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Cash Flow Trends and Their Fundamental Drivers: Comprehensive Review (Quarter 2, 2017)

Free Cash Margin Index:

0.99%, 3.45%	4.90%	6.88%
Recession Lows	**Current**	**Recent High**
(Dec. 2000, Dec. 2008)	**(Jun. 2017)**	**(Dec. 2009)**

Median free cash margin decreased to 4.90% for the twelve months ended June 2017, compared with 5.28% for the twelve months ended March 2017 and 4.64% in June 2016. This metric is down slightly from the last reporting period, but is still running well above pre- and post-recession norms. Similar fluctuations in free cash margin have been seen in other periods with healthy economic growth, and this would appear to be no different.

This sentiment is supported by continued revenue growth during the June 2017 reporting period. Median revenues increased to another record level of $1,151.55 million in June 2017, up to 13.1% year-over-year from $1,018.28 in June 2016. Cash flow data is also suggestive of positive economic conditions, as cash and short-term investments grew to a record $147.47 million. However, this revenue and cash flow growth is still not translating into a much-anticipated increase in capital expenditure investments, which would likely enhance economic growth. Capital expenditures declined from 3.93% of revenue in June 2016 to 3.74% in June 2017. Tax reform holds the potential to unlock cash and short-term investment balances and drive a renewal in capital expenditure spending.

Factors impacting free cash margin were operating cushion, or operating profit before depreciation, which improved to 14.52% during the twelve months ended June 2017 from 13.54% in June 2016. This was driven by rising gross margins and a drop in SG&A expenses. The decline in free cash margin could be attributed to a rise in the cash cycle, which increased to 50.68 days in June 2017, up from 50.31 days in March 2017. The primary drivers of this change were increases in accounts receivable days and inventory days, offset by rising accounts payable days. The increase in inventory days may indicate an expectation of higher revenue growth.

Looking at individual industries for the reporting period ending June 2017, free cash margin was stable in seven industry groups, higher in eight, and lower in five.

Data for this research were provided by S&P's Capital IQ's Compustat database. **October 2017**

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, the Lab thinks that independent research organizations, such as this Lab, have an important role to play in providing information to market participants.

Because the Lab is housed within a university, all of its research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Its focus is on issues that it believes will be of interest to a large segment of stock market participants. Depending on the issue, it may focus its attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in the work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. The Labs defines earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, its research may look into reporting practices that affect either earnings or cash flow, or both. At times, its research may look at stock prices generally, though from a fundamental and not technical point of view.

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Free Cash Margin Index*:

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The ***Free Cash Margin Index** is free cash flow measured as a percentage of revenue for the trailing twelve month period.

Introduction

This research report is part of a continuing series that examines cash flow trends and the underlying drivers that are causing changes in those trends. The current study contains a review of the cash flow performance of all non-financial companies for a series of rolling twelve-month periods from the first quarter of 2000 through the second quarter of 2017. Additionally, it looks at individual industry results and focuses its attention on the drivers that pushed free cash margin higher or lower in those industries. All companies with total assets of $100 million or more are included, resulting in a total sample of 2,610 companies. Please see page 7 for a list of industries included. That list is followed by a summary of the findings.

Measured as free cash flow divided by revenue, free cash margin is a cash flow profit margin. It indicates what percent of revenue is left for shareholders in the form of free and discretionary cash flow. If the company sells its products or services for a dollar, free cash margin tells how many cents the shareholders can take home without reducing the company's ability to generate more. Thus, as the report looks at cash flow trends and their underlying drivers, its particular interest is on how those factors impact free cash margin.

Continuous Focus on Cash Flow

Corporate financial success is dependent not only on a company's ability to generate revenues and earnings, but also cash flow, especially free cash flow. It is free cash flow and growth in free cash flow, that discretionary stream of cash that a company can put to use for acquisitions, debt retirement, dividends and stock buybacks that works with growing earnings to drive firm value higher. Because it is "free," free cash flow comes with no strings attached. It is truly discretionary. Spending it does not impact the company's ability to generate more. A company with revenue growth will eventually lose the favor of investors if it never finds a way to generate earnings. In a similar way, a company with profits that is unable to generate cash will also experience waning investor enthusiasm. It may take a while. Investors are patient with profitable, growing companies. Ultimately, however, a company must show an ability to generate free cash flow.

Companies that consume cash must continually seek new sources of capital – whether debt or equity. At some point, those sources of capital will dry up or become prohibitively expensive if the firm does not show at least some progress toward getting closer to positive cash generation. Worse, if cash flow does not back a company's earnings, ultimately those earnings themselves may become suspect, necessitating write-downs of the resulting non-cash assets. Net losses will likely accompany those write-downs.

When free cash margin is positive, a firm is covering all ongoing claims and is able to pay dividends, reduce debt or simply add to its cash coffers. When free cash margin turns negative, ongoing claims are not being met. Cash and short-term investments can be used to meet the shortfall. However, on-hand cash and short-term investments are not an unlimited source of funds. Firms can borrow money to meet their needs. However, even if this were an option, increasing debt levels add new, unwanted risks. Equity issues provide another avenue, but capital markets can be painfully dilutive when share prices are depressed for firms that are seemingly unable to generate cash.

During periods of growth, firms may have problems generating cash as profits are consumed with growth-related investments in working capital and property, plant and equipment needed to support that growth. During recessions, cash generation can be particularly problematic as revenues and profits decline, draining the economic engine that supports cash generation. Regardless of the economic environment, however, free cash margin serves as an important measure of long-term financial health for individual companies, industries and the economy as a whole. The Lab thinks that by periodically examining their cash generating ability, readers will gain insight into the overall financial health of important segments of U.S. firms. With all "non-financial firm industry" data dating back to 2000, it is possible to see how the cash-generating performance of these firms presently compares with their performance during previous periods of economic contraction (e.g., 2001 and 2008-2009) and economic expansion.

Cash Flow Definitions

Free cash flow is the cash flow equivalent of the income statement "bottom line". Like net income, free cash flow is available for shareholders after all prior claims have been satisfied. However, also like net income, which, to facilitate analysis, can be divided into certain sub-measures of performance, like gross profit and operating profit, free cash flow can be similarly divided. Thus, while the primary focus of the report is on free cash flow and free cash margin, or free cash flow as a percentage of revenue, it analyzes the fundamental drivers underlying two distinct, but also closely related, measures of cash flow:

1) Operating cash flow and operating cash margin - cash flow from operations after interest charges and income taxes. Operating cash margin is operating cash flow divided by revenue.

2) Free cash flow and free cash margin - cash flow available for common shareholders that can be used for such discretionary purposes as stock buybacks and dividends without affecting the firm's ability to grow and generate more. This measure is calculated as operating cash flow less preferred dividends and net capital expenditures. Free cash margin is free cash flow divided by revenue.

Data and Methodology

The data is provided by Compustat through a license with the Wharton Research Data Services. As noted, each data amount is for a rolling twelve-month period ending with the quarter end in question. For example, cash flow amounts for June 30, 2017 represent amounts for the twelve months (four quarters) ended June 30, 2017.

The 20 analyzed industry groups are as follows:

GICS	Industry Group
1010	Energy
1510	Materials
2010	Capital Goods
2020	Commercial & Professional Services
2030	Transportation
2510	Automobiles & Components
2520	Consumer Durables & Apparel
2530	Consumer Services
2540	Media
2550	Retailing
3010	Food & Staples Retailing
3020	Food, Beverage, & Tobacco
3030	Household & Personal Products
3510	Health Care Equipment & Services
3520	Pharmaceuticals, Biotech, & Life Sciences
4510	Software & Services
4520	Technology Hardware & Equipment
4530	Semiconductors & Equipment
5010	Telecommunication Services
5510	Utilities

The 20 industry groups use the four-digit Global Industrial Classification System (GICS) and represent 10 overall sectors. The ten sectors with industry groups included in parentheses are: Energy (Energy), Materials (Materials), Industrials (Capital Goods, Commercial & Professional Services, and Transportation), Consumer Discretionary (Automobiles & Components, Consumer Durables & Apparel, Consumer Services, Media and Retailing), Consumer Stapes (Food & Staples Retailing, Food, Beverage & Tobacco and Household & Personal Products), Health Care (Health Care Equipment & Services and Pharmaceuticals, Biotech & Life Sciences), Information Technology (Software & Services, Technology Hardware & Equipment and Semiconductors & Equipment), Telecommunications (Telecommunication Services) and Utilities (Utilities).

Summary of Results for All Non-Financial Companies

Median free cash margin decreased to 4.90% for the twelve months ended June 2017, compared with 5.28% for the twelve months ended March 2017 and 4.64% in June 2016.

Factors impacting free cash margin were operating cushion, or operating profit before depreciation, which improved to 14.52% during the twelve months ended June 2017 from 13.54% in June 2016. This was driven by rising gross margins and a drop in SG&A expenses. The decline in free cash margin could be attributed to a rise in the cash cycle, which increased to 50.68 days in June 2017, up from 50.31 days in March 2017. The primary drivers for this change were increases in accounts receivable days and inventory days, offset by rising accounts payable days. The increase in inventory days may indicate an expectation of higher revenue growth.

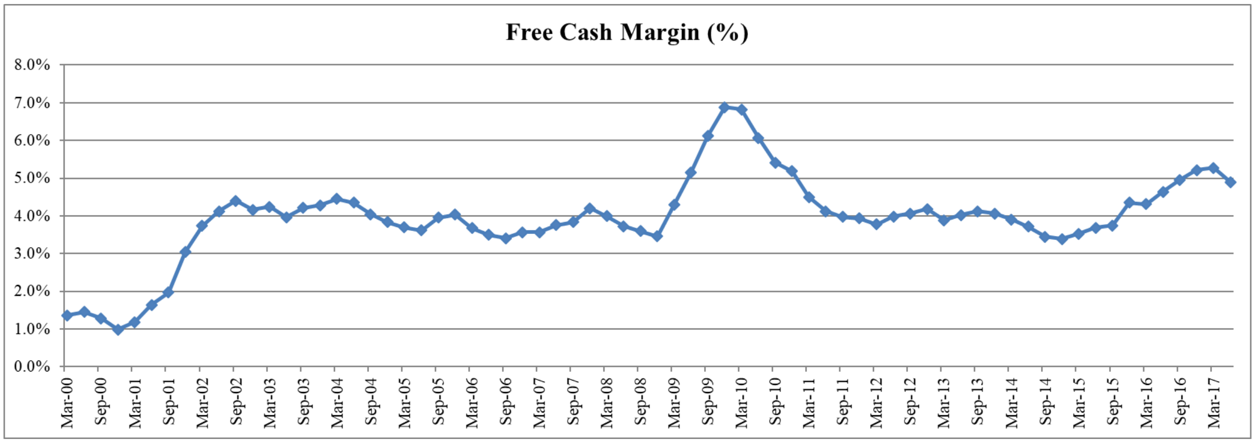
Revenue growth continued and hit another all-time high during this reporting period. Median revenues increased to $1,151.55 million in June 2017, up to 13.1% year-over-year from $1,018.28 in June 2016.

Drivers of Free Cash Margin

ALL NON-FINANCIAL INDUSTRIES	Q2 2017 (Jun 2017)	Q1 2017 (Mar 2016)	Q2 2016 (Jun 2016)	Effect on FCM (Q2 2017 vs. Q2 2016)
Revenue (millions)	**1,151.55**	**1,131.96**	**1,018.28**	**UP 13.09%**
Free Cash Flow (millions)	**48.59**	**50.11**	**40.97**	**UP 18.60%**
Free Cash Margin	**4.90%**	**5.28%**	**4.64%**	**UP 0.26%**
Operating Cushion %	14.52%	14.39%	13.54%	Driving **UP**
Gross Margin % (before depreciations)	37.50%	37.38%	36.72%	Driving **UP**
SGA% (before depreciation)	18.08%	18.38%	18.42%	Driving **UP**
Cash Cycle (rev days)	50.68	50.31	49.91	Driving **DOWN**
Accounts Receivable (rev days)	51.53	50.59	50.39	Driving **DOWN**
Inventory (rev days)	24.84	24.51	24.00	Driving **DOWN**
Accounts Payable (rev days)	25.70	24.80	24.47	Driving **UP**
Income tax to Rev %	1.32%	1.34%	1.28%	Driving **DOWN**
Cap Exp. to Rev %	3.74%	3.77%	3.93%	Driving **UP**

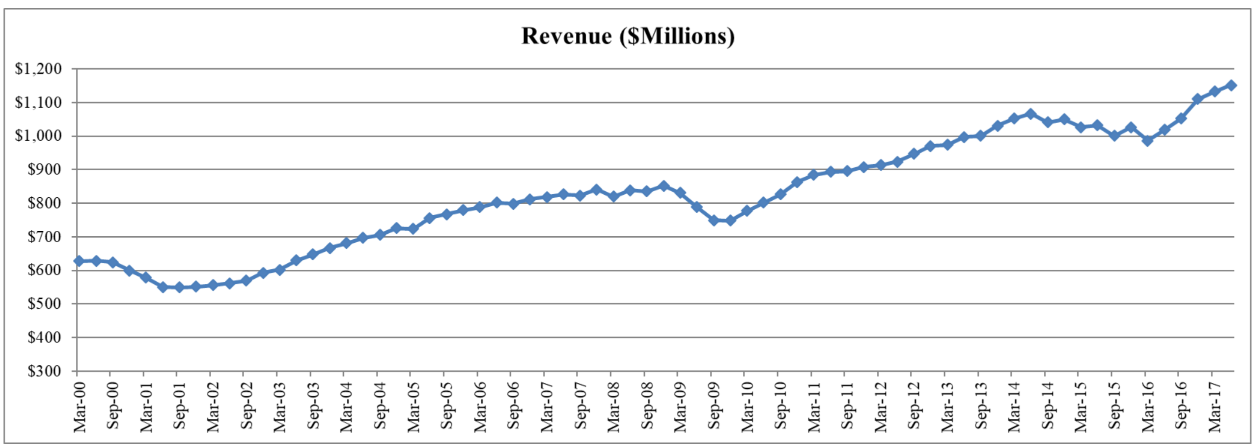
In the exhibits below we present graphs of free cash margin and several of its underlying drivers. These exhibits were constructed with data from the complete sample of 2,610 non-financial companies. For more details on each of the 20 individual industry groups included, please refer to the individual industry spreadsheets and supporting charts that are available on our website (www.scheller.gatech.edu/finlab).

All Non-financials, Q1 2000 – Q2 2017



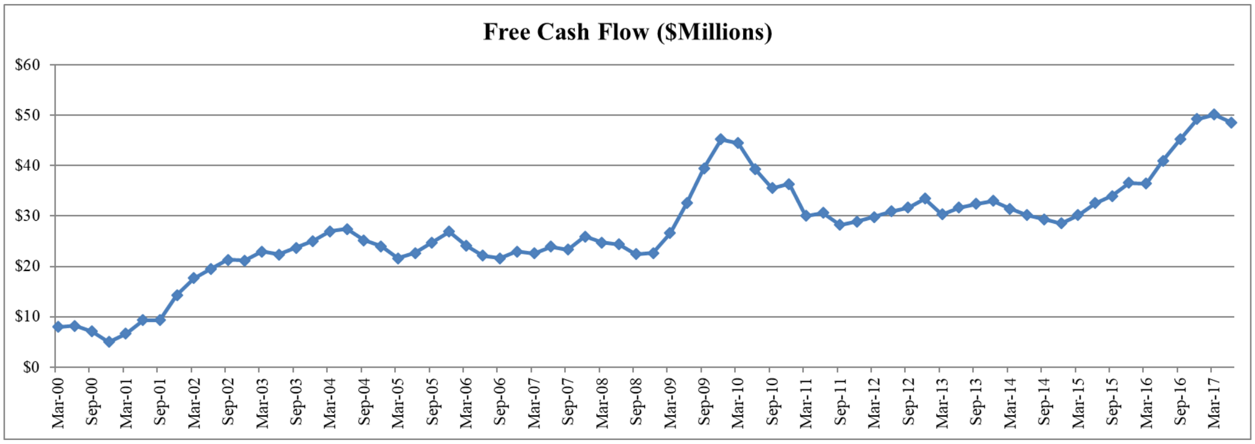
Free cash margin continues to sit above the upper end of its historical range of between 3.00% and 4.50%. Helping to drive free cash margin higher, operating cushion, or operating profit before depreciation, improved to 14.52% during the twelve months ended June 2017 from 13.54% in 2016.

All Non-financials, Q1 2000 – Q2 2017



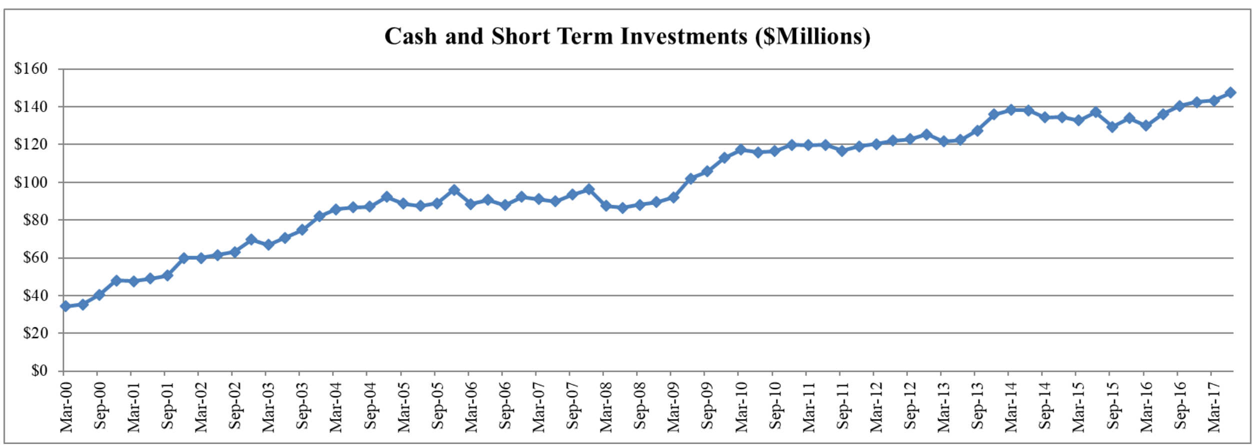
Median revenues hit another all-time high in the June 2017 reporting period, rising to $1,151.55 million, up 13.1% year-over-year.

All Non-financials, Q1 2000 – Q2 2017



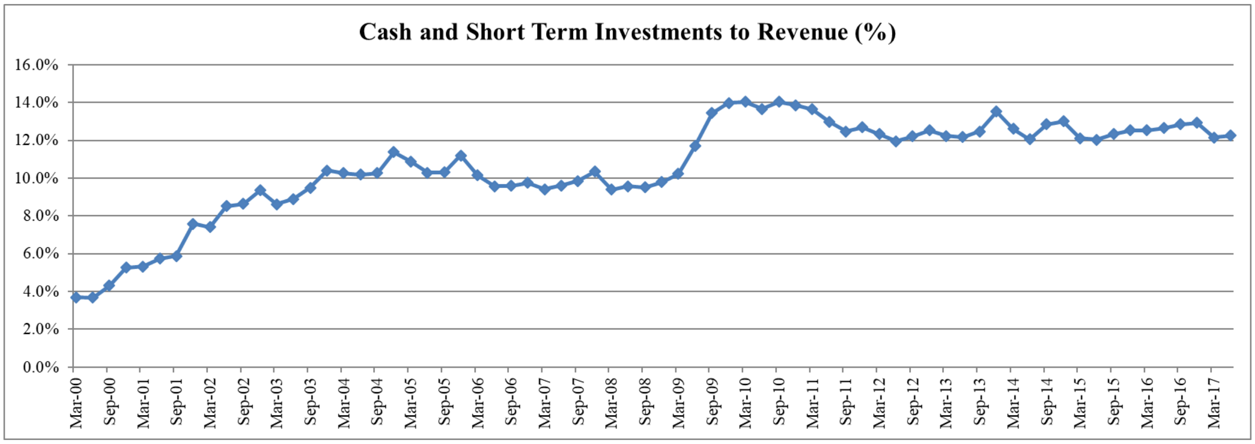
The decline in free cash margin offset an increase in revenues, producing a slight decrease in free cash flow. Median free cash flow fell to $48.59 million for the twelve months ended June 2017, but still up 18.6% from $40.97 million in June 2016.

All Non-financials, Q1 2000 – Q2 2017



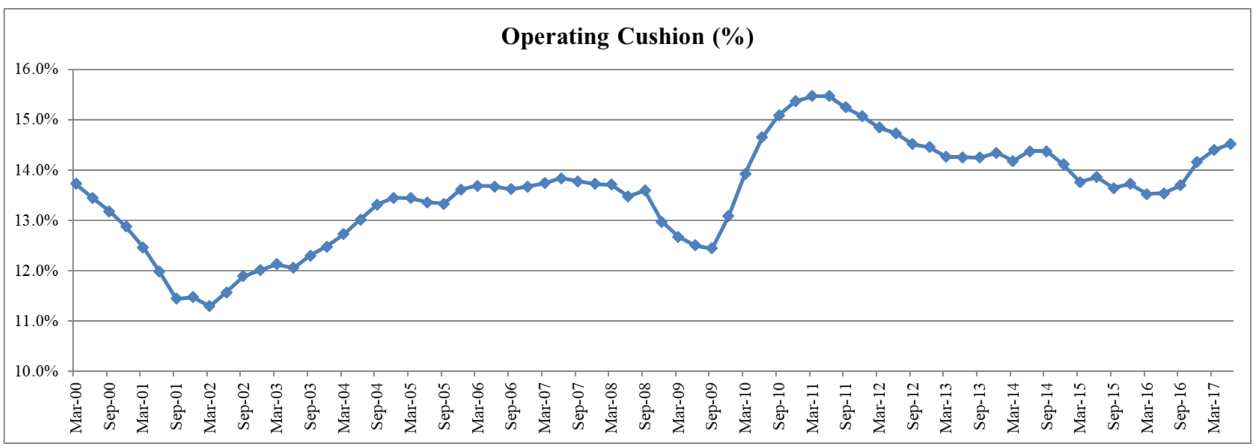
Median cash and short-term investments increased to an all-time high of $147.47 million in June 2017, up 8.3% from $136.18 million reported in June 2016.

All Non-financials, Q1 2000 – Q2 2017



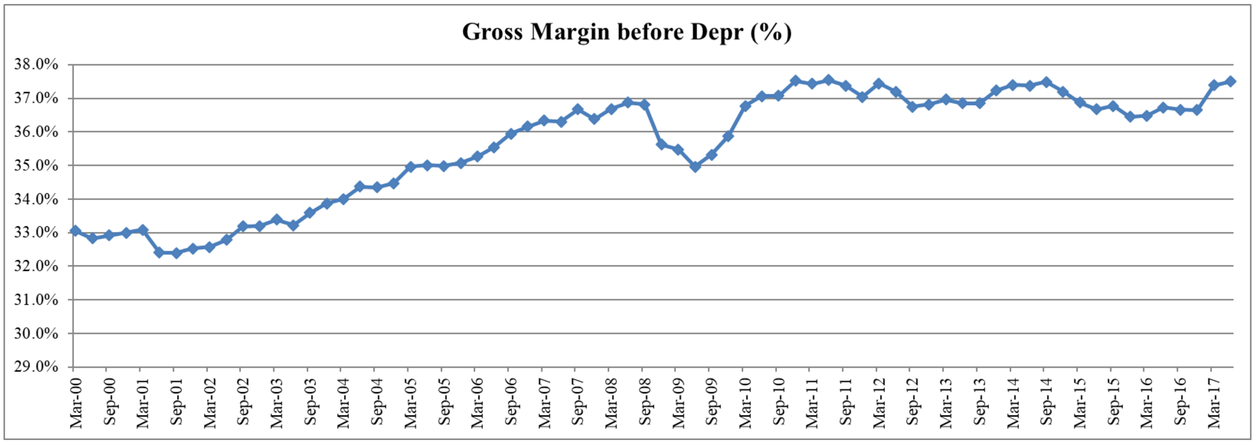
Cash and short-term investments to revenue increased slightly to 12.25% in June 2017, but were still down year-over-year from 12.65% in June 2016. Prior to the recession, cash and short-term investments were approximately 10% of revenue.

All Non-financials, Q1 2000 – Q2 2017



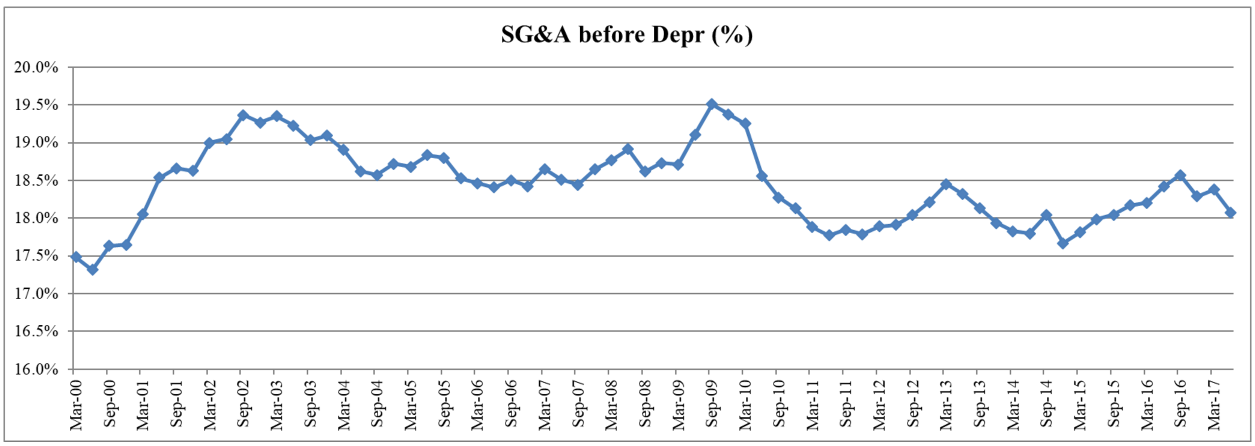
Median operating cushion increased to 14.52% in the reporting period ended June 2017, up from 14.39% in March 2017 and 13.54% in June 2016.

All Non-financials, Q1 2000 – Q2 2017



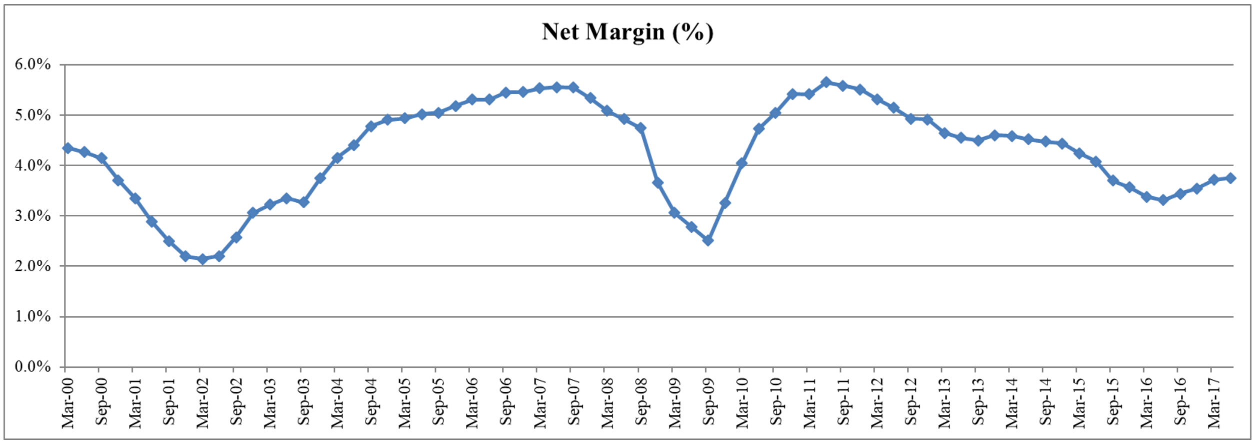
Median gross margin before depreciation increased to 37.50% for the twelve months ended June 2017 versus 37.38% in March 2017 and 36.72% in June 2016.

All Non-financials, Q1 2000 – Q2 2017



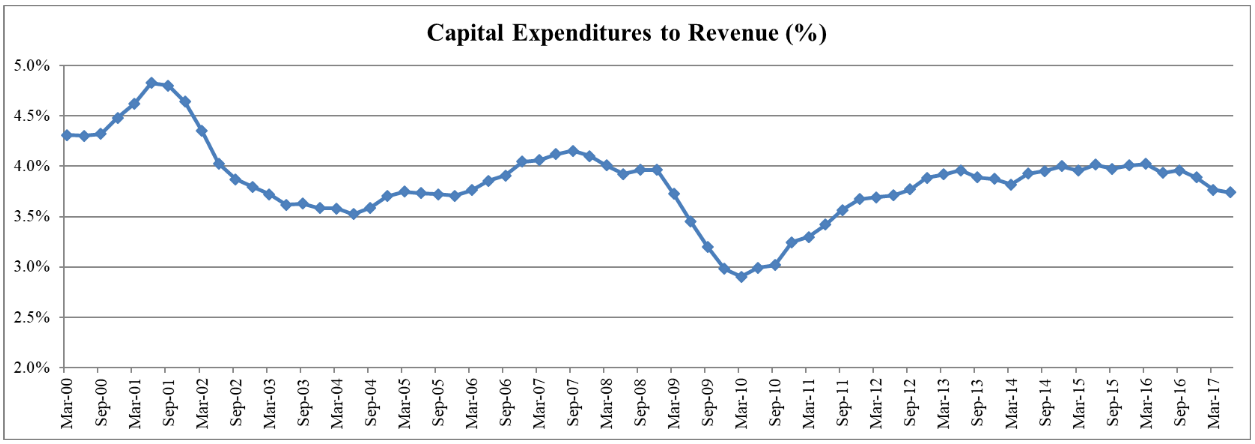
Median selling, general, and administrative expense (before depreciation) as a percent of revenue decreased to 18.08% in June 2017, down from 18.38% in March 2017.

All Non-financials, Q1 2000 – Q2 2017



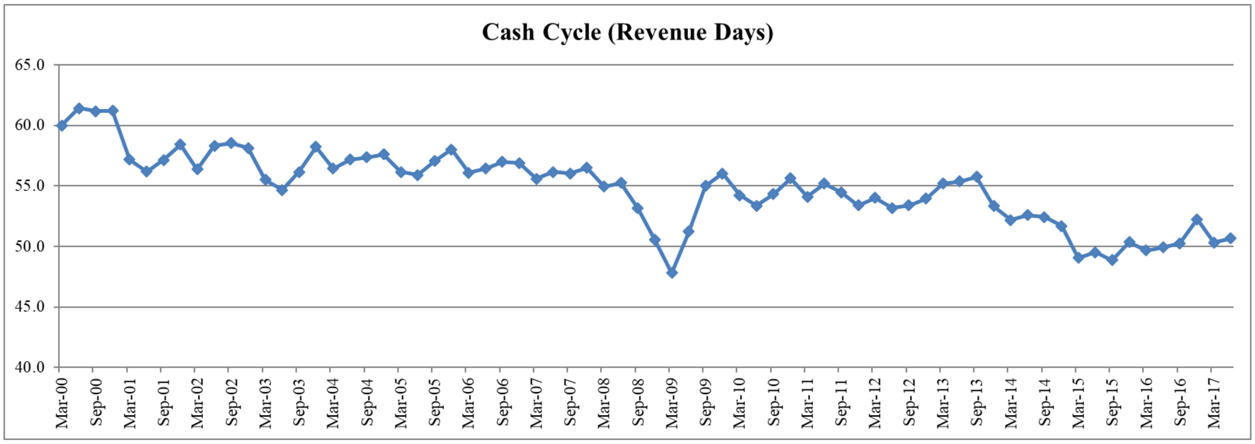
Median net margin increased to 3.75% for the June 2017 period from 3.71% for the March 2017 reporting period, and was also above the 3.32% reported in June 2016.

All Non-financials, Q1 2000 – Q2 2017



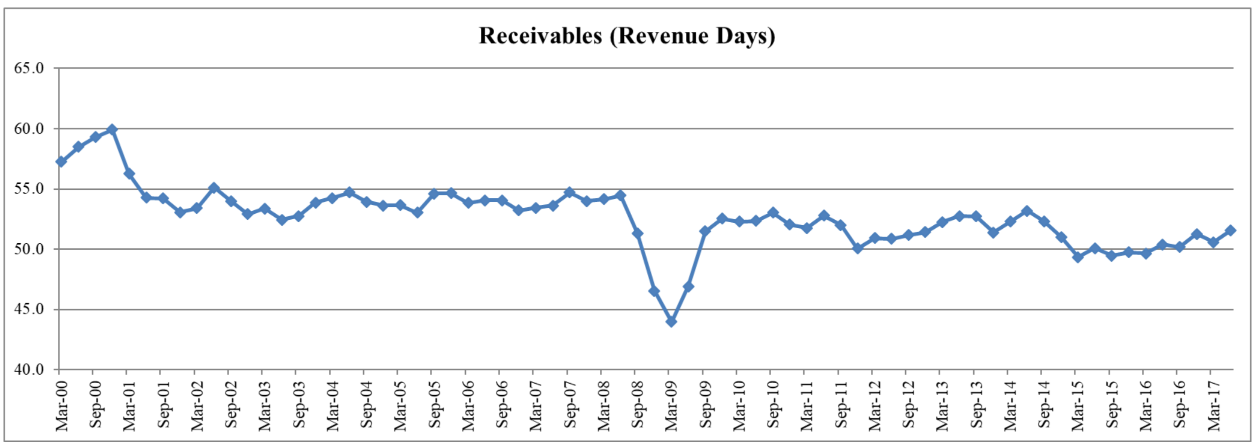
Capital expenditures as a percentage of revenue declined slightly to 3.74% in the June 2017 reporting period, down from 3.77% in March 2017 and 3.93% in June 2016. This softness in capital expenditures continues to be a trend worth monitoring, as spending remains well-below the level of investment needed to replace capital expenditures lost during the recession.

All Non-financials, Q1 2000 – Q2 2017



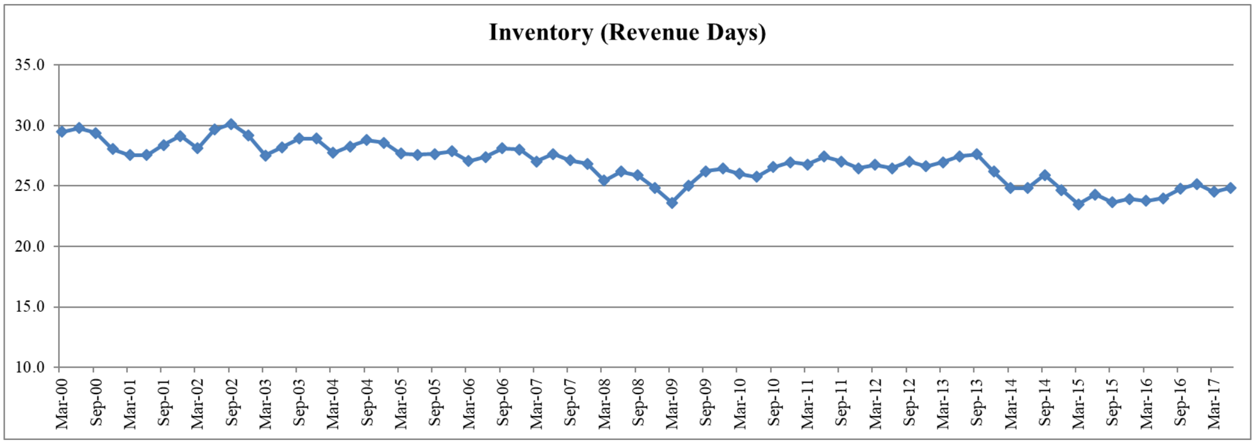
The cash cycle measures the proportion of operating cash flow carried in working capital and is measured by receivables days plus inventory days less payables days. The metric increased marginally to 50.68 days for the period ended June 2017 from 50.31 days for the period ending March 2017, and is slightly above the 49.91 days recorded during the period ended June 2016.

All Non-financials, Q1 2000 – Q2 2017



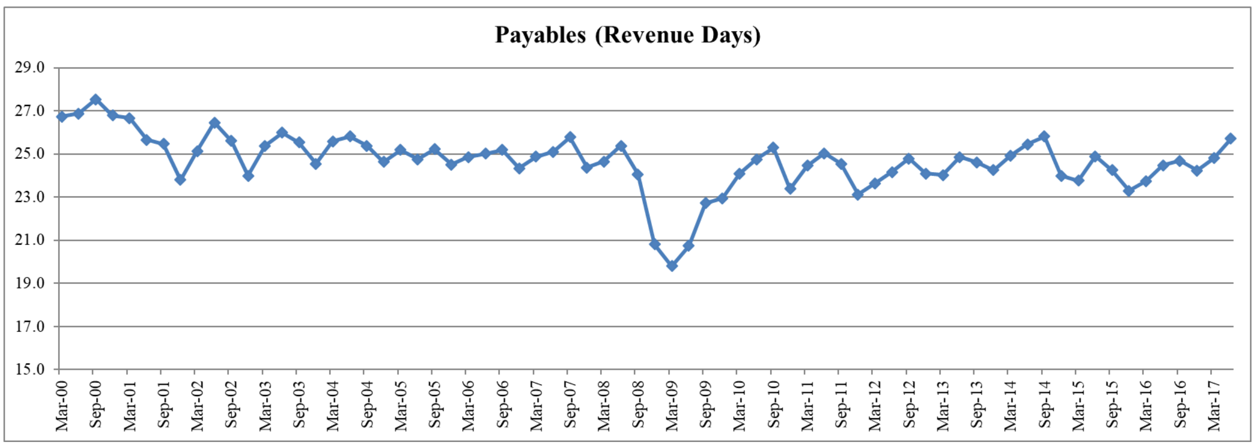
Median accounts receivable days increased to 51.53 days in the June 2017 reporting period from 50.59 days in March 2017, and is also above the 49.91 days seen in June 2016.

All Non-financials, Q1 2000 – Q2 2017



Median inventory days increased to 24.84 days in June 2017 from 24.51 days in March 2017, and is above the 24.00 days recorded in March 2016.

All Non-financials, Q1 2000 – Q2 2017



Accounts payable days increased to 25.70 days in the June 2017 reporting period from 24.80 in March 2017, and was also above the 24.47 days in the period ending June 2016.

Individual Industry Results

During the twelve months ended June 2017, recent industry trends evidenced a moderate to substantial improvement in free cash margin in **8** industries, relatively stable free cash margin in **7** industries, and a declining free cash margin in **5** industries.

Please refer to the individual industry spreadsheets, available on our website, for charts and further details on each of the 20 industry groups outlined in the following tables.

Industry Trends in Free Cash Margin

GICS	Industry Group	Increasing	Stable	Declining
1010	Energy	X		
1510	Materials		X	
2010	Capital Goods			X
2020	Commercial & Prof Services		X	
2030	Transportation			X
2510	Automobiles & Components			X
2520	Consumer Durables & Apparel		X	
2530	Consumer Services	X		
2540	Media	X		
2550	Retailing	X		
3010	Food & Staples Retailing		X	
3020	Food, Beverage, & Tobacco		X	
3030	Household & Personal Products		X	
3510	Health Care Equipment & Services	X		
3520	Pharmaceuticals, Biotech, & Life Sciences			X
4510	Software & Services	X		
4520	Technology Hardware & Equipment	X		
4530	Semiconductors & Equipment	X		
5010	Telecommunication Services		X	
5510	Utilities			X
	Total	**8**	**7**	**5**

The following table compares Free Cash Margin for the 20 industry groups in the period ending June 2017 (Q2 2017) with the March 2017 and June 2016 reporting periods.

GICS	Sector/Industry Group	Q2 2017	Q1 2017	Q2 2016
1010	Energy	0.90%	1.34%	-0.55%
1510	Materials	5.63%	6.00%	5.52%
2010	Capital Goods	4.20%	4.97%	5.64%
2020	Commercial & Prof Services	6.16%	7.10%	6.48%
2030	Transportation	1.14%	1.54%	1.96%
2510	Automobiles & Components	2.75%	2.66%	3.92%
2520	Consumer Durables & Apparel	5.34%	6.55%	5.22%
2530	Consumer Services	5.69%	5.95%	4.93%
2540	Media	9.02%	7.97%	7.80%
2550	Retailing	3.57%	4.19%	3.18%
3010	Food & Staples Retailing	1.43%	1.19%	1.42%
3020	Food, Beverage, & Tobacco	6.27%	6.00%	6.41%
3030	Household & Personal Products	9.71%	9.58%	10.45%
3510	Health Care Equipment & Services	6.50%	6.42%	4.47%
3520	Pharmaceuticals, Biotech, & Life Sciences	-20.57%	-10.58%	-15.61%
4510	Software & Services	9.65%	8.93%	8.55%
4520	Technology Hardware & Equipment	5.24%	5.58%	4.75%
4530	Semiconductors & Equipment	10.61%	11.31%	7.10%
5010	Telecommunication Services	3.94%	4.56%	4.24%
5510	Utilities	0.46%	-0.16%	1.04%
	All Industries Median	**4.90%**	**5.28%**	**4.64%**

The Standouts: A Closer Look

The drivers of improvements or declines in free cash margin consist of factors that impact profitability and efficiency. On the profitability front, operating cushion measures operating profit, exclusive of the non-cash expenses, depreciation and amortization. Factors impacting operating cushion consist of gross margin (excluding depreciation and amortization), and SG&A% (excluding depreciation and amortization). Also impacting profitability and a firm’s ability to generate free cash flow, but excluded from operating cushion, is income taxes paid, which is measured as a percent of revenue. Capital expenditures do not impact profitability directly, but through depreciation on fixed asset additions. However, these expenditures are subtracted in computing free cash flow. It is also important to look at capital expenditures because these are investments in fixed assets that will likely improve a company’s ability to generate revenue, and subsequent profit, in the future. Like operating expenses and taxes, capital expenditures are measured as a percent of revenue.

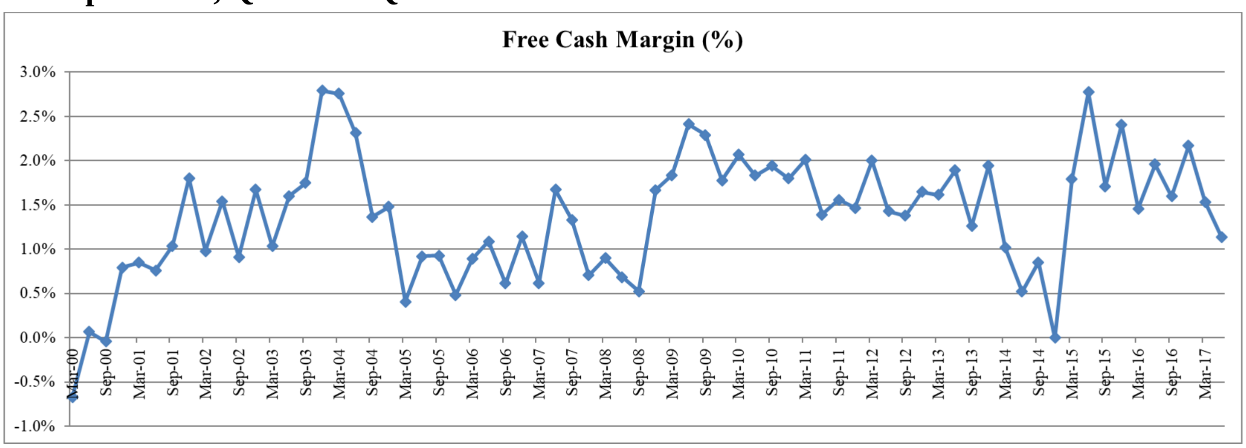
On the efficiency front, increases in receivables and inventory consume free cash flow. Increases in accounts payable provide free cash flow. The combination of receivables days plus inventory days less payables days is a firm's cash cycle. Reductions in the cash cycle provide free cash flow, while increases in the cash cycle consume free cash flow. All of these factors are evaluated when analyzing changes in free cash margin for the standout firms discussed in this section.

Graphs of free cash margin for select industries studied in the reporting period are provided below. With each graph we provide a short summary of the primary drivers or factors that are behind the observed changes in free cash margin for the selected industries. For more details regarding the industries, please refer to the separate industry spreadsheets found on our website.

Industries with Declining Free Cash Margin

In the twelve month period ended June 2017, five industries saw free cash margin decline: Capital Goods; Transportation; Automobiles & Components, Pharmaceuticals, Biotech, & Life Sciences; and Utilities. In the following paragraphs we take a closer look at an industry with declining free cash margin: Transportation.

Transportation, Q1 2000 – Q2 2017



Drivers of Free Cash Margin

Transportation	Q2 2017 (Jun 2017)	Q1 2017 (Mar 2016)	Q2 2016 (Jun 2016)	Effect on FCM (Q2 2017 vs. Q2 2016)
Revenue (millions)	**1,750.55**	**1,745.02**	**1,601.56**	**UP 9.30%**
Free Cash Flow (millions)	**18.03**	**23.03**	**31.97**	**DOWN 43.60%**
Free Cash Margin	**1.14%**	**1.54%**	**1.96%**	**DOWN 0.82%**
Operating Cushion %	17.38%	17.62%	17.09%	Driving **UP**
Gross Margin % (before depreciations)	27.83%	25.33%	24.55%	Driving **UP**
SGA% (before depreciation)	9.02%	9.15%	8.91%	Driving **DOWN**
Cash Cycle (rev days)	16.99	15.82	17.18	Driving **UP**
Accounts Receivable (rev days)	32.08	31.96	35.16	Driving **UP**
Inventory (rev days)	1.52	1.34	1.92	Driving **UP**
Accounts Payable (rev days)	16.61	17.48	19.90	Driving **DOWN**
Income tax to Rev %	1.53%	1.79%	1.76%	Driving **UP**
Cap Exp. to Rev %	10.60%	9.83%	11.63%	Driving **UP**

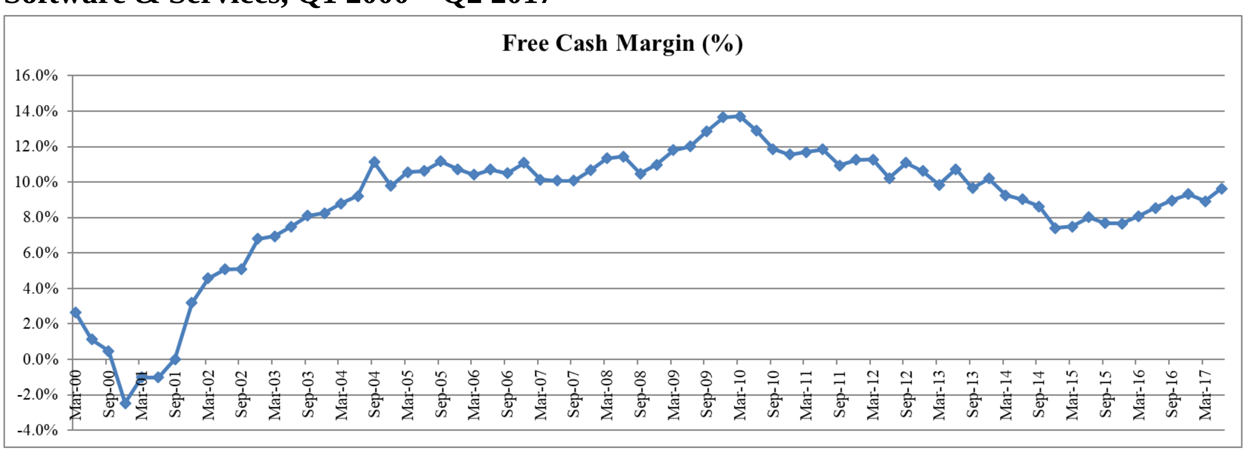
Analysis

Free cash margin for the Transportation industry dropped to its lowest level since December 2014, due to declining free cash flows. The industry has also seen an increase in the cash cycle, due to increasing accounts receivable and decreasing accounts payable.

Industries with Improving Free Cash Margin

In the twelve month period ended June 2017, eight industries enjoyed improving free cash margin: Energy; Consumer Services; Media; Retailing; Health Care Equiptment & Services; Software & Services; Technology Hardware & Equipment; and Semiconductors & Equipment. In the following paragraphs we take a closer look at an industry with improving free cash margin: Software & Services.

Software & Services, Q1 2000 – Q2 2017



Drivers of Free Cash Margin

Software & Services	Q2 2017 (Jun 2017)	Q1 2017 (Mar 2016)	Q2 2016 (Jun 2016)	Effect on FCM (Q2 2017 vs. Q2 2016)
Revenue (millions)	**633.77**	**600.38**	**553.47**	**UP 14.51%**
Free Cash Flow (millions)	**61.50**	**57.04**	**49.01**	**UP 25.48%**
Free Cash Margin	**9.65%**	**8.93%**	**8.55%**	**UP 1.10%**
Operating Cushion %	11.53%	12.02%	12.32%	Driving **DOWN**
Gross Margin % (before depreciations)	62.49%	62.51%	63.04%	Driving **DOWN**
SGA% (before depreciation)	47.32%	46.78%	46.86%	Driving **DOWN**
Cash Cycle (rev days)	50.73	49.95	49.12	Driving **DOWN**
Accounts Receivable (rev days)	62.94	62.44	61.68	Driving **DOWN**
Inventory (rev days)	0.00	0.00	0.00	-
Accounts Payable (rev days)	12.21	12.48	12.56	Driving **DOWN**
Income tax to Rev %	1.11%	1.39%	1.30%	Driving **UP**
Cap Exp. to Rev %	2.80%	2.84%	2.88%	Driving **UP**

Analysis

Improving free cash margin for the Software & Services industry is being driven by increases in revenue and free cash flow. Free cash margin should be monitored since there have been minor decreases in operating cushion and gross margins. The industry has also seen a slight decrease in income taxes paid.

Conclusions

The cash flow data reported through the second quarter of 2017 provides us with new insight into the U.S. economy. The ratios suggest a continuation of improved operating results for U.S. companies and a generally healthy economy. Even with many positive indicators, the ongoing lower than anticipated capital expenditures is suggestive of additional potential growth for the US economy.

While median free cash margin decreased slightly in June 2017, they are still well-above historical averages. Median revenues increased to $1,151.55 million in June 2017, up to 13.1% year-over-year from $1,018.28 in June 2016. Also during this period, median cash and short-term investments hit an all-time record of $147.47 million.

These savings from underinvestment in capital expenditures continues to bolster corporate balance sheets, and US firms could further accelerate economic growth by putting this capital to use again. The new US administration should soon be revealing specifics around tax reform policies that may target increased capital spending and business investment. The success of these policies will be apparent in the data of future quarterly reports on free cash margin.

We expect a continuation in the trend of gradual improvements in both revenues and free cash flow as companies benefit from generally healthy economic conditions. This was the first decline in free cash margin since December 2014, but similar fluctuations have been seen in other periods with healthy economic growth, and this would appear to be no different. Through the second quarter of 2017, company performance continues to be suggestive of a growing economy. Multiple potentially significant macroeconomic events continue to demand close attention, such as US tax policy changes, trade policy decisions, and geopolitical developments – in addition to continued uncertainty around the new U.S. administration.