



## **The Factors Affect the Free Cash Flow in the Joint-Stock Companies**

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There are several types of cash flows in the course of a business. The total (gross) amount of money is fixed in the NCF indicator (net cash flow), which is formed on the basis of the summation of all positive and negative financial transactions from the investment, financial and operating activities of the company. However, another indicator is much more expressive.

Free cash flow (FCF - free cash flow) is the amount of money that remains at the disposal of owners and investors after deducting all taxes, as well as capital investments. In fact, it is cash that increases the company's shareholder value and expands its asset base. If the FCF has a good positive indicator, then the company can develop and produce new products, pay increased dividends, acquire assets, and therefore become more attractive to its shareholders.

In the activities of any enterprise, there are two main types of free cash flows:

- Enterprise Free Flow (FCFF) is money after capital expenditures and taxes are deducted, but before interest is calculated. It is used to understand the real value of the enterprise itself and is important for lenders and investors.
- Free flow on equity (FCFE) is the funds left after deducting interest on loans, taxes and operating expenses. The indicator is important for owners and shareholders, as it assesses the shareholder value of the company.

There are several ways to objectively calculate the free cash flow of a company (or firm). The main elements of its structure are:

- net investment in working capital;
- net investment in fixed capital;
- money from the operating activities of the enterprise after taxes.

The first two positions are taken from the balance sheet.

To find the free flow indicator of an enterprise, the following formula is most often used:

$$FCFF = EBIT \times (1 - \text{Tax}) + DA - \text{CNWC} - \Delta WCR \quad (1)$$

Where:

Tax - the amount of income tax;

DA is the depreciation rate of assets (intangible and tangible);

EBIT - profit before all taxes;

$\Delta WCR$  - the amount of capital expenditures, the term CAPEX can also be used;

CNWC - dynamics of working net capital (expenses for the purchase of new assets). It is calculated in the following way:



$(M_i + R_i - AP_i) - (M_o + R_o - AP_o)$ , where M – row material, R - receivables, AP - accounts payable. From the sum of these indicators for the current period (index i), the sum of similar values for the previous time period (index o) is subtracted.

There are also other payment options. For example, in 2001 the following methodology was proposed:

$$FCFF = CFO + \text{Interest expensive} \times (1 - \text{Tax}) - CFI \quad (2)$$

Where:

- CFO stands for the amount of money from a company's operating activities;
- Tax - income tax (interest rate);
- Interest expensive - interest costs;
- CFI - funds from investment activities.

Some use the most simple formula to calculate the value of the desired indicator:

$$FCFF = NCF - CAPEX \quad (3)$$

The FCFF flow is created by the company's assets (operating and production) and directed to investors, so its value is equal to the total amount of payments, this rule also works in reverse. This rule is called the cash flow identity and is written graphically as follows:  $FCFF = FCFE$  (finance to owners) +  $FCFD$  (finance to creditors)

The free-to-own capital flow (FCFE) indicates the amount remaining at the disposal of shareholders and owners after settlement of all tax liabilities and mandatory investments in the operating activities of the enterprise. The most important criteria here are:

- NI (Net Income) - the net profit of the company, its value is taken from the accounting report;
- DA (Depletion, Depreciation & Amortization) - depreciation, depletion and depreciation, accounting indicator;
- $\Delta WCR$  (CAPEX) is the cost of current activities (capital expenditures), they can be found in the investment activity report.

Ultimately, the general formula looks like this:

$$FCFF = NI + DA - \Delta WCR - \text{Investmen} + \text{Net borrowing} \quad (4)$$

In addition to the abbreviations explained above, some more apply here:

Investment - the volume of investments made by the company in short-term assets, the source is the balance sheet;

Net borrowing is the delta between already repaid and newly received loans, the source is financial statements.

However, some "expenditure" items (for example, depreciation) do not lead to real spending, so a slightly different system for calculating this indicator is often used. Here, the value of the cash flow from production operations is used, which already takes into account changes in working capital, net profit, the indicator is also adjusted for depreciation and other non-cash transactions:

$$FCFE = CFFO - \Delta WCR + \text{Net borrowing} \quad (5)$$

In fact, the main difference between the considered types of free cash flows is that the calculation of FCFE is made after the receipt (payment) of debts, and FCFF - before that.



Billionaire Warren Buffett uses the most conservative method of estimating this indicator, which he calls Owner's earnings. In his calculations, in addition to the usual indicators, he also takes into account the average annual amount of funds that should be invested in fixed assets in order to maintain a competitive market position and production volumes in the long term/

Ideally, a stable operating enterprise in a normal economic situation should have a positive FCF at the end of a year or other reporting period. This state of affairs enables the company to repay all its obligations in a timely manner, as well as expand (produce new products, modernize equipment, diversify sales markets, open new facilities).

If the FCF is above zero, then this means the following:

- timely payment of dividends to shareholders;
- increase in the value of the company's securities;
- an opportunity to carry out an additional issue of shares;
- the owners and management of the enterprise are effective managers.
- If free cash flow is negative, then this may indicate two possible options for the state of the company:
  - the enterprise is unprofitable;
  - the management of the enterprise invests heavily in its development, which can give a return in the long term due to a high level of profitability.

To understand the real state of the company, it is necessary, in addition to the current situation, to also study the strategy of its development. To increase the value of the company, you need to use growth levers, which include:

- tax optimization;
- revision of the direction of capital investments;
- increase in revenue and reduce costs to increase EBIT;
- bringing assets to an acceptable minimum by increasing their efficiency.

Investors often use the free cash flow indicator to calculate a number of statistical and dynamic coefficients that evaluate the performance and profitability of an enterprise, including IRR (internal rate of return), DPP (discounted payback period), ARR (profitability of an investment project), NV (current cost).

Free cash flow is arguably the most important financial measure of a company's stock value. The value/price of a share is considered to be the sum of the company's expected future cash flows. However, stock prices are not always accurate. Understanding a company's FCFF allows investors to check if a stock is fairly valued. FCFF also represents a company's ability to pay dividends, conduct share buybacks, or repay debt holders. Any investor wishing to invest in a company's corporate bonds or public equity should check its FCFF.

A positive FCFF indicates that the firm has cash left over from expenses. A negative value indicates that the firm has not generated sufficient income to cover its costs and investment activities. In the latter case, the investor should dig deeper to understand why costs and investments exceed returns. This may be the result of a specific business goal, such as in fast-growing technology companies that constantly invest from outside, or a signal of financial trouble.



## References

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