Hey Earnings, where's my Cash?

March 2019 – James Miller, Portfolio Manager

How can Treasury Wine Estates report cashflow of $27m and profit of $219m? Should we be concerned?

One of the joys of analysing investment opportunities is that every opportunity is unique. In making investment decisions, we look at each company through a slightly different lens. During the February reporting season one of the key issues that arose was the mismatch between cashflow and earnings for many companies. In the article below we explore why this happens, and how it affects our decision making.

There are three key areas to focus on:

1. What drives the difference between cashflow and earnings?
2. When should you be concerned?
3. How does it affect our decision making?

We conclude that recurring or deteriorating cashflow issues may be symptomatic of a broader issue in the business. In our Absolute Return Strategy, poor cashflow can be a red flag for further research of potential short opportunities.

1. What drives the difference between cashflow and earnings?

Changes in working capital can often explain the key differences between operating cashflow and earnings. Key drags on cashflow for a company can be:

- Increasing receivables - a company is yet to be paid from customers
- Reducing payables - suppliers being paid quicker by the company
- Increasing inventory – a company is yet to sell goods they have produced

Ideally you have high payables, low inventory and low receivables. The combination means a company is getting paid quickly, for goods you recently produced, and not having to pay your suppliers quickly.

2. When should you be concerned?

Cashflow is a concern if you believe that the company isn't going to receive that cash at some point in the future. Two companies that had poor cashflow conversion in the Dec 18 half were engineering firm Worley Parsons and wine exporter, Treasury Wine Estates. Cash conversion is a ratio of operating cashflow to accounting earnings – the higher the better.

We weren't concerned in February 19 when Worley Parsons announced operating cashflow of $21m versus profit of $98m. For companies with skinny margins and large revenues, such as Worley Parsons, a small move in timing of receivables or payables can have large effects on cashflow. To put it in context, in that 6-month period Worley had ~$2.6b of cash receipts from customers and paid nearly $2.6b in payments to suppliers. Put simply, the scale of the cashflows in and out of the company during the period were large compared to the profit, so a couple of days change in payment timing can make all the difference.

One result that warrants more research was Treasury Wine Estates (TWE). Management went to the effort of explaining that, whilst their 31 December 2018 cash conversion was just 54%, at the end of January this had stepped up to 85%. A possible explanation of changes in cash conversion is the timing of sales. One key question that springs to mind is whether Treasury's customers have been receiving better payment terms to get sales completed in the half year?

For the contracting sector (think companies like Cimic, Monadelphous and Lend Lease) poor cashflow always requires investigation. The first sign of a large construction contract encountering problems is often the customer stopping or slowing payments to the contractor until the problem is rectified. Given that the profit on construction contracts is recognised by a management assessment of completion progress, the profit can be more subjective than the cashflow.

3. How does it affect our decision making?

Earnings are the key metric we use to assess most companies. Earnings are far less volatile than cashflow and enable the best comparison for valuation between companies on a timely basis. For example, doing cross-industry comparison, we can compare banks (with very messy cashflows) to resource companies effectively using earnings as the primary metric.

However, understanding a business's cashflow is also critically important. Typically, a short-term hiccup in cashflow, that is well explained by management, is not a concern. But recurring poor cashflow, or deteriorating cashflows in certain industries, can be a warning sign.

Summary

Making investment decisions involves looking at many aspects of a company's financial position. One critical component is understanding a company's cashflow. Recurring or deteriorating cashflow issues may be symptomatic of a broader issue in the business. In our Absolute Return Strategy, poor cashflow can be a red flag for further research of potential short opportunities.