

IOI Glossary

IOI's proprietary measures allow for unique perspectives on value drivers at companies

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Key Takeaways

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- **Owners' Cash Profits = Cash Flow from Operations less an estimate of maintenance capital expenditures.** We usually abbreviate it "OCP."
- **Net Expansionary Cash Flow (Net ECF) is an estimate of the cash impact of investment spending at a company.** It is a much more inclusive view of investment activity than considered by most analysts and investors.
- **Free Cash Flow to Owners = OCP – Net ECF.** This is the measure we project to estimate the value of a firm.

Introduction

IOI subscribes to the belief that being a good investor means thinking like an owner. As such, all of our proprietary metrics are designed to look at a firm from an owner's perspective.

Cash is an indisputable and universally accepted store of value and is one of the only numbers in a set of financial statement that is not based on an accounting estimate. It is for this reason that we use it as the basis to determine our profitability, expenditure, and valuation metrics.

None of our metrics are radically different from those taught in modern business schools and in CFA coursework, however, we approach valuation from a practical, owner-centric approach and that is the one factor that sets us apart.

Through our training classes, we have shown these metrics to business owners who have later reported that using them in their own business have provided them added clarity to their operational strategy. We believe they will provide added clarity to your work as an investor.

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Owners Cash Profits

This is a measure of profitability similar to Buffett's Shareholder Earnings.

Given the emphasis we have placed on the importance of cash and the flow of cash, it makes sense that we will find most of the information essential to valuing a company by analyzing the Statement of Cash Flows (SCF).

In fact, for our calculations of OCP, we need not look much further than the very first section of the SCF—the section entitled Cash Flow from Operations (CFO). The precise definition of Owners' Cash Profit is:

$$OCP = CFO - Maintenance\ Capex$$

$$Maintenance\ Capex = [(1 + inflation\ rate\ assumption) \times Depreciation\ Expense]$$

Even though these are pretty simple equations, there are a few things to be said about each of the terms that make up "Maintenance Capex". However, before delving into that, please realize that whenever we are calculating ranges, we are dealing less with hard numbers and more with estimates and educated guesses. It is vital not to get hung up on the exact numerical value being calculated and to conceive of the calculations as an estimate and a starting place to understand true profitability.

There are two facts to economic life that the OCP calculation attempt to quantify:

1. Equipment, buildings, and other physical assets essential for generating revenues break or wear out.
2. Generally, prices for things increase over time.

The OCP equation uses the accounting line item "Depreciation" to represent the first fact. Depreciation is meant to formalize the assumption we made about our taxi driver's business—that he would need to set some money aside each year to buy a new car when the first one had come to the end of its economic life.

Depreciation expense is a fiction codified by accounting convention. I will not go into all of the different ways depreciation might be calculated—I can think of three right offhand and there are probably more—since those details would only add confusion. You will notice that the OCP equation takes that accounting fiction and multiplies it by a fiction of economics—the inflation rate (which I usually simply take as the rate for Consumer Price Inflation published by the U.S. government). I have read fascinating articles about how the present method for calculating inflation probably ignores things that it shouldn't and why these omissions have taken place over time. I know that inflation is a fiction and it is not representative of the actual rise in cost that the company will need to pay to repair its machinery or spruce up its offices, but still I add inflation to keep in mind that prices usually increase over time.

The main point is that depreciation is about the best estimate we can get for the amount of capital expenses needed to maintain the business as a going concern. Keeping in mind that all of what we are dealing with when analyzing companies are estimates and that no one will ever know exactly how much money is needed for maintenance capex at a given company ahead of time, the estimate we are using seems plausible and directionally right. That's good enough.

Net Expansionary Cash Flow

The proportion of excess profits a company invests in order to enjoy greater than trend growth in the future.

Because the purpose of these investments is to expand either the revenues or profits of at a faster rate than the economy in which it operates, we call these investments “Expansionary Cash Flows.” We start with OCP and define Expansionary Cash Flows like this:

Deduct	Expenditures for Property Plant & Equipment over and above maintenance capex as defined in OCP (“Growth Capex”)
Deduct	Cash spent on acquisitions
Deduct (Add Back)	Cash paid to (received from) JV partners (loans or investments)
Deduct	Net cash spent anti-dilutionary stock repurchases
Add Back	Cash received from sale of assets / divisions
Equals	Expansionary Cash Flows

Because we are adding back cash received from JVs, asset sales, and the like, we qualify this term further as “Net Expansionary Cash Flows.”

Let’s take a look at the actual numbers for each of these items for Oracle over five years and understand each component one by one.

<i>Fiscal Year Ending</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>
Estimated Growth Capex	(258)	77	(71)	(147)	(88)
(Acquisitions)	(1,159)	(5,606)	(1,847)	(4,702)	(3,305)
(Investments in) Payments from JVs, etc.	-	-	-	-	-
(Antidilutionary Share Buybacks)	(1,464)	(1,422)	(2,311)	(1,274)	(2,780)
Issuance of common stock	954	984	1,768	830	1,591
Asset Sales & Disposals	-	-	105	-	-
Net Expansionary Cash In- (Out-) Flows	(1,927)	(5,967)	(2,356)	(5,293)	(4,581)

Estimated Growth Capex

In our calculation of OCP, we already made an estimate of the amount of money that is needed to maintain the company as a going concern—maintenance capex. Keeping that number in mind, we can also look in the “Cash Flow from Investing” section of the Statement of Cash Flows and find a line item related to spending on “Property Plant & Equipment (PP&E)” This is what analysts usually look for as a measure of capital expenditures.

The first line in our calculation of Expansionary Cash Flows is simply the amount of money spent on PP&E less the amount of money we have already estimated as necessary for maintenance capex. Usually, PP&E will be greater than inflation-adjusted Depreciation, but in the case of Oracle, we can see that this is not always the case—note the cash inflow of \$77 in 2010 associated with expansionary capex. This simply means that the company has temporarily “underinvested” in maintenance capex. For a company like Oracle, which mainly derives revenues from its intellectual property rather than from manufacturing and selling physical goods, this is not strange. For a manufacturing company, though, if one sees that one’s estimates for maintenance capex are consistently higher than the amount the

company is actually spending on PP&E, one needs to do some further investigation to figure out why. The company might be outsourcing more of its manufacturing—which is not necessarily a bad thing—but the company might also simply be underspending on maintaining its productive assets—which is always a bad thing.

Acquisitions

In a 1992 interview with the Harvard Business Review, Phil Knight, co-founder of the sporting goods company Nike, spoke about the decision that company managers face regarding buying or building new product lines. In this quote, Knight is talking about his decision to acquire casual shoe brand Cole-Haan.

“We bought [Cole-Haan] knowing its potential, and we’ve simply turned up the marketing volume. We could have created a brand and got it up to \$60 million in sales, which is where Cole-Haan was when we bought it, but it would have taken millions of dollars and a minimum of five years. We’re further ahead this way. In the four years we’ve owned Cole-Haan, it’s repaid the purchase price and is now at \$150 million in sales.”

From this quote, it is obvious that money spent to acquire a business—which subsequently becomes a division of the acquirer—should be considered as substantively the same as money spent to buy equipment and buildings in order to build up a new division. It is amazing to me that so many analysts and strategists ignore spending on acquisitions as a deduction from free cash flows. Certainly, whether one spends money to buy a business or to build one, that money has been invested and thus cannot be distributed to equity owners.

This reasoning suggests we must include cash spent on acquisitions into the calculation of expansionary cash flows.

Antidilutionary Share Buybacks

Cash outflows associated with anti-dilutionary stock repurchases arise from two situations:

1. Management issues shares to acquire another company
2. Management issues shares to employees and executives

In most cases, company managers issue shares as a form of currency to pay for some strategic project (an acquisition in the first case, encouraging development of greater intellectual property assets in the second). However, company managers are evaluated—both by boards and the equity market—by trends in earnings per share (EPS). Because of this, issuing shares can become dangerous from a career security perspective to CEOs and CFOs—issue too much equity too often, and one’s EPS will be negatively affected.

Enter the corporate hobby of stock repurchases.

Academics have encouraged a belief amongst investing professionals and the public at large that stock buyback programs “create value” for shareholders. Of course, the company’s purchase of shares does make one’s own stake more valuable, so to the extent that buyback programs do increase the concentration of one’s position, they are helpful to long-term shareholders. The problem is that some proportion of these programs do not increase the concentration of ownership interests, but merely limit the dilution of them.

Management teams proudly announce their enormous buyback plans knowing that these massive purchases will swamp the millions of dollars here and there spent to 1) obfuscate the mediocre results of a prior acquisition and / or 2) hide the true extent of stock issuance as a form of employee compensation.

Stock buybacks use owners' cash in order to boost EPS. It is for this reason that, in most cases, we consider all the stock issued by a company for acquisitions or compensation schemes in a given year as having to be bought back at the average price of shares that year. For instance, the \$1,464 million spent by Oracle in 2009 is a result of its purchasing 81 million shares at an average price of just over \$18 per share. This is partially offset by cash received for selling shares (employees pay the company to exercise stock option grants) and by a tax benefit related to those transactions. So, continuing with our 2009 example, the company received \$954 million related to stock issuance which partially offset our estimate for the cash outflow associated with buying those shares back detailed above. The net effect was a cash outflow of \$510 million that year.

<i>Fiscal Year Ending</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>
(Antidilutionary Share Buybacks)	(1,464)	(1,422)	(2,311)	(1,274)	(2,780)
Issuance of common stock	954	984	1,768	830	1,591

Of course, this is only an estimate of the true value of the cash expended on antidilutionary stock buybacks, but even though it is a fiction, it is a useful one and likely directionally right in terms of the absolute amount spent.

Cash Received From (Paid To) JVs, Internal Software Development, etc.

Investing in JVs does not represent a huge part of the company in this example's business strategy, but it can be for some firms. For instance, NAND Flash memory producer SanDisk (SNDK) forms JVs with Japanese chipmaker Toshiba and both firms contribute capital to these JVs. The JVs purpose is to build (enormously expensive) chip fabrication facilities, produce chips, and sell them to the owners of the JVs (i.e., SanDisk and Toshiba) at the cost of production. The JVs pay interest to the parent companies, and if there are any excess profits, those profits are divided proportionally between the parents as dividends.

Clearly, this example of a loan made to a JV is exactly the same as money spent to fund a capital project to build a fabrication plant. The cost of funding such a plant is so high that the two partners can spread risk and reduce their annual capex bill.

Clearly these expenditures should be treated as expansionary outflows and any interest or dividends received should be netted out against it.

Cash Inflow from Asset Sales

Clearly, any cash that flows in from a company's sale of equipment, a division, or a property should be treated as a source of cash that can be used to buy new assets. Oracle, being an asset-lite company, does not have much in the way of asset sales or disposal of divisions, but you can see that in 2011, it sold something worth \$105 that we have counted as a net inflow against growth capex that year.

Free Cash Flow to Owners (FCFO)

Once we have estimated OCP and understand how much of it the management is spending on expansionary projects, we finally come to the number by which we value the firm—Free Cash Flow to Owners. In equation form:

$$FCFO = OCP - \text{Expansionary Cash Flows}$$

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