Growing earnings, negative free cash flow

Amazon letters: 2004 · Difficulty: Intermediate

Summary

Bezos's example business buys machines to grow. Its earnings double every year, but it must pay for more machines than its operating cash flow covers, so its **free cash flow** is negative every year. Earnings (and **EBITDA**) look healthy only because depreciation spreads each machine's cost over its life, while the cash is paid up front.

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?

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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. Though some may find it counterintuitive, a company can actually impair shareholder value in certain circumstances by growing earnings. This happens when the capital investments required for growth exceed the present value of the cash flow derived from those investments.

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Continue to imagine that business is booming, with 100,000 trips in Year 1, completely and perfectly utilizing the capacity of one machine. This leads to earnings of $10 million after deducting operating expenses including depreciation —a 10% net margin. The company's primary focus is on earnings; so based on initial results the entrepreneur decides to invest more capital to fuel sales and earnings growth, adding additional machines in Years 2 through 4.

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Investors considering only the above income statement would be delighted.

(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.

But as our transportation example illustrates, one cannot assess the creation or destruction of shareholder value with certainty by looking at the income statement alone. Notice, too, that a focus on EBITDA—Earnings Before Interest, Taxes, Depreciation and Amortization—would lead to the same faulty conclusion about the health of the business. Sequential annual EBITDA would have been $50, $100, $200 and $400 million— 100% growth for three straight years. But without taking into account the $1.28 billion in capital expenditures necessary to ge nerate this 'cash flow,' we're getting only part of the story—EBITDA isn't cash flow.

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.

Source: Jeffrey P. Bezos, Letters to Amazon.com Shareholders: 2004 (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.