The Return of Free Cash Flow

At whatever level the market finds its 'final' bottom, the real question is: What is the path of economic, and consequently market, recovery? The current volatility and magnitude of refinancing requirements implies more sideways movement than up. Once volatility recedes, value appears. Forget P/B, P/E etc., the immediate answer to value lies in the ability of the firm to continue to defend its own stock. The necessary condition is solvency, and the sufficient condition is the ability to pay out a dividend backed by free cash flow that makes it expensive to short the stock. If the two conditions are not met, the stock is not worth owning, because as we have experienced, the potential failure to refinance can send the equity plummeting to 0. Even tech / growth stocks in this environment will trade at compressed multiples until they pay dividends or shrink the float through buybacks, which might take years for shell shocked boards to consider. As of now, even Microsoft is issuing bonds while it can, believing that the best acquisition opportunities will occur when there is zero ability to finance them. If MSFT is worried about financing, the rest of us need a big mattress.

Why are we here? Many banks are insolvent towards a recession bottom, but as the Fed allows them to earn wider spreads and as their clients recover, reserves stabilize. Subsequently banks are able to earn back their capital depletion and restore dividends. In the meantime, their stocks find bottom in the arms of value investors willing to absorb bankruptcy risk. The difference this time was that leverage was so much higher than historical norms as to be indefensible, hence the spectacular wipeouts faced by bold faced names. You can blame the shorts, the Paulson Treasury, or phases of the moon, but leverage is what did LEH in. No one can be sure whether this will be the last round of capital raises, and whether all of the big four: WFC, C, JPM, BAC will live to tell.

As for industrials, in a tight credit market, the lower the amount or further out the maturity of debt, the more likely the equity survives, and the more defensible the stock. The true backing of the stock comes from the sustainable free cash flow of the firm.

Here-in lies the rub. A market that until 18 months ago was trading on buyout premium expectations will probably not see that day again for 18 years. So the fact that a stock is down 90% and then up 50% in a short squeeze is irrelevant. Defensible free cash flow is likely the only driver of sustained equity value revival.

In the circumstances, oil and agricultural commodities come to mind as a pair of businesses which provide free cash flow and have sustained demand from Asia offsetting declines in the G7. These represent the lowest risk cash flows, despite the fundamental volatility of commodities. Though in normal times one assigns a higher commodity risk, the volatility of every other business has risen to match them, real estate being the most spectacular example. If anything, their costs of drilling and pipeline construction will fall and they might generate more cash over time, especially if they pull in their horns and wait for better deals from wayward governments. E.g. BG, CHK, POT, DO, AGU. Industrial metals have to wait for the revival of construction and car making, both currently in the dumps, or for the lack of CapEx to kick in, which will constrain supply.

The rise of gold does not represent consumer inflation – it reflects the risk that the central banks print too much money, and perversely, the ECB doing truly stupid things that will damage the Euro economy permanently, and the suffering of the Indian Rupee and other currencies dependent on foreign investment to support deficits. We managed to prove a very crude relationship between gold stock performance and inflation expectations embedded in the spread between short term and long term rates, which reflects, to a degree, an expectation for future spot rates.

dGDX = a + b * d(T1-T10 spread)

The values are of our regression are
dGDX = -.03% + 8.95% * d(1-10 spread)

We are nowhere near submitting this to the Journal of Corporate Finance, but it at least told us that the intuition that cheap money has been pushing up gold stocks is not wrong.

Many industrial / service stocks have been caught in the downdraft where there is little exposure to financing problems and often demand is sustainable. Medical and computer technology and agricultural equipment come to mind. E.g. KCI, CSC, TEX, CAT

Many global media businesses have suffered from the withdrawal of advertising by autos and other industries in survival mode. NWS, TWX etc. are global franchises that are as a matter of chance less than typically levered due to prior near death experiences. Cable and telecom cash flows are also comfortable buys – whatever the price cuts, there is little history of the world consuming less telephony or TV / internet despite classification as discretionary, though their maintenance capex is proving higher than most assumed.

Grocery chains are often leveraged, but the ones without looming debt maturities should stabilize quickly. Car rental companies can simply offer older cars and preserve cash in this environment, the business should survive. E.g. GAP, CAR, HTZ, WINN, SWY.

Many hotel firms, at least in the US, are not overbuilt unlike prior cycles because the dot com bust + improved communication created a permanent plateau in business travel. They should have muddled through but for bad PR over TARP money being spent on conferences. Asian hotels should be wildly profitable on an operating basis. Some may have overpaid for land, corrupting capital structure based on today's rents, but that is irrelevant going forward. E.g. HST, IHG, MAR.

The market has run up, and most sectors have become fully valued, with expectations of quick revenue revival. If revenue does revive across the board, then any pullback will be moderate. If it does not, and neither unemployment nor housing offer immediate encouragement, we could visit a new low. While Fed action and 'stimulus' stop decline, confidence in a quick bounce is quite low. The equity market will re-price forcefully downwards as the permanence of the consumer pullback becomes apparent.