Why Cash Is King!

Description

When deciding which companies to buy and sell, most investors view profitability as the most important consideration. Similarly, for companies in a number of sectors including healthcare, sales potential is what matters. However, the reality is that neither of these areas is most important. That's because high sales do not guarantee profitability, and high profitability does not guarantee financial strength. What really matters is a company's cash flow.

Pragmatism

While investing in shares is often viewed as being speculative in nature by some investors, it should not be forgotten that shares are a part of a real, living business. Therefore, the same business principles which govern small businesses matter to large companies just as much. In fact, ask any small business owner what the most important part of their company is and they are most likely to say 'cash flow'. That's because a relatively large proportion of smaller companies go bankrupt precisely because of a lack of cash, rather than low sales or even a lack of profitability.

Therefore, focusing on a company's cash flow is arguably the most pragmatic way to act as an investor. It means that you are thinking just as Warren Buffett advises you to; as a part-owner of a business. By considering cash flow above all else, it is possible to look beyond inflated sales figures and accruals on the income statement to see whether or not a business is successful.

Focus

Of course, there are numerous ways to determine if a company has strong cash flow. However, for time poor private investors perhaps the most effective means is to focus on a company's free cash flow. This is essentially all of the cash generated in a specific time period which is available for distribution to shareholders. It is the amount of cash available after investment has been made in the business and provides a guide as to the financial health of the company.

Free cash flow is calculated by simply subtracting capital expenditure from the net operating cash flow figure. Due to the natural fluctuation in capital expenditure each year, it is prudent to take an average of free cash flow over perhaps a three or five year period. That way, it is possible to gain an idea of the normalised performance of a company, as well as seek out a trend.

If a company has poor free cash flow when compared to its profitability, it could indicate that there are potential problems which could become evident over the medium term. A business with strong free cash flow will generally be highly sustainable, pay a relatively high dividend and attract investors over time.

Foolish Takeaway

While sales growth and rises in profitability may be exciting, cash flow is the cold, harsh reality of business. Without it, staying in business is simply impossible. Therefore, it makes sense for investors to prioritise focusing on cash flow above sales and profitability in order to make an assessment of a company's financial strength and, potentially, its valuation. Doing so may lack excitement, but if it can also help you to avoid investing in a failing business then it could be a highly worthwhile endeavour.

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