DSR PREMIUM NEWSLETTER

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AUGUST 30TH, 2023

Dear DSR member,

It is with great pleasure that we present our weekly premium newsletter which is an important component of your subscription to Dividend Stocks Rock.

You may benefit from viewing our video explaining the differences between the Buy List, our ratings, and our portfolio models. You can retrieve this information in the Videos section of the website.

Referral

Feel free to share our ideas with your friends or associates who may benefit from this information. **We would personally consider any referrals you make on our behalf to be the ultimate compliment for our efforts.**

DIVIDEND STOCKS ROCK
INVEST WITH CONVICTION, ENJOY YOUR RETIREMENT

CASH IS KING

If you have ever run a business, you no doubt have heard that saying about cash a thousand times. If you have not been around entrepreneurs, the comparison could apply to how much you have in your personal bank account on the first of the month vs. the last day of the month. If the amount continuously increases or the excess is being saved or invested, you are in a financially advantageous position.

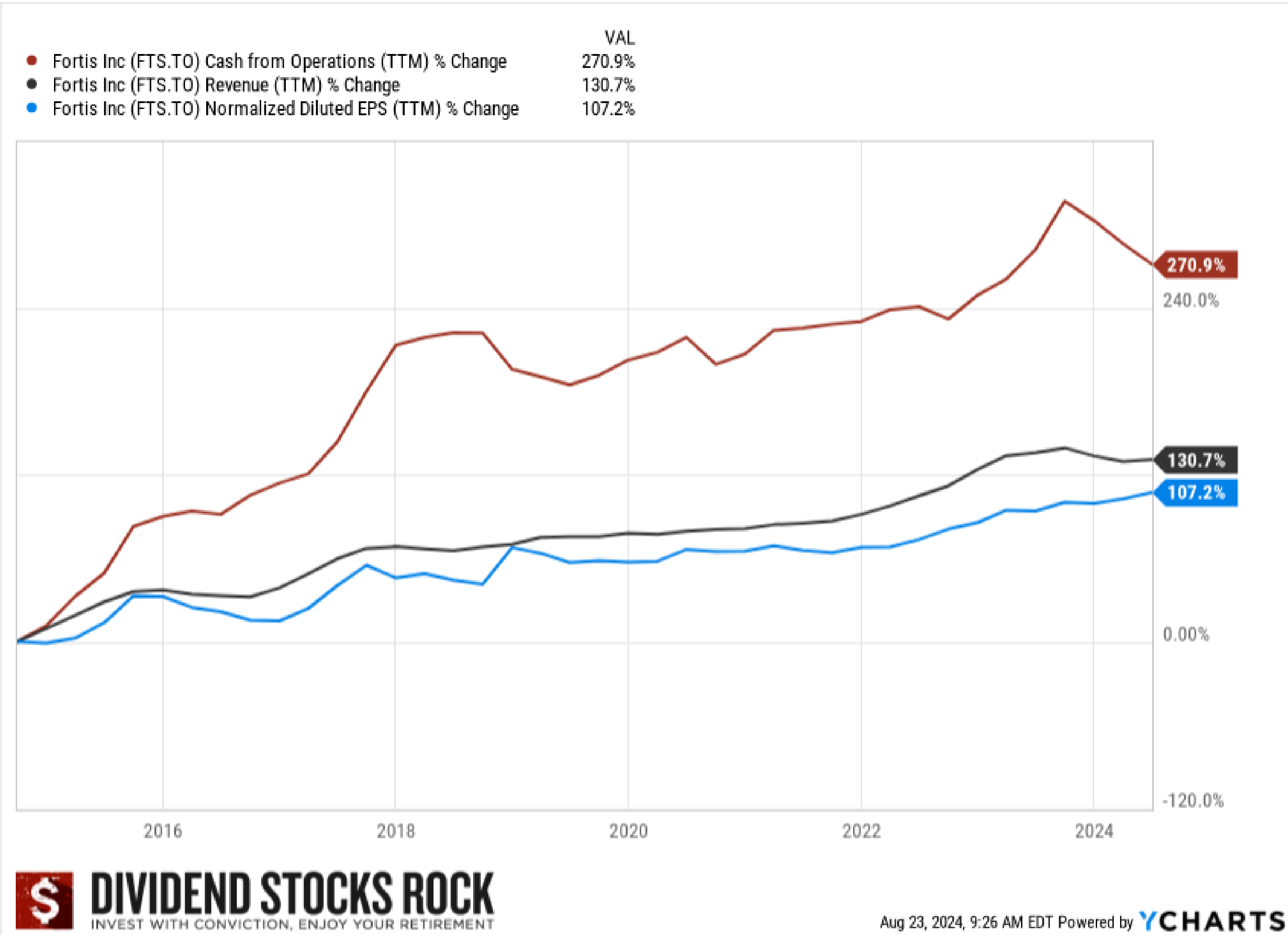
We refer to cash is king for corporations because it is often the first thing management discusses during their quarterly earnings reports - revenues and earnings. Free cash flow or cash from operations (aka operating cash flow) are found in the cash flow statements, but they are not necessarily part of the highlights presented by management.

Many investors prefer to look at how cash flow fluctuates over time. Cash flow fluctuation is the result of three types of cash flows:

- **Cash from Operations:** This is how much cash the company generates from its normal operations. This is calculated by what cash is coming into the corporation minus what goes out to run the business. Cash from Operations can be thought of as "how much did the firm generate in the day-to-day operations of the firm?"
- **Cash from Financing:** Whenever a corporation borrows money from their bank or issues bonds, there is a new cash entry (positive) in the company's bank account. When the company pays down debt or distributes dividends it has a negative effect on this element of cash flow.
- **Cash from Investing:** Includes the company's cash inflows and outflows from investments in the financial markets and the sale of capital assets.

We will focus on cash from operations in this newsletter. Operating cash flow gives a cold, hard picture of what is going on in the company's operations and it is difficult for management to manipulate as compared to net income. If margins are stable, cash flow from operations will follow the revenue trends.

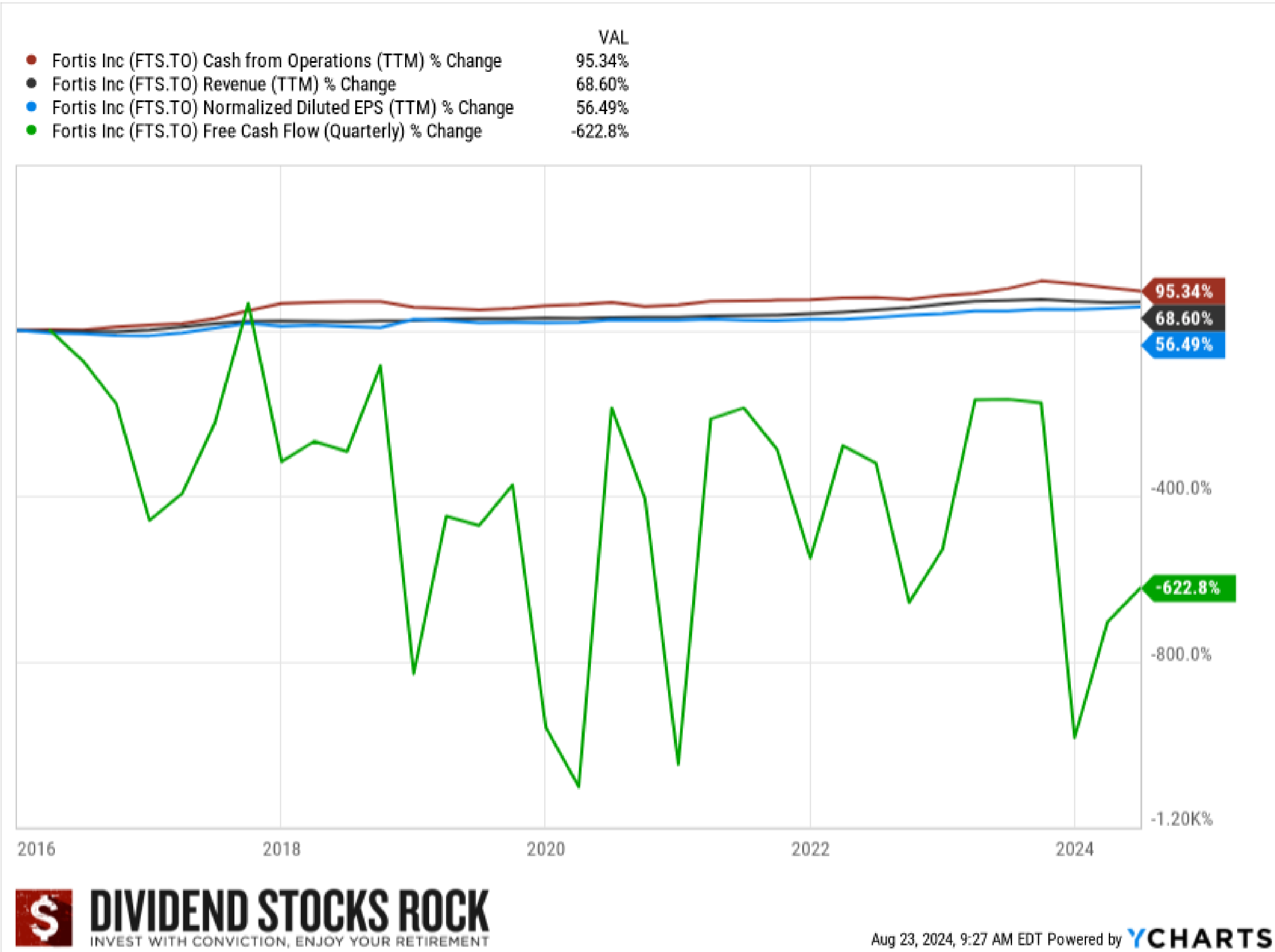
The following graph will show you how earnings per share (EPS), revenue, and cash from operations have changed over the course of ten years at one company we follow (Fortis). You will see how the three metrics do not necessarily evolve in an equivalent manner. While revenue and cash from operations are close, earnings are completely different. That is explained by the fact that Fortis spends a lot of money on capital expenditures (CAPEX) and this could have an impact on earnings (notably amortization hurting earnings, but not changing the company's bank account).



We tend to look at the operating cash flow instead of the free cash flow as the latter has more variation. Free cash flow (FCF) will include capital expenditures. If you remember our payout ratio newsletter, CAPEX could fluctuate significantly over time. Depending on management's projects and how they are financed, the picture could be quite difficult to understand.

As a comparison with a person's situation, looking at the free cash flow (what money comes in minus what goes out) could be misleading depending on when we look at it. Imagine that I saved money for 12 months to take a trip. My free cash flow would be positive for 12 consecutive months. However, if we look at my free cash flow for the month where I take that trip, it may be heavily negative. In the end, I saved for 12 months and spent it all on traveling. My entire project was cash flow neutral.

For this reason, I always prefer to look at cash from operations. A constantly increasing operating cash flow normally means the company is quite healthy and its dividend is normally safe.



How to calculate cash from operations

Here is the simple formula to calculate where the cash from operations number comes from:

Cash from operations = Net Income + Non-Cash Items + Changes in Working Capital

The Net Income can also be referred to as earnings (earnings are net income after taxes). This is the accounting profit. We will cover the cash flow statement later in this newsletter.

You then must add all **non-cash items** such as capital appreciation or depreciation, amortization, investment gains or losses, which does not involve an actual cash payment. For example, a company could report a $100M amortization on a building or a $250M value impairment on a brand's value that is not doing well. Those movements will reduce the company's net income but will not affect its cash in their bank account.

Finally, the **changes in working capital (**the difference between current assets and current liabilities) are one of the major ways that net income and operating cash flow can differ. A company may be investing in assets or becoming less efficient when the change in working capital is negative and depleting assets or becoming more efficient when the change in working capital is positive.

If you don't want to perform your own calculations, you can go directly to DSR's stock card or the company's earnings statement and get the metric calculated for you.

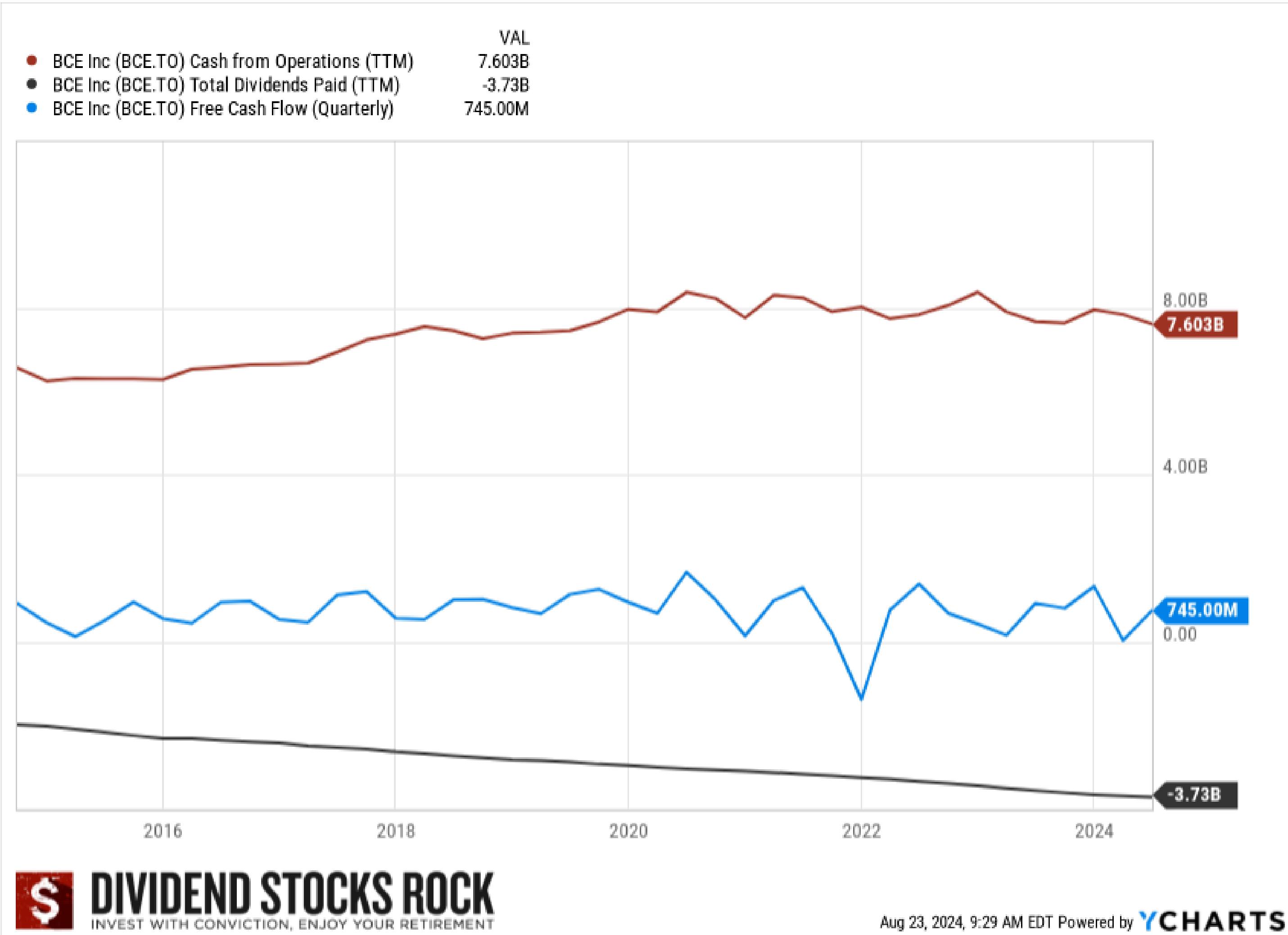
What really matters is that you understand that cash from operations is telling the real story behind the company's business model. A company could report positive earnings by being too loose on accounting rules, but it cannot lie if the bank account is bleeding cash.

You can see cash from operations as the blood pumping through your veins. It enables all your body parts to function normally and contribute to your well being. When a company is running low on cash flow, it is missing the blood (cash) to nourish its business arms.

The next example will show you the dividend and cash flow from operations over the past 5 years for BCE (BCE.TO / BCE). If you have looked at this company's profile, you will notice its dividend payout ratio is at 176.70%, but its cash payout ratio is at 130.90% (as of August 2024). Do you think the dividend is at risk?

Dividend ($)	3.99
Dividend Yield Fwd	8.50 %
Dividend Frequency	Quarterly
Average 5-Yr Yield	6.25 %
Payout Ratio (%)	176.70
Cash Payout Ratio (%)	130.90

Let's see how the company has been generating cash during this period.

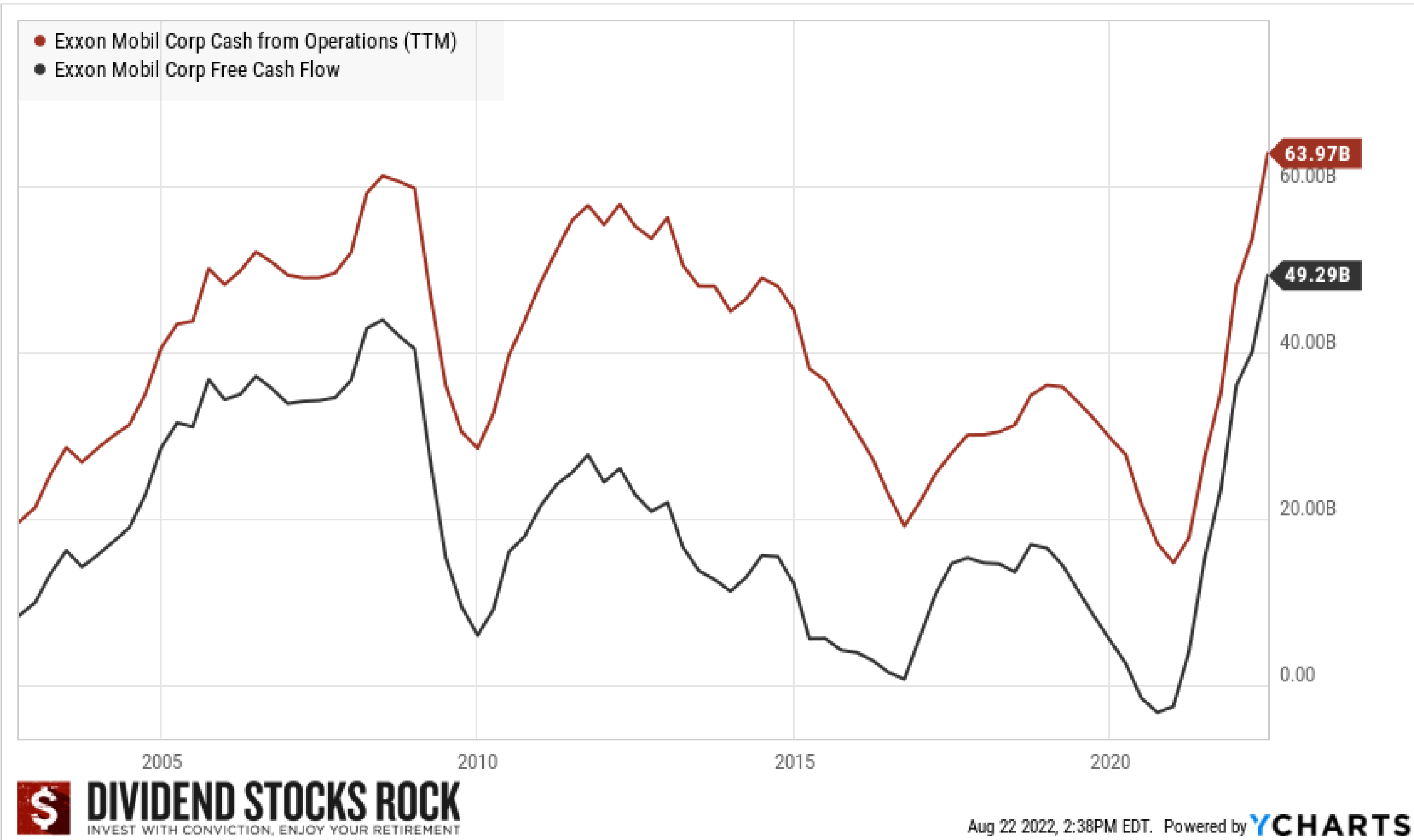


BCE disbursed $3.73B in dividends over the past 12 months while generating only $745M in free cash flow. You must remember, however, that capital expenditures are being deducted from cash flow to calculate the free cash flow. Since BCE invests massively in its network infrastructure (including 5G development), its free cash flow is not enough to pay the dividends.

But when we look at the cash from operations, we can see that BCE generates about double the amount required to pay their shareholders. In other words, the company is borrowing money to finance its CAPEX in wireless network infrastructure and has plenty of cash flow to pay its dividends.

This explains how management has kept the dividend growth streak alive while showing ridiculously high payout ratios. **To be fair, this is not a sustainable situation. A corporation can't just borrow more money each year to finance its CAPEX and dividends.** This is the problem BCE faces right now. If management can't find a solution quickly, BCE won't increase its dividend in 2025…

Let's look at another example: Exxon Mobil (XOM). You can see how 2020 rapidly "killed" the company's cash flow generation.



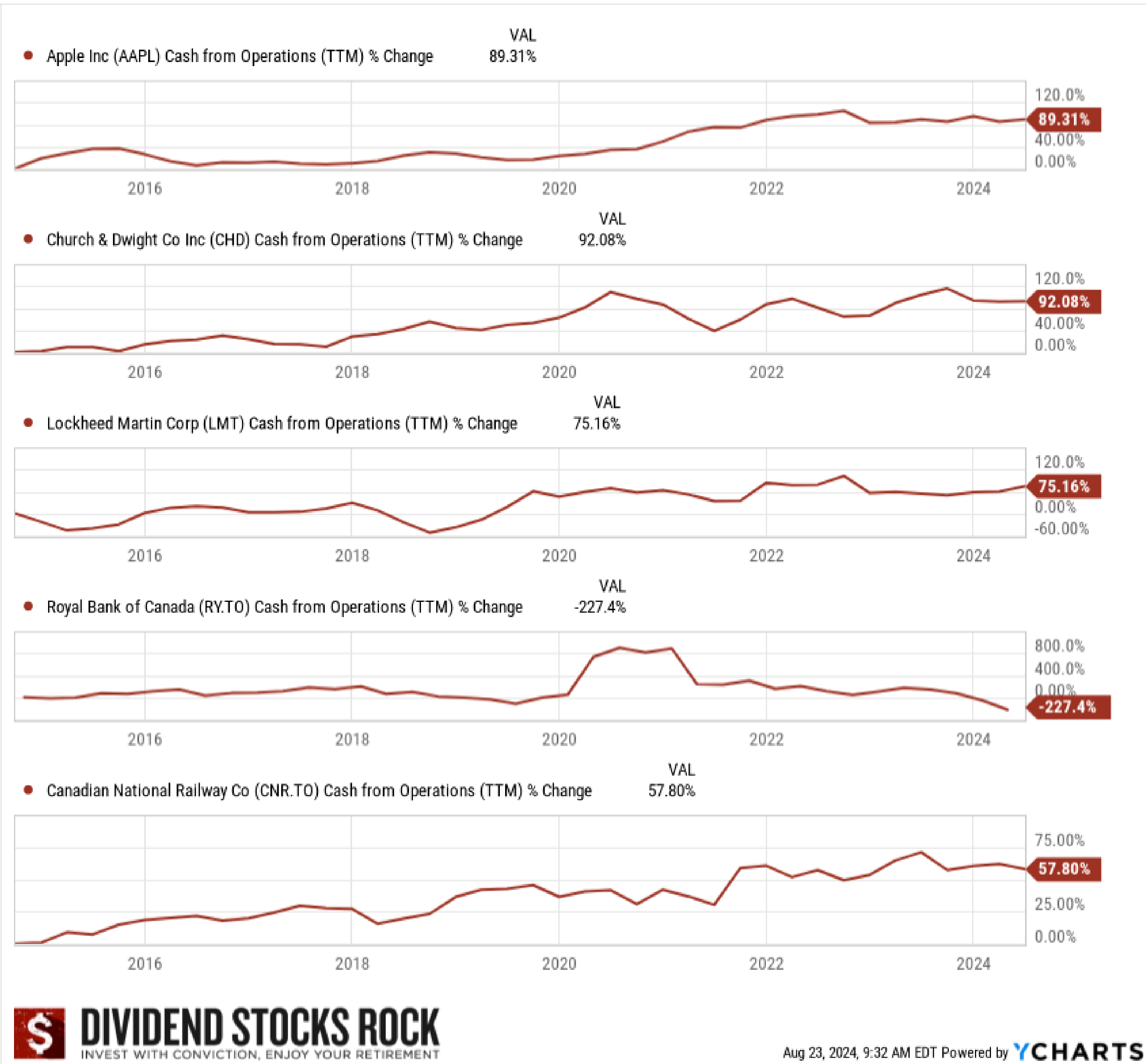
While the XOM cash flow was reduced rapidly during 2020, it doesn't mean it was the end for their shareholders. It all depended on how long the price of a barrel of crude oil's price stayed depressed. Fortunately for investors, demand rapidly returned and XOM is now generating historical record cash flows.

You can also see why I find it so hard to "trust" oil companies to constantly increase their dividends with such hectic cash flow generation. While operating cash flow is a particularly important metric to follow, it tends to be extremely volatile at times. This is one of the metric's most important downsides.

If cash flow matters, why is it not a top highlight in quarterly earnings presentations?

That is a particularly good question. Another one could be, *if operating cash flow is so important and crucial for a business, why don't we use it instead of earnings in our dividend triangle?*

Because cash flow is highly volatile.



As you can see from this graph, I have pulled out some random companies in different sectors to show you how variable cash flows can be. Please note that all stocks in this graph performed better than the market. Apple is the top performer in terms of total return over the past 5 years, but it still does not show a steady cash flow graph. When you look at the Lockheed Martin, Royal Bank and Canadian National Railway's cash flow graphs, you will easily discern that cash flows bounce up and down all the time.

This shows how operating cash flow can be volatile. Think of how your own bank account fluctuates from month to month. Most of the time it is clearly stable. If you are making more money than you spend, you will gradually see your bank account (or savings) grow. But then you get to a month where you need to change out both your refrigerator and your dishwasher at the same time (true story, it just happened to me this month!) your cash flow is all over the place. Once again, it teaches us that you cannot focus on a single metric to explain everything.

At DSR, we use earnings per share for our dividend triangle mostly because it is an easy metric to obtain. The second reason is that cash flow could be quite volatile. Over a longer period, we can see trends defining where the company is going. Obviously, a corporation cannot bleed money for an extended period of time before other side effects are plainly visible.

Therefore, the operating cash flow trend is part of our second set of metrics to analyze. Once we are done with the dividend triangle, we will look at the dividend and cash dividend payout ratio along with long-term debt and operating cash flow trends.

The combination of several metrics put together is the key to a well-defined investing analysis process. When you find a company with a strong dividend triangle, you will normally find a company with decent payout ratios, with debt under control, and with growing cash flows.

There are three financial statements issued quarterly (and consolidated yearly) by companies:

- ✓ Income statement
- ✓ Balance sheet
- ✓ Cash flow statement

We will now look deeper at the cash flow statement so as to help you read these numbers the next time you encounter them. Then, you will have access to a glossary of various financial terms used when we discuss cash in a business. Do not hesitate to email me if there is any information upon which you require further clarity.

Cheers,

Mike.

THE CASH FLOW STATEMENT: COOLER THAN YOUR ACCOUNTANT

In this section, we will review Procter & Gamble's (PG) 2023 cash flow statement for a better understanding of how cash flow is calculated. The cash flow statement is a great place to look if you want to know about all the amounts of cash that came in or went out of the company.

The Cash flow statement is divided into three categories:

Operating Activities include any sources and uses of cash for business activities. That's the fuel for the company's engine to work.

Investing Activities include any sources and uses of cash for investments. We are talking about CAPEX, the purchase or sales of assets or mergers & acquisitions.

Financing Activities include any sources of cash from investors, banks, or cash paid to those entities.

Operating Activities

Consolidated Statements of Cash Flows

Amounts in millions; fiscal years ended June 30	2023	2022	2021
CASH, CASH EQUIVALENTS AND RESTRICTED CASH, BEGINNING OF YEAR	**$ 7,214**	$ 10,288	$ 16,181
OPERATING ACTIVITIES			
Net earnings	**14,738**	14,793	14,352
Depreciation and amortization	**2,714**	2,807	2,735
Loss on early extinguishment of debt	**—**	—	512
Share-based compensation expense	**545**	528	540
Deferred income taxes	**(453)**	(402)	(258)
Loss/(gain) on sale of assets	**(40)**	(85)	(16)
Change in accounts receivable	**(307)**	(694)	(342)
Change in inventories	**(119)**	(1,247)	(309)
Change in accounts payable and accrued and other liabilities	**313**	1,429	1,391
Change in other operating assets and liabilities	**(1,107)**	(635)	(369)
Other	**564**	229	135
TOTAL OPERATING ACTIVITIES	**16,848**	16,723	18,371

The operating activities reflect money generated by the company's day-to-day business. We start with net earnings (calculated based on accounting principles) and adjust those numbers to subtract any non-cash items such as amortization.

The bottom line will tell you how much "real money" the company made from its daily operations. This example shows that the operating cash flow hasn't moved much from 2022 to 2023. In other words, the business is stable, but it's not growing significantly. If I were going to invest in PG after looking at those numbers, I would like to know why. Chances are that a review of the income statement (mostly looking at revenue) will explain why. From 2022 to 2023, PG sales went from $80B to $82B (+2.5%). A slower global economy and currency headwinds can explain that.

Investing Activities

INVESTING ACTIVITIES			
Capital expenditures	**(3,062)**	(3,156)	(2,787)
Proceeds from asset sales	**46**	110	42
Acquisitions, net of cash acquired	**(765)**	(1,381)	(34)
Other investing activity	**281**	3	(55)
TOTAL INVESTING ACTIVITIES	**(3,500)**	(4,424)	(2,834)

This is where you will see how much the company spends in capital expenditures (CAPEX). CAPEX are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment.

The CAPEX and acquisitions are negative since cash is going out of the company to improve the business or acquire assets. The proceeds are positive since cash flow is coming into the company's bank account.

If you are curious about where the company spends its money, a good old "CTRL+F" to search for "capital expenditures" across the 88-page annual report will provide you with this result:

Investing Cash Flow

Net investing activities used $3.5 billion of cash in 2023, primarily due to capital spending and acquisitions.

Capital Spending. Capital expenditures, primarily to support capacity expansion, innovation and cost efficiencies, were $3.1 billion in 2023. Capital spending as a percentage of net sales decreased 20 basis points to 3.7% in 2023.

Acquisitions. Acquisition activity used cash of $765 million in 2023, primarily related to a Beauty acquisition.

It will help you provide additional context to numbers.

Financing Activities

FINANCING ACTIVITIES			
Dividends to shareholders	**(8,999)**	(8,770)	(8,263)
Additions to short-term debt with original maturities of more than three months	**17,168**	10,411	7,675
Reductions in short-term debt with original maturities of more than three months	**(13,031)**	(11,478)	(7,577)
Net additions/(reductions) to other short-term debt	**(3,319)**	917	(3,431)
Additions to long-term debt	**3,997**	4,385	4,417
Reductions in long-term debt [1]	**(1,878)**	(2,343)	(4,987)
Treasury stock purchases	**(7,353)**	(10,003)	(11,009)
Impact of stock options and other	**1,269**	2,005	1,644
TOTAL FINANCING ACTIVITIES	**(12,146)**	(14,876)	(21,531)
EFFECT OF EXCHANGE RATE CHANGES ON CASH, CASH EQUIVALENTS AND RESTRICTED CASH	**(170)**	(497)	101
CHANGE IN CASH, CASH EQUIVALENTS AND RESTRICTED CASH	**1,032**	(3,074)	(5,893)
CASH, CASH EQUIVALENTS AND RESTRICTED CASH, END OF YEAR	**$ 8,246**	$ 7,214	$ 10,288

The financing activities include the dividends paid to shareholders (negative as its money going out of the bank account), stock repurchase (negative) and debt repayment (negative) or issuance (positive). This segment is of great use if you wish to know if a dividend is safe.

For example, the PG operating cash flow is $16.8B and its investing activities are -$3.5B. Therefore, before paying down debts, buying back shares or paying dividends, PG has $13.3B in cash. Of course, Procter & Gamble must put some money aside for taxes, for example, but it has enough room to pay $8.999B in dividends that year.

You can see in this statement that the company not only paid dividends but also bought back some shares ($7.35B). At the end of this year, PG shows a cash flow improvement of $1,032M (change in cash, cash equivalents and restricted cash).

Despite a slow year, Procter & Gamble managed to show a healthy cash flow statement.

GLOSSARY: REVENUE, EPS, CASH FLOW AND MORE LINGO!

Revenue

Income that a company gains from its business activities, calculated before any expenses are subtracted. This Includes all sales and other increases in owner's equity. Increasing revenues over time are a good sign of a company's growth and solidity.

If a lemonade company has generated 30 million in revenue and has 10 million in costs of goods sold, the company's revenue is still 30 million. Expenses are not accounted for in calculating Revenue.

Earnings per share

Earnings per share (EPS) is the amount of income that "belongs" to each share of common stock. This is a valuable tool for investors as EPS is often used in determining the value of a stock.

The average number of shares outstanding (the denominator of the EPS formula) is usually calculated by averaging the number of shares at the beginning of the earnings period and the number of shares at the end of the period. For example, if a company earned $1 million in 2009 and had 900,000 shares at the beginning of 2009 and 1.1 million shares at the end of 2009, the 2009 EPS would be $1 million/ (.9 million shares + 1.1 million shares)/2] = $1/share.

EPS are reported in annualized form from the most recent fiscal year. From time to time, you will see the abbreviation **"ttm"** associated with earnings per share. That means that the earnings number is the sum of the previous four quarters, which is not necessarily the same as the previous fiscal year.

Net income

Net income is what remains of a company's revenue after subtracting all costs. It is also referred to as net profit, earnings, or the bottom line. Net Income that is not paid out in dividends is added to retained earnings. Increasing (decreasing) net income is a good (or bad) sign for a company's profitability. Companies with consistent and increasing net income over time are looked at very favorably by stockholders and analysts.

Working capital

The difference between current assets and current liabilities. Working Capital is the amount of liquid assets that a company possesses to build its business.

Working capital is the funds used for operational liquidity. A firm often has day to day liquidity needs that require short term liquidity. Large quantities of working capital indicate the potential to expand quickly. Firms needing to make quick equipment purchases benefit from being able to use working capital for those expenditures. Firms that do not have sufficient working capital (or negative amounts) may find themselves having to borrow that needed money from other sources thereby potentially slowing down growth.

While having a surplus of working capital is good for facilitating growth, excess amounts of working capital may mean the company needs to focus on finding better uses for its current assets.

Change in working capital

Change in Other Working Capital is a line item in the consolidated statement of cash flows, and specifically the operating cash flow section.

Change in working capital is one of the major ways that net income and operating cash flow can differ. A company is investing in assets or becoming less efficient when the change in working capital is negative and depleting assets or becoming more efficient when the change in working capital is positive.

Capital expenditure (aka CAPEX)

Capex is incurred when a business spends money to purchase fixed assets or to add value to an existing fixed asset. In accounting, a capital expenditure is added to an asset account, thus increasing the value of the asset.

Examples of capital expenditures include the purchase of a new manufacturing plant, investment in server farms for tech companies, or other purchases of assets expected to help the company earn profits in the future.

Unlike other investments like research and development and marketing expenditures, capital spending is not immediately expensed. Rather, property, plant and equipment acquired using capital expenditures are usually expensed over time using depreciation.

You can go back to these definitions and some more any time on the DSR Glossary page.