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Cash Flow Trends and Their Fundamental Drivers:

Comprehensive Review (Quarter 3, 2011)

Free Cash Margin Index:

2.43%, 3.96%	4.41%	7.18%
Recession Lows	Current	Recent High
(Mar. 2001, Dec. 2008)	(Sep. 2011)	(Mar. 2010)

Median free cash margin stands at 4.41% for the twelve months ended September 2011, down from 4.63% in the June 2011 period. The metric has now declined for six straight, twelve-month reporting periods off of its March 2010 high of 7.18%. As has been the case in recent surveys, however, the decline is anything but unwelcome news as the factors behind the decline signal recovery for the U.S. economy.

Contributing to the decline was an increase in capital expenditures, which, as a percent of revenue, increased to 3.29% in the September period from 3.16% in June. Income taxes paid were also up marginally. Offsetting the decline in free cash margin was an increase in operating cushion, or operating profit before depreciation. The profitability measure improved to 16.02% in the September period from 15.78% in June. Also aiding free cash margin were declines in receivables and inventory. Receivables days declined to 51.99 days in the September period from 53.12 days in June, while inventory days declined to 23.86 days in September from 24.00 in June.

Median revenues improved in the twelve months ending September 2011. Revenues increased for the fourth straight reporting period, rising 6.67% to \$675.82 million. Accompanying the increase in revenues was an increase in median free cash flow, which improved .76% to \$21.76 million in the September reporting period from \$21.60 million in June. Overall, with rising revenues and improving profitability, it was a good quarter, a decline in free cash margin notwithstanding.

In the September 2011 period, six industries reported an increasing trend in free cash margin, free cash margin was stable in twenty industries and eighteen industries saw free cash margin decline. Four individual companies are examined in this report: Six Flags Entertainment Corp. (SIX), Regal Entertainment Group (RGC), Clorox Company (CLX) and Procter & Gamble Co (PG).

Data for this research were provided by Cash Flow Analytics, LLC., www.cashflowanalytics.com. Charles Mulford is a principal in Cash Flow Analytics, LLC. **January, 2012**

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, the Lab thinks that independent research organizations, such as this Lab, have an important role to play in providing information to market participants.

Because the Lab is housed within a university, all of its research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Its focus is on issues that it believes will be of interest to a large segment of stock market participants. Depending on the issue, it may focus its attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in the work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. The Labs defines earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, its research may look into reporting practices that affect either earnings or cash flow, or both. At times, its research may look at stock prices generally, though from a fundamental and not technical point of view.

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Cash Flow Trends and Their Fundamental Drivers: Comprehensive Industry Review (Quarter 3, 2011)

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Cash Flow Trends and Their Fundamental Drivers: Comprehensive Industry Review (Quarter 3, 2011)

Free Cash Margin Index*:		
2.43%, 3.96%	4.41%	7.18%
Recession Lows (Mar. 2001, Dec. 2008)	Current (Sep. 2011)	Recent High (Mar. 2010)

The ***Free Cash Margin Index** is free cash flow measured as a percentage of revenue for the trailing twelve month period.

Introduction

This research report is part of a continuing series that examines cash flow trends and the underlying drivers that are causing changes in those trends. The current study contains a review of the cash flow performance of all non-financial companies for a series of rolling twelve-month periods from the first quarter of 2000 through the third quarter of 2011. Additionally, it looks at individual industry results and focuses its attention on the cash flow performance of several companies in those industries that stood out with improving free cash margin and in those that suffered from significant declines in free cash margin. All companies with a current market capitalization of \$50 million or more are included, resulting in a total sample of 2,893 companies. Please see page 7 for a list of industries included. That list is followed by a summary of the findings.

Measured as free cash flow divided by revenue, free cash margin is a cash flow profit margin. It indicates what percent of revenue is left for shareholders in the form of free and discretionary cash flow. If the company sells its products or services for a dollar, free cash margin tells how many cents the shareholders can take home without reducing the company's ability to generate more. Thus, as the report looks at cash flow trends and their underlying drivers, its particular interest is on how those factors impact free cash margin.

For more detail, the industry spreadsheets that identify trends in free cash margin and its underlying drivers for 44 separate industries for the all available reporting periods through the third quarter of 2011 have been posted. The spreadsheets, which are updated quarterly, can be found on the Lab's website at www.mgt.gatech.edu/finlab.

Continuous Focus on Cash Flow

Corporate financial success is dependent not only on a company's ability to generate revenues and earnings, but also cash flow, especially free cash flow. It is free cash flow and growth in free cash flow, that discretionary stream of cash that a company can put to use for acquisitions, debt retirement, dividends and stock buybacks that works with growing earnings to drive firm value higher. Because it is "free," free cash flow comes with no strings attached. It is truly discretionary. Spending it does not impact the company's ability to generate more. A company with revenue growth will eventually lose the favor of investors if it never finds a way to generate earnings. In a similar way, a company with profits that is unable to generate cash will also experience waning investor enthusiasm. It may take a while. Investors are patient with profitable, growing companies. Ultimately, however, a company must show an ability to generate free cash flow.

Companies that consume cash must continually seek new sources of capital – whether debt or equity. At some point, those sources of capital will dry up or become prohibitively expensive if the firm does not show at least some progress toward getting closer to positive cash generation. Worse, if cash flow does not back a company's earnings, ultimately those earnings themselves may become suspect, necessitating write-downs of the resulting non-cash assets. Net losses will likely accompany those write-downs.

When free cash margin is positive, a firm is covering all ongoing claims and is able to pay dividends, reduce debt or simply add to its cash coffers. When free cash margin turns negative, ongoing claims are not being met. Cash and short-term investments can be used to meet the shortfall. However, on-hand cash and short-term investments are not an unlimited source of funds. Firms can borrow money to meet their needs. However, even if this were an option, increasing debt levels add new, unwanted risks. Equity issues provide another avenue, but capital markets can be painfully dilutive when share prices are depressed for firms that are seemingly unable to generate cash.

During periods of growth, firms may have problems generating cash as profits are consumed with growth-related investments in working capital and property, plant and equipment needed to support that growth. During recessions, cash generation can be particularly problematic as revenues and profits decline, draining the economic engine that supports cash generation. Regardless of the economic environment, however, free cash margin serves as an important measure of long-term financial health for individual companies, industries and the economy as a whole. The Lab thinks that by periodically examining their cash generating ability, we will gain insight into the overall financial health of important segments of U.S. firms. With all "non-financial firm industry" data dating back to 2000, it is possible to see how the cash-generating

performance of these firms presently compares with their performance during previous periods of economic contraction (e.g., 2001 and 2008-2009) and economic expansion.

Cash Flow Definitions

Free cash flow is the cash flow equivalent of the income statement “bottom line”. Like net income, free cash flow is available for shareholders after all prior claims have been satisfied. However, also like net income, which, to facilitate analysis, can be divided into certain sub-measures of performance, like gross profit and operating profit, free cash flow can be similarly divided. Thus, while the primary focus of the report is on free cash flow and free cash margin, or free cash flow as a percentage of revenue, it analyzes the fundamental drivers underlying two distinct, but also closely related, measures of cash flow:

- 1) Operating cash flow and operating cash margin - cash flow from operations after interest charges and income taxes. Operating cash margin is operating cash flow divided by revenue.

- 2) Free cash flow and free cash margin - cash flow available for common shareholders that can be used for such discretionary purposes as stock buybacks and dividends without affecting the firm's ability to grow and generate more. This measure is calculated as operating cash flow less preferred dividends and net capital expenditures. Free cash margin is free cash flow divided by revenue.

Data and Methodology

The data is provided by Cash Flow Analytics, LLC¹. As noted, each data amount is for a rolling twelve-month period ending with the quarter end in question. For example, cash flow amounts for September 30, 2011 represent amounts for the twelve months (four quarters) ending September 30, 2011.

The 44 analyzed industries are as follows:

CICS	Industry	CICS	Industry
1	Agricultural	23	Automobiles and trucks
2	Food Products	24	Aircraft
3	Candy and Soda	25	Shipbuilding and railroad equipment
4	Beer and Liquor	26	Defense
5	Tobacco Products	27	Precious metals
6	Recreation	28	Non-metallic and industrial metal mining
7	Entertainment	29	Coal
8	Printing and Publishing	30	Petroleum and natural gas
9	Consumer Goods	31	Utilities
10	Apparel	32	Communications
11	Healthcare	33	Personal services
12	Medical Equipment	34	Business services
13	Pharmaceutical Products	35	Computer hardware
14	Chemicals	36	Computer software
15	Rubber and Plastic Products	37	Electronic equipment
16	Textiles	38	Measuring and control equipment
17	Construction Materials	39	Business supplies
18	Construction	40	Shipping containers
19	Steel Works, etc.	41	Transportation
20	Fabricated Products	42	Wholesale
21	Machinery	43	Retail
22	Electrical Equipment	44	Restaurants hotels motels

¹ Cash Flow Analytics, LLC, 1727 Malvern Place, Duluth, Georgia, 30097. www.cashflowanalytics.com. Charles Mulford is a principal in Cash Flow Analytics, LLC.

Summary of Results for all non-financial companies

Median free cash margin declined for the sixth straight quarter off of its March 2010 high of 7.18%. The metric stands at 4.41% for the twelve months ended September 2011, down from 4.63% in June 2011 and 6.18% in September 2010. The decline, however, is not an unwelcome development, as the factors behind it signal recovery for the U.S. economy.

Drivers of Free Cash Margin

ALL INDUSTRIES	Q3 2010 (Sep. 2010)	Q2 2011 (June 2011)	Q3 2011 (Sep. 2011)	Effect on FCM (Q3 2011 vs. Q2 2011)
Revenue (millions)	536.69	633.57	675.82	UP 6.67%
Free Cash Flow (millions)	24.53	21.60	21.76	UP 0.76%
Free Cash Margin	6.18%	4.63%	4.41%	DOWN 0.22%
Operating Cushion %	16.99%	15.78%	16.02%	Driving UP
Gross Margin % (before depreciations)	43.27%	43.15%	43.26%	Driving UP
SGA% (before depreciation)	19.23%	20.58%	20.31%	Driving UP
Cash Cycle (rev days)	49.78	51.17	50.10	Driving UP
Accounts Receivable (rev days)	52.36	53.12	51.99	Driving UP
Inventory (rev days)	22.81	24.00	23.86	Driving UP
Accounts Payable (rev days)	25.39	25.95	25.75	Driving DOWN
Income tax to Rev %	0.86%	1.09%	1.13%	Driving DOWN
Cap Exp. to Rev %	2.77%	3.16%	3.29%	Driving DOWN

Contributing to the decline in free cash margin was an increase in capital expenditures, which, as a percent of revenue increased to 3.29% in the September period from 3.16% in June 2011 and 2.77% in September 2010. Income taxes paid were also up marginally to 1.13% of revenue in September 2011 from 1.09% in June 2011 and .86% in September 2010.

Offsetting the decline in free cash margin was an increase in operating cushion, or operating profit before depreciation. The profitability measure improved to 16.02% in the September period from 15.78% in June 2011, but remained below the level of 16.99% reached in the September 2010 period. The lower operating cushion seen for the September 2011 period vs. September 2010 was the result of an increase in spending on selling, general and administrative expenses. This measure of operating expenses increased to 20.31% in the September 2011 period from 19.23% in the September 2010 reporting period. Also helping to offset the decline in free cash margin were declines in receivables and inventory. Receivables days declined to 51.99 days in the September period from 53.12 days in June and 52.36 days in September 2010, while inventory days declined to 23.86 days in September from 24.00 days in June. Inventories were up, however, in September 2011 from the 22.81 days recorded in September 2010.

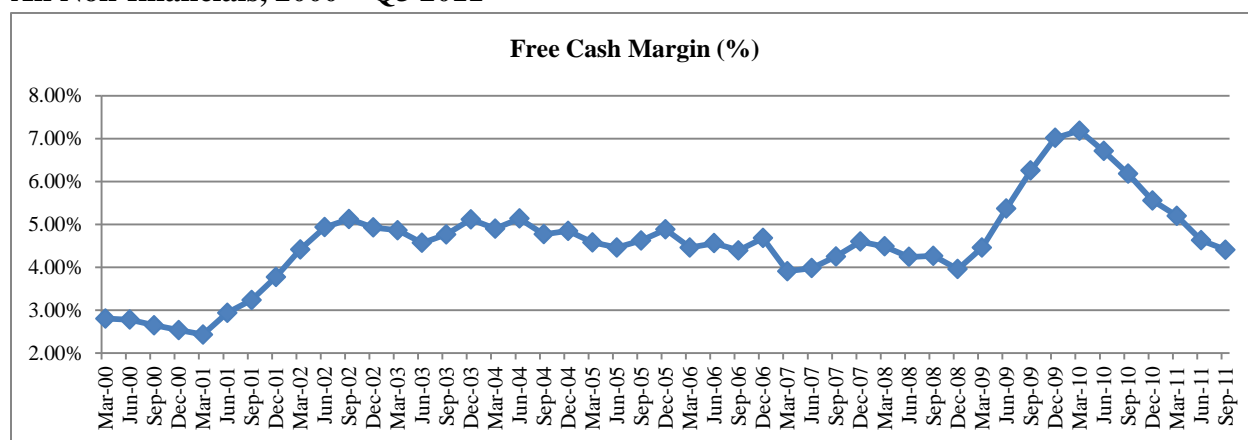
In the twelve months ended September 2011, median revenues increased 6.67% to \$675.82 million from \$633.57 million in June 2011 and from \$536.69 million in September 2010. A decline in free cash margin notwithstanding, the increase in revenues was accompanied by an increase in median free cash flow, which rose to \$21.76 million in the twelve months ended

September 2011 from \$21.60 million in June 2011, though the measure was below the \$24.53 million reached in September 2010.

The median balance in cash and short-term investments declined to \$83.72 million in September 2011 from \$84.12 million in June 2011, but increased from the \$74.40 million observed in September 2010. Measured as a percent of revenue, however, cash and short-term investments declined to 13.88% in September 2011 from 15.01% in June 2011 and 14.62% in September 2010.

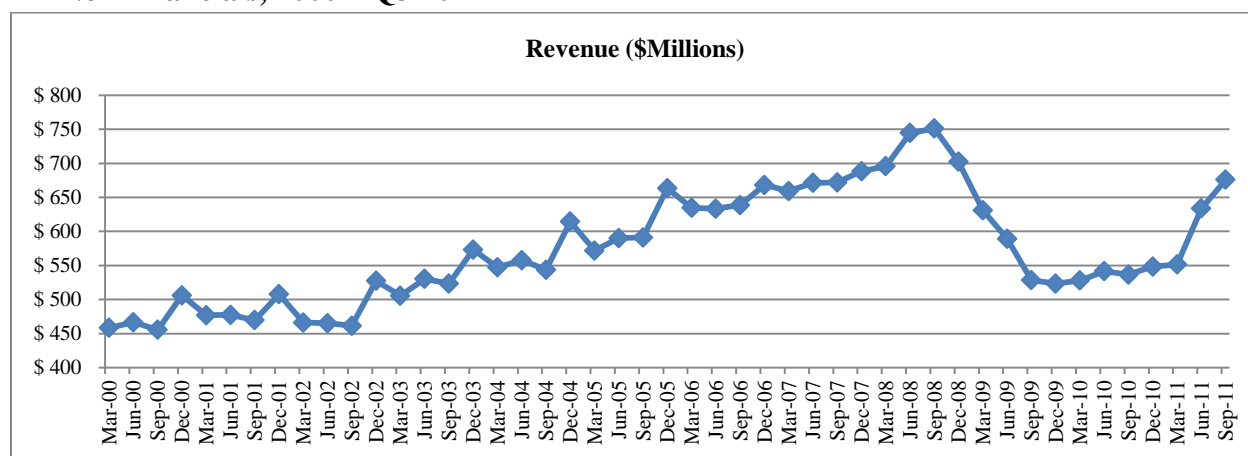
In the exhibits below we present graphs of free cash margin and several of its underlying drivers. These exhibits were constructed with data from the complete sample of 2,893 non-financial companies. For more details on each of the 44 individual industries included, please refer to the individual industry spreadsheets that are available on our website (www.mgt.gatech.edu/finlab).

All Non-financials, 2000 – Q3 2011



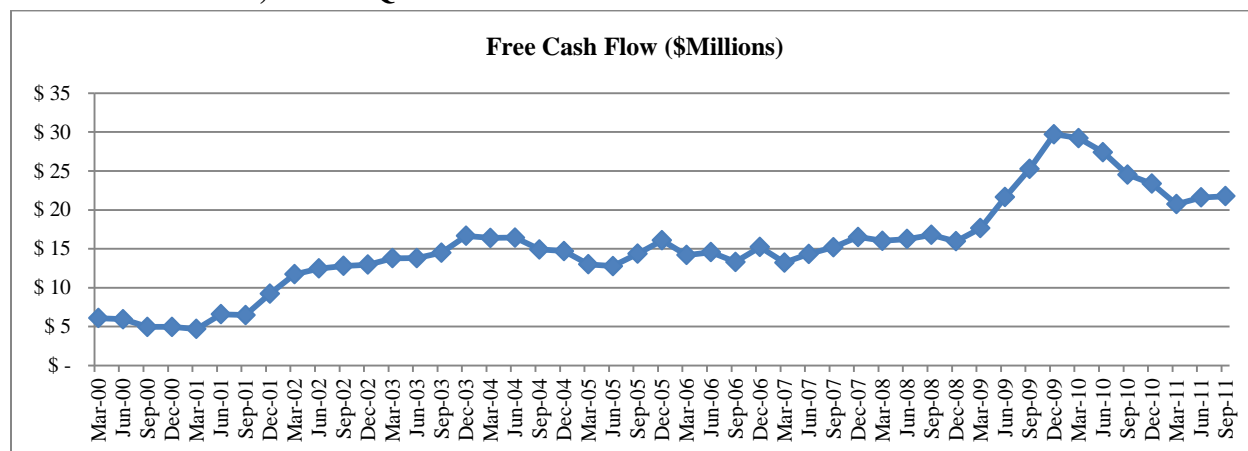
Median free cash margin has now declined for sixth straight quarters. At 4.41%, the metric is now in-line with the 4% to 5% levels seen prior to the recent recession.

All Non-financials, 2000 – Q3 2011



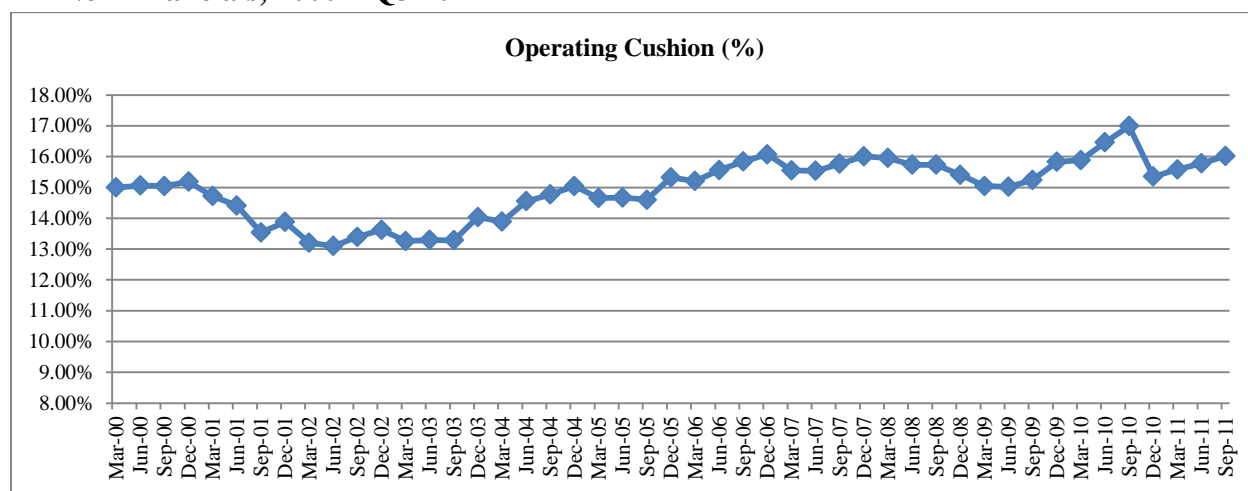
Median revenues are moving higher, continuing an uptrend began in early 2010. Median revenue growth for the twelve months ended September 2011 from June 2011 was 6.67%.

All Non-financials, 2000 – Q3 2011



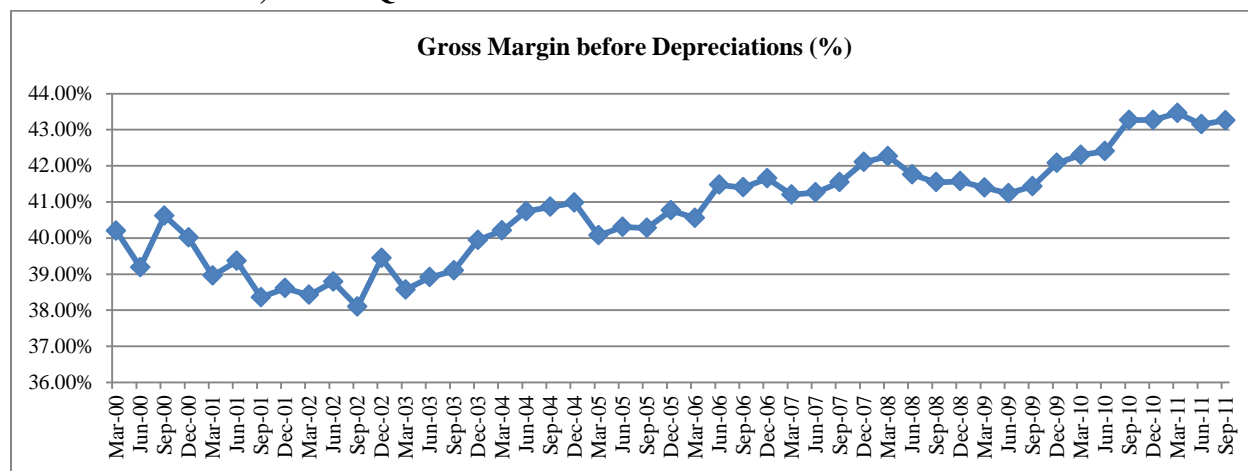
A decline in free cash margin notwithstanding, median free cash flow increased as a result of higher revenues.

All Non-financials, 2000 – Q3 2011



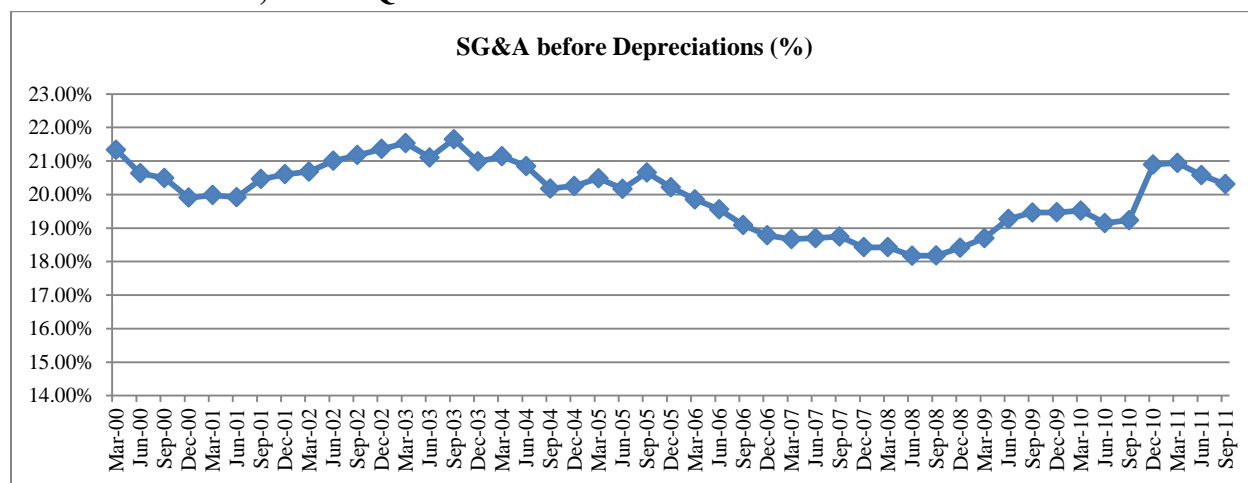
Operating cushion increased for the third consecutive quarter to 16.02% in September 2011 from 15.35% in September 2010. Contributing to the increase was an increase in gross margin and a decline in SG&A expenses as a percent of revenue.

All Non-financials, 2000 – Q3 2011



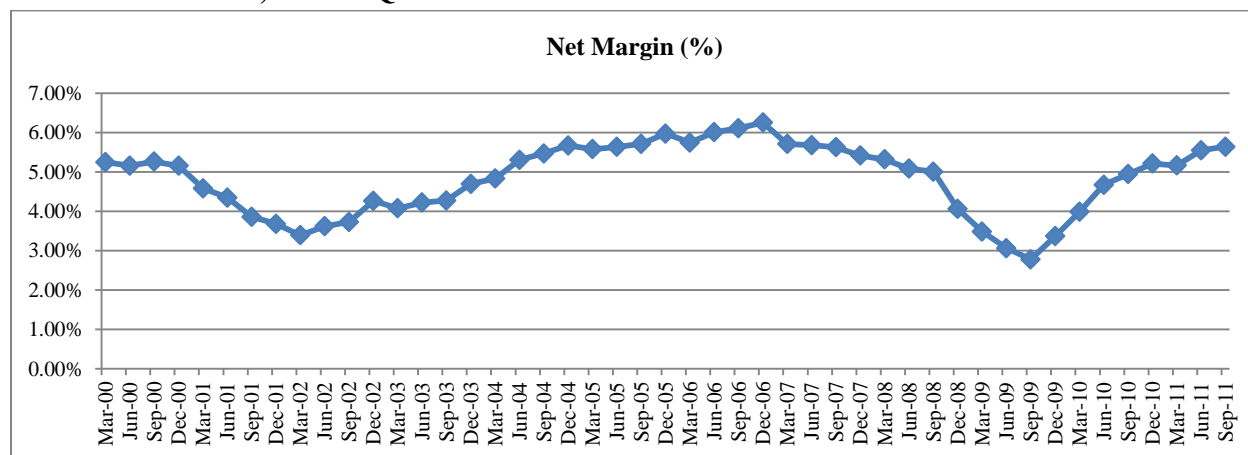
Gross margin improved to 43.26% in September 2011 from 43.15% in June 2011.

All Non-financials, 2000 – Q3 2011



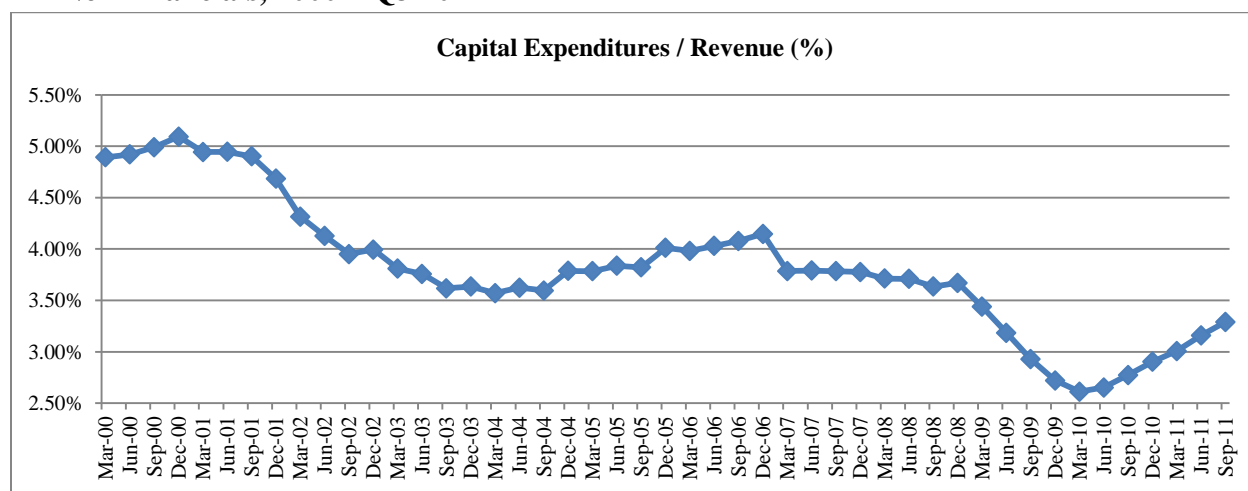
SGA (before depreciations) continued a declining trend for the third consecutive period. The metric dropped to 20.31% in September 2011 from 20.58% in June 2011.

All Non-financials, 2000 – Q3 2011



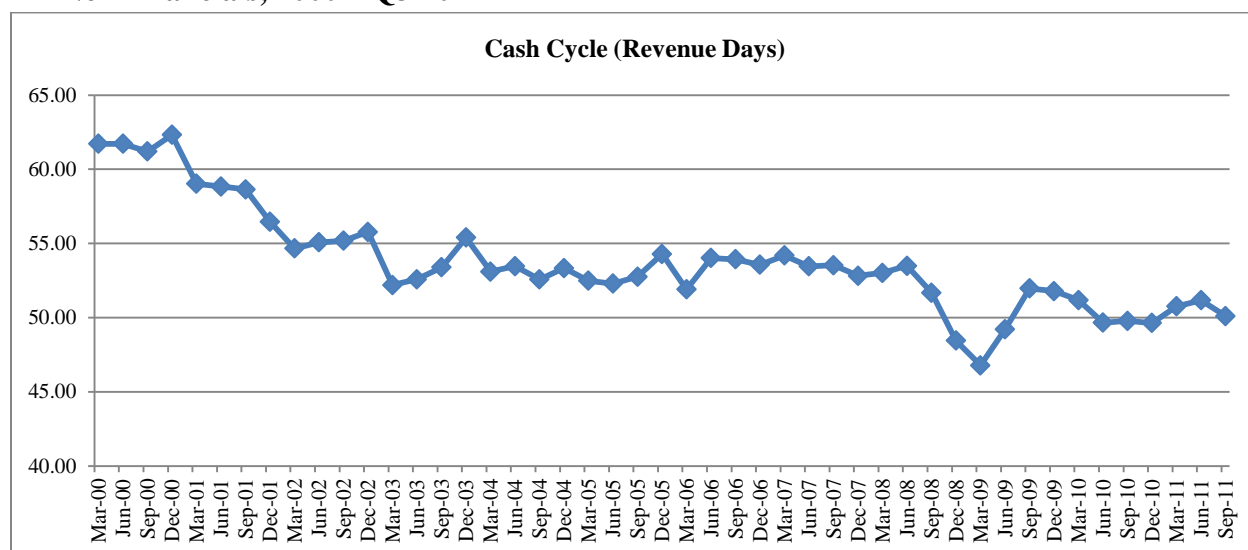
Median net margin has increased since September 2009. The metric now stands at 5.64%, a level similar to that reported prior to the recent recession.

All Non-financials, 2000 – Q3 2011



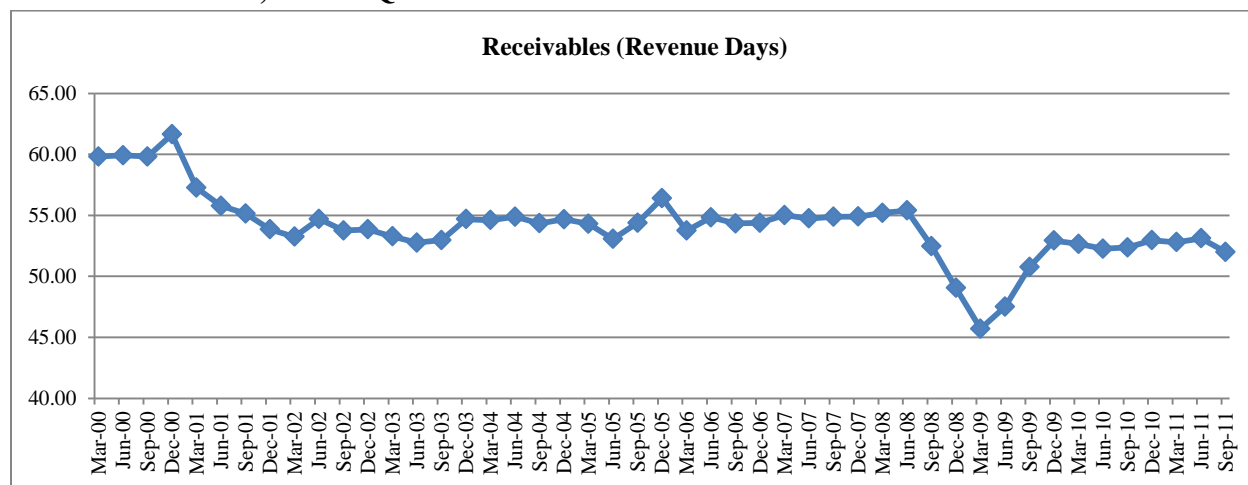
Continuing a recent trend, capital expenditures as a percentage of revenue increased, but at 3.29%, the metric remains below historical norms of 3.50% to 4.00%.

All Non-financials, 2000 – Q3 2011



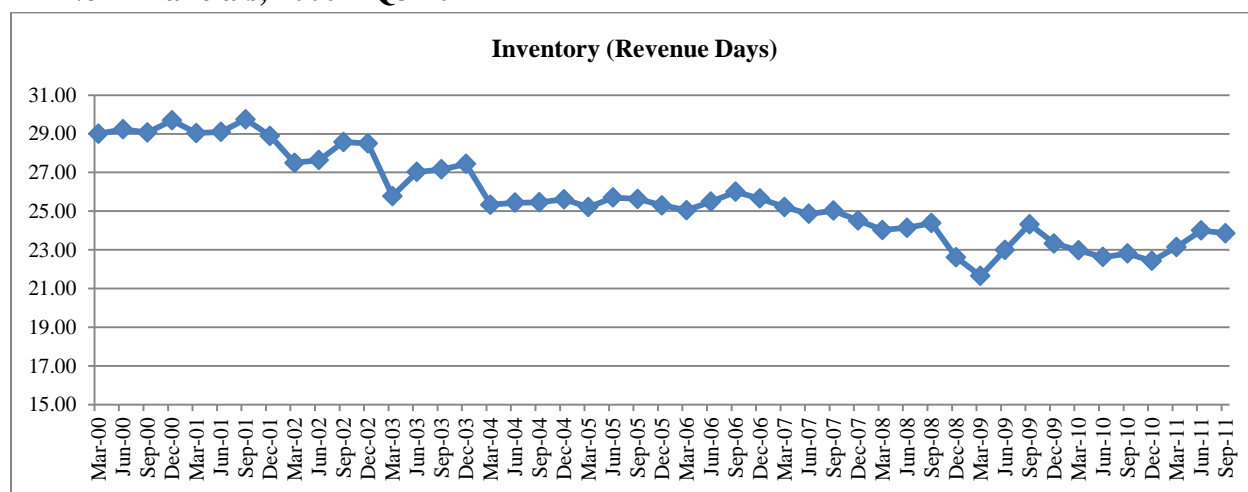
The cash cycle, which measures the proportion of operating cash flow carried in working capital and is measured as receivables days plus inventory days less payables days, decreased in the September 2011 reporting period. Receivables, inventory and accounts payable all declined.

All Non-financials, 2000 – Q3 2011



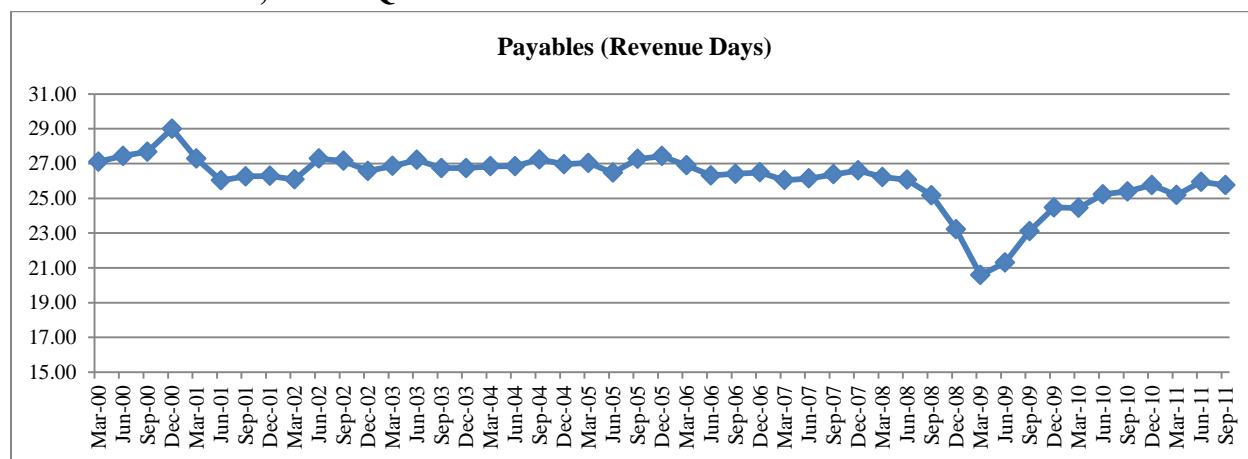
Accounts receivable days had a positive impact on cash cycle. The indicator declined to 51.99 days in September 2011 from 53.12 days in June 2011.

All Non-financials, 2000 – Q3 2011



Inventory days declined slightly to 23.86 days in September 2011 from 24.00 days in ending June.

All Non-financials, 2000 – Q3 2011



Accounts payable days declined to 25.75 days in September 2011 from 25.95 days in June.

Individual Industry Results

Of the 44 industries studied, during the twelve months ended September 2011 when compared with the twelve months ended September 2010, there was a moderate to substantial improvement in free cash margin in **6** industries, relatively stable free cash margin in **20** industries, and **18** industries with declining free cash margin.

CICS	Industry	Increasing	Stable	Declining
1	Agricultural			x
2	Food Products			x
3	Candy and Soda			x
4	Beer and Liquor			x
5	Tobacco Products		x	
6	Recreation	x		
7	Entertainment	x		
8	Printing and Publishing		x	
9	Consumer Goods			x
10	Apparel			x
11	Healthcare		x	
12	Medical Equipment		x	
13	Pharmaceutical Products			x
14	Chemicals			x
15	Rubber and Plastic Products		x	
16	Textiles		x	
17	Construction Materials			x
18	Construction			x
19	Steel Works, etc.		x	
20	Fabricated Products		x	
21	Machinery		x	
22	Electrical Equipment		x	
23	Automobiles and trucks			x
24	Aircraft			x
25	Shipbuilding and railroad equipment	x		
26	Defense		x	
27	Precious metals	x		
28	Non-metallic and industrial metal mining		x	
29	Coal		x	
30	Petroleum and natural gas			x
31	Utilities			x
32	Communications		x	
33	Personal services			x
34	Business services	x		
35	Computer hardware		x	
36	Computer software		x	
37	Electronic equipment		x	
38	Measuring and control equipment		x	
39	Business supplies		x	
40	Shipping containers			x
41	Transportation			x
42	Wholesale			x
43	Retail		x	
44	Restaurants hotels motels	x		
	Total	6	20	18

Please refer to the individual industry spreadsheets, available on our website, for charts and further details on each of the 44 industries outlined above.

The Standouts: A Closer Look

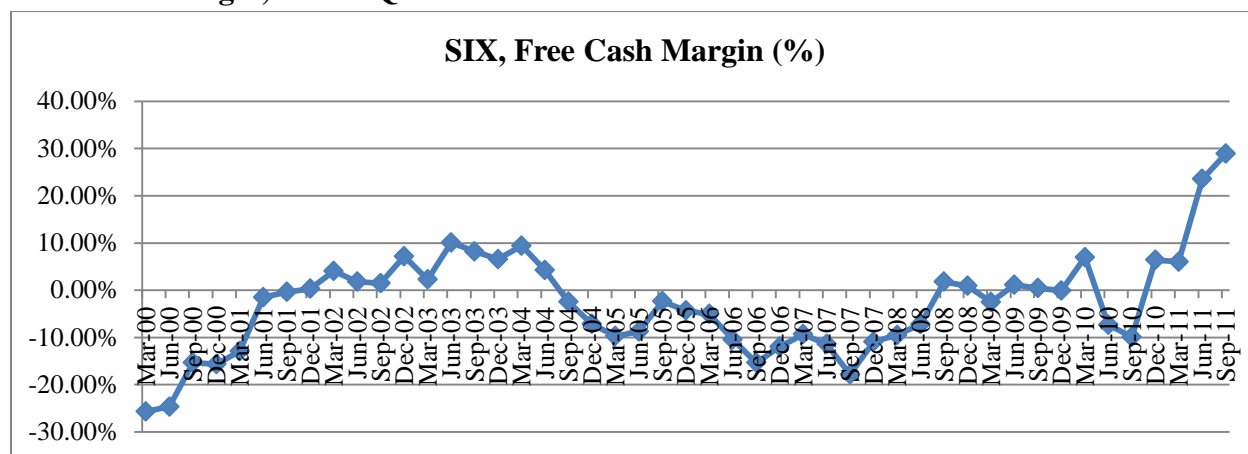
The drivers of improvements or declines in free cash margin consist of factors that impact profitability and efficiency. On the profitability front, operating cushion measures operating profit, exclusive of the non-cash expenses, depreciation and amortization. Factors impacting operating cushion consist of gross margin (excluding depreciation and amortization), and SG&A% (excluding depreciation and amortization). Also impacting profitability and a firm's ability to generate free cash flow, but excluded from operating cushion, is income taxes paid, which is measured as a percent of revenue. Capital expenditures do not impact profitability directly, but through depreciation on fixed asset additions. However, these expenditures are subtracted in computing free cash flow. It is also important to look at capital expenditures because these are investments in fixed assets that will likely improve a company's ability to generate revenue, and subsequent profit, in the future. Like operating expenses and taxes, capital expenditures are measured as a percent of revenue.

On the efficiency front, increases in receivables and inventory consume free cash flow. Increases in accounts payable provide free cash flow. The combination of receivables days plus inventory days less payables days is a firm's cash cycle. Reductions in the cash cycle provide free cash flow, while increases in the cash cycle consume free cash flow. All of these factors are evaluated when analyzing changes in free cash margin for the standout firms discussed in this section.

Graphs of free cash margin for sample companies studied in the reporting period are provided below. With each graph we provide a short summary of the primary drivers or factors that are behind the observed changes in free cash margin for the selected firms. For more details regarding the industries, please refer to the separate industry spreadsheets found on our website.

Industries with Improving Free Cash Margin

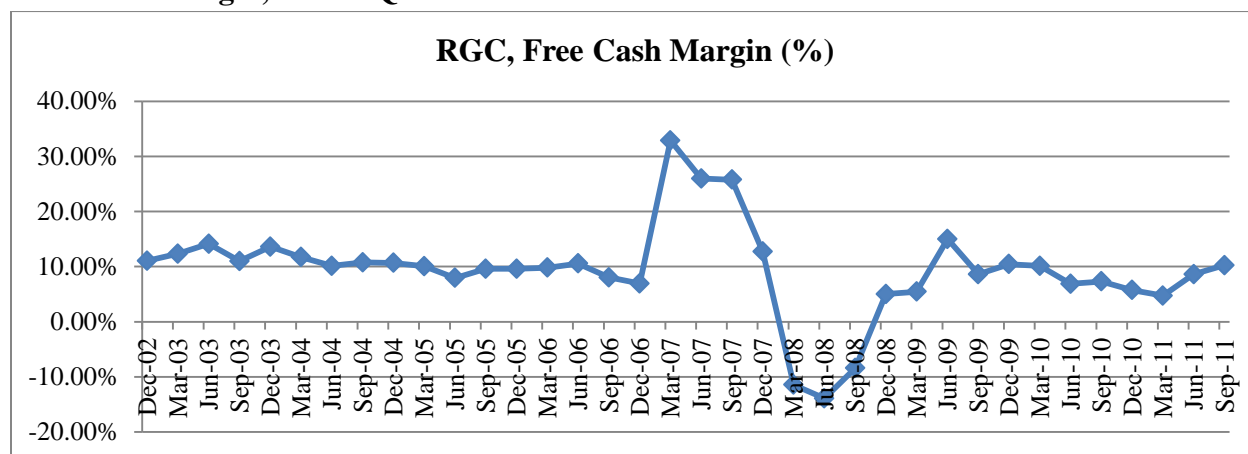
In the twelve month period ended September 2011, six industries enjoyed improving free cash margin. Among the industries with improving free cash margin was Entertainment, where free cash margin improved to 9.33% in September 2011 from 5.27% in September 2010. Here we look closer look at two companies in this industry, Six Flags Entertainment Corp. (SIX) and Regal Entertainment Group (RGC).

Six Flags Entertainment Corp. (SIX)**Free Cash Margin, 2000 – Q3 2011****Drivers of Free Cash Margin**

SIX	Q3 2010	Q2 2011	Q3 2011	Effect on FCM (Q3 2010 vs. Q3 2011)
Free Cash Margin	-9.80%	23.55%	28.88%	
Operating Cushion %	30.71%	36.00%	37.35%	Driving UP
Gross Margin % (before depreciations)	92.70%	93.30%	94.06%	Driving UP
SGA% (before depreciation)	62.00%	57.33%	56.71%	Driving UP
Cash Cycle (rev days)	16.47	10.65	18.77	Driving DOWN
Accounts Receivable (rev days)	21.66	17.66	18.56	Driving UP
Inventory (rev days)	11.03	13.89	9.65	Driving UP
Accounts Payable (rev days)	16.22	20.90	9.44	Driving DOWN
Income tax to Rev %	0.51%	0.83%	0.83%	Driving DOWN
Cap Exp. to Rev %	10.40%	9.14%	9.00%	Driving UP

Analysis

Free cash margin for Six Flags Entertainment Corp increased to 28.88% for the twelve months ending September 2011 from -9.80% for the twelve months ending September 2010. Increasing operating cushion and decreasing capital expenditures drove the improvement in free cash margin. The increase in operating cushion was caused by both an increase in gross margin and a decline in SG&A.

Regal Entertainment Group (RGC)**Free Cash Margin, 2000 – Q3 2011****Free Cash Margin Drivers**

RGC	Q3 2010	Q2 2011	Q3 2011	Effect on FCM (Q3 2010 vs. Q3 2011)
Free Cash Margin	7.31%	8.62%	10.23%	
Operating Cushion %	17.51%	16.52%	17.22%	Driving DOWN
Gross Margin % (before depreciations)	60.00%	61.00%	60.83%	Driving UP
SGA% (before depreciation)	42.54%	44.46%	43.61%	Driving DOWN
Cash Cycle (rev days)	(8.81)	(13.33)	(8.25)	Driving DOWN
Accounts Receivable (rev days)	2.73	7.34	4.98	Driving DOWN
Inventory (rev days)	1.55	2.06	1.79	Driving DOWN
Accounts Payable (rev days)	13.07	22.73	15.02	Driving UP
Income tax to Rev %	1.38%	2.45%	2.45%	Driving DOWN
Cap Exp. to Rev %	3.17%	3.14%	3.15%	Driving UP

Analysis

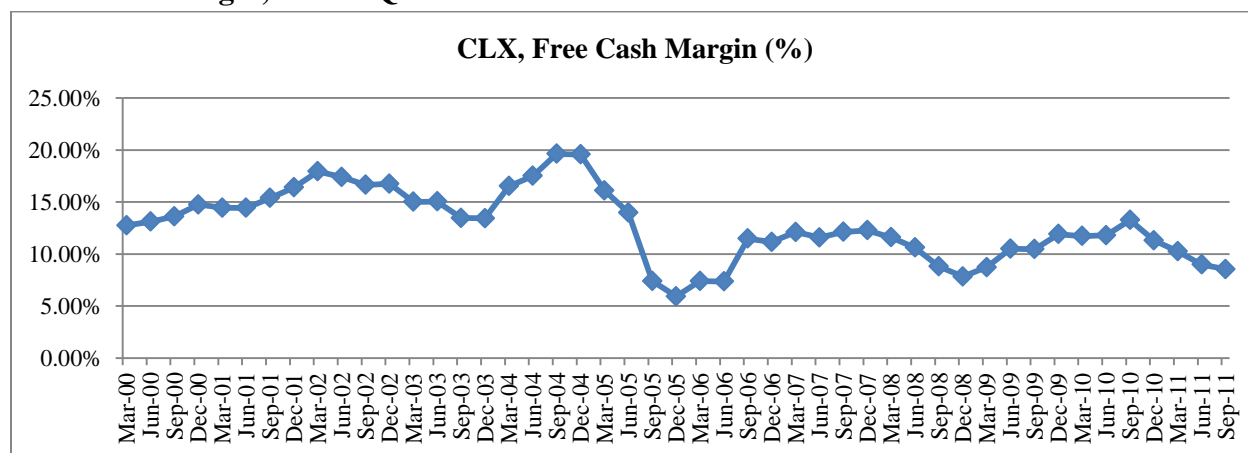
Regal Entertainment Group increased its free cash margin to 10.23% for the twelve months ending September 2011 from 7.31% for the twelve months ending September 2010. The primary contributors were an increase in gross margin from 60.00% to 60.83%, an increase in accounts payable days from 13.07 days to 15.02 days, and a decline in capital expenditures to revenue from 3.17% to 3.15%.

Industries with Declining Free Cash Margin

In the following paragraphs we take a closer look at two companies in the Consumer Goods industry, an industry that exhibited a decline in free cash margin to 4.31% in September 2011 from 7.09% in September 2010. The two companies examined here are Clorox Company (CLX) and Procter & Gamble Co (PG).

Clorox Company (CLX)

Free Cash Margin, 2000 – Q3 2011



Free Cash Margin Drivers

CLX	Q3 2010	Q2 2011	Q3 2011	Effect on FCM (Q3 2010 vs. Q3 2011)
Free Cash Margin	13.26%	8.98%	8.54%	
Operating Cushion %	22.74%	21.53%	20.82%	Driving DOWN
Gross Margin % (before depreciations)	47.66%	46.76%	46.15%	Driving DOWN
SGA% (before depreciation)	22.59%	23.00%	23.17%	Driving DOWN
Cash Cycle (rev days)	33.08	33.76	33.87	Driving DOWN
Accounts Receivable (rev days)	33.71	36.63	30.41	Driving UP
Inventory (rev days)	25.99	26.65	28.19	Driving DOWN
Accounts Payable (rev days)	26.62	29.52	24.73	Driving DOWN
Income tax to Rev %	5.75%	5.64%	5.64%	Driving UP
Cap Exp. to Rev %	3.87%	4.36%	4.38%	Driving DOWN

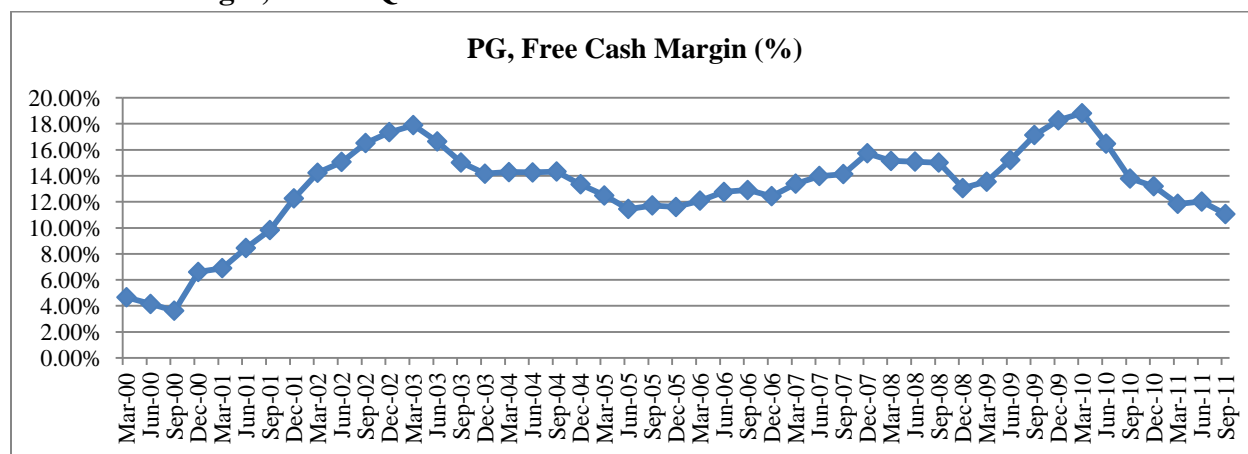
Analysis

Clorox Corp showed a decline in free cash margin to 8.54% for the twelve months ending September 2011 from 13.26% for the twelve months ending September 2010. Most of the drivers impacted free cash margin in a negative way. Operating cushion dropped to 20.82% from

22.74%, caused by a decline in gross margin (before depreciations) and an increase in SGA%, while capital expenditures increased.

Procter & Gamble Co (PG)

Free Cash Margin, 2000 – Q3 2011



Free Cash Margin Drivers

PG	Q3 2010	Q2 2011	Q3 2011	Effect on FCM (Q3 2010 vs. Q3 2011)
Free Cash Margin	13.80%	12.00%	11.06%	
Operating Cushion %	24.66%	23.10%	22.47%	Driving DOWN
Gross Margin % (before depreciations)	55.61%	54.06%	53.47%	Driving DOWN
SGA% (before depreciation)	30.95%	31.00%	31.00%	Driving DOWN
Cash Cycle (rev days)	30.59	24.89	31.57	Driving DOWN
Accounts Receivable (rev days)	28.01	27.74	28.49	Driving DOWN
Inventory (rev days)	33.51	32.62	34.62	Driving DOWN
Accounts Payable (rev days)	30.93	35.47	31.54	Driving UP
Income tax to Rev %	5.29%	3.62%	3.62%	Driving UP
Cap Exp. to Rev %	3.83%	4.00%	4.29%	Driving DOWN

Analysis

Procter and Gamble Co.'s free cash margin declined to 11.06% for the twelve months ending September 2011 from 13.80% for the twelve months ending September 2010. Behind the decline was a decrease in operating cushion, which fell to 22.47% from 24.66%, caused by a decline in gross margin and an increase in SG&A, an increase in the cash cycle, and an increase in capital expenditures as a percent of revenue.

Conclusions

Median free cash margin stands at 4.41% for the twelve months ended September 2011, down from 4.63% in the June 2011 period. The metric has now declined for six straight twelve-month reporting periods from a post-recession high of 7.18%. As has been the case in recent surveys, however, the decline is anything but unwelcome news as the factors behind the decline signal recovery for the U.S. economy. Consider the positive developments. Revenue growth was strong as median revenues increased 6.67%, from \$633.57 million for the twelve months ended June 2011 to \$675.82 million for the twelve months ended September 2011. Accompanying the rise in median revenues was an improvement in operating cushion. This measure of operating profit before depreciation increased to 16.02% of revenue from 15.78%. Thus, our sample companies grew revenue and increased profitability – a powerful combination. A decline in receivables days to 51.99 days in September 2011 from 53.12 days in June 2011 and a decline in inventory days to 23.86 days from 24.00 days also helped our sample companies generate more free cash flow. What worked against the generation of additional free cash flow and led to a decline in median free cash margin was a small increase in income taxes paid and an increase in capital expenditures, measured as a percent of revenue. Income taxes increased to 1.13% of revenue in September from 1.09% in June while capital expenditures as a percent of revenue increased to 3.29% in September from 3.16% in June.

In previous reports we noted that reductions in free cash margin could be expected as firms returned to more normal levels of spending on capital expenditures. The observed decline in free cash margin was driven primarily by the observed increase in capital spending, a healthy sign, especially when observed in the presence of improving operating profitability. In effect, we can say that free cash margin is declining for the right reason.

Adding to what is, by most accounts, an optimistic report, since the previous reporting period we also began to see an increase in median revenues, which during the September 2011 reporting period increased 6.67%. Further, with cash and short-term investments remaining near historically high levels, firms hold plenty of ammunition for continued investments in operations, if desired.

With recent declines in free cash margin, at 4.41%, the metric is now positioned at levels observed before the last recession. Our data indicate that a median free cash margin of 4.00% to 4.50% is typical for the median non-financial company. At 3.29% of revenue, however, capital spending still remains stubbornly low when compared with historical levels of 3.50% to 4.00% of revenue. Our expectation is that as the economy gains a stronger footing, capital spending as a percent of revenue should continue to rise, possibly by as much as another 50 basis points, pushing free cash margin lower by a similar amount. Thus, we think that within the next few quarters we should see free cash margin hovering around 4%.

In the last report we concluded that the big uncertainty was whether credit problems in Europe might lead to a new world slowdown and a return to recessionary conditions here. If such conditions were to develop, early indicators in our data will be a decline in median revenues, significant reductions in inventory days and capital expenditures, and, very possibly, an increase again in free cash margin. The third quarter results do not present evidence yet of negative effects of the European credit crisis on the US economy as median revenues continue to grow and our sample companies continue to increase investments in capital assets. Certainly, with cash balances remaining at historically high levels, companies have the resources to continue spending.

There was one other development observed in the data that deserves mention. Spending on selling, general and administrative expenses (SG&A) increased to 20.31% in the twelve months ended September 2011 from 19.23% in September 2010. SG&A includes spending on promotion and marketing costs as well as non-selling costs incurred to run the office. Such spending can be viewed as containing a significant discretionary component. Increases in these costs, especially when accompanied by rising revenues, send a positive signal about managers' outlook for the economy and can be expected to have a positive effect on future revenue trends and employment levels. We will continue to analyze the data and report our findings.