



Letter to the Editor

December 21, 2010

The following is in response to the article, [*The Kings of Cash Flow - Investing in Tomorrow's Potential Winners Today*](#), which appeared on November 16:

Dear Editor:

Given the large net cash balances on many of the Kings of Cash's balance sheets, do the authors believe an Enterprise Value to Free Cash Flow Yield (EV/FCF) would be more indicative of relative/absolute valuation?

Michael X. Quigley, CFA
Wedgewood Partners, Inc.
St. Louis, MO

The authors of the article respond:

Thanks for the question, Mike. As you can see, we believe that free cash flow (FCF) is an important metric for determining a stock's attractiveness, however, not the only one. We agree with you, and strongly support the notion that Enterprise Value to Free Cash Flow (EV/FCF) is another useful valuation indicator. This metric, EV/FCF, is one of a number of measures incorporated into the Alger investment process.

Enterprise value [EV = (Equity + Debt) – Cash] is the public market value of a company's securities less the cash on its balance sheet. EV/FCF tells us how expensive or cheap a company is relative to its free cash flow. EV/FCF is a simple, but powerful, measure that can show an investor, hypothetically, how many years it would take for a company to generate enough cash to retire all its outstanding issuances and go private.

EV/FCF is similar to P/E in concept, but even more robust. P/E only considers the value of the firm's equity, while EV/FCF also incorporates the amount of debt the company incurred to generate the FCF. So, EV doesn't ignore leverage as a P/E analysis would. Additionally, P/E frameworks are also hurt by their reliance on the vagaries of accrual accounting. FCF is a purer way to measure the true cash a company is throwing off, and thus, is more difficult to be 'manipulated' through accounting treatments, such as accruals, which can make earnings based analysis a more vulnerable tool.

At Alger, when an analyst recommends the purchase of a stock to a portfolio manager, they present bear, base, and bull case models which discount the company's future free cash flow and compare it to the firm's enterprise value. By incorporating multi-scenario



analysis viewed through a free cash flow lens, our portfolio managers can have a more sound appreciation of the potential risk/reward when analyzing a company's stock price. The scope of potential outcomes is determined, to a great extent, by the EV/FCF in each of the scenarios across a range of capitalization multiples and discount rates.

The EV/FCF modeling framework can allow our managers to enhance their portfolio's risk control at the individual security level, which augments portfolio construction practices on sector and industry weightings that help ensure sufficient diversification. The use of EV/FCF can also provide potential buy / sell signals. This can occur when an Alger analyst has strong conviction in a company's fundamentals *and* the company's EV/FCF valuation is not reflected in the stock price. As you may imagine, this can very likely lead to a dialogue with a portfolio manager with the hope to initiate or add to the position size of that company. As an example, in March 2009, investor concern regarding end market demand drove Apple's shares as low as \$83.11. At that share price, no debt, and \$28.80 cash per share on the balance sheet, Apple's enterprise value was just over \$54 per share. Yet Apple was selling for only 6.8X the analyst's bear case estimate of \$8 per share of FCF. At Alger, we are constantly searching to buy high quality growth stocks where there is little apparent downside risk.

EV/FCF analysis can be a real differentiator and a tool Alger uses often. Thank you for your question.

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