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Cash is the King
Realising importance of cash in stock valuation

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Premise

Indian stock markets have witnessed a strong bull run after the Covid related disruption in first half of 2020. As lock down began and economic activity came to a halt, predictions made related to prolonged disruption to economic activity coupled with disruption of global supply chain lead to a steep fall in stock markets. Once the clarity emerged and economic activity started to rebound in 2021 coupled with favourable oil and BOP situation for India the stock markets witnessed a very strong uptrend in a short period of time in 2021 and 2022 where front line indexes like NSE & BSE generated returns of over 50%. This entire period was market with volatility and also attracted a large cache of your investors who started trading from home during the phase of lockdowns and work from home phase. In 2022 more than 4.5 crore new demat accounts were opened. At the same time app based trading platforms and technical call services flourished in India offering an imputes to the young generation to trade in Indian markets.

In 2022 as the Ukraine-Russia war began new geo political risk factors came to the fore and created more volatility in global stock markets. However the disruption remained short lived in Indian context due to a largely domestic driven growth and favourable oil prices keeping the BOP position in control and rupee stable. Stock markets remined stable and continued their uptrend despite heightened geo political risk also due to channelling of savings from traditional investment avenues in India like FD's and Gold to stock markets in search of quick returns. This change was facilitated by depressed interest rate and lack of growth in gold prices. The derivative trading volumes in India therefore are the highest in the world right now.

Year 2023 began with stronger GDP projection, reduced worries about the spread of war between Ukraine and Russia and slow down in Chinese economy bringing about a shift in money flow by Global hedge funds to Indian shores. Year 2023 also witnessed another important geo political risk event with attack by Hammas in Israel and declaration of war by Israel against Hammas and its subsequent war campaign in Palestine that continues still now. Although the volatility increased in Indian stock markets, but they continued their upward journey. Now 2024 being a major election year with major countries witnessing elections in coming 12 months there are enough worries and risk factors prevailing in environment to further increase the volatility in Stock Markets.

With fears of increasing go political tensions in Europe and Middle East and possibility of changes in Governments in India and USA the two largest democracies markets are poised to experience more and more volatility for a prolonged period. The new breed of retail investors who began their trading journeys after 2020 have so far benefited by upward trending markets where it is easier to identify winning stock trades. The commonly used parameters like PE, EPS, Book Values, Price to Sales, EV, EVA, etc. so far have worked well for investors in last few years. However increased volatility and feeling of fatigue in stock markets are now expected to make them choppy and side ways or even begin a temporary bear phase something which is not experienced by these new investors or traders. In such times where growth expectations are expected to taper down

and it is likely to become difficult to identity winning investment bets one factor that can come to the rescue is the ability of a company to generate or conserve cash in such volatile times.

Importance of Cash in Valuation:

In times like these investors are better of relying on concepts in traditional financial management. Simply put, in confusing times like these investors are not likely to be flattered by growth prospects of a company only. Growth claims can fall flat if interest costs, input costs, and uncertainties in organic growth of a business fears do not subside in the economy.

Traditional financial management concepts stress a lot of importance on earnings and cash generating ability of a company. The focus on earnings is a play on accounting treatment, market factors and quality of management. While focus on cash is purely based on core operating model of a business (product, market, and customer) and execution of its strategy. As market factors become predominant and affect earnings of a company, investors can still rely on operating strength of a company based on cash flows and take intelligent investment decisions. For instance, steel and mining industry in India and globally is experiencing distress due to slowdown of Chinese economy and cheap export of steel out of China. As China slowed down over last two years the imports of Iron ore and Coal have seen a considerable decline and thus fall in prices. The major consumers of steel products are construction industry, transport (cars, trucks, aviation, shipbuilding, rail), appliances, machinery and metals industry. Most of these steel consuming industries in India are doing well due to increased infrastructure building activity by Government and boom in realty sector and thus there will not be any impact on volume of steel products consumed but due to the external pressure of market forces (like cheap imports from Korea, Japan & China) the steel prices keep falling and put pressure on earning of the steel companies. Playing out of this phenomenon means that steel companies need to cut operating costs, reduce working capital requirements and shelve capex plans to survive the in the short run. In short conserve cash in operations so that profitability can improve.

In reality a company has to focus on both cash and profits in running a successful business. The reality is that “cash is king” without cash, a company won’t last long. How much cash a company can generate is one of the more important measures of its health. Yet in stock market parlance investors rely more on Price to Earnings Ratio (P/E) than almost any other metric on valuation. As P/E ratio is driven by the earnings of a company solely it may not give an accurate picture of a company’s intrinsic health and ability to generate cash and grow in the long term.

What is Cash?

There has to be a separation in valuation metrics based on earnings and cash. Earnings are defined by Gross Profit, EBITDA, EBIT, Profit before Tax and Net Profit. These are calculations based on deducting manufacturing costs, SG&A, Depreciations & Amortization costs, Interest costs and Tax from revenues of a company. Profit numbers are also widely used in calculating important performance indicators relied on by investors like profitability margins, ROE, ROCE, ROA, EV/EBITDA, etc.

A company generates cash three ways i.e. selling its products, selling its assets and borrowing loans. Obviously not all sources of cash are good. Operating cash flow (OCF) which represents cash generated by company from internal operations (working capital cash) and sales is not the same thing as net profit, but is derived from net profit through a series of adjustments to working capital accounts on the balance sheet. This OCF details how cash flows into and out of a company. If more flows in than out, the flow is positive, if not, the flow is negative. Stock valuation will be affected when company is able to post a positive earning and still suffer from negative OCF. If a company is regularly spending more cash than generating it, signals a sign of weakness. A strong positive OCF is the hall mark of a good company be it good times or bad times.

Similar to valuation ratios based on earnings there are Cash flow ratios. As an investor one needs to focus not just on earnings base but also the cash base of a company. Reading cash flow ratios with earnings ratios offer a better insight on valuation and prospect of the business. P/E represents the ratio of the stock’s price to its earnings per share (EPS). It is an important metric. When a company’s P/E is very high or low, it gets top billing on the news. Overlooked by many are the equally important and in times like these more

important metrics that examine a company's price relative to its cash position.

Cash and Stock Valuation:
Is there a way to establish a link between valuation of a company and cash it carries on its balance sheet? If yes, so, how do you use cash flows to see if a company is under or over-valued, which is the same purpose of P/E?

In this regards two primary measurements shed light on a company's valuation.

1. **Price to Cash Flow**
2. **Free Cash Flows**

Price to Cash Flow:
The price to cash flow is determined by dividing the stock's price by operating cash flow (OCF) per share. The reason many prefer this measurement is the use of cash flow instead of net income.
Cash flow is a company's net income with the depreciation and amortization charges added back in. These charges, which reduce net income, do not represent outlays of cash so they artificially reduce the company's reported cash.
Since these expenses don't involve actual cash, the company has more cash than the net income figure indicates.

Importance:
It is a much sophisticated measure than an EPS as EPS uses net income. The short coming with net income is through some accounting jugglery net income can be shown as a positive figure. While Operating Cash Flow which is a base for this ratio provides a correct picture of hard cash generated and which can be relied upon.

Free Cash Flow (FCF)
Free cash flow is a refinement of cash flow that goes a step farther and adds one-time expenses capital expenses, dividend payments, and other non-occurring charges back to cash flow. The result is how much cash the company generated in the trailing twelve months.

You divide the current price by the free cash flow per share and the result describes the value the market places on the company's ability to generate cash.

Importance:
A company may report strong earnings (total revenue minus total expenses) by manipulating what qualifies as an expense, but FCF can reveal how much of that money is actually left over after additional company spending. For investors, FCF indicates a strong company capable of generating growth and real money. An aggressive company which has strong FCFs even after heavy spending indicates a company with strong potential for growth. Deceptively, conservative companies may also achieve a large FCF by spending only a small portion of their earnings. A small or negative cash flow indicates a company which is spending its savings or borrowing money. A negative FCF, however, may have two implications. Young company's often have negative FCFs because they are spending heavily now with the hope of rapid growth in future revenue. However, a mature company with a low FCF usually signals a company has low prospects for future growth.

What they Mean?
Like the P/E, both of these cash flow ratios suggest where the market values the company. Lower numbers relative to its industry and sector, suggests the market has undervalued the stock.
Higher numbers than its industry and sector may mean the market has overvalued the stock.

Conclusion
Both of these methods present a useful way to find out the valuation the market assigns to the stocks of a particular company. Depending on the results of the calculations you can determine whether the market has overvalued or undervalued the company.

For example, if the result is a higher number than the numbers of the other companies from the same industry, then it is reasonable to conclude that the market has overvalued the company.

On the other hand, if the result is a lower number as compared to those of the other companies from the same industry, then it is reasonable to conclude that the market has undervalued the company.