

## A Note on Wealth Creation

Wealth Creation evaluates your ability to create wealth during your tenure as Management. It examines three measures:

- **Cumulative Profits**, the sum of all company profits;
- **Cumulative Free Cash Flow**, the sum of all of the Free Cash Flows since you took over management of the company;
- **Market Capitalization**, the current value of your stock price times shares outstanding.

Each measure is worth up to 33 1/3 points. Since we are looking at accumulated wealth, the targets increase each year:

	Cumulative Profits (\$M)	Cumulative Free Cash Flow (\$M)	Market Capitalization (\$M)
Year 1	\$6	\$7	\$60
Year 2	\$14	\$10	\$66
Year 3	\$24	\$15	\$78
Year 4	\$36	\$22	\$88
Year 5	\$52	\$31	\$110
Year 6	\$73	\$42	\$140
Year 7	\$100	\$55	\$180
Year 8	\$135	\$70	\$234

If you do not reach the target, you can still earn points. For example, if your Year 4 Cumulative Profits is \$18 million, it would earn  $\$18/\$36 * 33 \frac{1}{3}$  points = 16.65 points.

Let's look at each of these measures.

Profit is the traditional measure of wealth creation. One can describe profit as a common sense measure, "Was anything left over after we subtract expenses from revenues?" However, profits are limited in two ways.

1. Profits do not look at issues related to additional investment. For example, your CFO comes to you and says, "Boss, I have good news and bad news. The good news is that we made a profit of \$10 million. The bad news is we need to invest \$15 million into new plant and equipment to stay competitive next year."
2. Profits are not directly accessible to stockholders. Owners have only two ways to get the wealth that has been created, dividends and stock appreciation.

Free Cash Flow addresses the first problem. One can describe Free Cash Flow as the money left after investment that a company could either put in the bank or give to shareholders.

Consider "Cash Flows From Operations" from the Cash Flow Statement. It consists of Net Income (that is, profits, the results from the Income Statement), Depreciation (typically we can ignore any "extraordinary" items), and fluctuations in A/R, A/P, and Inventory.

In practice, A/R and A/P tend to cancel each other out (a loan to customers versus a loan from vendors). They rarely fluctuate enough to cause serious damage to cash flow, although they do consume some wealth over the long haul, growing at about the rate of industry growth.

Inventory swings in Capstone® (and the real world) can be large, but if you average the swings over several years, they too average towards zero. Therefore, Inventory swings are a Working Capital issue, not a Free Cash Flow issue.

In the end we are left with Profits plus Depreciation plus small fluctuations we can ignore.

<b>Cash Flow Statement Survey</b>	<b>Andrews Baldwin Chester</b>		
<b>Cash flows from operating activities</b>			
Net Income (Loss)	\$708	\$5,304	\$1,572
Adjustment for non-cash items			
Depreciation	\$8,013	\$9,040	\$7,960
Extraordinary gains/losses/writeoffs	\$0	\$0	\$251
Changes in current assets and liabilities			
Accounts payable	(\$1,029)	\$6,215	\$3,425
Inventory	\$3,406	(\$4,934)	(\$1,304)
Accounts receivable	\$206	(\$3,306)	(\$383)
Net cash from operations	\$11,304	\$12,318	\$11,520
<b>Cash flows from investing activities</b>			
Plant improvements (net)	(\$6,400)	(\$25,300)	(\$12,180)
<b>Cash flows from financing activities</b>			
Dividends paid	\$0	\$0	\$0
Sales of common stock	\$0	\$5,000	\$6,000
Purchase of common stock	\$0	\$0	\$0
Cash from long term debt issued	\$0	\$10,000	\$6,000
Retirement of long term debt	\$0	\$0	\$0
Change in current debt	\$0	\$0	\$0
Net cash from financing activities	\$0	\$15,000	\$12,000
<b>Net Change in Cash Position</b>			
	\$4,904	\$2,018	\$11,340
<b>Free Cash Flow</b>			
	\$4,904	(\$12,982)	(\$660)

### *EXAMPLE*

Even if Profit is small, Depreciation would continue to deliver a Cash Flow From Operations. Indeed, in the early years of Capstone®, Depreciation is usually larger than Profits. However, you never actually write a check for Depreciation, yet it was deducted as an expense from your Income Statement. The money is sitting in the Cash account like a check that has not been cashed. It follows that the next thing Free Cash Flow must do is subtract Capital Expenditures, the investments in plant and equipment. If it turns out that you are plowing money back into plant at the same rate you are depreciating it, the whole business reduces back to our old friend, profits.

Still, there is a lot of noise here, and Free Cash Flow cuts through it. If the result is a positive number, then the company is creating wealth. The Free Cash Flow can be used to pay dividends, repurchase stock, or reinvest in the company, any of which delights Owners. If negative, then the company needs to consume somebody's wealth, and there are only three places to get it — working capital (our own wealth), a new stock issue (Owner's wealth), or more debt (Lender's wealth).

In any particular year, swings in inventory or profits could push Free Cash Flow negative, but over several years the swings should cancel out. Therefore, the Wealth Creation category uses Cumulative Free Cash Flow to measure your success.

Market Capitalization is the value that the stock market places on the firm — stock price times shares outstanding.

One can argue that Market Cap is a better measure than stock price for evaluating the wealth created by Management. For example, suppose two firms, Andrews and Baldwin, have stock prices of \$100. If Andrews has a Market Cap of \$200 million, and Baldwin \$300 million, then Baldwin created more wealth. Baldwin issued stock to fund its growth, and therefore its stock price is diluted by more shareholders. Nevertheless, its ending stock price is the same. We can infer that Baldwin's EPS, dividend, and book value are similar to Andrews. If that is true, Baldwin's profits must be much higher.