Why Cash Flow Is a Better Indicator Than Earnings

Description

Cash flow is what keeps companies alive, thriving, investing in their businesses, and giving back to shareholders. More specifically, free cash flow, which is the company's cash flow after it has made necessary capital expenditures for the business, reflects the cash the company has generated over and above expenses, thus giving a better indication of the long-term health and prospects of a company.

Earnings, however, is an accounting measure that allows some flexibility in how transactions are recorded to give an accurate picture of the company's financials in certain periods. Unfortunately, this flexibility also means that it is subject to manipulation that can inflate the earnings power of a company, whether it is intentional or not.

So, what we as investors should be looking for is a company that produces a high-quality earnings-per-share (EPS) number — a number that is relatively close to the cash that a company actually earned and, ideally, is even higher than what the company reported as earnings.

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What are some examples of this?

Power Financial Corp. (TSX:PWF) had a free cash flow yield of 14% in 2016, although this has come down from prior years (15.9% in 2015 and 19.6% in 2013) due to industry challenges and company-specific challenges that Power Financial's subsidiaries, IGM and Great West Life, have been experiencing.

IGM has been negatively affected by weakening sales, increased competition, and fee pressure. Great West Life continues to struggle with low interest rates.

On a more positive note, Power Financial increased its dividend last quarter by 5.1%, and its dividend yield now stands an attractive 4.85%.

Another company that has performed well with respect to the cash flow generation is **Celestica Inc.** (TSX:CLS)(NYSE:CLS). Year after year, the company continues to report cash flow from operations that is higher than its net income — a very good position to be in.

And lastly, after a couple of years of downward pressure on **Avigilon Corp.'s** (TSX:AVO) margins, it looks like they are showing signs of strengthening. In 2016, cash flow from operations of $43 million exceeded net income of $7.2 million, and the company had a cash flow margin of 12.2% (free cash flow was $6 million for a free cash flow margin of 1.7%, reflecting continued elevated spending on growth).

Bottom line

So, at the very least, investors should keep in mind that they should not look at EPS in isolation. Always be sure to also evaluate a company's ability to generate cash flow and its history of cash flow generation, because, ultimately, this is what really matters.

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karenjennifer

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