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Cash Flow Trends and Their Fundamental Drivers:

Comprehensive Industry Review (Qtr 3, 2009)

FREE CASH MARGIN INDEX:

2.43, 4.12	5.36	5.14
Recession Lows (Mar. 2001, Dec. 2008)	Current (Sept. 2009)	Last Expansion High (June, 2004)

In this research paper we report free cash margin and its determining factors for our sample of 3,704 non-financial companies with market caps exceeding \$50 million measured for the twelve months ended September 2009. Our results indicate that for the September 2009 period, free cash margin improved to 5.36%, which is its highest level since we began tracking the metric in March 2000. The improvement appears to be driven primarily by a decrease in capital expenditures. As a percent of revenue capital spending is now lower than it has been for any reporting period since March 2000 – even significantly lower than it was during the 2001 recession. Increases in capital spending will weigh on free cash margin in future periods.

In the third quarter we did note a significant increase in inventory days, which is now at pre-recession levels. Receivables days and payables days also increased, but remain below pre-recession amounts.

For the twelve months ended September 2009, eleven industry sectors reported improved free cash margin from the same period in 2008, while one sector saw free cash margin decline. Eight sectors saw their free cash margin remain relatively stable.

Please refer to our website, www.mgt.gatech.edu/finlab where spreadsheets of our cash flow data are provided.

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

December, 2009

**Georgia Tech Financial Analysis Lab
College of Management
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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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Cash Flow Trends and Their Fundamental Drivers: Comprehensive Industry Review (Qtr 3, 2009)

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Cash Flow Trends and Their Fundamental Drivers: Comprehensive Industry Review (Qtr 3, 2009)

FREE CASH MARGIN INDEX*:

2.43, 4.12

5.36

5.14

Recession Lows (Mar. 2001, Dec. 2008)

Current (Sept. 2009)

Last Expansion High (June, 2004)

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 third quarter of 2009. Additionally, we look at the 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 3,704 companies. Please see pages 6-8 for a list of the industry sectors and 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.

Our industry spreadsheets that detail trends in free cash margin and its underlying drivers for 20 separate four-digit GICS industry sectors and 61 six-digit GICS industries for the 3rd Quarter 2009 have been posted to our website. The spreadsheets, which will continue to be updated quarterly, can be found 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.

Cash Flows During Recessions

During periods of economic contraction, revenues and profitability decline. A company’s ability to generate cash flow declines as well. A decline in a firm’s ability to generate cash is of particular concern given the importance of cash flow to a firm’s economic well being. 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, but even if this were an option, increasing debt levels add new, unwanted risks. Equity issues provide another avenue, but capital markets are painfully dilutive when share prices are depressed by recession. Thus, free cash margin serves as an important measure of long-term financial health and one that is particularly relevant during a recession.

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 such as the S&P 500, or of different industry groups. With data dating back to 2000, we will see how the cash-generating performance of these firms presently compares with their performance during the 2001 recession.

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, 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, 2009 represent amounts for the twelve months (four quarters) ending September 30, 2009.

Industries

The 20 four-digit GICS industry sectors (**in bold**) and 61 six-digit GICS industries are as follows:

- **Energy – 1010**
- Energy Equipment & Services – 101010
- Oil, Gas & Consumable Fuels – 101020
- **Materials – 1510**
- Chemicals – 151010
- Construction Materials – 151020
- Containers & Packaging – 151030
- Metals & Mining – 151040
- Paper & Forest Products – 151050
- **Capital Goods – 2010**
- Aerospace & Defense – 201010
- Building Products – 201020
- Construction & Engineering – 201030
- Electrical Equipment – 201040
- Industrial Conglomerates – 201050
- Machinery – 201060
- Trading Companies & Distributors – 201070
- **Commercial & Professional Services – 2020**
- Commercial Services & Supplies – 202010
- Professional Services – 202020

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

Cash Flow Trends and Their Fundamental Drivers: Comprehensive Industry Review (Qtr 3, 2009). (c) 2009 by the College of Management, Georgia Institute of Technology, Atlanta, GA 30332-0520.

- **Transportation – 2030**
 - Air Freight & Logistics – 203010
 - Airlines – 203020
 - Marine – 203030
 - Road & Rail – 203040
 - Transportation Infrastructure – 203050
- **Automobiles & Components – 2510**
 - Auto Components – 251010
 - Automobiles – 251020
- **Consumer Durables & Apparel – 2520**
 - Household Durables – 252010
 - Leisure Equipment & Products – 252020
 - Textiles, Apparel & Luxury Goods – 252030
- **Consumer Services – 2530**
 - Hotels, Restaurants & Leisure – 253010
 - Diversified Consumer Services – 253020
- **Media – 2540**
 - Media – 254010
- **Retailing – 2550**
 - Distributors – 255010
 - Internet & Catalog Retail – 255020
 - Multiline Retail – 255030
 - Specialty Retail – 255040
- **Food & Staples Retailing – 3010**
 - Food & Staples Retailing – 301010
- **Food Beverage & Tobacco – 3020**
 - Beverages – 302010
 - Food Products – 302020
 - Tobacco – 302030
- **Household & Personal Products – 3030**
 - Household Products – 303010
 - Personal Products – 303020
- **Health Care Equipment & Services – 3510**
 - Health Care Equipment & Supplies – 351010
 - Health Care Providers & Services – 351020
 - Health Care Technology – 351030
- **Pharmaceuticals, Biotechnology & Life Sciences – 3520**
 - Biotechnology – 352010
 - Pharmaceuticals – 352020
 - Life Sciences Tools & Services – 352030
- **Software & Services – 4510**
 - Internet Software & Services – 451010
 - It Services – 451020
 - Software – 451030

- **Technology Hardware & Equipment - 4520**
- Communications Equipment – 452010
- Computers & Peripherals – 452020
- Electronic Equipment, Instruments & Components – 452030
- Office Electronics – 452040
- Semiconductor Equipment & Products – 452050
- **Semiconductors & Semiconductor Equipment – 4530**
- Semiconductors & Semiconductor Equipment – 453010
- **Telecommunication Services – 5010**
- Diversified Telecommunication Services – 501010
- Wireless Telecommunication Services – 501020
- **Utilities – 5510**
- Electric Utilities – 551010
- Gas Utilities – 551020
- Multi-utilities – 551030
- Water Utilities – 551040
- Independent Power Producers & Energy Traders – 551050

Results: All Non-financial Companies

In the exhibits below we present a graph of free cash margin and its underlying drivers, including operating cushion, capital expenditures to revenue, income taxes paid to revenue, and cash cycle. These exhibits were drawn using data from our complete sample of companies, including firms from all 20 industry sectors with market caps exceeding \$50 million. A total of 3,704 companies are included. These summary graphs are followed with exhibits that show the trend in free cash margin for each of the 20 industry sectors. For more details on each industry sector and 61 component industries, please refer to the individual industry spreadsheets reports that are available on our website (www.mgt.gatech.edu/finlab).

Even in the midst of a recession and periods of increasing unemployment, free cash margin has reached its highest mark (5.36%) since we began tracking the metric in 2000. The previous high was reached during June 2004 with a free cash margin of 5.14%. Firms have been quite adept at wringing as much cash flow from operations as possible.

What is particularly remarkable about the feat is that firms have continued to improve on free cash margin even as median revenue has declined. Median revenue for our sample of firms peaked a year ago, in the twelve months ending September 2008, at \$751.1 million, and it has been falling ever since. For the twelve months ended September 2009, median revenue for our sample was measured at \$528.4 million, a 29.7% decline. Normally, profit margins, and free cash margin is a cash flow-based profit margin, are expected to decline with revenue. Indeed, net margin, declined from 6.08% for the twelve months ended September 2008 to 3.27% for the twelve months ended September 2009. Similarly, operating cushion, a measure of cash flow profitability, calculated as operating profit before depreciation, also worsened, declining to

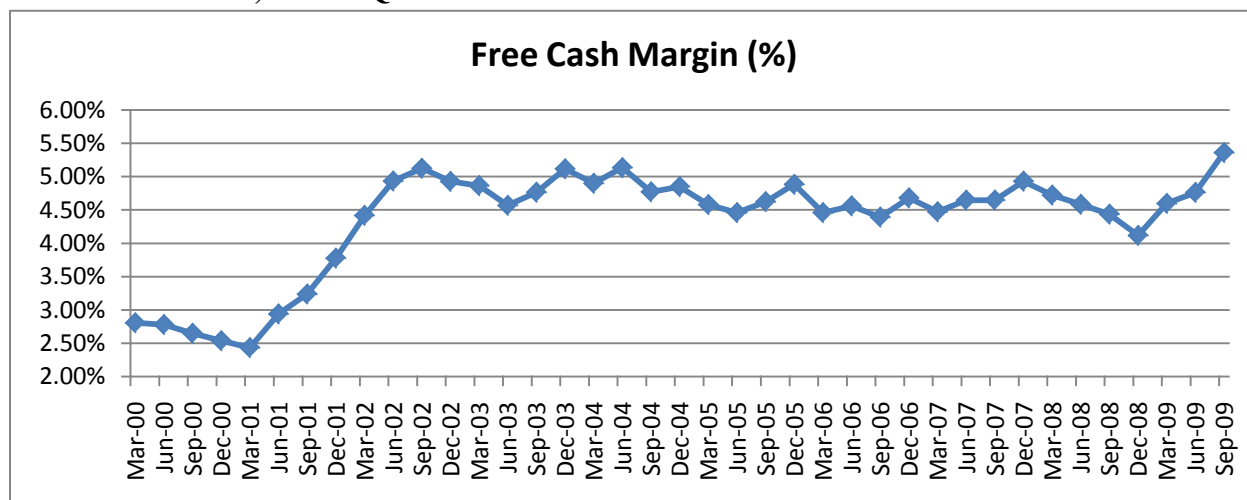
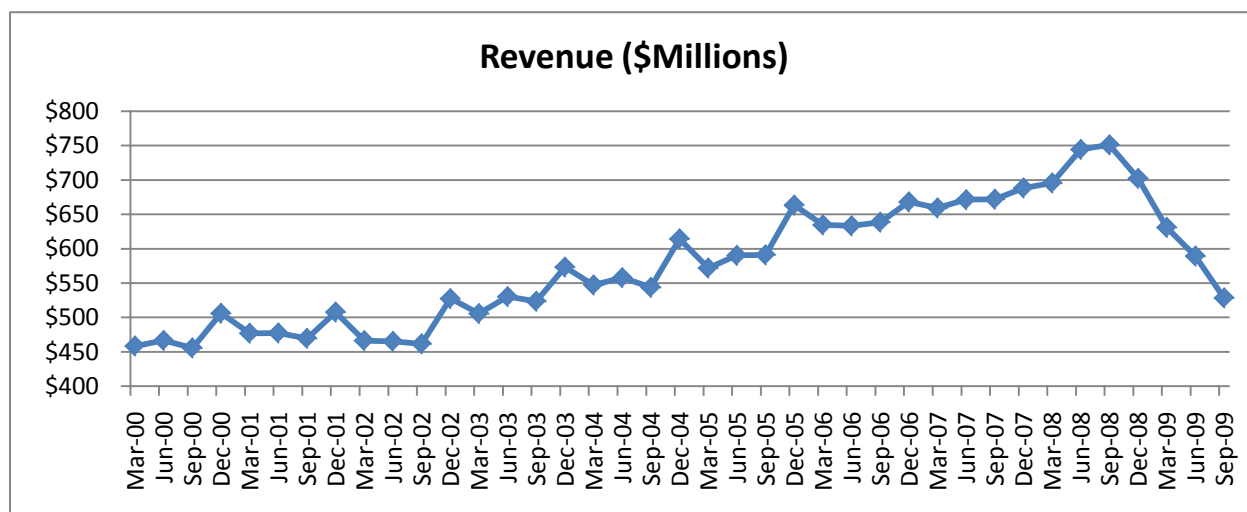
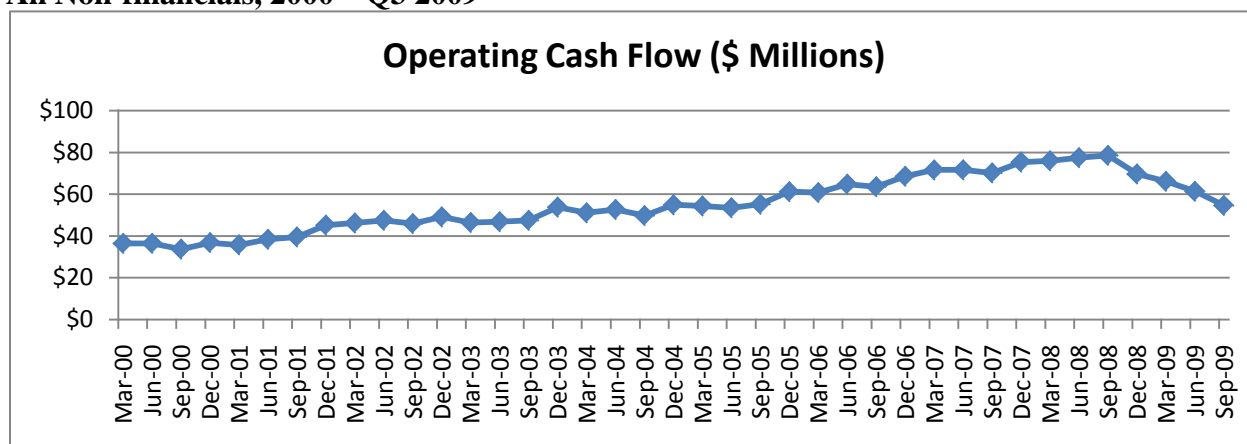
13.91% in the twelve months ended September 2009 from 16.17% for the twelve months ended September 2008.

Also working against an improvement in free cash margin was an observed increase in the cash cycle, which was pushed upward by a renewed interest in our sample companies to build inventories. Measured in terms of revenue days, inventory increased to 24.52 days at September 2009 from 20.75 days at June 2009. This is the first meaningful increase in inventory days that we have seen since the twelve months ended June 2008, bringing inventory days to levels that existed before the recession began. Companies appear to be 'stocking up' in anticipation of higher company sales. Days receivables and days payables also increased, but remained well below pre-recession levels. The combined increase in these working capital accounts pushed the median cash cycle upward to 48.64 days at September 2009 from 43.52 days at June 2009.

Helping to improve free cash margin for the twelve months ended September 2009 was a decline income taxes paid measured as a percent of revenue. The metric declined to .92% of revenue for the twelve months ended September 2009 from 1.35% at September 2008 and .99% at June 2009. The real driver, however, behind the improving free cash margin noted for the twelve months ended with the third quarter 2009 is a reduction in capital expenditures measured as a percent of revenue. For the twelve months ended September 2009, capital expenditures declined to 3.02% of revenue from 4.15% for the period ended September 2008 and 3.76% for the June 2009 reporting period. As a point of reference, capital expenditures measured as a percent of revenue measured as high as 4.39% as recently as the twelve months ended March 2008. Interestingly, during the last 2001 recession, companies did not reduce capital spending the way they are this time. In fact, capital expenditures measured as a percent of revenue peaked at 5.09% in the period ended December 2000 and remained as high as 4.68% throughout that recession. It was only after the recession ended that firms began to reduce their capital spending and build free cash margin. The open question that the Q3 2009 data cannot answer is when will companies return to pre-recession levels of capital spending and what impact will that increase capital expenditures have on free cash margin? We will watch and report.

A Declining Level of Cash Flow

It should be pointed out that the actual level of cash flow generated in September 2009 continued a decline that began in December 2008. Driven by the decline in revenue noted above, median operating cash flow declined from \$78,579,000 in September 2008 to \$54,598,000 in September 2009. Free cash flow declined as well, but the decent was tempered by a reduction in capital expenditures. Graphs of the data with additional commentary follow.

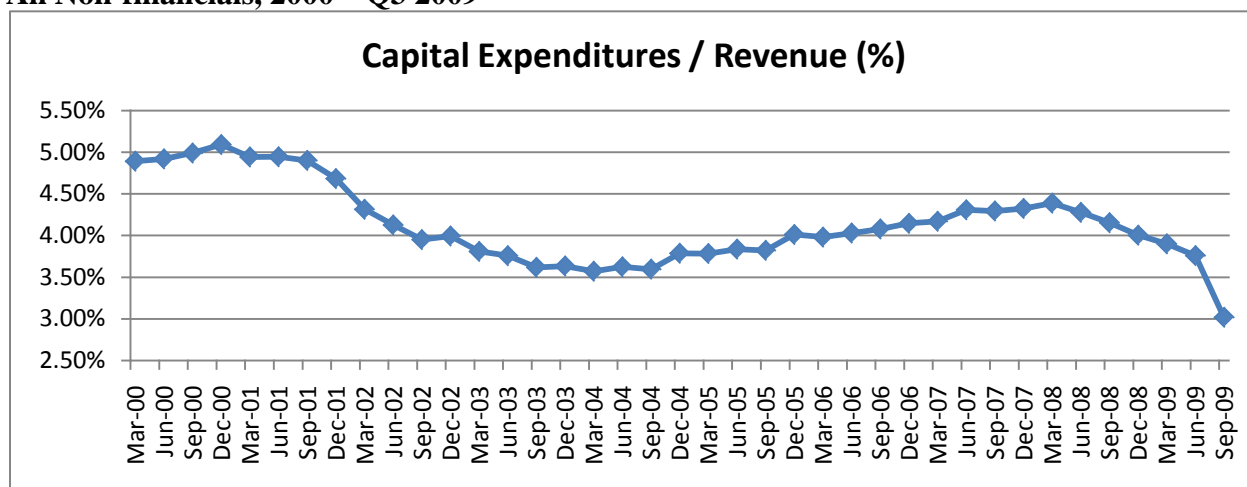
All Non-financials, 2000 – Q3 2009**All Non-financials, 2000 – Q3 2009**

As seen in the graphs above, free cash margin hit this recession's low of 4.12% in December 2008 and has been increasing ever since, to 5.36% for the twelve months ended with the third

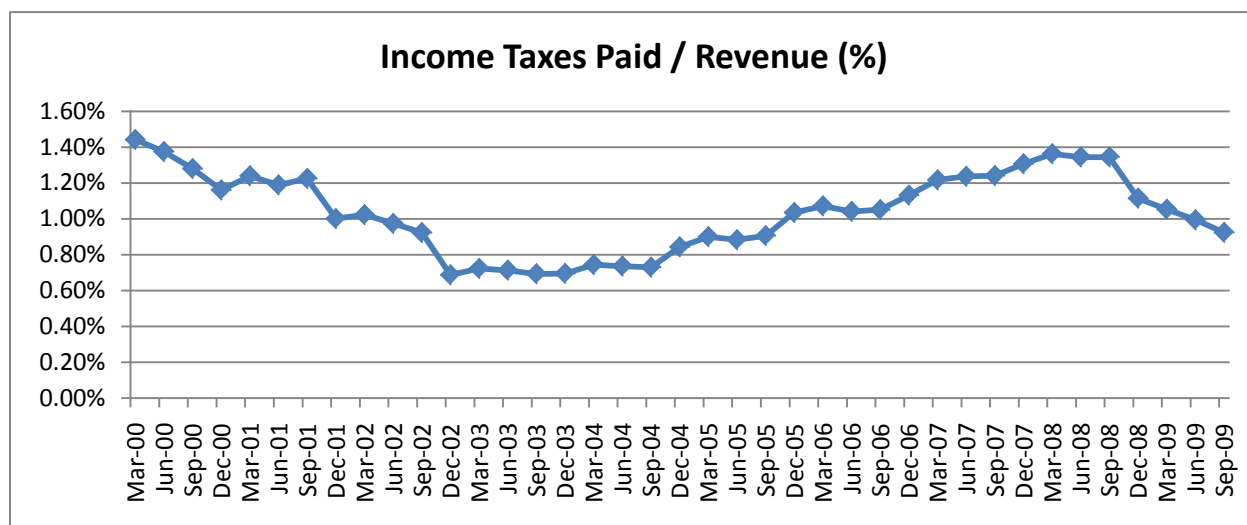
Cash Flow Trends and Their Fundamental Drivers: Comprehensive Industry Review (Qtr 3, 2009). (c) 2009 by the College of Management, Georgia Institute of Technology, Atlanta, GA 30332-0520.

quarter of 2009. The improvement in free cash margin notwithstanding, driven by a decline in revenue, actual operating cash flow continued to decline during the third quarter of 2009. And, while not graphed here, driven by a decline in median revenue, median free cash flow also declined.

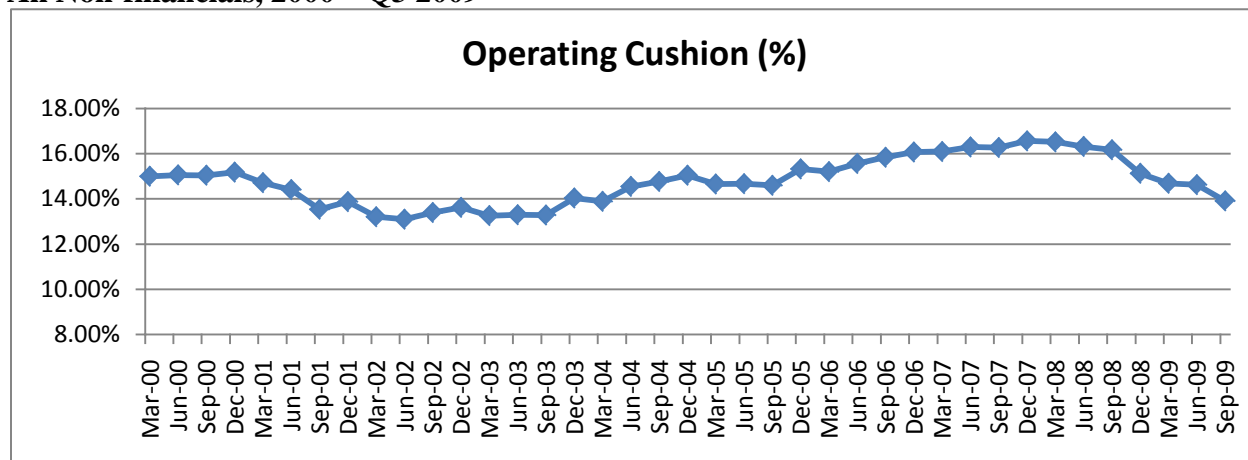
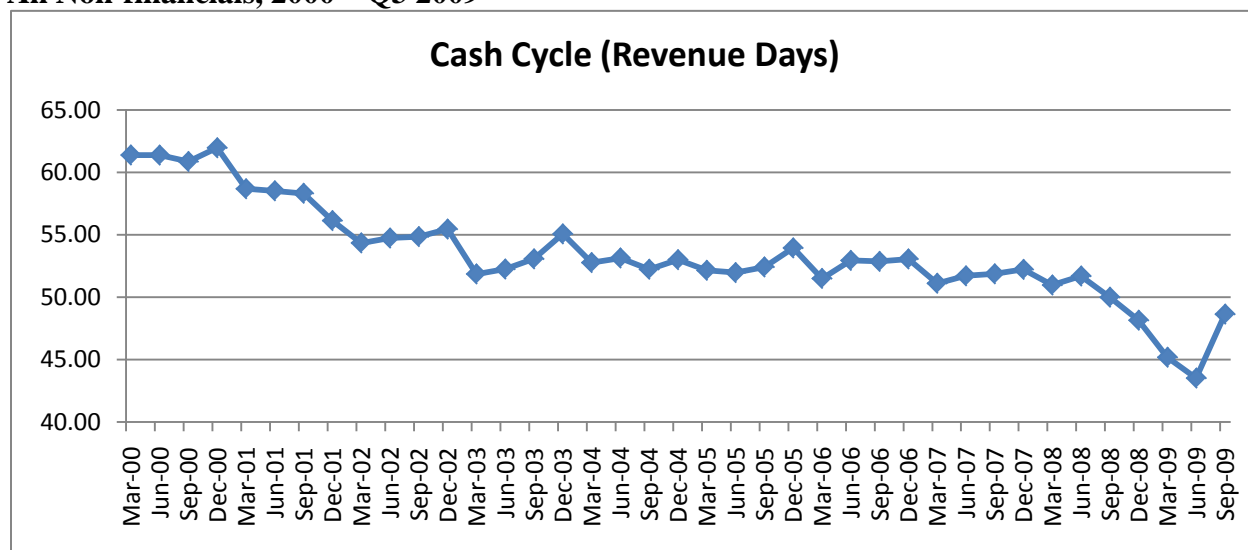
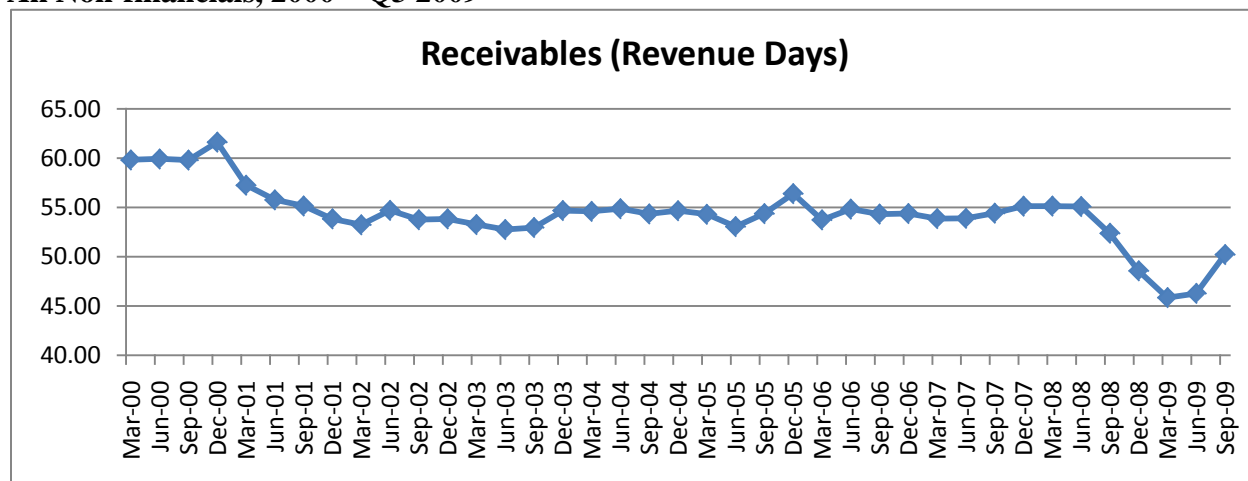
All Non-financials, 2000 – Q3 2009

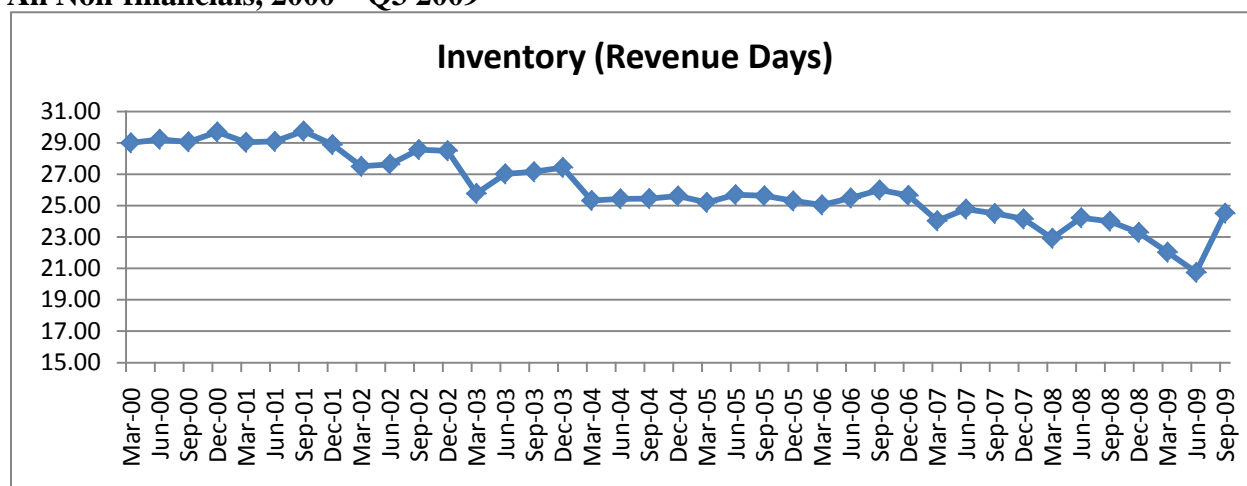
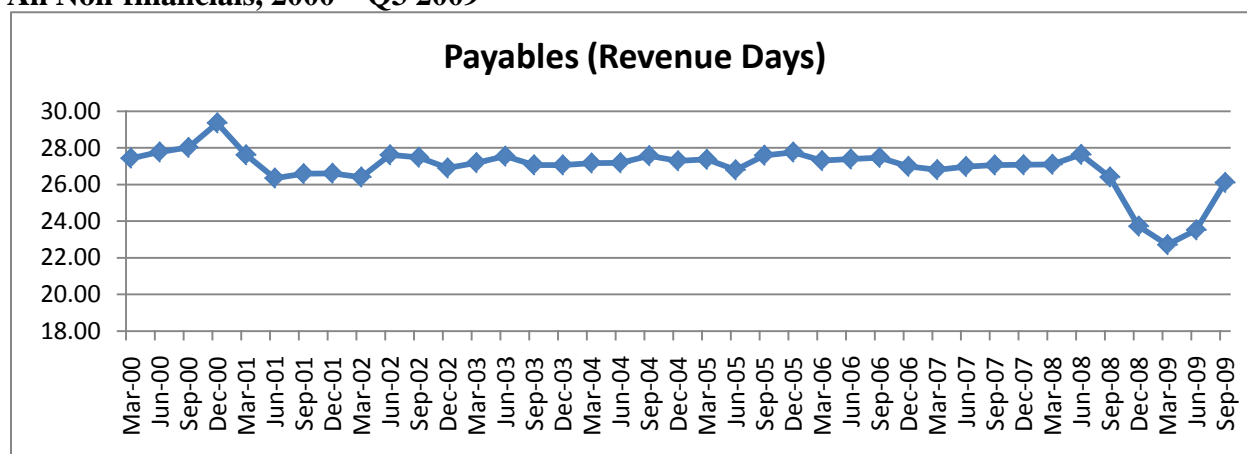


All Non-financials, 2000 – Q3 2009



The improvement in free cash margin was driven by a decline in income taxes paid as a percent of revenue and, especially by the noted drop in capital expenditures, both evident in the graphs above.

All Non-financials, 2000 – Q3 2009**All Non-financials, 2000 – Q3 2009****All Non-financials, 2000 – Q3 2009**

All Non-financials, 2000 – Q3 2009**All Non-financials, 2000 – Q3 2009**

The decline in operating cushion and the increase in the cash cycle, driven by increases in accounts receivable and inventory, net of the effects of increasing accounts payable, are evident in the graphs above.

Results: Industry Sectors

In observing the individual industry trends in free cash margin, the stability seen in the sample-wide data is not apparent across all industries studied. For example, of the 20 four-digit GICS industry sectors studied, during the twelve months ended September 2009 when compared with other recent twelve-month ending periods, we saw moderate to substantial improvement in free cash margin in eleven industries and a relatively stable free cash margin in eight industries. We saw a decline in free cash margin in one industry, Pharmaceuticals, Biotechnology and Life Sciences that can be attributed to an increase in receivables days and inventory days and a decline in payables days. In the industry, capital spending was reduced, but less than the decline seen in the overall sample.

Industry sectors with improving free cash margin:

Materials (GICS 1510)
Capital Goods (GICS 2010)
Commercial and Professional Services (GICS 2020)
Automobiles and Components (GICS 2510)
Consumer Durables and Apparel (GICS 2520)
Consumer Services (GICS 2530)
Retailing (GICS 2550)
Food and Staples Retailing (GICS 3010)
Food, Beverage and Tobacco (GICS 3020)
Household and Personal Products (GICS 3030)
Telecommunications Services (GICS 5010)

Industry sectors with stable free cash margin:

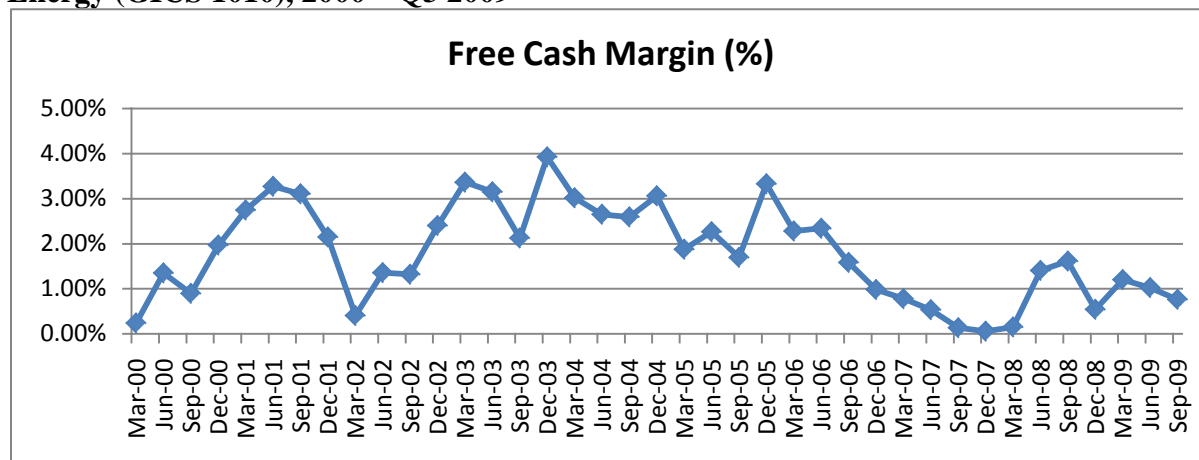
Energy (GICS 1010)
Transportation (GICS 2030)
Media (GICS 2540)
Healthcare Equipment and Services (GICS 3510)
Software and Services (GICS 4510)
Technology Hardware and Equipment (GICS 4520)
Semiconductors and Semiconductor Equipment (GICS 4530)
Utilities (GICS 5510)

Industry sectors with declining free cash margin:

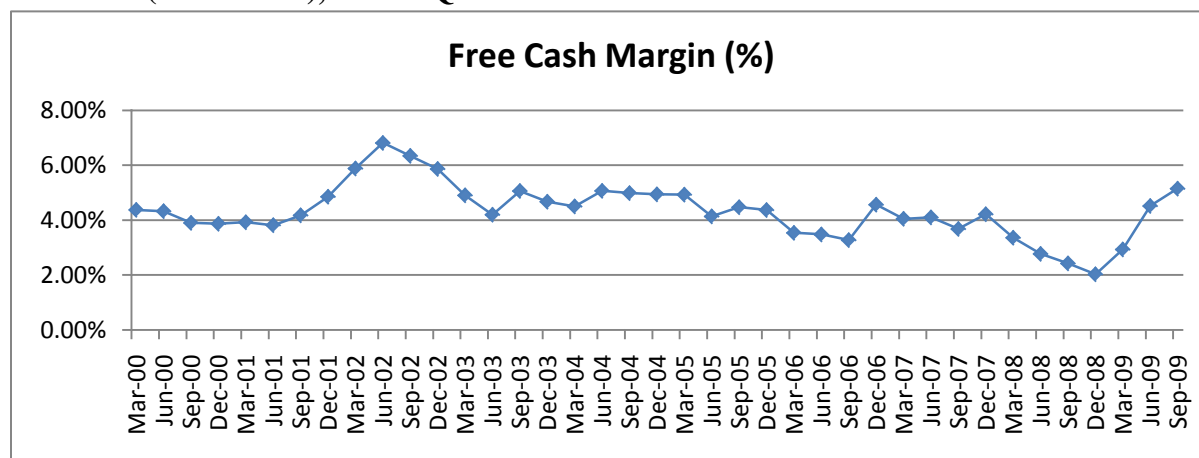
Pharmaceuticals, Biotechnology and Life Sciences (GICS 3520)

Please refer to the individual industry spreadsheets, available on our website at www.mgt.gatech.edu/finlab, for further detail on the industries discussed in this report.

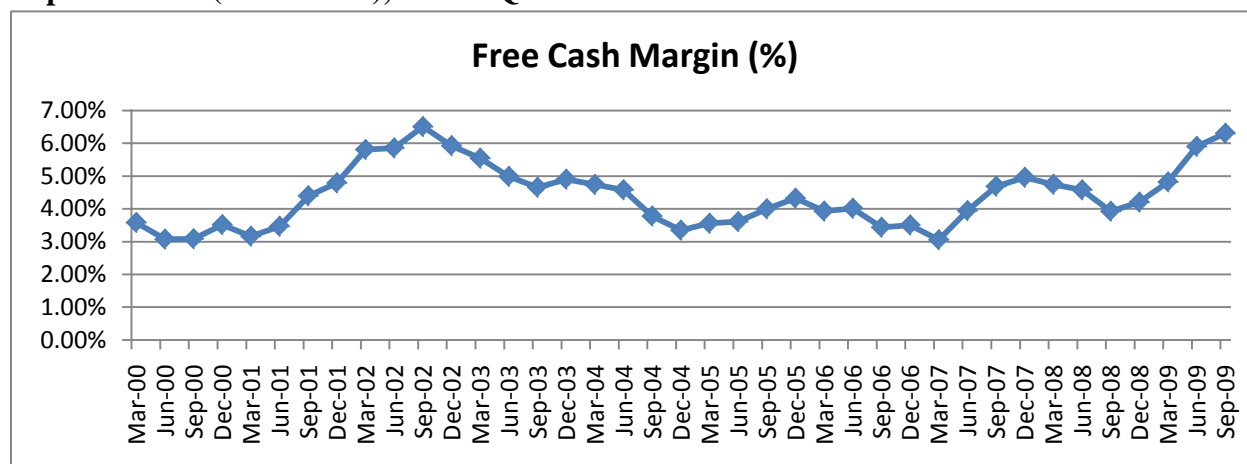
Our results show the following trends in free cash margin:

Energy (GICS 1010), 2000 – Q3 2009

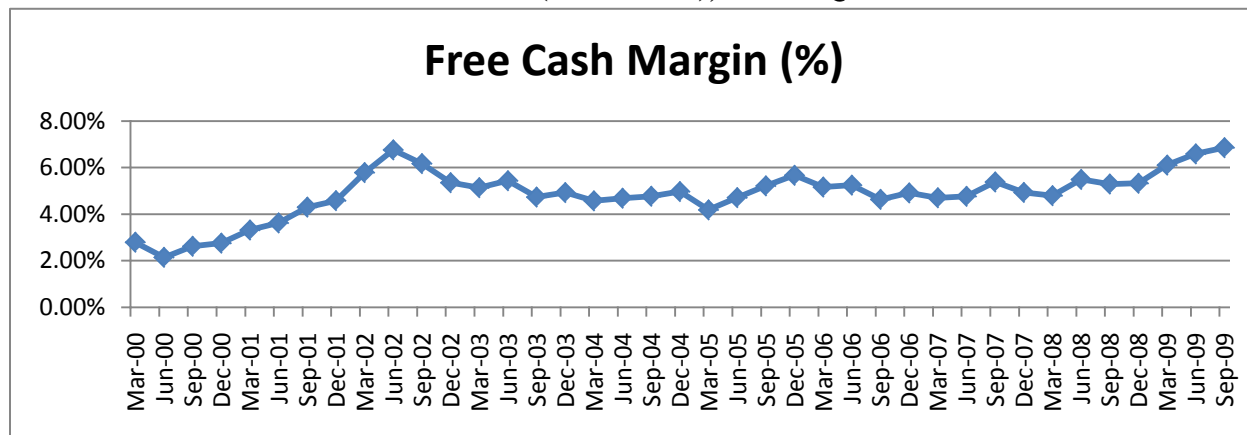
See industry specific spreadsheet for details.

Materials (GICS 1510), 2000 – Q3 2009

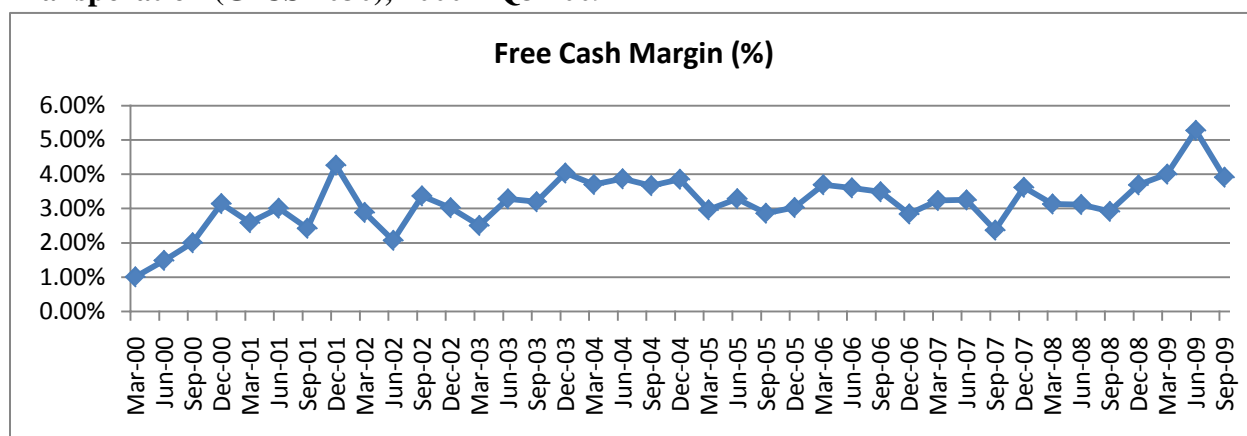
See industry specific spreadsheet for details.

Capital Goods (GICS 2010), 2000 – Q3 2009

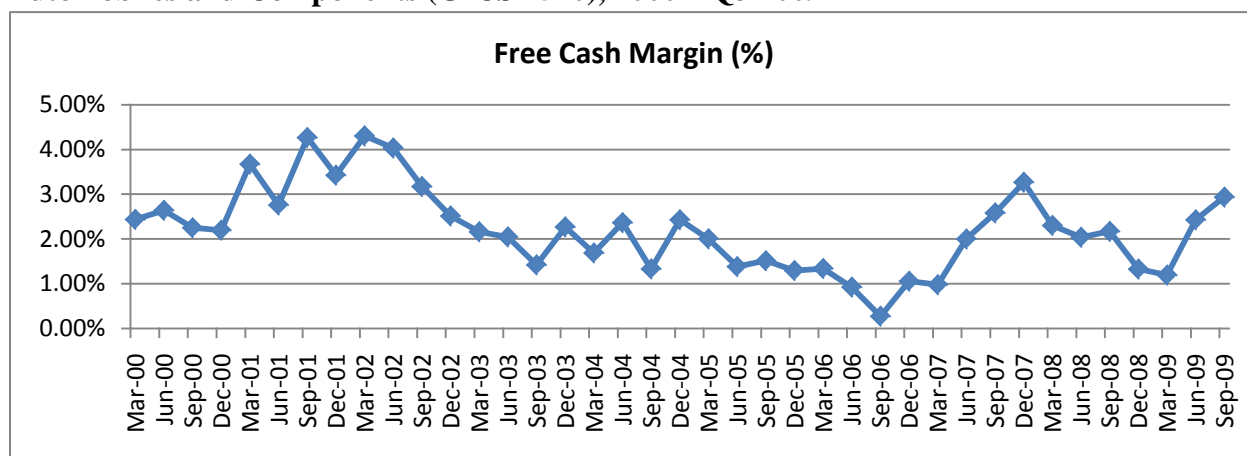
See industry specific spreadsheet for details.

Commercial and Professional Services (GICS 2020), 2000 – Q3 2009

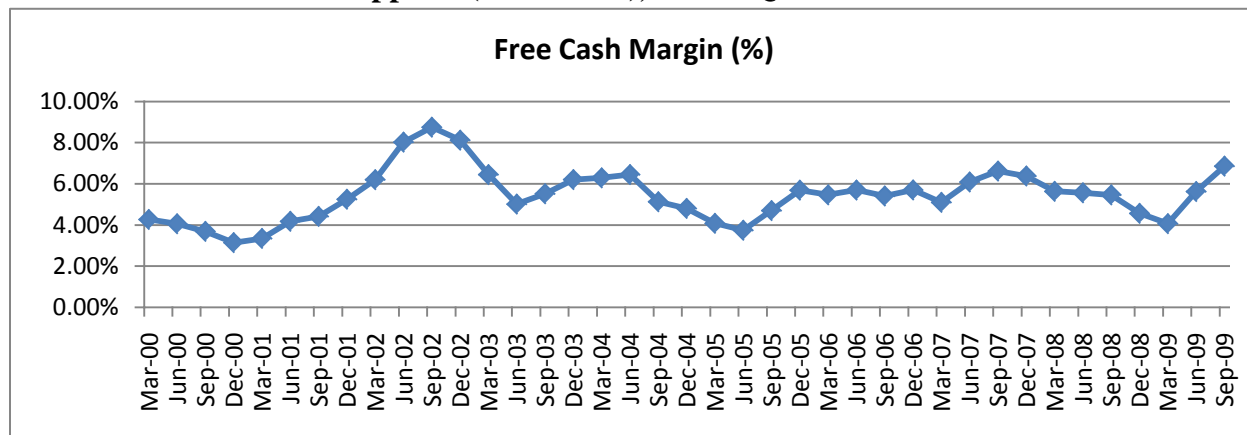
See industry specific spreadsheet for details.

Transportation (GICS 2030), 2000 – Q3 2009

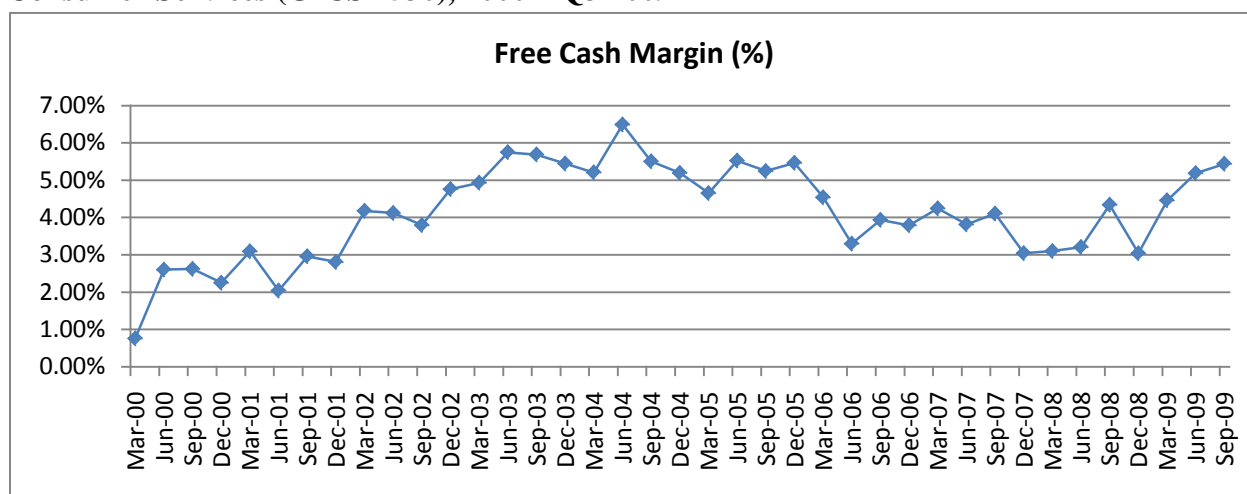
See industry specific spreadsheet for details.

Automobiles and Components (GICS 2510), 2000 – Q3 2009

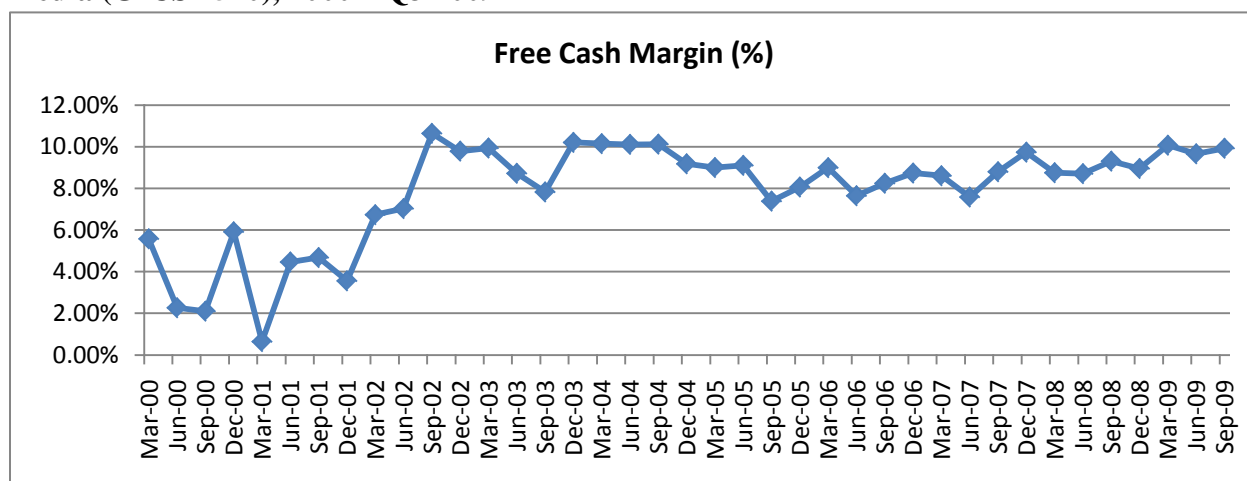
See industry specific spreadsheet for details.

Consumer Durables and Apparel (GICS 2520), 2000 – Q3 2009

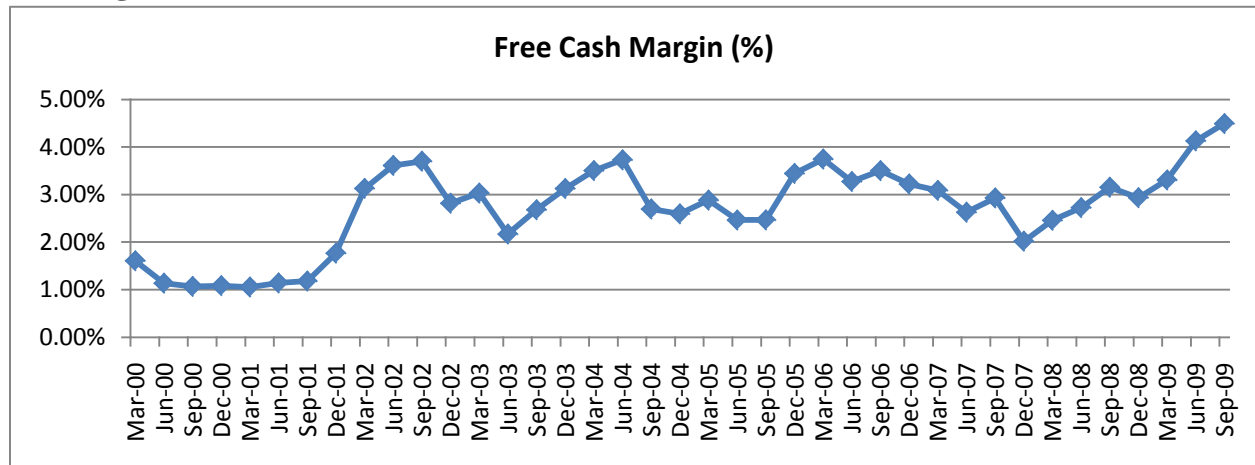
See industry specific spreadsheet for details.

Consumer Services (GICS 2530), 2000 – Q3 2009

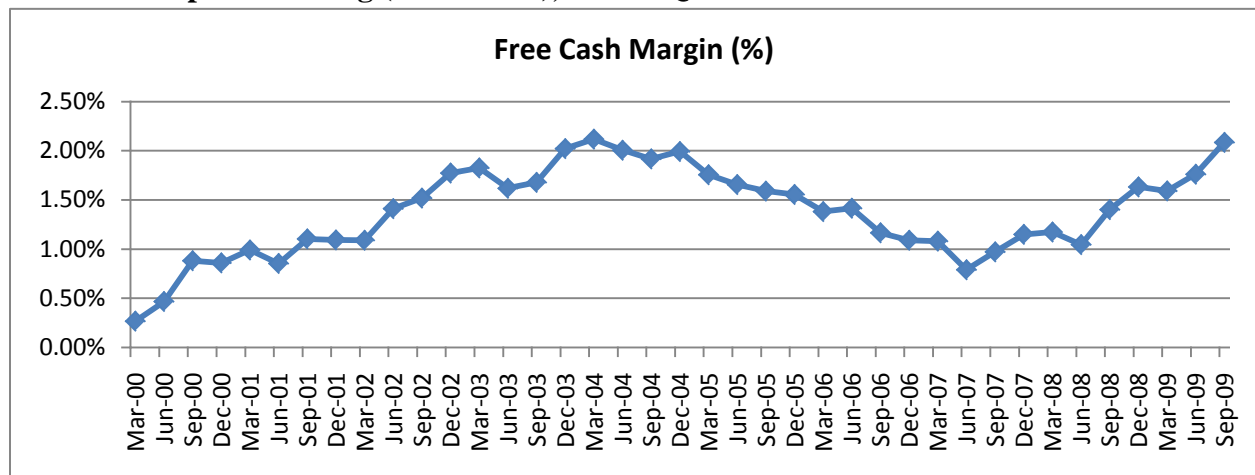
See industry specific spreadsheet for details.

Media (GICS 2540), 2000 – Q3 2009

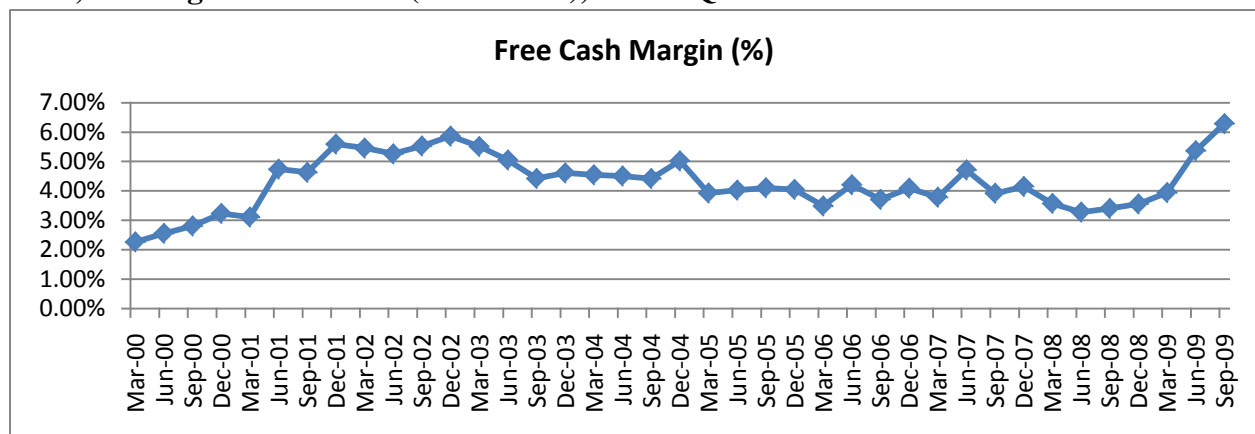
See industry specific spreadsheet for details.

Retailing (GICS 2550), 2000 – Q3 2009

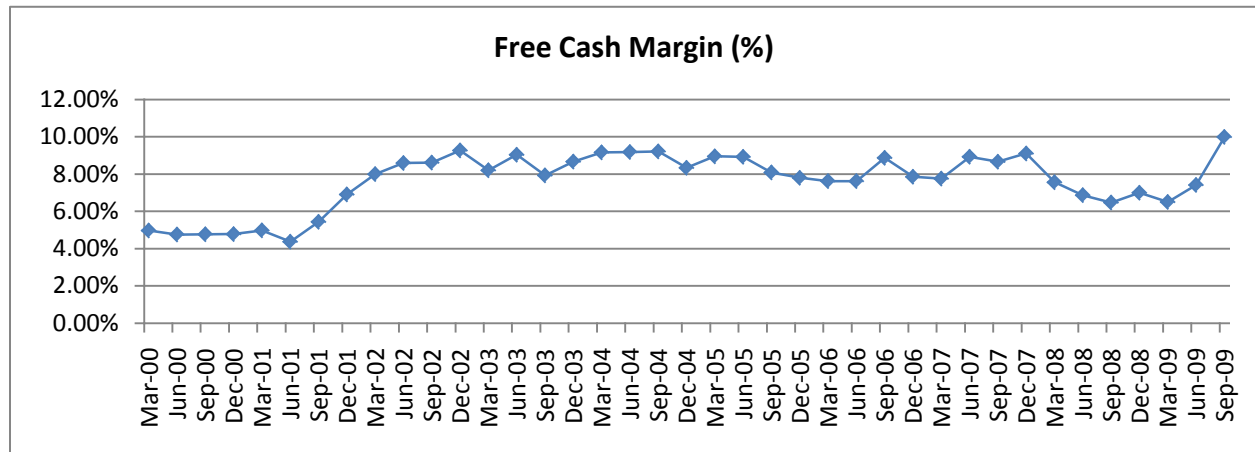
See industry specific spreadsheet for details.

Food and Staples Retailing (GICS 3010), 2000 – Q3 2009

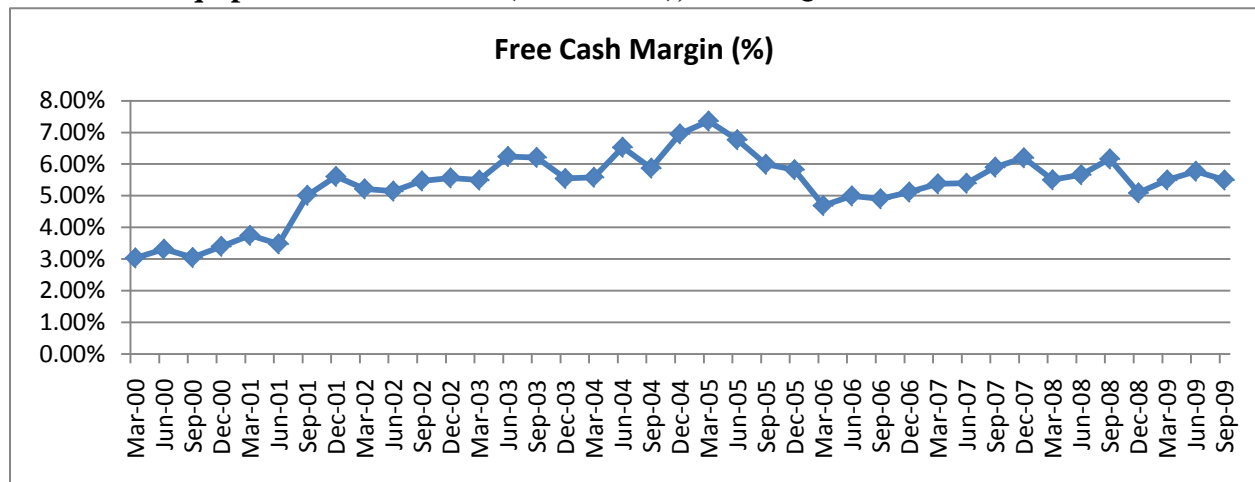
See industry specific spreadsheet for details.

Food, Beverage and Tobacco (GICS 3020), 2000 – Q3 2009

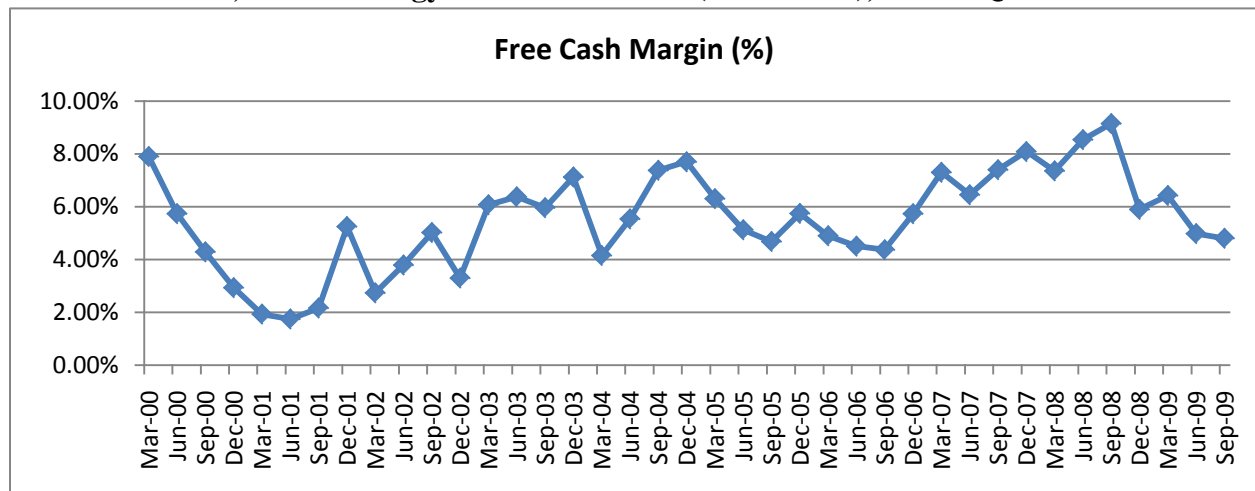
See industry specific spreadsheet for details.

Household and Personal Products (GICS 3030), 2000 – Q3 2009

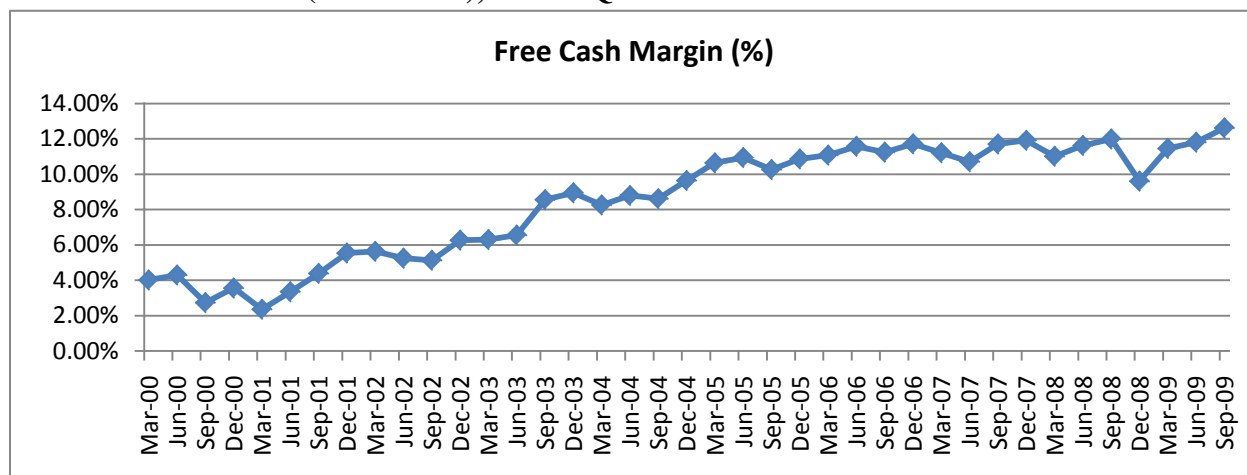
See industry specific spreadsheet for details.

Healthcare Equipment and Services (GICS 3510), 2000 – Q3 2009

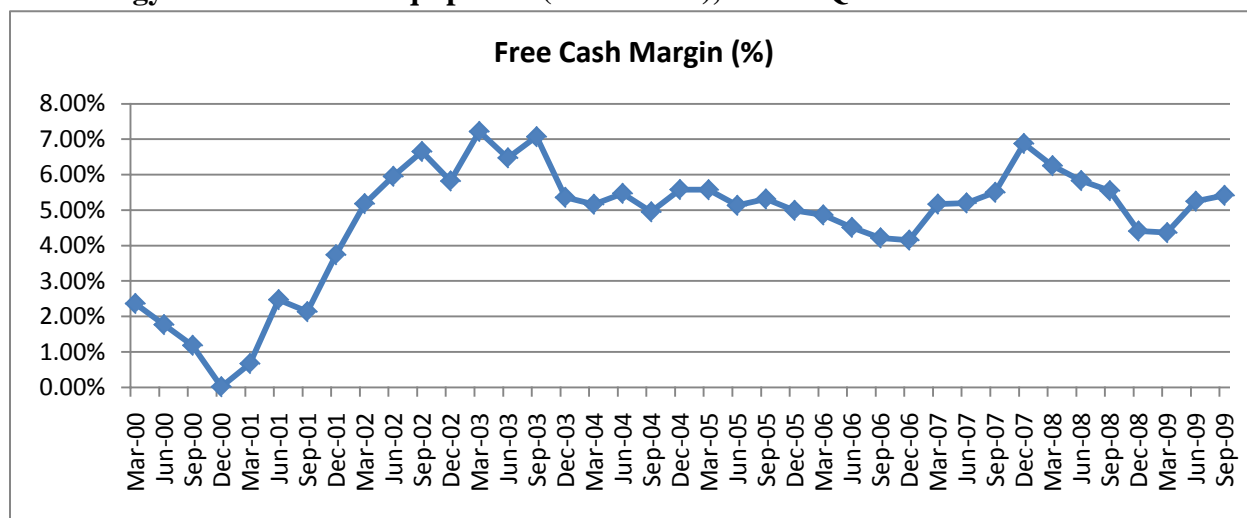
See industry specific spreadsheet for details.

Pharmaceuticals, Biotechnology and Life Sciences (GICS 3520), 2000 – Q3 2009

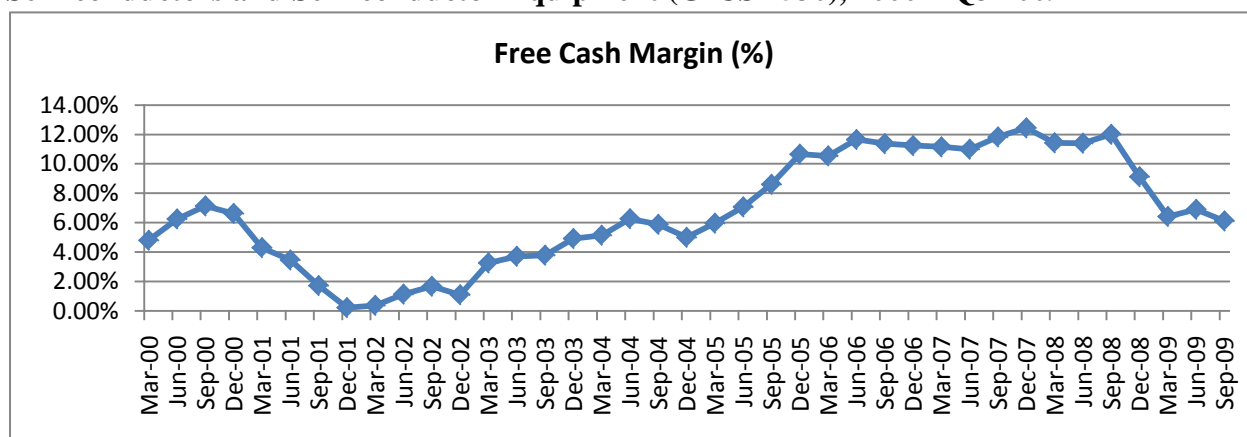
See industry specific spreadsheet for details.

Software and Services (GICS 4510), 2000 – Q3 2009

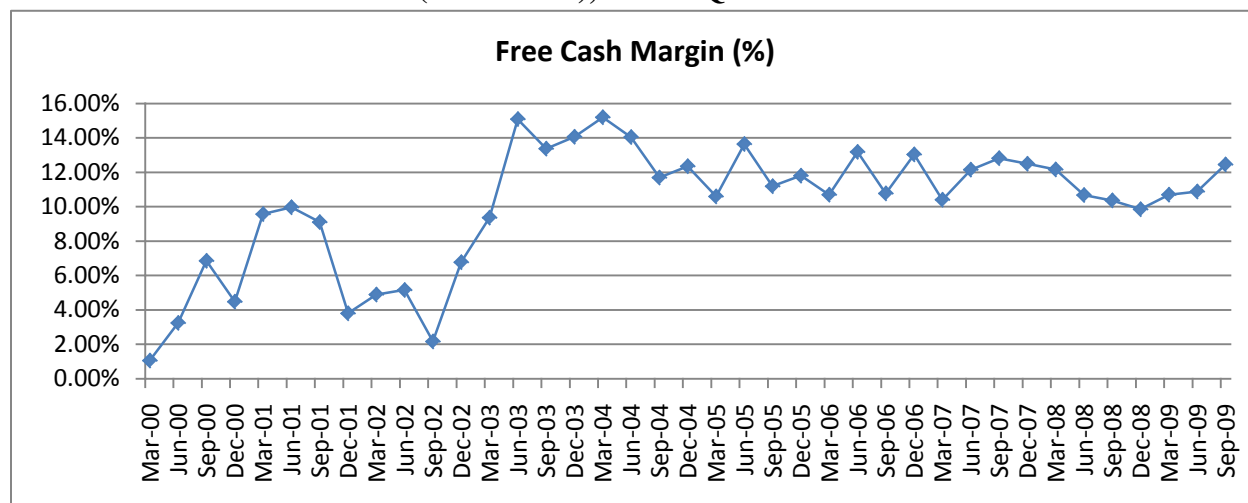
See industry specific spreadsheet for details.

Technology Hardware and Equipment (GICS 4520), 2000 – Q3 2009

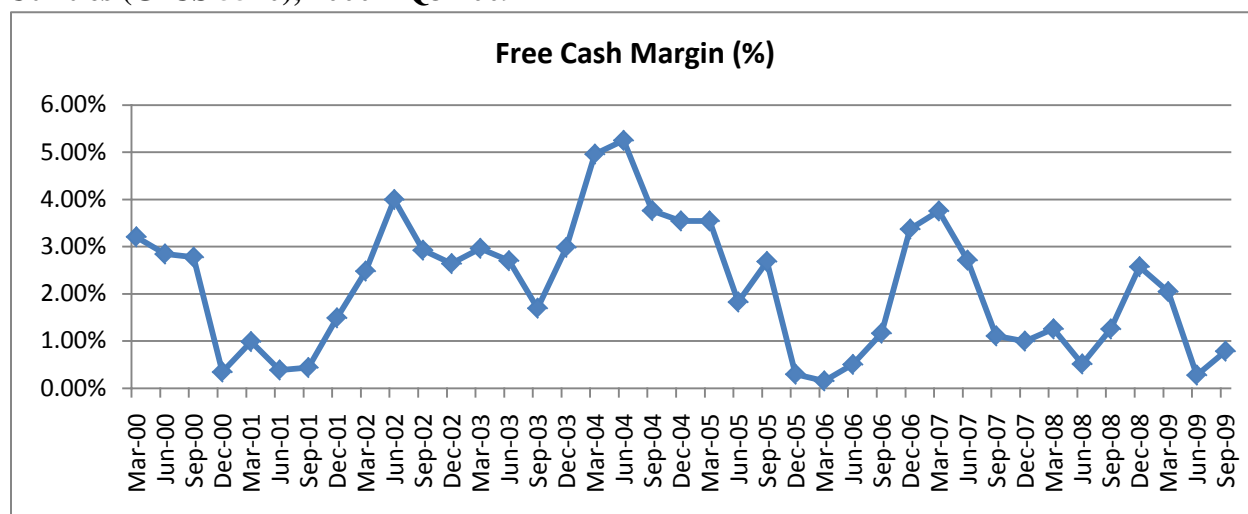
See industry specific spreadsheet for details.

Semiconductors and Semiconductor Equipment (GICS 4530), 2000 – Q3 2009

See industry specific spreadsheet for details.

Telecommunications Services (GICS 5010), 2000 – Q3 2009

See industry specific spreadsheet for details.

Utilities (GICS 5510), 2000 – Q3 2009

See industry specific spreadsheet for details.

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.

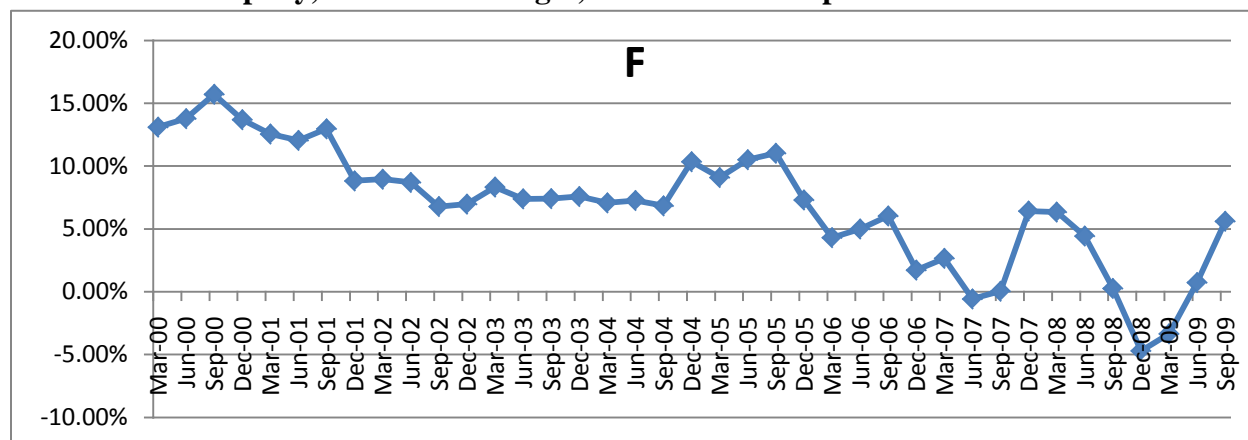
Improving free cash margin

Among the industry sectors with improving free cash margin, there are three groups that stand out. The first is the Automobiles & Components industry sector (GICS 2510). For this group, free cash margin improved to 2.94% for the twelve months ended September 2009, up from 1.20% in March 2009 and 2.17% in September 2008. One company in this industry that showed particular improvement is Ford Motor Company (F).

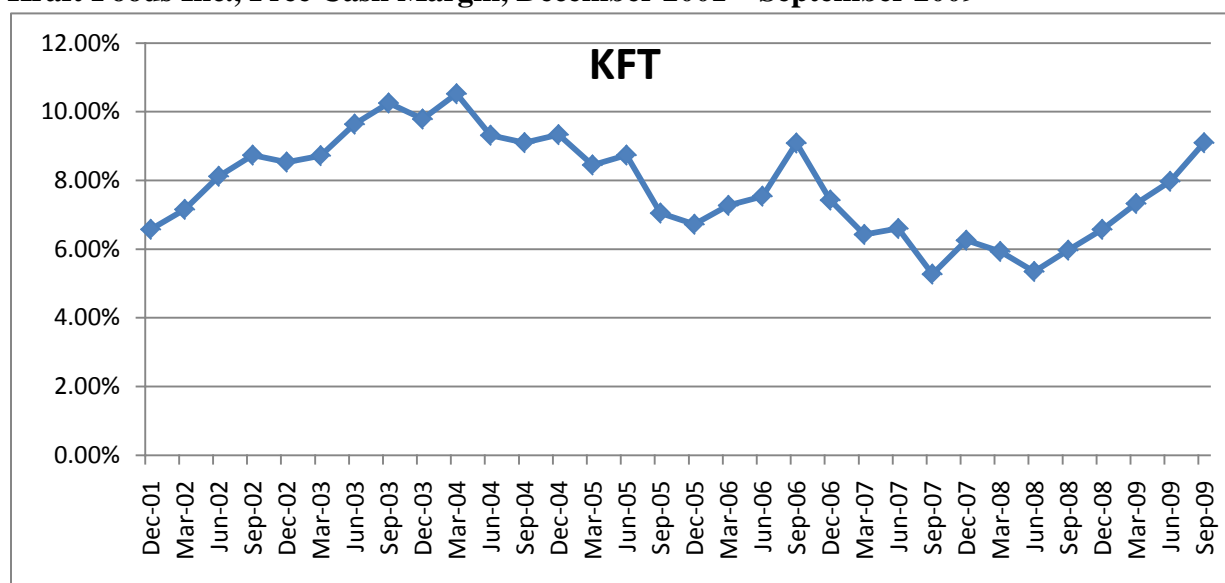
Second, we saw improving fortunes in the Food, Beverage, and Tobacco industry sector (GICS 3020), where free cash margin increased to 6.29% for the twelve months ended September 2009 from 3.40% for the twelve months ended September 2008. A representative company from this group is Kraft Foods (KFT).

Finally, free cash margin for the Household & Personal Products industry sector (GICS: 3030) improved to 9.99% for the twelve months ending September 2009 from 6.47% in September 2008. This was the highest free cash margin for the industry since December 2002 when it was 9.27%. We will investigate Kimberly-Clark's (KMB) noticeable increase in free cash margin.

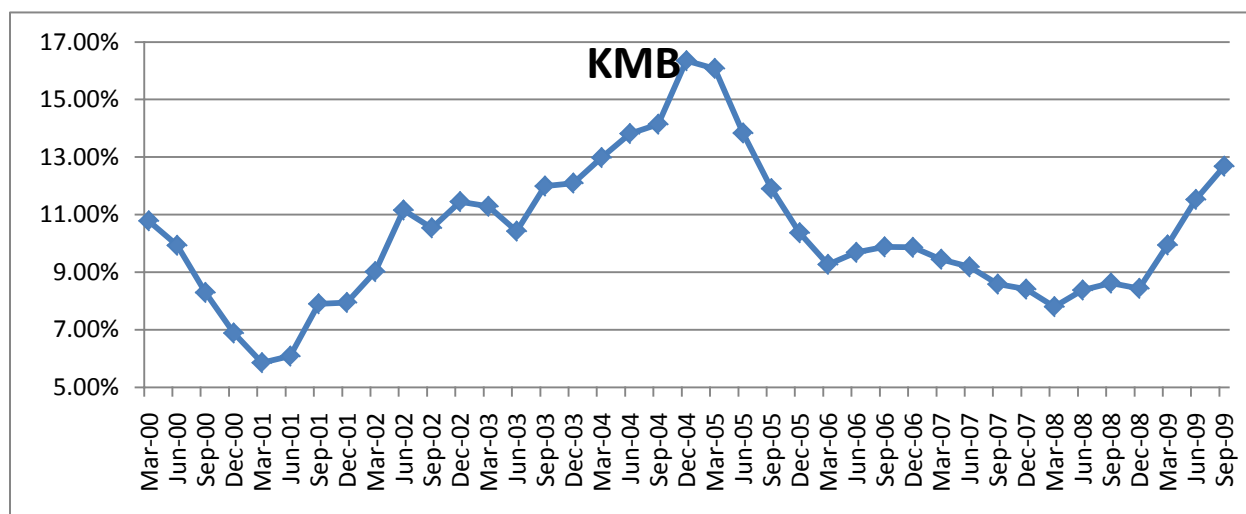
Graphs of free cash margin for these companies across the period studied are provided below. With each graph we also provide a short summary of the primary drivers or factors that we think were behind the observed changes in free cash margin for the selected firms. For more details regarding the industries,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

Ford Motor Company, Free Cash Margin, March 2000 – September 2009

Ford Motor Company (F). Free cash margin improved to 5.61% for the twelve months ended September 2009 from 0.27% for the twelve months ended September 2008. During the 2009 reporting period, the company increased its capital spending, raising capital expenditures as a percent of revenue to 4.61% in 2009 from 4.17% in 2008. Working to improve free cash margin was a reduction in the company's cash cycle. In particular, the company reduced its inventory days to 21.19 days at September 2009 from 27.44 days at September 2008.

Kraft Foods Inc., Free Cash Margin, December 2001 – September 2009

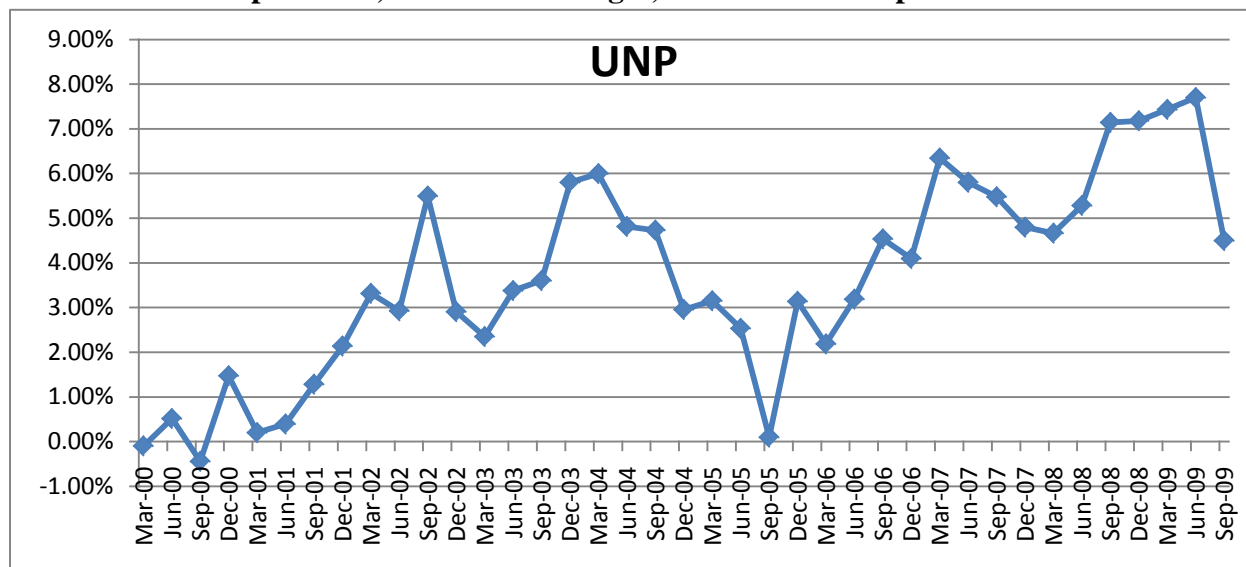
Kraft Foods, Inc. (KFT). Kraft Foods' free cash margin improved to 9.09% for the twelve months ended September 2009 from 5.97% for the twelve months ended September 2008. During 2009, at 3.0%, the company's capital spending was relatively equal to its spending in 2008. Helping to improve its free cash margin in 2009 was a noted decline in inventory. During the twelve months ended September 2009, inventory days declined to 36.88 days from 40.05 days for the same period in 2008.

Kimberly-Clark Corp., Free Cash Margin, March 2000 – September 2009

Kimberly-Clark Corp. (KMB). Free cash margin improved to 12.68% for the twelve months ended September 2009 from 8.62% for the twelve months ended September 2008. The improvement in free cash margin was driven by an increase in operating cushion from 17.92% in September 2008 to 20.41% in September 2009. Additionally, a reduction in the cash cycle, driven primarily by a reduction in inventory days to 39.25 revenue days in September 2009 from 47.92 revenue days in September 2008 helped to improve free cash margin. Capital spending in 2009 was relatively stable with 2008 levels.

Stable free cash margin

Even though the free cash margin for the Transportation industry is stable over the last twelve month period, there was a significant decline in the 3rd quarter from 5.28% in June 2009 to 3.91% for the twelve months ending September 2009. We take a closer look at Union Pacific Corp. (UNP) who exhibited a noticeable decline in free cash margin.

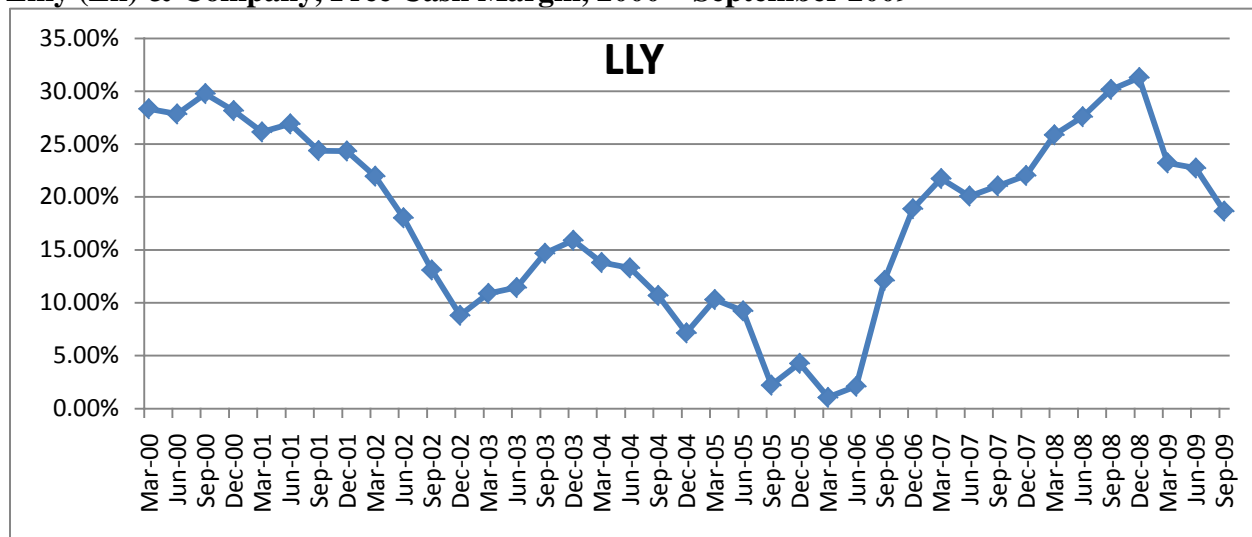
Union Pacific Corporation., Free Cash Margin, March 2000 – September 2009

Union Pacific Corporation (UNP): Union Pacific Corporation's free cash margin declined from 7.14% for the twelve months ending September 2008 to 4.50% for the same period ending September 2009. This decline appears to be driven primarily by a substantial increase in capital spending. Measured as a percent of revenue capital expenditures rose to 17.68% in September 2009 from 14.94% in September 2008. Given a noted improvement in operating cushion, the company should be on track for improving cash flows once revenue begins to grow.

Declining free cash margin

The one industry that exhibited a notable declining trend in free cash margin was Pharmaceuticals, Biotech, and Life Sciences industry sector (GICS 3520), where free cash margin declined to 4.80% for the twelve months ended September 2009 from 9.15% in the September 2008 period. Lilly (Eli) & Company (LLY) is one representative company from this group that showed a noticeable decline in free cash margin. The decline, however, belies a certain underlying strength in the company's cash flow generation.

Lilly (Eli) & Company, Free Cash Margin, 2000 – September 2009



Lilly (Eli) & Company (LLY). Free cash margin declined to 18.66% for the twelve months ended September 2009 from 30.16% for the same period in September 2008. Noteworthy, however, is the fact that free cash margin is still noticeably higher than the low point reached in 2006. Since September 2008, the decline in free cash margin can be attributed primarily to an increase in inventory days, which rose to 54.08 days in the twelve months ended September 2009 from 37.86 days for the same period in 2008. Helping to improve the company's free cash margin during the period was an improvement in operating cushion and a decline in capital spending.

Conclusions

For the twelve months ended with the 3rd quarter of 2009, overall free cash margin for the 3,704 firms in our all non-financial industries sample improved to its highest point, 5.36%, since we began tracking the measure in March 2000. This increase in free cash margin appears to be driven primarily by decreases in income taxes paid and capital expenditures and not by improving profitability. We did note that inventory days returned to pre-recession levels. Companies appear to be ‘stocking up’ in anticipation of higher company sales. Receivables days and payables days also increased, but remained well below pre-recession levels.

Revenue generally declined during the third quarter 2009 reporting period, taking the level of operating cash flow and free cash flow down with it.

The drop in capital spending that we have witnessed over the last several quarters continued unabated in the third quarter. Capital expenditures measured as a percent of revenue declined to 3.02% for the twelve months ended September 2009 from 4.15% for the period ended September 2008 and 3.76% for the June 2009 reporting period. The decline is particularly noteworthy given the drop in revenue recorded in recent periods. Capital expenditures are now at the lowest level we have seen for all reporting periods – below that recorded even in the 2001 recession. In December 2001, capital expenditures declined slightly to 4.68% of revenue from 5.09% in December 2000. It was not until after the 2001 recession ended that firms began reducing capital expenditures relative to revenue. This time, given their relentless cutting of capital spending during the recession, there would appear to be little room remaining for future reductions. Assuming firms begin to increase capital spending as the recession ends, free cash margin will likely suffer. We will continue to update our findings, via our webpage and with our reports, as new quarterly financial data become available.