance the risk (variability) and timing of the expected cash flow stream against the magnitude of the expected returns. The cash flow generation process for a firm is illustrated in Figure 4.2.

A firm can raise funds by issuing different types of financial securities, including both debt and equity types. Financing decisions such as these are summarized on the liabilities and owners' equity side of the balance sheet. In addition to selling securities, a firm can raise cash by borrowing from a lender such as a commercial bank. Funds can also be raised by generating cash flow internally. Internal cash flows include cash generated from operations and cash generated by the sale of assets.

Once cash is available, a decision must be made to invest it in one or more assets. The acquisition of the best long-term assets is crucial, because once acquired, long-term assets impact the firm for a long time. Long-term assets can be sold if necessary but sometimes only at a significant loss. Current assets, or working capital, such as cash, accounts receivable, and inventory, are held for operating purposes and generally offer

little or no explicit return. If current asset balances are kept too high, shareholder wealth is sacrificed due to the opportunity cost of funds, that is, the returns that could be earned if these funds had been invested elsewhere. On the other hand, if current asset balances are too low, the risk of the firm increases because the firm may encounter difficulty in meeting its current financial obligations. In addition, low current asset balances (particularly inventories and accounts receivable) may prevent a firm from responding to the needs of prospective customers in a timely and profitable way.

Eventually, all assets are transformed into a cash flow. Plant and equipment generate a product or service. Inventory is gradually sold and generates cash sales or accounts receivable. Cash flow is generated as accounts receivable are collected. Then, the firm must decide how much of its cash flow to use to acquire additional assets, pay off creditors, and distribute to its owners.

## **Reference**

Moyer, R. Charles; McGuigan, James R.; Rao, Ramesh P. (2014-01-01). Contemporary Financial Management (Page 122). Cengage Learning. Kindle Edition.