Unlevered Free Cash Flow: What Goes In It, and Why It Matters

The Third Explanation’s a Charm…

This Lesson: Explanation 2.0…

Yes, we had a video on this exact topic before – it was one of the first ones in this channel.

But some of the explanations in it were off, and the Excel setup we demonstrated there is inconsistent with our newer material.

This Lesson: Explanation 2.0…

So, consider this "Unlevered Free Cash Flow 2.0": A better, simpler explanation of what it is and why it matters.

As well as a few examples of Unlevered FCF for real companies, and answers to common questions we've received.

Step 1 of a DCF Analysis

- Remember that a DCF is split into the **Explicit Forecast Period** (Part 1) and the **Terminal Period** (Part 2)

- We start the analysis by projecting the company's Cash Flows over 5-10 years (or sometimes more than that)

- Many different types of "Cash Flow": Unlevered FCF, Levered FCF, just Free Cash Flow…

- But in a DCF, you **almost always use Unlevered FCF** because it doesn't depend on the company's capital structure, it's faster and easier, and it gets you the most consistent results

Defining Unlevered FCF

- **Unlevered FCF:** Should *only* reflect items that are:

1) Related to or “available” to **all** investor groups in the company – think of it as “Free Cash Flow to ALL Investors”




2) Recurring for the company’s core-business operations

- Unlevered FCF corresponds to **Enterprise Value**, which represents the value of the company’s core business to ALL investors in the company

- **Result:** You *ignore* many items on the financial statements!

Defining Unlevered FCF

- In practice, that means that Unlevered FCF consists of:

1) Revenue
2) COGS and Operating Expenses
3) Taxes
4) Depreciation & Amortization (and *sometimes* other non-cash charges)
5) Change in Working Capital
6) Capital Expenditures

- **IGNORE:** Net Interest Expense, Other Income / (Expense), most non-cash adjustments, most of the CFI section, and the CFF section on the CFS

Example: Unlevered FCF for Steel Dynamics

- **Method:** Yellow Highlight Over Name and Numbers = Use As-Is; Yellow Highlight Over Name But Not Numbers = Use But Modify

- **Asset Impairment Charges:** Non-recurring item, so we exclude it

- **Net Interest Expense:** Only goes to Debt investors, so we exclude it

- **Other (Income) / Expense:** Non-core-business – exclude!

- **Income Tax Expense / (Benefit):** Include it, but *adjust it* by ignoring the impact of Net Interest, Other Income, Impairments, etc. – can't assume tax savings from those items if they don't exist!

Example: Unlevered FCF for Steel Dynamics

- **Net Income on CFS:** Modify this and use NOPAT instead

- **D&A:** Yes, always keep it in Unlevered FCF

- **Impairment Charges and Gains/Losses:** Non-recurring, so exclude

- **Stock-Based Compensation:** Exclude it! Affects only the Equity investors, changes share count, and is **not** a real non-cash expense

- **Deferred Income Taxes:** Yes, but make them decrease over time; should **not** be a major value driver for most companies

Example: Unlevered FCF for Steel Dynamics

- **Working Capital:** Keep everything – core-business and all investors

- **Cash Flow from Investing:** Keep CapEx, but drop everything else – purchases of investments, acquisitions, etc. are non-recurring or do not affect all investor groups

- **Cash Flow from Financing:** Ignore everything – these items are all non-recurring, *or* related to *just* Equity or *just* Debt investors

Example: Unlevered FCF for Snap

- ***Very*** similar despite a much different industry – see our Snap Valuation video for more!

- **IS:** Revenue, Cost of Revenue, and all Operating Expenses; we'll modify the Income Tax figure; no apparent one-time charges

- **CFS:** We'll modify the starting line to make it NOPAT instead, and then we'll include D&A, Deferred Taxes, Change in Working Capital, and CapEx…

- **And:** *Maybe* the Purchases of Intangible Assets – depends on the company's plans and how they're contributing to the business

Lingering Questions About Unlevered FCF…

- ***QUESTION #1:** What about Stock-Based Compensation (SBC)?*

- ***ANSWER:*** No! Never count it as a non-cash add-back because it increases the company's share count (see our video on this topic)

- ***QUESTION #2:** What's the deal with Deferred Taxes?*

- ***ANSWER:*** In a DCF, you want to reflect the company's **Cash Taxes**, so you use Deferred Taxes to account for the Book vs. Cash Tax difference…

- …but they should <u>not</u> be a huge value driver, which is why they usually decline as a % of Income Taxes over the long term

Lingering Questions About Unlevered FCF…

- ***QUESTION #3:*** *What about impairments and write-downs?*

- ***ANSWER:*** Nope! Non-recurring items

- ***QUESTION #4:*** *What about an add-back for non-cash (PIK) Interest?*

- ***ANSWER:*** Nope! You should completely exclude all forms of Interest, so you can't add back *a component of a non-existent item*

- ***QUESTION #5:*** *What about Purchase of Intangibles?*

- ***ANSWER:*** Maybe – if they're truly recurring and you count the Amortization from them (depends on the company and industry)

Lingering Questions About Unlevered FCF…

- ***QUESTION #6:*** *What goes in the Change in Working Capital? The company's doing something that doesn't match the definition!*

- ***ANSWER:*** Use the company's version on the CFS. If *they* think the item's operational, assume that it is (possible exception for DTAs and DTLs – better to skip and just show Book vs. Cash Taxes in the Deferred Tax line)

- ***QUESTION #7:*** *What if the company is highly acquisitive?*

- ***ANSWER:*** You can include cash outflows for the acquisitions and the additional revenue/expenses from them in future years, but eventually they should go to 0, and the company's FCF should "normalize"

Lingering Questions About Unlevered FCF…

- ***QUESTION #8:*** *Some people define Unlevered FCF by taking NOPAT and adding all the non-cash adjustments shown on the CFS instead of just D&A and Deferred Taxes… why?*

- ***ANSWER:*** Sometimes people make "quick estimates" to analyze the historical statements and don't bother to separate out the charges…

- …but for *valuation purposes* in a DCF, you should use the definition here and project <u>only</u> the line items that go into Unlevered FCF

- Be careful because people use inconsistent definitions and terminology! Yes, there are numbers, but this is far less rigorous than "real math"

Recap and Summary

- **Step 1 of DCF:** Project the company's Cash Flows in the explicit forecast period (5-10 years, sometimes longer)

- **Unlevered FCF:** Corresponds to Enterprise Value, so it should include only items that affect ALL investors and are recurring for the company's core-business operations




- **Formula:** NOPAT + Non-Cash Adjustments +/- Change in Working Capital – CapEx




- **Exclude:** SBC, Impairments, Gains/Losses, most other non-cash adjustments, CFI except for CapEx, and the entire CFF section