Free cash flow per share

Amazon letters: 2004, 2002, 2001 · Difficulty: Intro

Summary

Free cash flow = net cash from operating activities − purchases of fixed assets (capital expenditures). Bezos calls **free cash flow per share** Amazon's ultimate financial measure because earnings do not turn directly into cash: working capital, capital spending and new shares also matter.

2004 letter

To our shareholders: Our ultimate financial measure, and the one we most want to drive over the long-term, is free cash flow per share. Why not focus first and foremost, as many do, on earnings, earnings per share or earnings growth? The simple answer is that earnings don't directly translate into cash flows, and shares ar e worth only the present value of their future cash flows, not the present value of their future earnings. Future earnings are a component—but not the only important component—of future cash flow per share.

Working capital and capital expenditures are also important, as is future share dilution.

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(in thousands)	Year 1	Year 2	Year 3	Year 4
Sales	$100,000	$200,000	$400,000	$800,000
Units sold	100	200	400	800
Gross profit	55,000	110,000	220,000	440,000
Depreciation	40,000	80,000	160,000	320,000
Labor & other costs	5,000	10,000	20,000	40,000
Earnings	**$10,000**	**$20,000**	**$40,000**	**$80,000**
Growth	N/A	100%	100%	100%

However, looking at cash flows tells a different story. Over the same four years, the transportation business generates cumulative negative free cash flow of $530 million. There are of course other business models where earnings more closely approximate cash flows.

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What if we modified the growth rates and, correspondingly, capital expenditures for machinery—would cash flows have deteriorated or improved?

(in thousands)	Year 1	Year 2	Year 3	Year 4
Earnings	$10,000	$20,000	$40,000	$80,000
Depreciation	40,000	80,000	160,000	320,000
Working capital	—	—	—	—
Operating cash flow	50,000	100,000	200,000	400,000
Capital expenditures	160,000	160,000	320,000	640,000
Free cash flow	**$(110,000)**	**$(60,000)**	**$(120,000)**	**$(240,000)**

Paradoxically, from a cash flow perspective, the slower this business grows the better off it is. Once the initial capital outl ay has been made for the first machine, the ideal growth trajectory is to scale to 100% of capacity quickly, then stop growing.

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Discerning investors don’t stop with the income statement. Our Most Important Financial Measure: Free Cash Flow Per Share Year 2, 3 and 4 Sales and Earnings Growth Rate Number of Machines in Year 4 Year 1 to 4 Cumulative Earnings Year 1 to 4 Cumulative Free Cash Flow (in thousands) 0%, 0%, 0% 1 $ 40,000 $ 40,000 100%, 50%, 33% 4 $100,000 $(140,000) 100%, 100%, 100% 8 $150,000 $(530,000) Amazon.com’s financial focus is on long-term growth in free cash flow per share. Amazon.com’s free cash flow is driven primarily by increasing operating profit dollars and efficiently managing both working capital and capital expenditures. We work to increase operating profit by focusing on improving all aspects of the customer experience to grow sales and by maintaining a lean cost structure.

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The capital efficiency of our business model is illustrated by our modest investments in fixed assets, which were $246 million at year end or 4% of 2004 sales. Free cash flow2 grew 38% to $477 million in 2004, a $131 million improvement over the prior year. We are confident that if we continue to improve customer experience—including increasing selection and lowering prices—and execute efficiently, our value proposition, as well as our free cash flow, will further expand. As to dilution, total shares outstanding plus stock-based awards are essentially unchanged at the end of 2004 compared with 2003, and are down 1% over the last three years.

During that same period, we’ve also eliminated over six million shares of pote ntial future dilution by repaying more than $600 million of convertible debt that was due in 2009 and 2010.

2002 letter

Net sales this year increased 26% to a record $3.9 billion, and unit sales grew at an even faster 34%. Free cash flow—our most important financial measure— reached $135 million, a $305 million improvement over the prior year.[1] In short, what's good for customers is good for shareholders. Once again this year, I attach a copy of our original 1997 letter and encourage current and prospective shareowners to take a look at it.

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Jeffrey P. Bezos Founder and Chief Executive Officer Amazon.com, Inc. _____ [1] Free cash flow for 2002 of $135 million is net cash provided by operating activities of $174 million less purchases of fixed assets of $39 million. Free cash flow for 2001 of negative $170 million is net cash used in operating activities of $120 million less purchases of fixed assets of $50 million.

2001 letter

Estimating the number of shares outstanding in the future requires you to forecast items such as option grants to employees or other potential capital transactions. Ultimately, your determination of cash flow per share will be a strong indicator of the price you might be willing to pay for a share of ownership in any company. Since we expect to keep our fixed costs largely fixed, even at significantly higher unit volumes, we believe Amazon.com is poised over the coming years to generate meaningful, sustained, free cash flow. Our goal for 2002 reflects just that.

As we said in January when we reported our fourth quarter results, we plan this year to generate positive operating cash flow, leading to free cash flow (the difference between the two is up to $75 million of planned capital expenditures). Our trailing twelve-month pro forma net income should, roughly but not perfectly, trend like trailing twelve-month cash flow. Limiting share count means more cash flow per share and more long-term value for owners. Our current objective is to target net dilution from employee stock options (grants net of cancellations) to an average of 3% per year over the next five years, although in any given year it might be higher or lower.

Source: Jeffrey P. Bezos, Letters to Amazon.com Shareholders: 2004, 2002, 2001 (ir.aboutamazon.com). Excerpts © Amazon.com, Inc., all rights reserved; reproduced in part for non-commercial teaching. “…” marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Amazon.com, Inc.