Q4 Are the company's terms of trade favorable? Is Cash flow healthy?

Objective:

These two questions have a two-fold objective –

1. To assess whether the company has reasonable bargaining power with its customers and suppliers, and
2. To ensure that much of the company's profit is not stuck in working capital and fixed capital.

What to look for:

- Companies with favorable Terms of Trade i.e. low Debtors to Creditors ratio (Framework #8).
- Companies with healthy and preferably rising Operating Cash Flow
- No sustained negative Free Cash Flow i.e. the company is not a capital guzzler.

Framework #8

Terms of Trade

We covered this framework in our 11th Wealth Creation Study.

Key concepts:

- **Terms of Trade (ToT):** ToT refers to the credit terms which any company has with its customers on the one hand and suppliers on the other. A company with highly favorable terms of trade will collect cash quickly from its customers and enjoy extended credit period with its suppliers.

  In contrast, a company with adverse terms of trade will need to extend lengthy credit period to its customers and pay its suppliers early. We measure ToT using the following formula –

Terms of Trade = Debtors ÷ Creditors

The lower the ratio, more favorable the ToT, and vice versa.

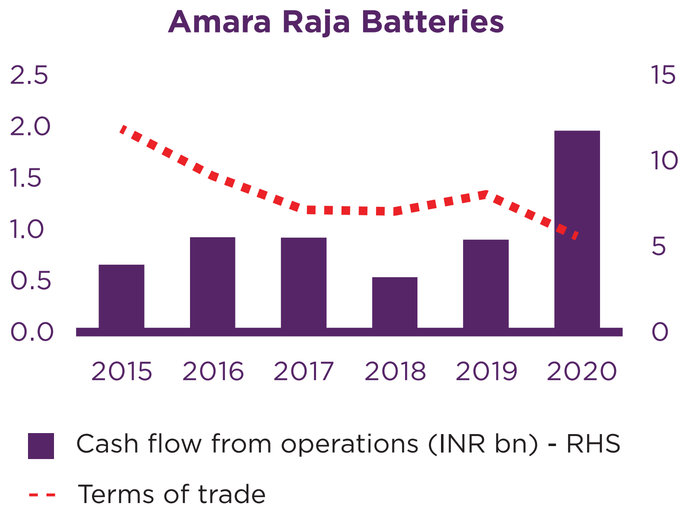
ToT and Operating Cash Flow (OCF): A company's ToT directly impacts its OCF, defined as Cash Profit adjusted for changes in Working Capital. The key components of Working Capital are Inventory, Debtors and Creditors. ToT reflects in both Debtors and Creditors and hence strongly influences OCF. The more adverse the ToT the lower will be OCF vis-à-vis PAT (Profit After Tax), and vice versa.

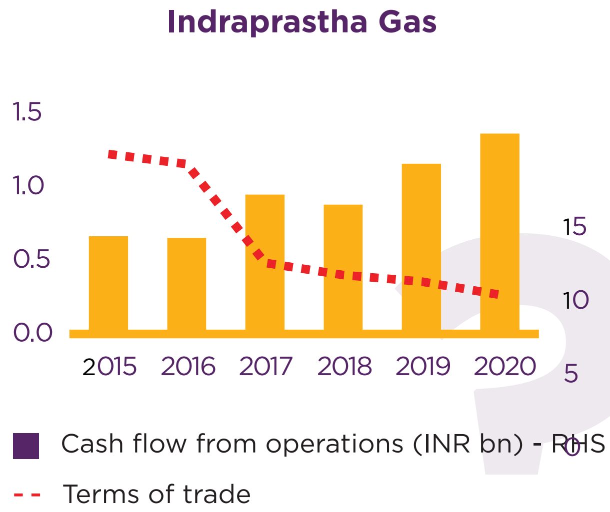
Framework #8

Key conclusions of our 11th Wealth Creation Study theme:

- ToT are broadly stable and do not change often.
- Favorable ToT are an important characteristic of a wealth creating company.
- When ToT changes from adverse to favorable, RoCE (Return on Capital Employed) is favorably impacted, inturn enabling significant wealth creation.
- To sum up, favorable ToT is one of the enablers of high RoCE and should be looked for in the search for winners in the stock market.

How classical Terms of Trade works – fall in Terms of Trade, rise in Cash Flow from Operations





Is Cash flow healthy?

This is the second part of Q#4. Healthy Cash flow is critical to the attractiveness of a company. As stated earlier, the intrinsic value of a company is the present value of its future Free Cash Flow (FCF). (FCF is OCF less Capex i.e. capital expenditure such as Plant & Machinery).

A company's past Cash flow track record is a fairly good pointer to its future. The ideal company is one where both OCF and FCF are robust. But in the least, OCF needs to be positive and not significantly lower than PAT. Companies can have intermittent negative FCF because of growth Capex. However, perennially negative FCF is a cause for concern as there could be misallocation of capital (e.g. outsized acquisitions).