



Markets & Economies

Value Stocks: Why Focus on Free Cash Flow?

In the first of a three-part series on key metrics for value stocks, we explain why an emphasis on free cash flow offers a better window on a company's value relative to other widely used measures.



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The empirical research on the long-term performance of value equities seemed overwhelming when it first appeared in the early 1990s, sparking a revolution in asset allocation and earning one of its progenitors a Nobel Prize. So why have longstanding approaches to value not worked as well as they once did? We believe many of the more traditional measures of value investing have become increasingly less relevant as the market has adapted and evolved. In this paper we will examine:

- Why we believe formulaic value is unlikely to work in the future.
- Why earnings-based valuation approaches are flawed.
- How investors should approach value investing moving forward.

The Fall of Formulaic Value Investing

What makes a value company cheap? The definition has evolved over the years, but the original metric, as outlined by Eugene Fama and Kenneth French in their influential research,¹ was price-to-book value (P/B). This concept became an integral determination of growth versus value across the investment universe, with equity style indexes such as Russell, Wilshire, and MSCI being constructed on the notion of price-to-book cheapness. Using this formulaic and rigid approach to value investing worked decades ago when the economy was heavily manufacturing and production-centric and as a result, balance sheets were largely comprised of physical assets.

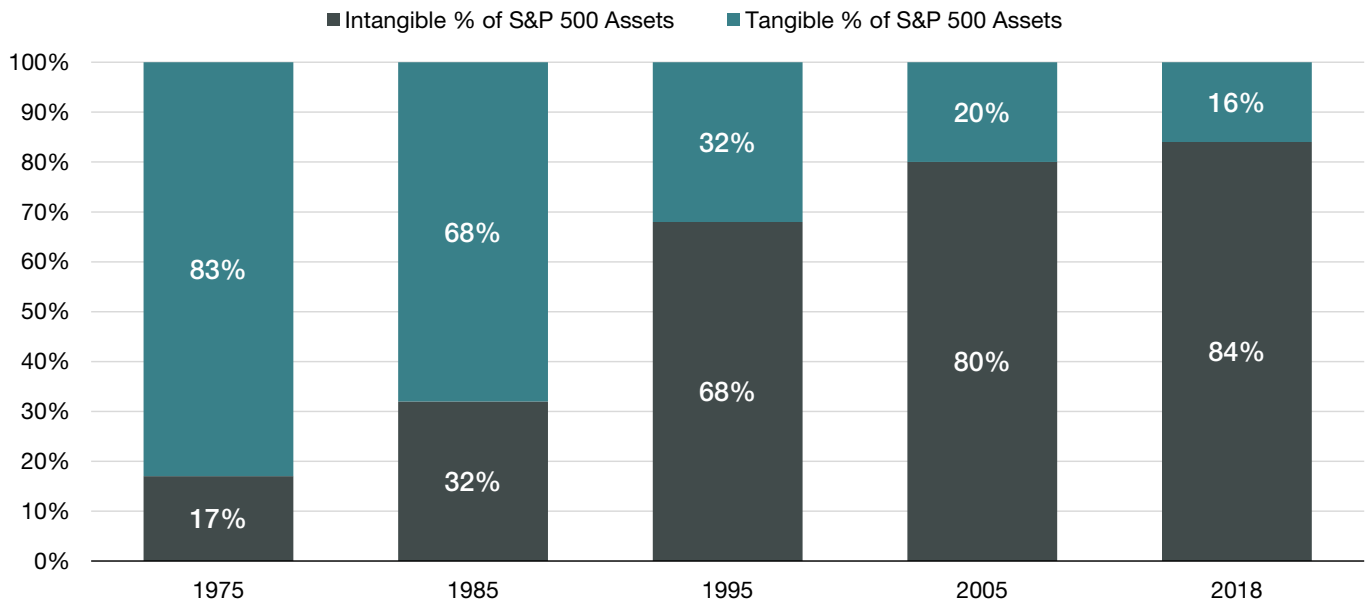
Over the last four decades however, we have witnessed a dramatic shift in the composition of assets on companies' balance sheets. As a result of intensifying technology solutions, intangible assets such as intellectual property have become far more important than storefront real estate and physical data services.

That shift has had a profound impact on winners and losers. In the 1970s and 1980s, adding to physical capital stock year after year allowed companies to fortify high barriers to entry by scaling their businesses to a point that made it difficult for new entrants to compete and take market share. Toys 'R' Us, for example, displaced small "mom-and-pop" toy stores through sheer scale that led to pricing power and better product selection. However, in recent decades, the emphasis on physical real estate became the very undoing of that franchise as it was displaced by relatively asset-light, direct-to-consumer retailer Amazon.com, which did not have to rely on widely dispersed brick-and-mortar stores.

As we see below, this evolution has been nothing short of dramatic. (See Figure 1.) Within the S&P 500 today, over 80% of total assets are intangible assets. Tangible book value of equity does not fully capture intangible assets and thus, price-to-book tangible cheapness, one of the key inputs in delineating growth and value stocks, has become less relevant when assessing a company's value.



Figure 1. Proportion of Companies' Tangible Assets Has Shrunk Greatly

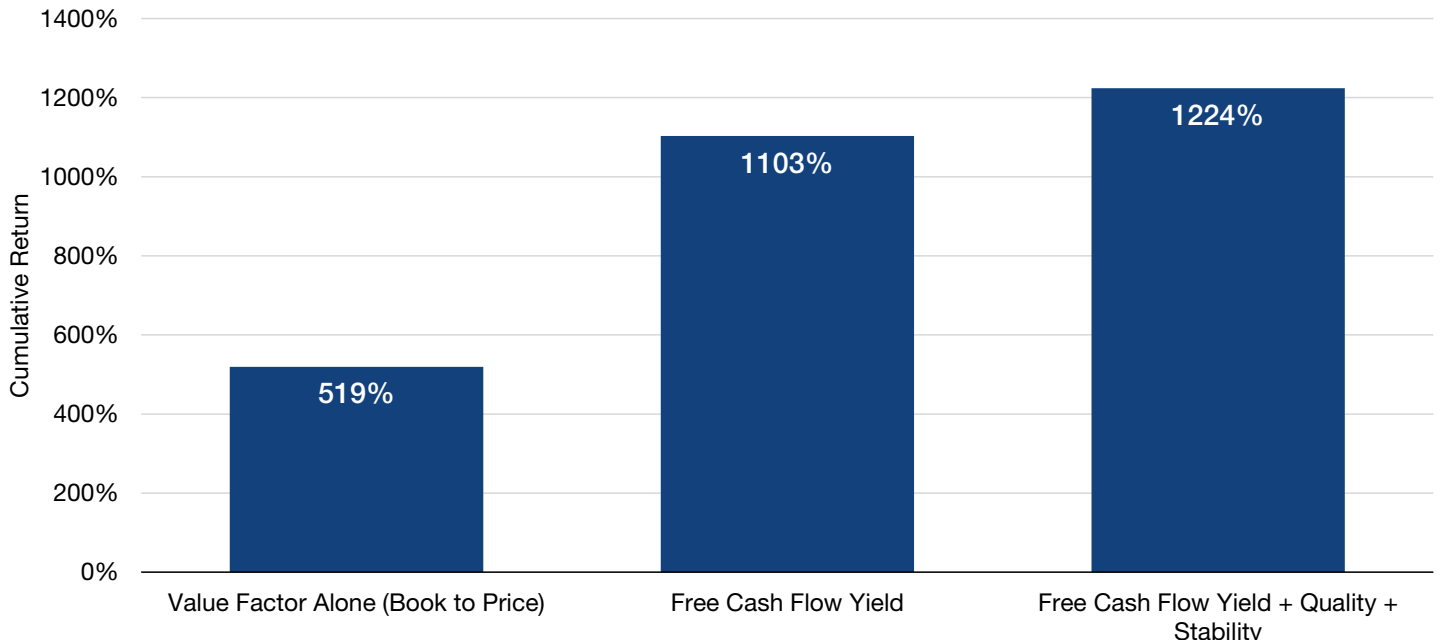


Source: "Boom of Intangible Assets Felt Across Industries and Economy," UCLA Anderson Review, April 19, 2023. Latest available historical data. Tangible assets are assets with a physical form and that hold value; examples include property, plant, and equipment. Intangible assets are non-monetary assets without physical substance and can include salable assets such as intellectual property, patents, and copyrights, as well as those that cannot be physically separated from the company, including goodwill. For illustrative purposes only.

While the price-to-book orientation still generated positive returns, investors found that a focus on free cash flow provided significant excess returns. Additionally, when incorporating measures of a business's quality and operating stability into the investment process, returns were even better. (See Figure 2.)



Figure 2. Focusing on a Broader Range of Metrics Has Led to Outperformance
Cumulative performance of indicated investment factors, January 2002–June 2024



Source: Lord Abbett and S&P Global. Results refer to comparing the cumulative returns of the top quintile portfolio based on a single factor (Book to Price, or “BP”) to the cumulative returns of the top quintile portfolio created based on a multi-factor scheme from January 2002 to June 2024. Top quintile portfolios were constructed based on the Russell 1000 Value index; for both single-factor and multi-factor portfolios, each stock in the index was assigned a score, and quintiles were created based on stock percentile rankings. For single-factor (BP) portfolios, the score was the factor value. For multifactor portfolios, the score was created as follows: Each single factor (Free Cash Flow to Price, Return on Equity, and Price Momentum) value was assigned a z-score based on the index, and the sum of the z-scores for each stock was calculated based on a 50%/25%/25% weighting scheme. Stocks were assigned to a quintile portfolio based on their score with the top quintile containing all the names with percentile ranks above 80%. Factor values were obtained from the S&P Alpha Factor Library. Please see Glossary and Index Definitions, below, for more information on terms used in this illustration.

Past performance is not a reliable indicator or guarantee of future results. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees and expenses, and are not available for direct investment.

In this three-part series, we will delve into each of these metrics (free cash flow—the focus of this paper, quality, and operating stability) and why we believe incorporating them as part of a security selection process is superior to more traditional measures used in value investing, such as price-to-book or price-to-earnings.

Why Earnings-Based Valuation Metrics Are Flawed

Famous tech entrepreneur Michael Dell once said about his company:

“[W]e were always focused on our profit and loss statement. Cash flow was not a regularly discussed topic. It was as if we were driving along, watching only the speedometer, when in fact we were running out of gas.”

There are many ways to evaluate a company’s performance and financial statements. Some of the most common are revenue, earnings per share, and EBITDA. Value investors seek out companies that are trading at a discount to current value and as such, we believe normalized profitability measures are more appropriate, but that picking the right measure can have a meaningful impact on overall performance. We believe there are flaws with some of the more traditional fundamental metrics, which we detail below.



Earnings per share

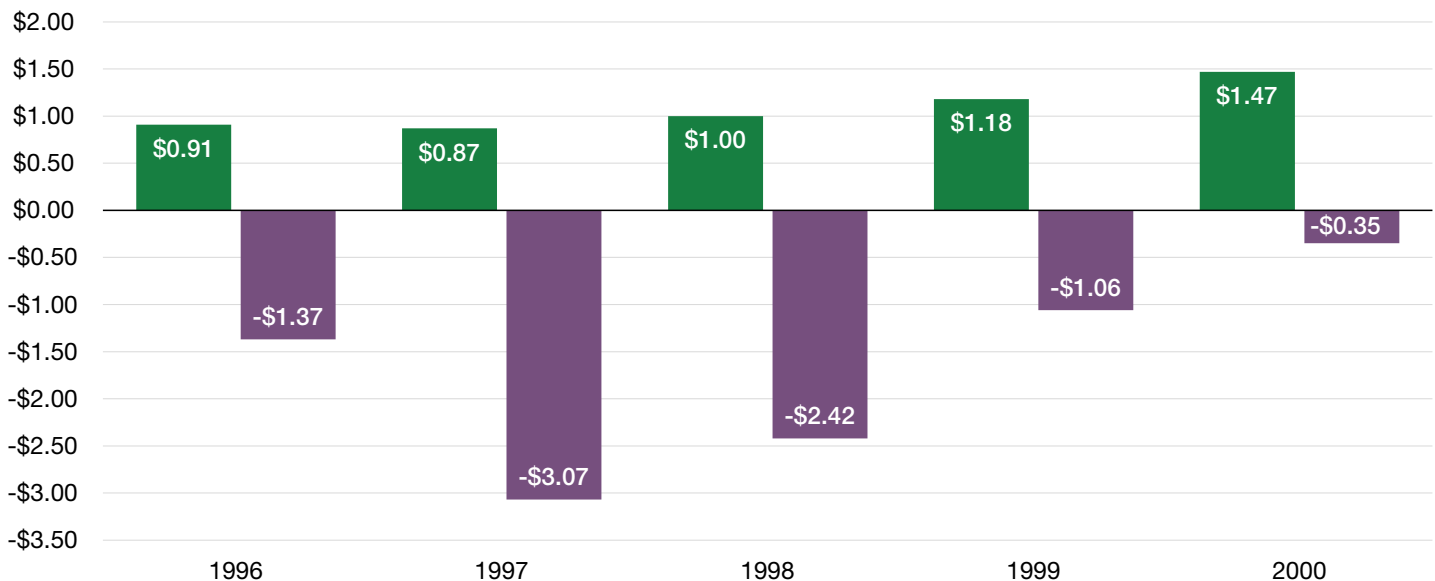
Earnings per share is certainly a relevant metric and is important to consider. But over 95% of S&P 500 companies report non-GAAP earnings. In other words, 95% of companies are reporting earnings per share numbers that can be manipulated through a variety of accounting techniques. Through non-GAAP reporting, companies have the flexibility to exclude certain expenses or income, such as stock-based compensation or restructuring costs, that are otherwise required under GAAP reporting. This flexibility can give managers too much discretion in determining EPS, as they can selectively omit unfavorable items to present a more favorable financial picture. While intended to provide a clearer view of core operations, non-GAAP reporting can obscure a company's true financial performance.

The case of Enron exemplifies how the misuse of non-GAAP reporting and overreliance on earnings per share as a means of measuring financial health can lead to financial misrepresentation. By excluding significant liabilities, Enron was able to manipulate EPS and other financial metrics, giving the illusion of financial health. However, an investor may have suspected deteriorating financial conditions had they looked at free cash flow, which is significantly harder for management to manipulate. (See Figure 3.)

Figure 3. A Tale of Two Metrics: Enron's Free Cash Flow Versus Earnings Per Share

Data for the years 1997–2001

■ Earnings per Share ■ Free Cash Flow per Share



Source: Enron historical financial statements. See Glossary, below, for more detailed descriptions of the terms used in this illustration. Enron filed for Chapter 11 bankruptcy protection on December 2, 2001. For illustrative purposes only.

Earnings before interest, taxes, depreciation & amortization (EBITDA)

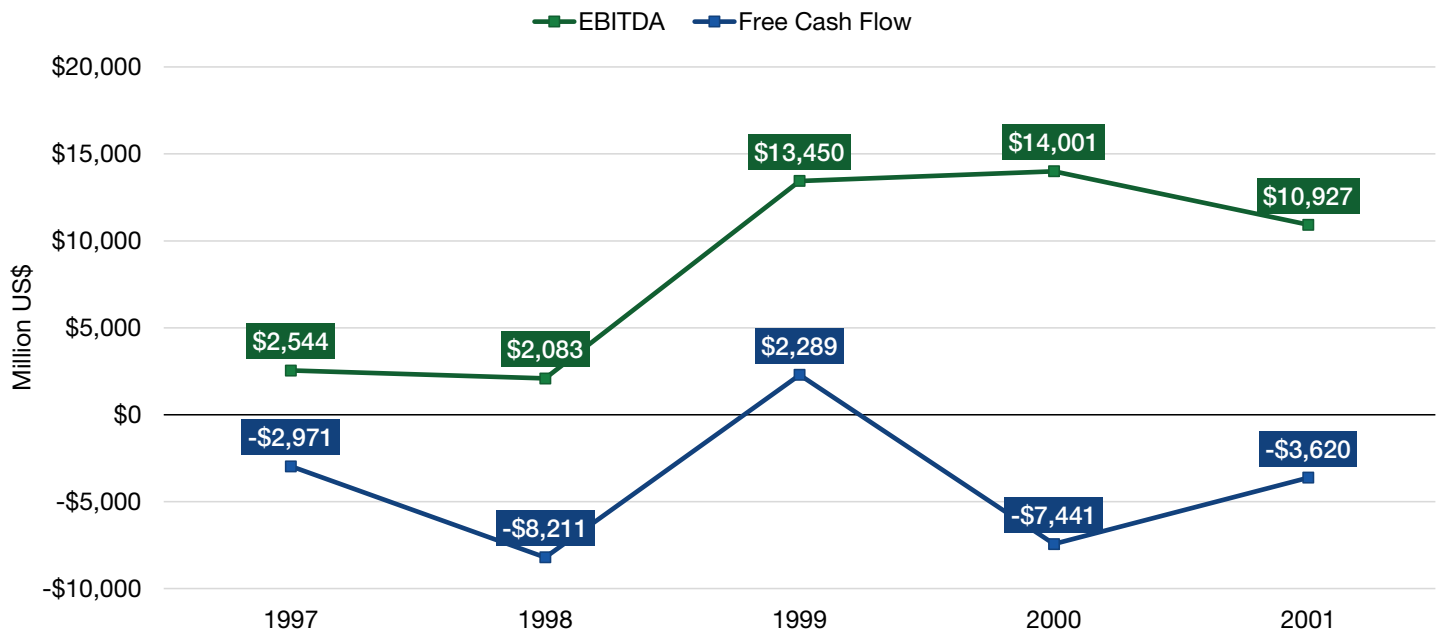
EBITDA is another commonly used metric to evaluate a company's performance and attempts to provide a better view of its cash generation. While this metric is a step closer to the cash flow statement it still has its pitfalls. EBITDA is a non-GAAP measure and thus lacks standardization across companies, and similar to earnings per share, it is subject to management adjustments. EBITDA also ignores a firm's capital expenditures and does not give the investor the full picture regarding the capital intensity of a business.

In another example from the early 2000s, WorldCom went bankrupt in 2002, and management acknowledged that the company inflated its corporate earnings by \$4 billion to record a "profit" of \$1.5 billion in 2001. In actuality, the company was recording its expenses as investments in capital spending. This is not permitted in GAAP accounting but was an "adjustment" the company undertook so that their adjusted EBITDA appeared more attractive. The company recorded the expenses directly on the cash flow statement instead of the income statement, a strategic move that effectively manipulated earnings and led to a lower P/E ratio; however, its free cash flow remained unaffected. (See Figure 4.)



Figure 4. WorldCom's Free Cash Flow Offered a Far Different View of Its Financial Health than Its EBITDA

Data for the years 1997-2001



Source: WorldCom historical financial statements. See Glossary, below, for more detailed descriptions of the terms used in this illustration. WorldCom filed for Chapter 11 bankruptcy protection on July 21, 2002. For illustrative purposes only.

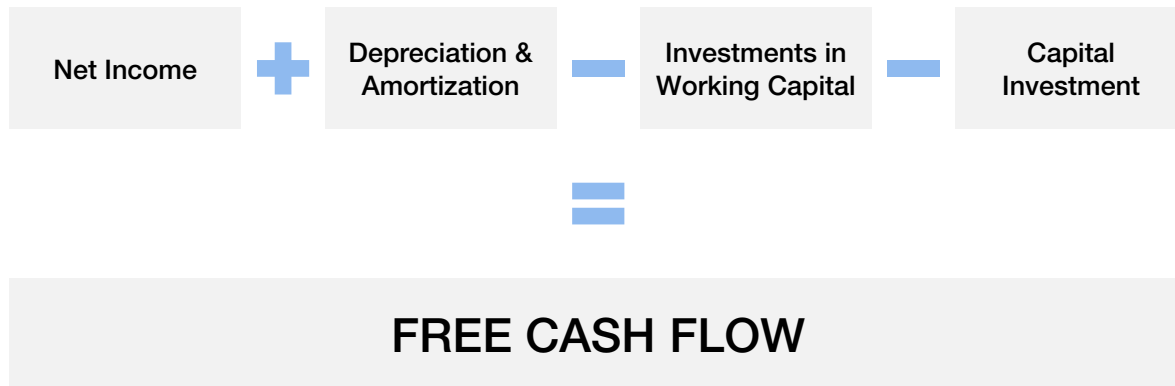
These examples highlight the drawbacks of relying on earnings per share and EBITDA alone to value a business. Regardless of which valuation multiple one may leverage, both are subject to manipulation and may provide a misleading financial picture.

Why We Believe That Free Cash Flow Is a Superior Valuation Metric

Free cash flow is a measure of a company's financial health and represents the cash that a company generates after accounting for cash outflow to support operations and maintain its asset base. Unlike net income and earnings per share, free cash flow excludes the non-cash expenses on the income statement but *includes* the spending on equipment and working capital a company needs to spend to sustain its business. (See Figure 5.) In essence, free cash flow is the money a company has available to reinvest back into the business or return to shareholders in the form of dividends or share buybacks.



Figure 5. The Components of Free Cash Flow



Source: Lord Abbett. See Glossary, below, for more detailed descriptions of the terms used in this illustration.

The Impact of Capital Intensity

Capital intensity is a key consideration when evaluating the underlying quality of a business. Every business needs to spend money to operate and grow. However, the amount of capital required can vary greatly depending on the business model. For instance, an airline needs to purchase planes, which are expensive assets. These costs are capitalized, meaning they are recorded as assets on the balance sheet and are expensed on the income statement on a pro-rata basis over time. This is because the planes provide value over many years, not just in the year they are purchased.

Capitalizing these investments spreads the cost over the useful life of the asset through depreciation. As a result, the airline may show lower free cash flow compared to its earnings per share. This means that while the company's equity may seem cheap based on P/E or EV/EBITDA ratios, it may not be as inexpensive when considering free cash flow, which provides a more accurate picture of the necessary investments.

On the other hand, a software business tends to be "asset light." These companies may rent office space and pay their engineers high salaries, both of which would show up on the income statement, but they do not have to spend substantial amounts of capital on new equipment. These are people- and innovation-driven firms that can create value through intellectual property. They do not have to undertake large purchases and investments and as a result, their capital investment levels are relatively modest, and a higher portion (if not more) of their traditional earnings per share are converted into cash. As such, they may look more expensive on a P/E or EV/EBITDA basis, but the cash flow per share may actually be higher than their earnings per share and subsequently, the stocks are cheaper on a cash basis, which is what we deem to be more important for the long-term health of a business.

Figure 6 provides an example of this dynamic by showing two capital-intensive businesses that look cheap based on the more commonly used performance metrics, EBITDA and EPS (Companies A and B, on the left side of the chart). However, these companies only convert 50% of their net income into free cash flow given their higher capital intensity and therefore, on a free cash flow basis, they are not cheap. On the other hand, the right side of the chart features two "capital light" businesses (Companies C and D) that look more expensive on traditional metrics. Considering their low capital needs, however, these businesses are cheaper on a free cash flow basis as they convert over 100% of their net income into free cash flow.



Figure 6. How Companies' Capital Intensity Can Potentially Affect Underlying Valuations

	CAPITAL INTENSIVE			CAPITAL LIGHT		
	Company A	Company B	Average	Company C	Company D	Average
EBITDA	1367	1562		788	190	
EV/EBITDA	5x	8x	7x	15x	16x	16x
Net Income	595	752		461	92	
Earnings per Share	\$4.72	\$18.50		\$20.42	\$3.92	
P/E	9x	9x	9x	21x	19x	20x
Free Cash Flow	194	505		425	128	
Free Cash Flow Yield	3%	4%	4%	4%	5%	5%
Free Cash Flow Conversion	33%	67%	50%	92%	139%	116%

Source: Lord Abbett. Data based on annual financial performance and valuations of four actual companies presented as examples (depicted here as A, B, C, and D) based on "capital intensive" (lower EV/EBITDA ratios) and "capital light" (higher EV/EBITDA ratios) classifications. Please see Glossary and Index Definitions, below, for more information on terms used in this illustration. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

The Process of Normalization

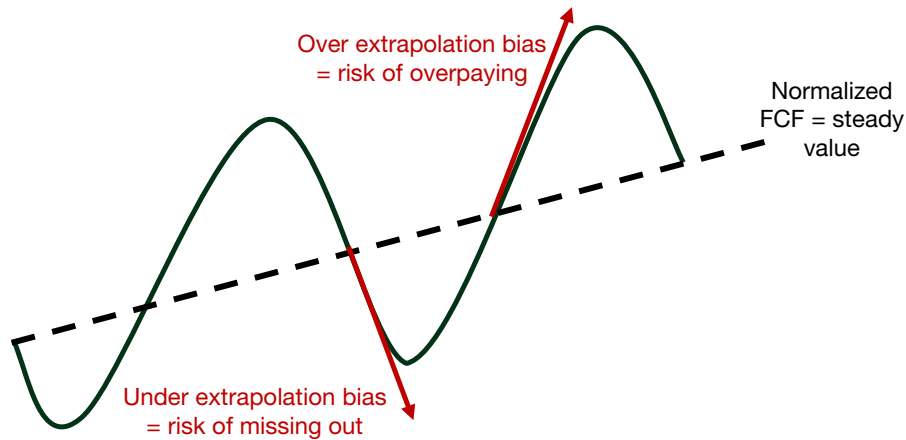
To understand a business's worth, we think it is important to look beyond the noise of unsustainable events, both good and bad, and focus on the stream of free cash flow. A highly cyclical business may look cheap on a variety of metrics at the peak of its business or end-market cycle. However, this relative cheapness may be deceiving if the earnings and cash flow of the business are materially lower in the future. While the valuation multiple looks inexpensive on current earnings, the earnings are potentially unstable, and future earnings are likely to move lower which, in turn, is likely a bad investment.

Conversely, markets also tend to be myopic and may over-penalize a quality company for a short-term operating issue that is unlikely to have a long-term impact on its intrinsic value. The willingness and ability to look through these near-term headwinds can potentially lead to outsized returns for equity investors if exploited properly.

In both cases, we believe an investor is better off taking a long-term but active approach and looking through these peaks and valleys by taking a more normalized view of a business's free cash flow. (See Figure 7.) This process, when applied appropriately, helps to avoid overpaying for an unsustainably high cash flow stream and can help investors take advantage of dislocations within the market that other investors may dismiss.



Figure 7. Normalized Free Cash Flow: A More Balanced View of Cash Generation



High-quality companies often grow their free cash flow over time, but this growth can ebb and flow; these firms may use accumulated cash for investments, dividends, etc. The most attractive entry point is often when cash flows are at their trough.

Source: Lord Abbett. **Free cash flow** (FCF) represents the amount of cash generated by a business, after accounting for reinvestment in non-current capital assets by the company. **Normalized free cash flow** attempts to smooth out a company's FCF by excluding non-core operations and one-time items. The green line illustrates the possible trajectory of free cash flow (FCF) over time for a company that is displaying persistent FCF growth. **Extrapolation bias** describes the tendency of investors to project recent trends into the future. For illustrative purposes only.

Conclusion

Unlike earnings metrics that can be manipulated through discretionary adjustments, normalized free cash flow focuses on actual cash generated by the business after accounting for capital expenditures. This measure is less prone to manipulation as it highlights the real cash available to the company, making it a more reliable measure of financial performance and the sustainability of that performance. For investors, normalized free cash flow offers a clearer, long-term view of a company's operational success and its ability to generate returns.

Lord Abbett Product Specialist JJ Titus contributed to this report.

¹Fama, Eugene; French, David (1992). "The Cross-Section of Expected Returns", *The Journal of Finance*.



Glossary & Index Definitions

Capital investment describes how a company allocates resources to acquire or upgrade long-term assets like property, machinery, or technology.

Working capital is the difference between a company's current assets and current liabilities.

Extrapolation bias describes the tendency of investors to project recent trends into the future.

Factor investing is an investment approach that involves targeting specific drivers of return across asset classes.

Free cash flow (FCF) represents the amount of cash generated by a business, after accounting for reinvestment in non-current capital assets by the company. Normalized free cash flow attempts to smooth out a company's FCF by excluding non-core operations and one-time items.

The **price-to-book ratio** compares a company's market value to its book value. The market value of a company is its share price multiplied by the number of outstanding shares. The book value is the net assets of a company.

Price-to-Earnings Ratio: Stock analysts calculate a price-to-earnings ratio by dividing a stock's current price by its earnings per share on a trailing 12-month basis. A forward price-to-earnings ratio is calculated by dividing a stock's current price by estimated future earnings per share.

Price momentum measures the velocity and direction of price changes in a stock as opposed to the actual price levels themselves.

A **quintile** is one of five values that divide a range of data into five equal parts, each being one fifth (20%) of the range.

Return on equity (ROE) is the measure of a company's annual return (net income) divided by the value of its total shareholders' equity, expressed as a percentage (e.g., 12%).

EBITDA (earnings before interest, taxes, depreciation and amortization) is a metric for understanding a company's financial performance and profitability. By excluding extraneous factors such as interest, taxes, depreciation and amortization from total earnings, EBITDA represents an attempt to provide a clearer, more accurate measure of a company's cash flow, especially compared with that of competitors.

Enterprise value (EV) is the numerator in the EV/EBITDA ratio. A firm's EV is equal to its equity value (or market capitalization) plus its debt (or financial commitments) less any cash (debt less cash is referred to as net debt).

Non-GAAP earnings are earnings measures that are not prepared using GAAP (Generally Accepted Accounting Principles) and are not required for external reporting or other public disclosures. However, non-GAAP earnings are sometimes reported in company filings with the Securities and Exchange Commission (SEC) when management feels it will be useful for stakeholders, and they are often used internally to make managerial decisions or to evaluate management.

Value stocks may be characterized as equities of companies that have fallen out of favor with investors but still have good fundamentals, or new companies that have yet to be recognized by investors. Value stocks typically feature lower price-to-earnings multiples than the broader market, and often industry peers, and somewhat lower volatility than the overall equity market.

Net income is a company's income minus cost of goods sold, expenses, depreciation and amortization, interest, and taxes for an accounting period. It is also called the bottom line on a company's income statement.

A **Z-Score** is a statistical measurement of a score's relationship to the mean in a group of scores.

The **Russell 1000 Index**® measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. The **Russell 1000 Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

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