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Cash Flow Trends and Their Fundamental Drivers: Comprehensive Review (Qtr 4, 2010)

FREE CASH MARGIN INDEX:

2.43%, 3.96%	**5.56%**	**7.18%**
Recession Low (Mar. 2001, Dec 2008)	**Current (Dec. 2010)**	**Recent High (Mar. 2010)**

Median free cash margin for the twelve months ending December 2010 stands at 5.56%, well off of its high of 7.18% reached in the March 2010 reporting period but still above long-term norms of around 5%. The main drivers of the decline in median free cash margin are a decrease in operating cushion and an increase in capital expenditures. Operating cushion declined from 16.99% for the twelve months ending September 2010 to 15.35% for the twelve months ending December 2010. This decline was driven by an increase in SG&A % (before depr) as gross margin % (before depr) remained stable. Also, capital expenditures to revenue increased to 2.90% in December 2010 from 2.77% last quarter.

During the current reporting period, none of the industries in our sample reported improved free cash margin from the same period in 2009. We noted that 21 industries saw declines in free cash margin while 23 industries saw their free cash margin remain stable. Individual companies with free cash margin trends that are examined in this report are Air Products & Chemicals Inc (APD), Potash Corp of Saskatchewan (POT), Cintas Corp (CTAS), and Polo Ralph Lauren Corp (RL).

Data for this research were provided by Cash Flow Analytics, LLC., www.cashflowanalytics.com. Charles Mulford is a principal in Cash Flow Analytics, LLC. April, 2011

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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, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

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

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

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FREE CASH MARGIN INDEX*:

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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. In the current study we conduct 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 fourth quarter of 2010. Additionally, we look at individual industry results and focus our 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 cap of $50 million or more are included, resulting in a total sample of 3,067 companies. Please see pages 6-7 for a list of industries included. That list is followed by a summary of our 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 us how many cents the shareholders can take home without reducing the company's ability to generate more. Thus, as we look at cash flow trends and their underlying drivers, our particular interest is on how those factors impact free cash margin.

For more detail, our 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 fourth quarter of 2010 have been posted. The spreadsheets, which are updated quarterly, can be found on the Lab's website at www.mgt.gatech.edu/finlab.

Our Continuing 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. We think 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, we will 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 our primary focus is on free cash flow and free cash margin, or free cash flow as a percentage of revenue, we analyze here 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

Our data is provided by Cash Flow Analytics, LLC[1]. 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 December 31, 2010 represent amounts for the twelve months (four quarters) ending December 31, 2010.

Industries

The 44 industries are as follows:

1) Agriculture
2) Food Products
3) Candy & Soda
4) Beer & Liquor
5) Tobacco Products
6) Recreation
7) Entertainment
8) Printing and Publishing
9) Consumer Goods
10) Apparel
11) Healthcare
12) Medical Equipment
13) Pharmaceutical Products

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

14) Chemicals
15) Rubber and Plastic Products
16) Textiles
17) Construction Materials
18) Construction
19) Steel Works, etc.
20) Fabricated Products
21) Machinery
22) Electrical Equipment
23) Automobiles and Trucks
24) Aircraft
25) Shipbuilding and Railroad Equipment
26) Defense
27) Precious Metals
28) Non-metallic and Industrial Metal Mining
29) Coal
30) Petroleum and Natural Gas
31) Utilities
32) Communication
33) Personal Services
34) Business Services
35) Computer Hardware
36) Computer Software
37) Electronic Equipment
38) Measuring and Control Equipment
39) Business Supplies
40) Shipping Containers
41) Transportation
42) Wholesale
43) Retail
44) Restaurants

Summary of Results

Median free cash margin declined for the third straight quarter off of its March 2010 high of 7.18%. Currently, the median free cash margin for the twelve months ending December 2010 stands at 5.56%. However, if you compare the metric to the previous decade of data the Georgia Tech Financial Analysis Lab has collected, free cash margin is still higher than any period prior to June 2009 (see graph).

In examining the primary drivers behind the decline in median free cash margin we see a decline in operating cushion, or operating profit before depreciation, and an increase in capital expenditures to revenue %. Operating cushion % declined from 16.99% for the twelve months ending in September 2010 to 15.35% for the twelve months ending December 2010. This was mainly caused by an increase in SG&A % (before depr) as gross margin % (before depr) remained relatively stable over the same period. Continuing a recently-noted trend, capital

expenditures to revenue increased to 2.90% in December 2010 from 2.77% last quarter. The increases noted in spending on SG&A and on capital expenditures may reflect a renewed optimism in the prospects for the U.S. economy.

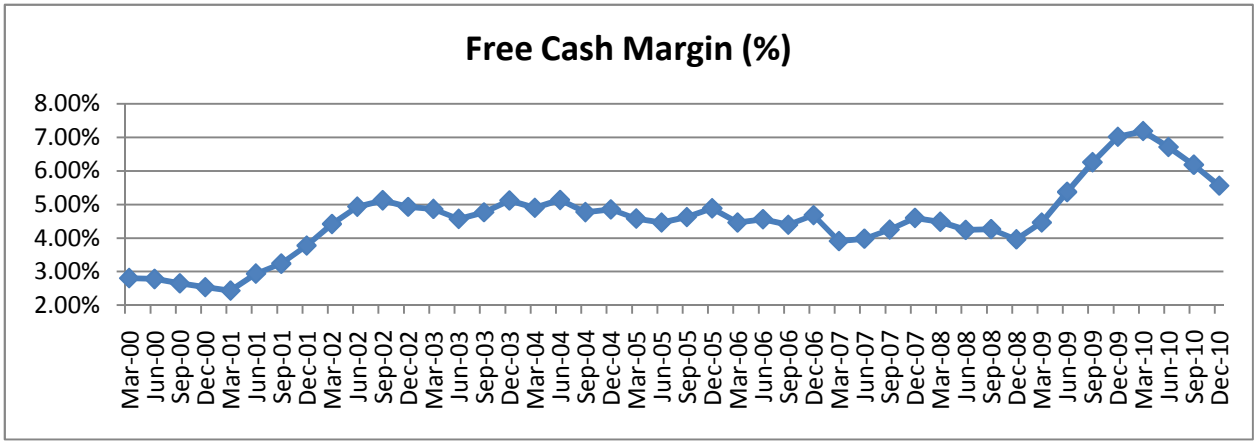
Also consuming cash flow, income taxes to revenue % rose from 0.86% for the twelve months ending September 2010 to 1.06% for the same period ending December 2010. The median cash cycle remained stable for the twelve months ending December 2010, not providing or consuming free cash flow. A small uptick in receivables days was offset by an offsetting decline in inventory days and increase in payables days.

Median company revenues increased slightly from $536.69M in September 2010 to $548.33M. Median company revenues are still well below 'pre-recession' levels. These stable revenues combined with a drop in median free cash margin caused another decline in median free cash flow. Median free cash flow fell from $24.53M in September 2010 to $23.37M.

Results for all non-financial companies

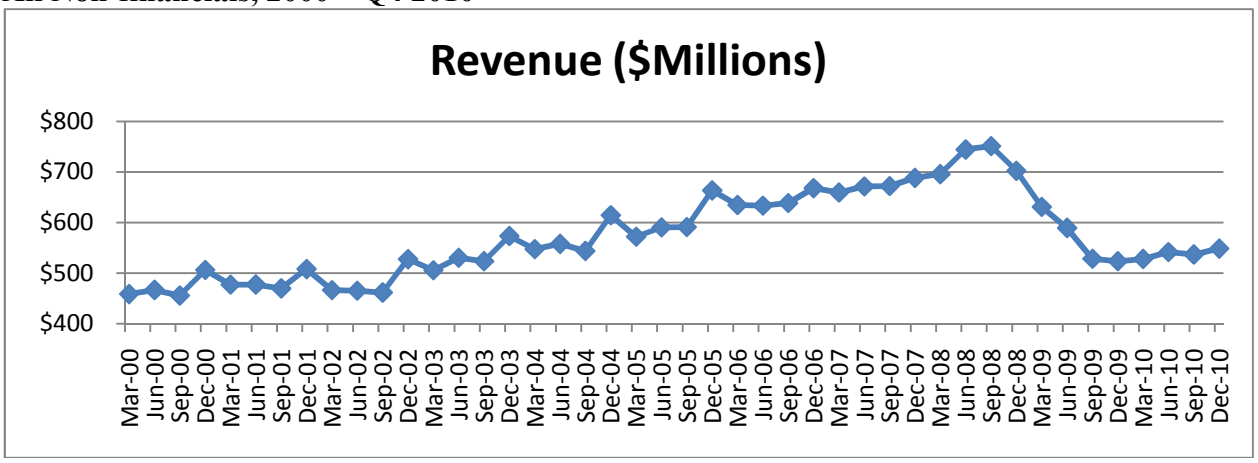
In the exhibits below we present a graph of free cash margin and several of its underlying drivers. These exhibits were constructed with data from our complete sample of non-financial companies, including all non-financial industries. A total of 3,067 companies are included. For more details on each individual industry, please refer to the individual industry spreadsheets reports that are available on our website (www.mgt.gatech.edu/finlab).

All Non-financials, 2000 – Q4 2010



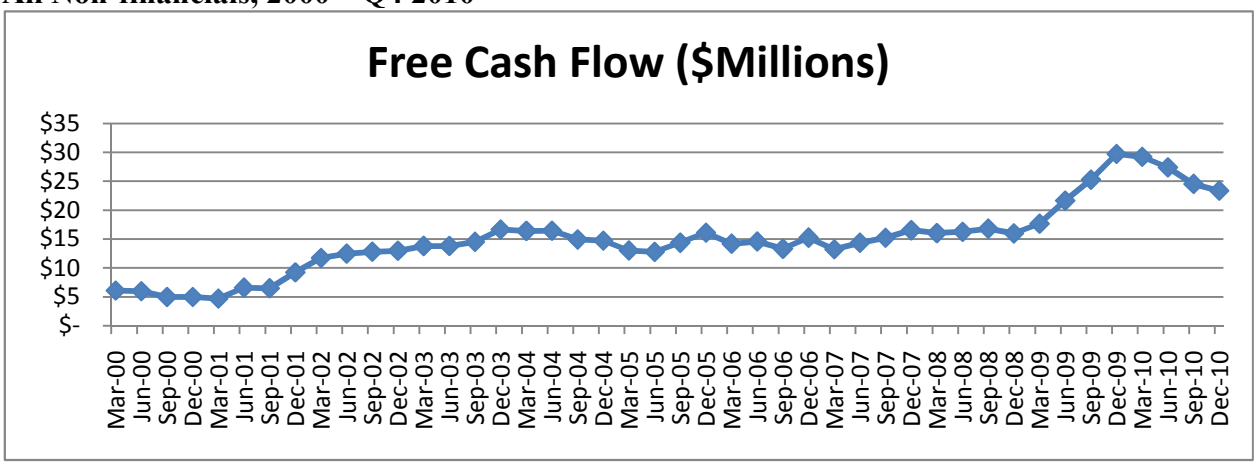
Median free cash margin has now declined for three straight quarters. However, at 5.56%, it still significantly above any data point prior to June 2009.

All Non-financials, 2000 – Q4 2010



Median revenues are somewhat stable, increasing only incrementally since September 2009.

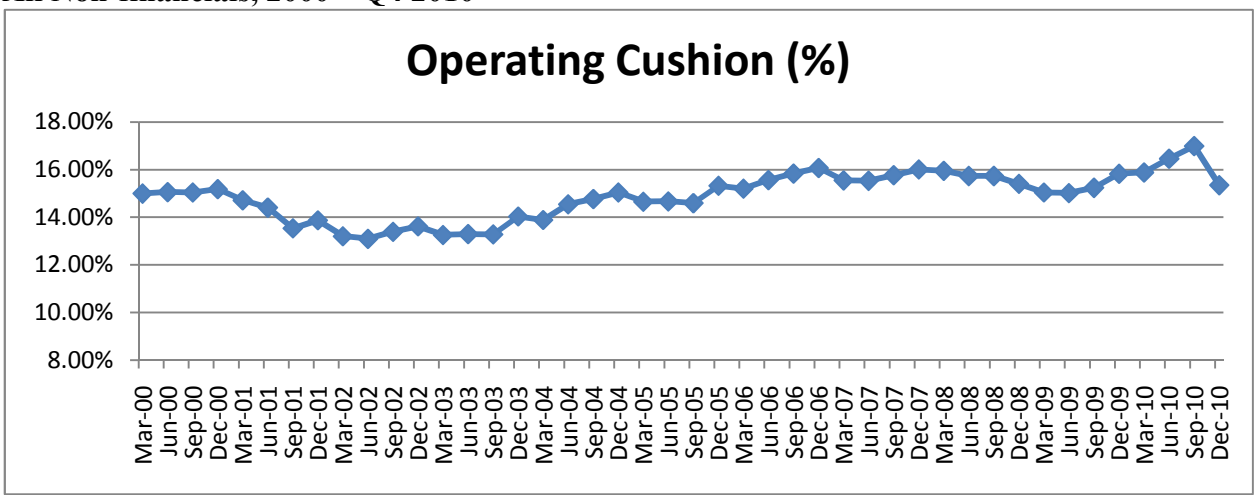
All Non-financials, 2000 – Q4 2010



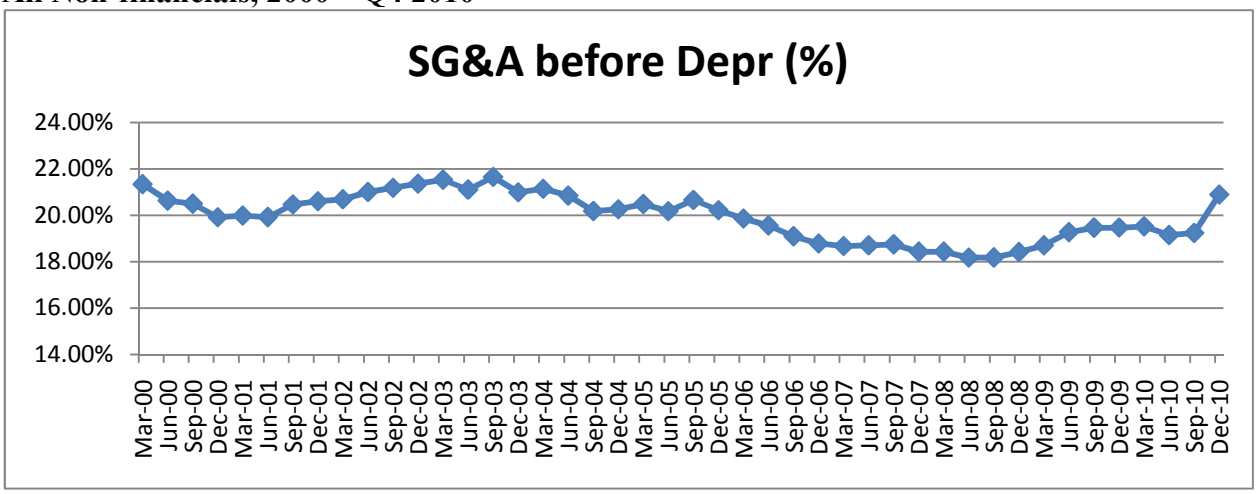
Median free cash flow declined as a result of lower free cash margin on stable revenues.

Operating cushion, or operating profit before depreciation and amortization, saw a significant decline in the current period. The decline was driven mainly by an increase in SGA % (before depr), while gross margin % (before depr) remained flat. The increase in SGA% reflects increased spending on marketing and support of operations and may reflect renewed optimism that growth is returning to the U.S. economy.

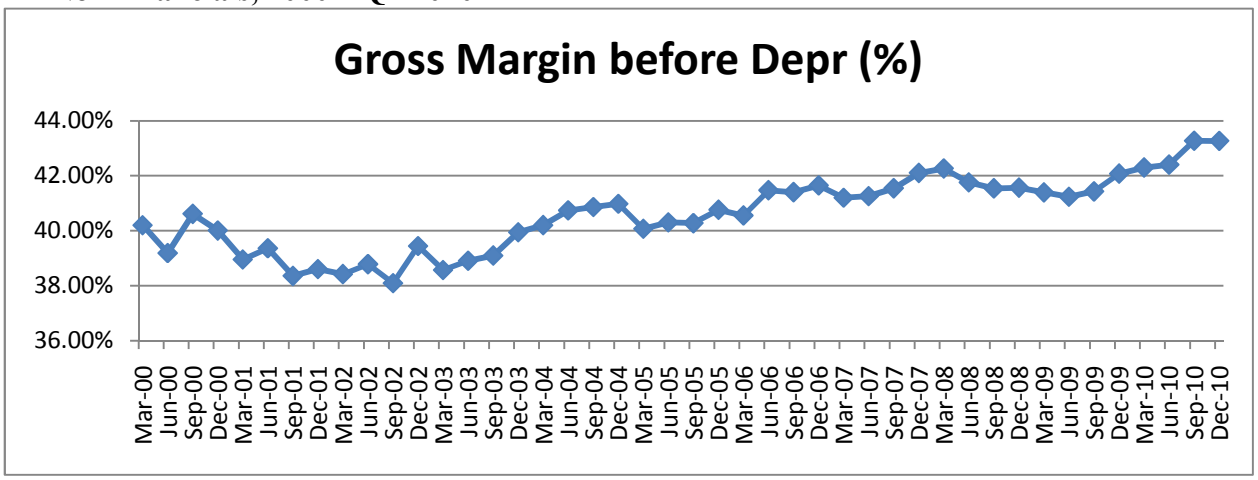
All Non-financials, 2000 – Q4 2010



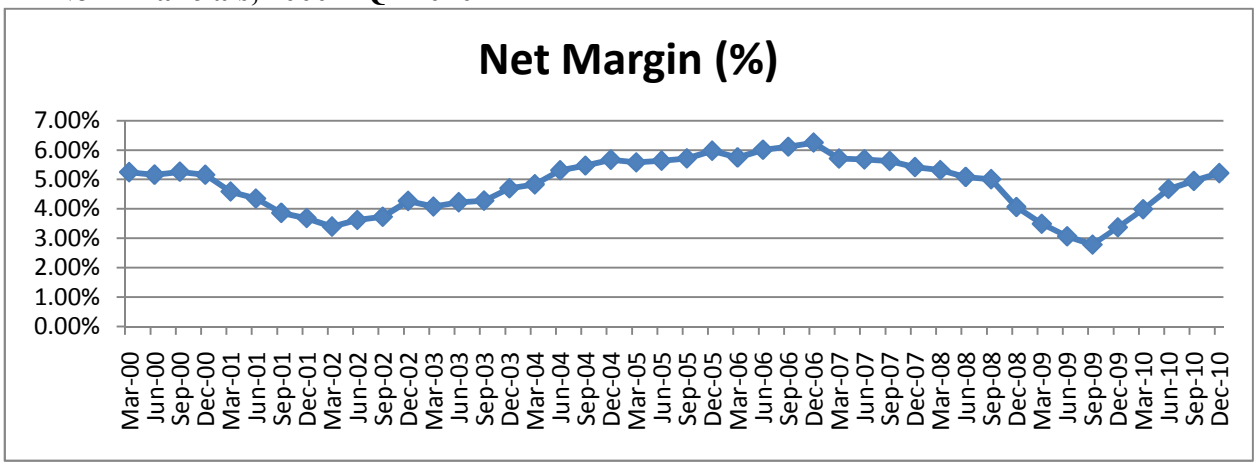
All Non-financials, 2000 – Q4 2010



All Non-financials, 2000 – Q4 2010

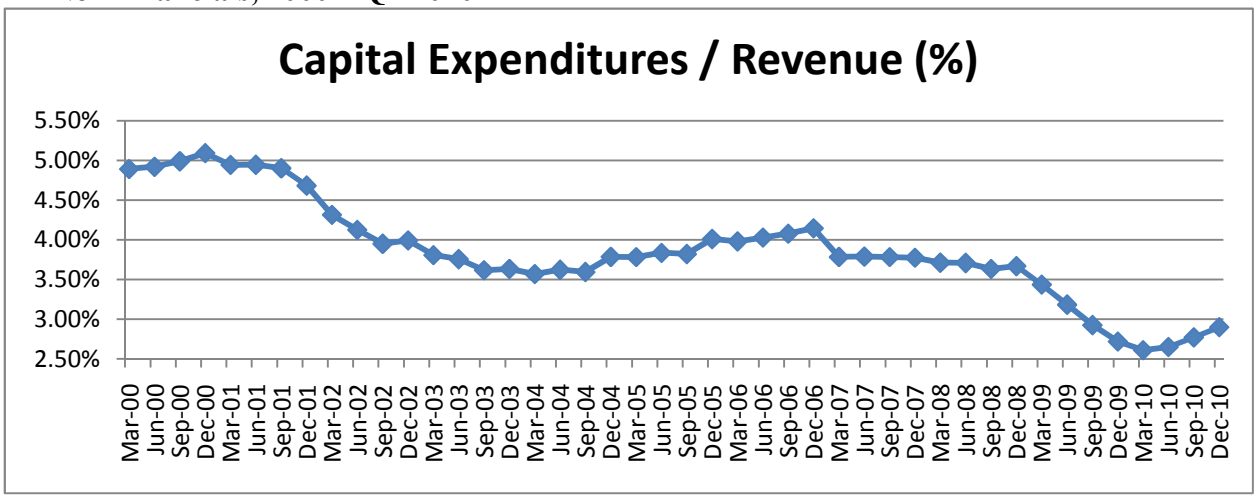


All Non-financials, 2000 – Q4 2010



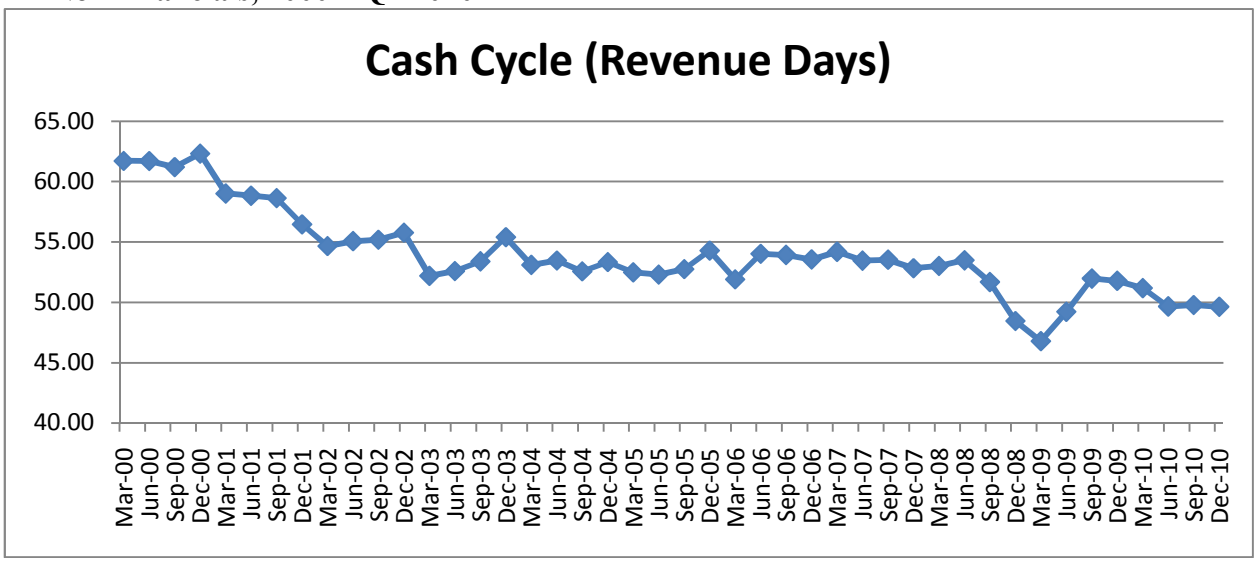
As stated in a last quarter's report, it is still interesting to note that median net margin has been on a steady increase since September 2009 when revenues began to flatten out.

All Non-financials, 2000 – Q4 2010



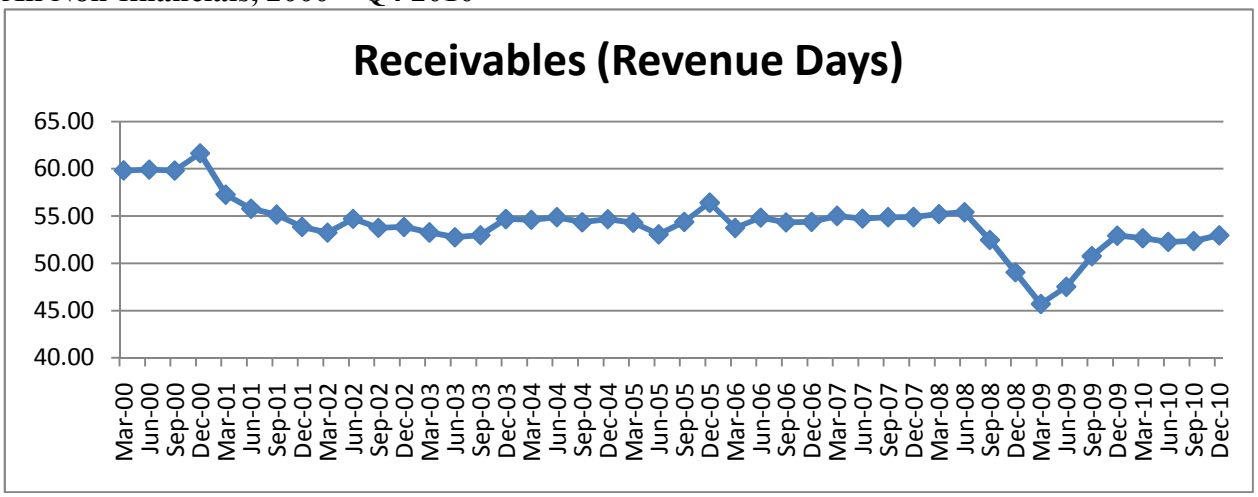
Continuing a recent trend, capital expenditures as a % of revenue increased but at 2.90% remain well below historical norms.

All Non-financials, 2000 – Q4 2010

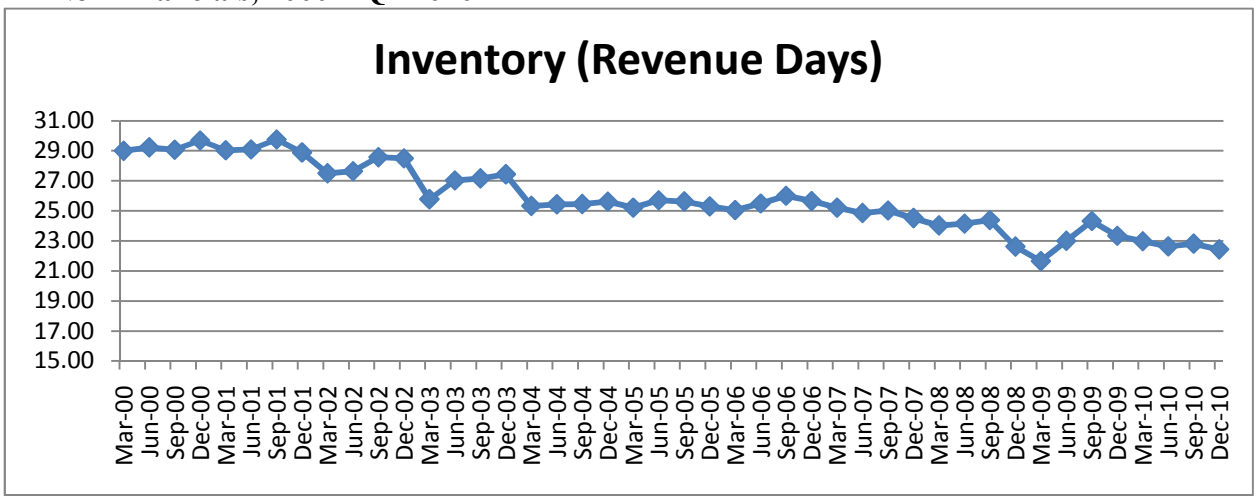


The cash cycle, which measures the proportion of operating cash flow carried in working capital and is measured by receivables days plus inventory days less payables days, held steady in the most recent reporting period. While receivables days increased slightly, that increase was offset by a small decline in inventory days and increase in payables days.

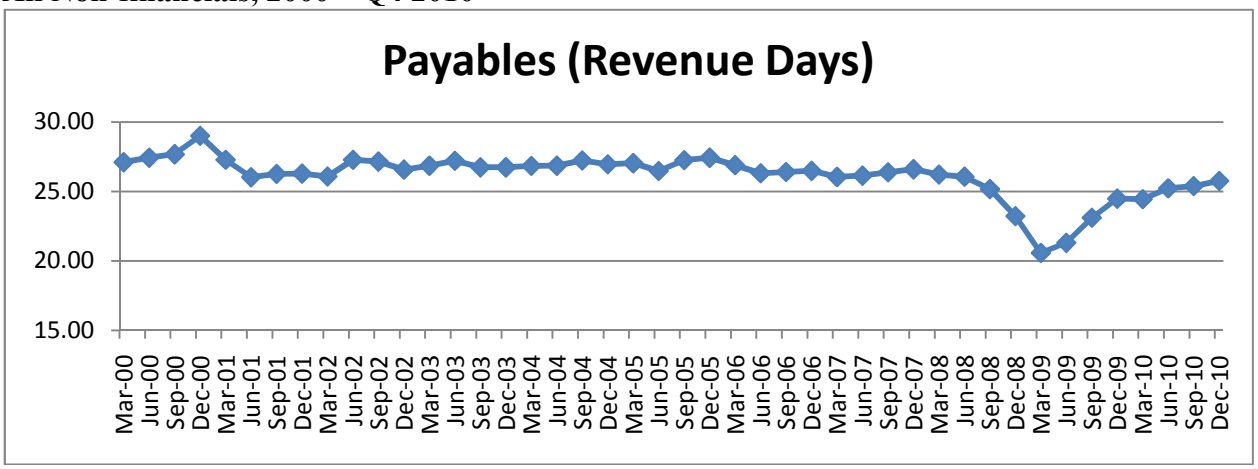
All Non-financials, 2000 – Q4 2010



All Non-financials, 2000 – Q4 2010



All Non-financials, 2000 – Q4 2010



Individual Industry Results

Of the 44 industries studied, during the twelve months ended December 2010 when compared with the twelve months ended December 2009, we saw a moderate to substantial improvement in free cash margin in **0** industries, relatively stable free cash margin in **23** industries, and **21** industries with declining free cash margin.

CICS	Industry	Increasing	Declining	Stable
1	Agriculture			x
2	Food Products		x	
3	Candy & Soda		x	
4	Beer & Liquor			x

5	Tobacco Products			x
6	Recreation			X
7	Entertainment			x
8	Printing & 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 & Trucks		x	
24	Aircraft		x	
25	Shipbuilding, Railroad Equipment		x	
26	Defense			x
27	Precious Metals			x

28	Non-metallic & Industrial Metal Mining			x
29	Coal			x
30	Petroleum & Natural Gas			x
31	Utilities			x
32	Communication			x
33	Personal Services		x	
34	Business Services		x	
35	Computer Hardware			x
36	Computer Software			x
37	Electronic Equipment		x	
38	Measuring & Control Equipment			x
39	Business Supplies		x	
40	Shipping Containers		x	
41	Transportation			x
42	Wholesale		x	
43	Retail		x	
44	Restaurants			x
	TOTAL	**0**	**21**	**23**

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 we measure as a percent of revenue. Capital expenditures do not impact profitability directly, but through depreciation. 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, we measure capital expenditures as a percent of revenue.

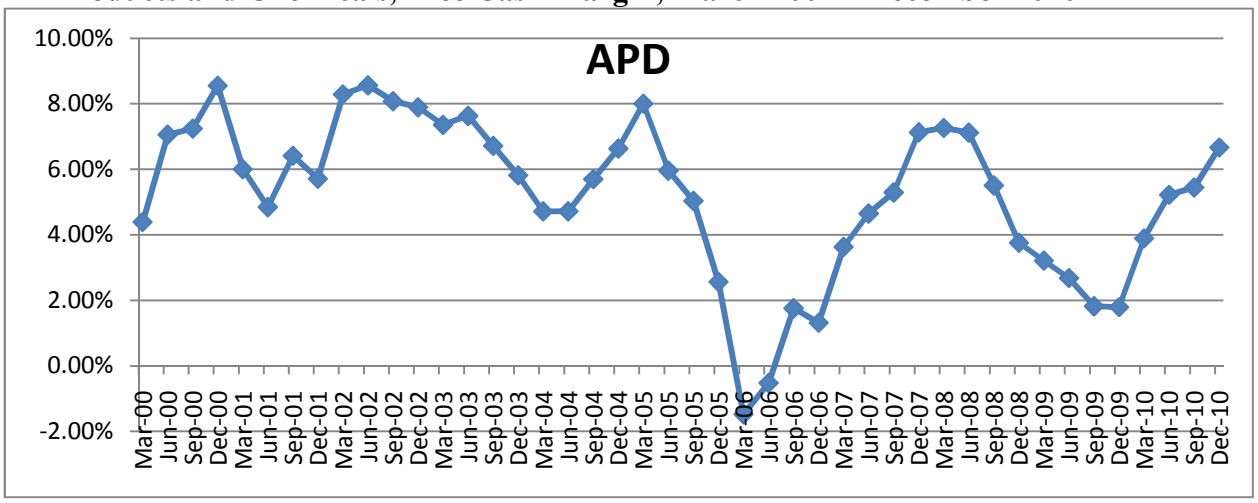
On the efficiency front, increases in receivables and inventory consume free cash flow. Increases in accounts payable provide free cash flow. The combination of receivables days plus inventory days less payables days is a firm's cash cycle. Reductions in the cash cycle provide free cash flow, while increases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

Improving free cash margin

Since there were no industries with improving free cash margin this quarter, we will look at a promising 'stable' industry that appears to be moving toward 'increasing', Chemicals. For the Chemicals industry, free cash margin has stayed flat over the previous 12 months at 6.45% for the twelve months ended December 2010 and 6.54% % in December 2009. However, over the past two periods, it has been increasing. Median free cash margin moved from 5.32% for the twelve months ending June 2010 to 6.45% for the twelve months ending December 2010. We will take a closer look at Air Products and Chemicals (APD) and Potash (POT).

Graphs of free cash margin for these companies across the period studied are provided below. With each graph we also provide a short summary of the primary drivers or factors that we think were 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.

Air Products and Chemicals, Free Cash Margin, March 2001 – December 2010



Air Products & Chemicals, Inc. (APD)

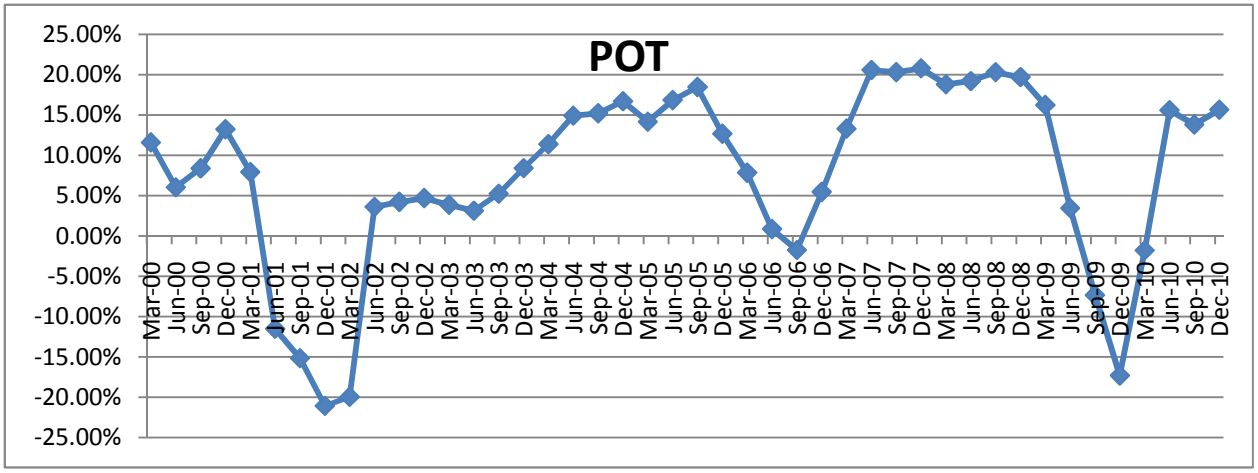
Drivers of Free Cash Margin

APD	Q4 2009	Q4 2010	Effect on FCM
Free Cash Margin	**1.79%**	**6.67%**	
Operating Cushion %	24.08%	26.62%	Driving UP
Gross Margin % (before depr)	37.84%	37.32%	-
SGA% (before depr)	12.42%	9.45%	Driving UP
Cash Cycle (rev days)	41.65	37.27	Driving UP
Accounts Receivable (rev days)	79.55	71.78	Driving UP
Inventory (rev days)	23.14	23.09	-
Accounts Payable (rev days)	61.04	57.60	Driving DOWN
Income tax to Rev %	1.51%	2.13%	Driving DOWN
Cap Exp. to Rev %	14.27%	11.35%	Driving UP

Analysis

Free cash margin for APD rose to 6.67% for the twelve months ending December 2010 from 1.79% for the twelve months ending December 2009. This increase was driven by improvements in operating cushion, and reductions in capital expenditures to revenue % and the cash cycle. Operating cushion increased to 26.62% in 2010 from 24.08% in 2009, mainly due to an increase in operating margin. Income taxes paid to revenue rose to 2.13% in 2010 from 1.51% in 2009, having only a marginal effect on the free cash margin. A drop in receivables days fueled the decline in the cash cycle from 41.65 revenue days for the 2009 to 37.27 revenue days in 2010. Finally, capital expenditures as a percentage of revenue declined to 11.35% in the 4rd quarter of 2010 from 14.27% the same period in 2009.

Potash (POT), Free Cash Margin, March 2000 – December 2010



Potash Corp of Saskatchewan Inc (POT)

Free Cash Margin Drivers

POT	Q4 2009	Q4 2010	Effect on FCM
Free Cash Margin	**-17.30%**	**15.64%**	
Operating Cushion %	37.39%	45.88%	Driving UP
Gross Margin % (before depr)	33.36%	44.43%	Driving UP
SGA% (before depr)	-4.00%	0.55%	Driving DOWN
Cash Cycle (rev days)	88.54	20.53	Driving UP
Accounts Receivable (rev days)	104.44	58.26	Driving UP
Inventory (rev days)	57.23	31.81	Driving UP
Accounts Payable (rev days)	73.13	69.54	Driving DOWN
Income tax to Rev %	16.10%	-0.69%	Driving UP
Cap Exp. to Rev %	40.53%	30.23%	Driving UP

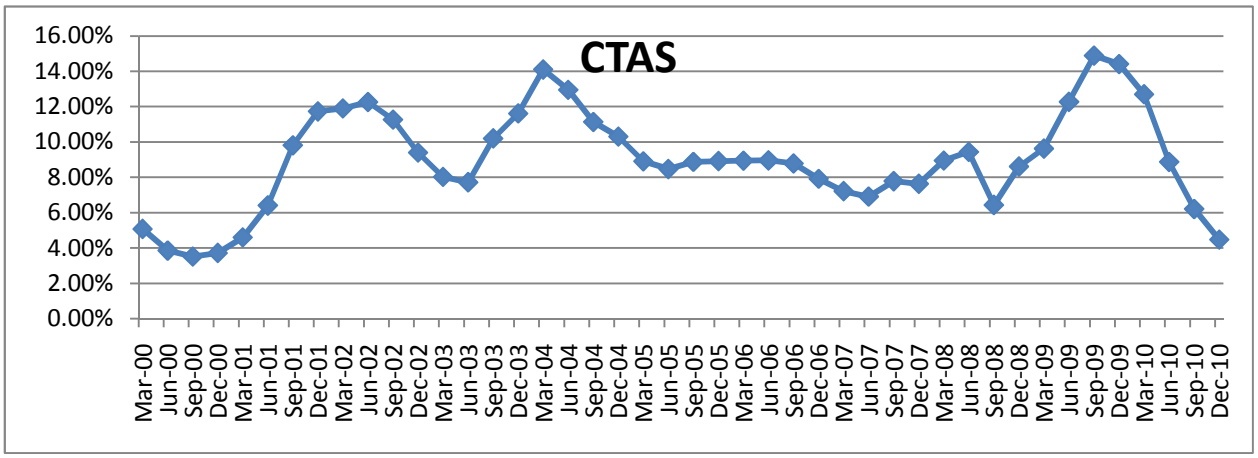
Analysis

POT's free cash margin rose from -17.30% for the twelve months ended with the fourth quarter of 2009 to 15.64% for the twelve months ended with the fourth quarter of 2010. The primary contributors were: a reduction in capital expenditures to revenue %, which declined from 40.53% in the fourth quarter of 2009 to 30.23% in the fourth quarter of 2010; an increase in operating cushion %, which rose up to 45.88% in December 2010 from 37.39% in December 2009, and a drop in the cash cycle, which fell to 20.53 revenue days in 2010, down from 88.54 revenue days in 2009. This drop in the cash cycle was mainly driven by a reduction in accounts receivable days. Also contributing to the increase in free cash margin was a decline in income tax to revenue % which dropped from 16.10% in the fourth quarter of 2009 to -0.69% in the fourth quarter of 2010.

Declining free cash margin

We take a closer look at two companies in the Apparel industry, which exhibited a notable drop in free cash margin. Free cash margin for the Apparel industry fell in the December 2010 reporting period to 5.73% from 9.86% in December 2009. The companies examined are Cintas Corp (CTAS) and Polo Ralph Lauren Corp (RL).

Cintas Corp (CTAS), Free Cash Margin, March 2000 – December 2010



Cintas Corp (CTAS)

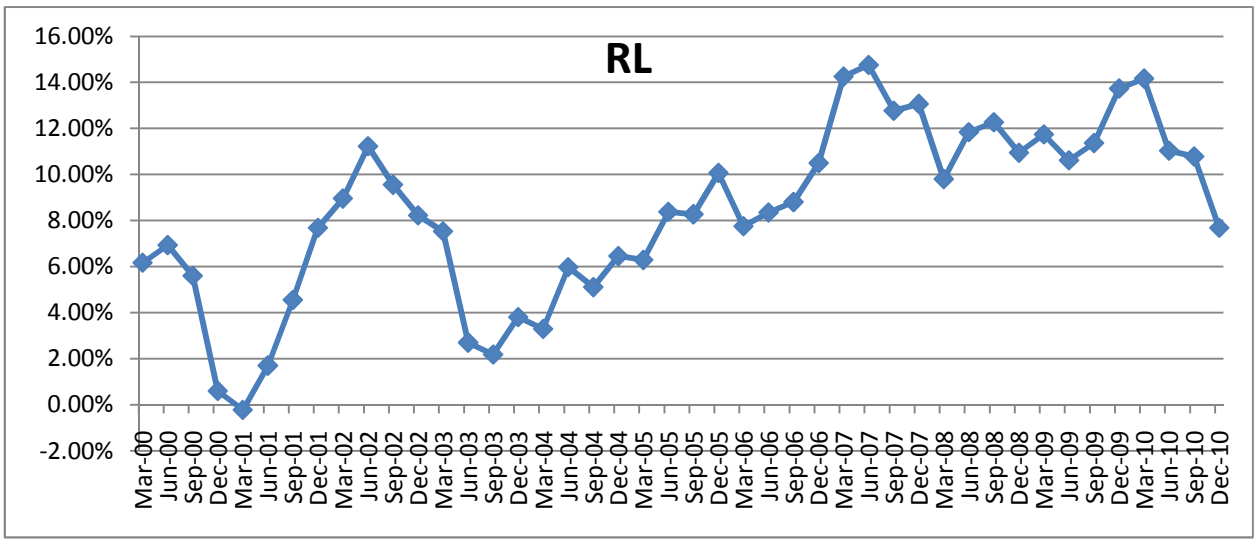
Free Cash Margin Drivers

CTAS	Q4 2009	Q4 2010	Effect on FCM
Free Cash Margin	**13.73%**	**7.68%**	
Operating Cushion %	17.13%	16.64%	Driving DOWN
Gross Margin % (before depr)	46.67%	47.33%	Driving UP
SGA% (before depr)	29.54%	30.69%	Driving DOWN
Cash Cycle (rev days)	47.74	55.10	Driving DOWN
Accounts Receivable (rev days)	38.67	42.26	Driving DOWN
Inventory (rev days)	17.42	22.87	Driving DOWN
Accounts Payable (rev days)	8.35	10.03	Driving UP
Income tax to Rev %	3.58%	3.62%	-
Cap Exp. to Rev %	3.00%	4.71%	Driving DOWN

Analysis

Cintas Corp showed a decline in free cash margin to 4.47% for the twelve months ending December 2010 from 14.41% for the twelve months ending December 2009. CTAS' capital expenditures to revenue %, income taxes paid to revenue %, and cash cycle all increased and pushed free cash margin lower. However, the main driver behind the decline in free cash margin was a drop in operating cushion, which declined to 16.64% for the 2010 reporting period from 17.13% in 2009.

Polo Ralph Lauren Corp (RL)., Free Cash Margin, March 2000 – December 2010



Polo Ralph Lauren Corp (RL)

Free Cash Margin Drivers

RL	Q4 2009	Q4 2010	Effect on FCM
Free Cash Margin	**13.73%**	**7.68%**	
Operating Cushion %	18.28%	20.83%	Driving UP
Gross Margin % (before depr)	59.68%	62.22%	Driving UP
SGA% (before depr)	41.40%	41.41%	-
Cash Cycle (rev days)	49.01	56.31	Driving DOWN
Accounts Receivable (rev days)	19.72	22.15	Driving DOWN
Inventory (rev days)	40.89	45.72	Driving DOWN
Accounts Payable (rev days)	11.60	11.56	-
Income tax to Rev %	3.62%	4.21%	Driving DOWN
Cap Exp. to Rev %	3.28%	4.82%	Driving DOWN

Analysis

RL's free cash margin fell to 7.68% for the twelve months ending December 2010 from 13.73% for the same period ending December 2009. Although the operating cushion % had a positive effect on free cash margin, driven by an increase in gross margin, free cash margin declined because of increases in capital expenditures to revenue %, income taxes paid to revenue %, and the cash cycle. RL's cash cycle increased to 56.31 revenue days in 2010 from 49.01 revenue days in 2009, pushed by increases in receivable days and inventory days.

Conclusion

Median Free Cash Margin continued its decline as has been exhibited over the last few quarters, falling to 5.56% for the twelve months ending December 2010. The main drivers appear to be a decrease in operating cushion, driven by an increase in SGA%, an increase in income taxes paid to rev %, and an increase in capital expenditures to revenue %. The Cash cycle remained flat over this period.

Median revenues are currently $548.33M, which is up slightly from the previous period. The combination of a declining free cash margin and relatively flat median revenues has resulted in a decline in median free cash flow.

Somewhat unexpectedly, during the most recent recession free cash margin increased significantly. By controlling operating expenses and reducing capital spending, companies were able to generate much more free cash flow than in any previous reporting period covered by our available data. In a "hunker down" and "batten the hatches" mentality, they built up significant cash reserves. Measured as a percent of revenue, cash and short-term investments grew to nearly 16%, up from norms closer to 10%. Afraid to spend, companies held on to their cash, exacerbating recessionary trends and slowing any potential recovery. In the December 2010 reporting period, it appears that companies are beginning to spend again. For example, take the SGA%, or selling, general and administrative expense as a percent of revenue. SG&A reflects spending on marketing and general support of operations. These are overheads that can be reduced, near term, to conserve cash. Increased spending on SG&A reflects a certain optimism that an economic recovery is taking hold. Such increased spending also works to increase hiring and general economic activity. Capital spending is also increasing, driven by a need to replace fixed assets and possibly by temporary changes in the tax code that permit a complete write-off against taxable income of eligible, newly installed equipment. While increases in SG&A and capital expenditures hurt free cash margin, they can be expected to lead to renewed economic growth and, hopefully, increases in median revenues, which have yet to show signs of a sustained recovery.

Overall, it would appear that a continued decline in free cash margin and a reduced generation of free cash flow should be expected as the recovery continues and growth accelerates. Companies still have cash and short-term investment balances that exceed 15% of revenue, about 50% higher than normal levels. As optimism for the future returns, it is expected that SG&A and capital spending will continue to increase, weighing on free cash flow, but boosting general economic activity. What remains to be seen is whether revenue increases will accelerate and pull median free cash flow higher even as free cash margin declines. We will continue to monitor these developments and report our findings on a quarterly basis.