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## **Adjusted Free Cash Flow and Capital Expenditures of the S&P 100**

### **What is the source of growth in Adjusted Free Cash Flow?**

#### **Executive Summary**

Noteworthy growth in free cash flow has been well reported over the past few years as company management, financial analysts, and investors increasingly focus on cash flow to validate reported earnings. Unfortunately, the calculation of free cash flow has limitations, just like earnings. For example, as capital expenditures decrease, free cash flow increases by the same amount, and vice versa. Thus, a temporary reduction in capital expenditures could cause reported free cash flow to increase in an unsustainable way.

This study examines growth in adjusted operating cash flow (operating cash flow adjusted for nonoperating and nonrecurring items), adjusted free cash flow (similarly adjusted), and capital expenditures for the non-financial firms of the S&P 100 for the years 2000 through 2003. The objective is to measure the extent to which growth observed in adjusted free cash flow is derived from operations or through reductions in capital expenditures. Our results indicate that reductions in capital expenditures have been an important contributing factor to the growth observed in adjusted free cash flow in recent years.

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**Georgia Tech Financial Analysis Lab**

The Georgia Tech Financial Analysis Lab conducts independent stock market research. Independent and 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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## **Adjusted Free Cash Flow and Capital Expenditures of the S&P 100**

### **Introduction**

Since the recent accounting scandals, we have seen an increased focus on cash flow, especially free cash flow. In the wake of company meltdowns such as Enron, WorldCom, and Global Crossing, it is not surprising that company executives and analysts have been touting increases in free cash flow over the past few years. Earnings that are supported by free cash flow are, in theory, of higher quality than results that are not so supported.

However, taking increased free cash flow numbers at face value without analyzing their source can be a dangerous proposition, especially when free cash flow is commonly used in performing valuation exercises. An unsustainable jump in free cash flow can lead to an overly optimistic company valuation.

Recent evidence indicates that the amount of cash flow being generated by corporations is increasing markedly. In our study, *Calculating Sustainable Cash Flow: A Study of the S&P 100 Using 2003 Data*, we found that total operating cash flow reported by the non-financial firms in the S&P 100 increased nearly 14% between 2000 and 2003.

In that study, we also adjusted reported operating cash flow for items we considered to be nonoperating and nonrecurring. The objective was to obtain a cleaned up and more sustainable operating cash flow amount for each firm for the purpose of determining a more meaningful measure of free cash flow. Overall for the non-financials of the S&P 100 adjusted operating cash flow increased 21% between 2000 and 2003, indicating even stronger corporate performance. However, individual company results varied. Some firms' improvements in reported operating cash flow were not as strong when adjustments were made. Others saw declines in adjusted operating cash flow even while they enjoyed improvements in reported operating cash flow. Adjusted free cash flow measures were similarly impacted. Overall adjusted free cash flow increased 58% between 2000 and 2003.

Based on our findings in that earlier study, it cannot be stated categorically that firms who saw increases in free cash flow based on reported operating cash flow would also see improvements in free cash flow once adjustments were made for nonoperating and nonrecurring items. Accordingly, we saw a need to examine adjusted free cash flow and capital expenditures for individual companies relative to their adjusted operating cash flow.

Over time, companies should be expected to maintain a fairly stable relationship between free cash flow and operating cash flow. When the two grow at different rates, reasons for the disparity should be investigated carefully.

## Purpose of the study

Overall our purpose is several-fold, including: a) to determine whether the non-financial companies of the S&P 100 have increased adjusted free cash flow by reducing capital expenditures, b) to identify companies who are reporting increasing amounts of adjusted free cash flow but greatly reducing capital expenditures suggesting that their adjusted free cash flow increases may not be sustainable, c) to determine whether the non-financial companies of the S&P 100 are currently replacing their fixed assets consumed, and d) to examine trends for the sample as a whole and comment on what it may mean for free cash flow in future periods.

## Adjusted Free Cash Flow and the Capital Expenditures of the S&P 100

We calculated adjusted free cash flow for the 86 non-financial firms found in the S&P 100 for the years 2000, 2001, 2002, and 2003. We excluded the financial firms because operating cash flow and resulting free cash flow is a less reliable indicator of operating performance for them than it is for the non-financials.

In order to calculate adjusted free cash flow, we examined the annual reports for the companies and manually adjusted operating cash flow for several items. The adjustments included cash overdrafts, trading securities, capitalized operating costs, taxes on non-operating gains and losses, tax benefits from stock options, accounts receivable securitizations, nonrecurring operating items such as restructuring and severance payments, cash provided or used by discontinued operations, and increased vendor reliance. Please see our October 2004 report titled *Calculating Sustainable Cash Flow: A Study of the S&P 100 Using 2003 Data* for a detailed explanation of the adjustments. The report is available to download at [http://mgt.gatech.edu/fac\\_research/centers\\_initiatives/files\\_finlab/ga\\_tech\\_cf\\_2004.pdf](http://mgt.gatech.edu/fac_research/centers_initiatives/files_finlab/ga_tech_cf_2004.pdf). Once we calculated adjusted operating cash flow, we subtracted capital expenditures and preferred dividends in order to determine adjusted free cash flow.

$$\text{Adjusted Free Cash Flow} = (\text{Adjusted operating cash flow} - \text{Capital expenditures} - \text{Preferred dividends})$$

In this calculation, capital expenditures were measured net of the proceeds from asset dispositions. Also, in order to avoid double counting items in the calculation of adjusted free cash flow, we added back items such as capitalized interest and capitalized software that were previously taken out during the calculation of adjusted operating cash flow.

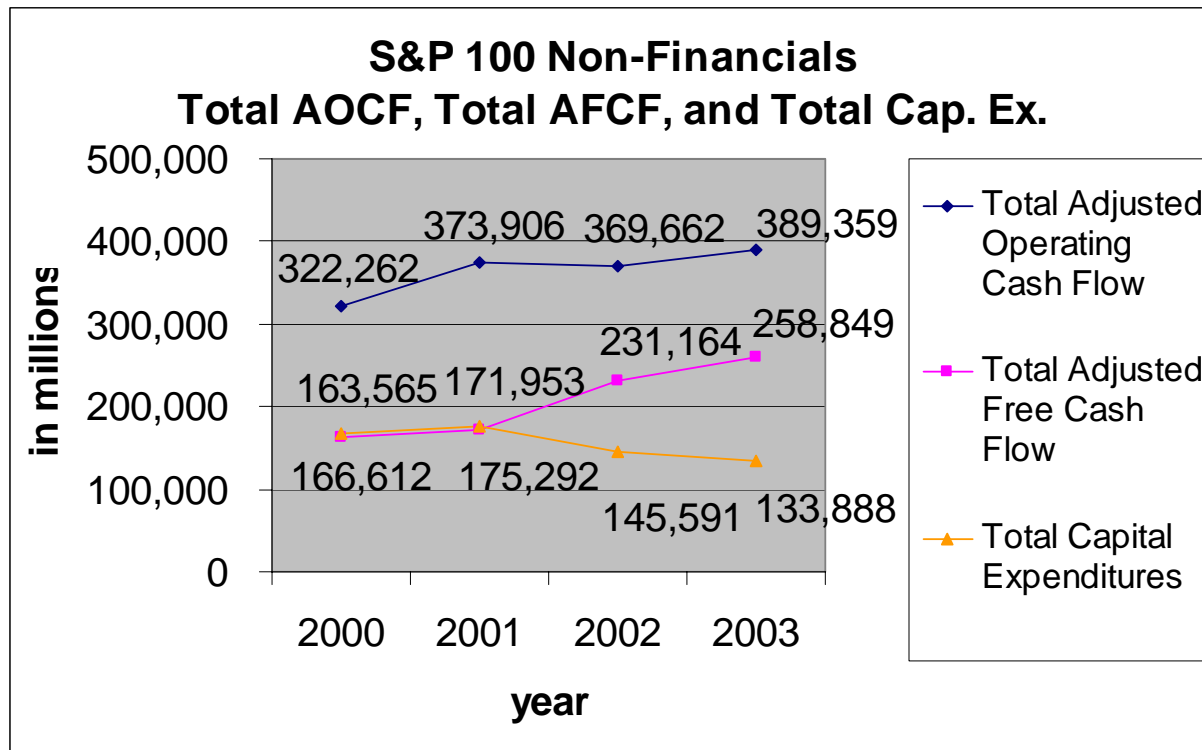
## Results

The results are presented in two tables. Table 1 shows the percentage changes in adjusted free cash flow, adjusted operating cash flow, and capital expenditures for the years 2000 to 2003 for the 86 non-financial companies in the S&P 100. Table 2 provides the supporting data, adjusted free cash flow, adjusted operating cash flow, and capital expenditures, from which Table 1 was prepared, and overall total figures for the sample as a whole.

## Adjusted Free Cash Flow versus Capital Expenditures

The first goal of this study is to determine whether and the extent to which the non-financial companies of the S&P 100 used reductions in capital expenditures to increase adjusted free cash flow. Our results indicate that from 2000 to 2003, total adjusted operating cash flow for the sample as a whole grew 20.8% from \$322,262 million to \$389,359 million. At the same time, total adjusted free cash flow increased from \$163,565 million to \$258,849 million, or 58.3%. In addition, during that same time period, capital expenditures decreased from \$166,612 million in 2000 to \$133,888 million in 2003, or -19.6%. These results are presented in Chart 1.

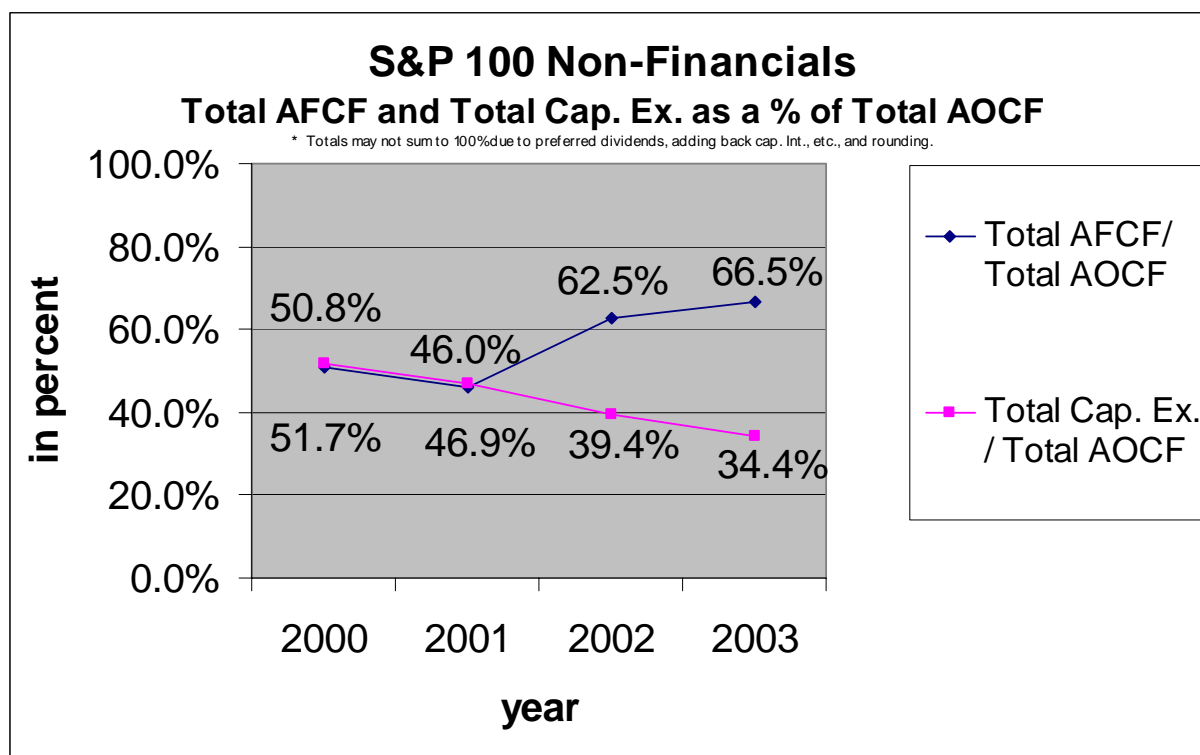
**Chart 1**



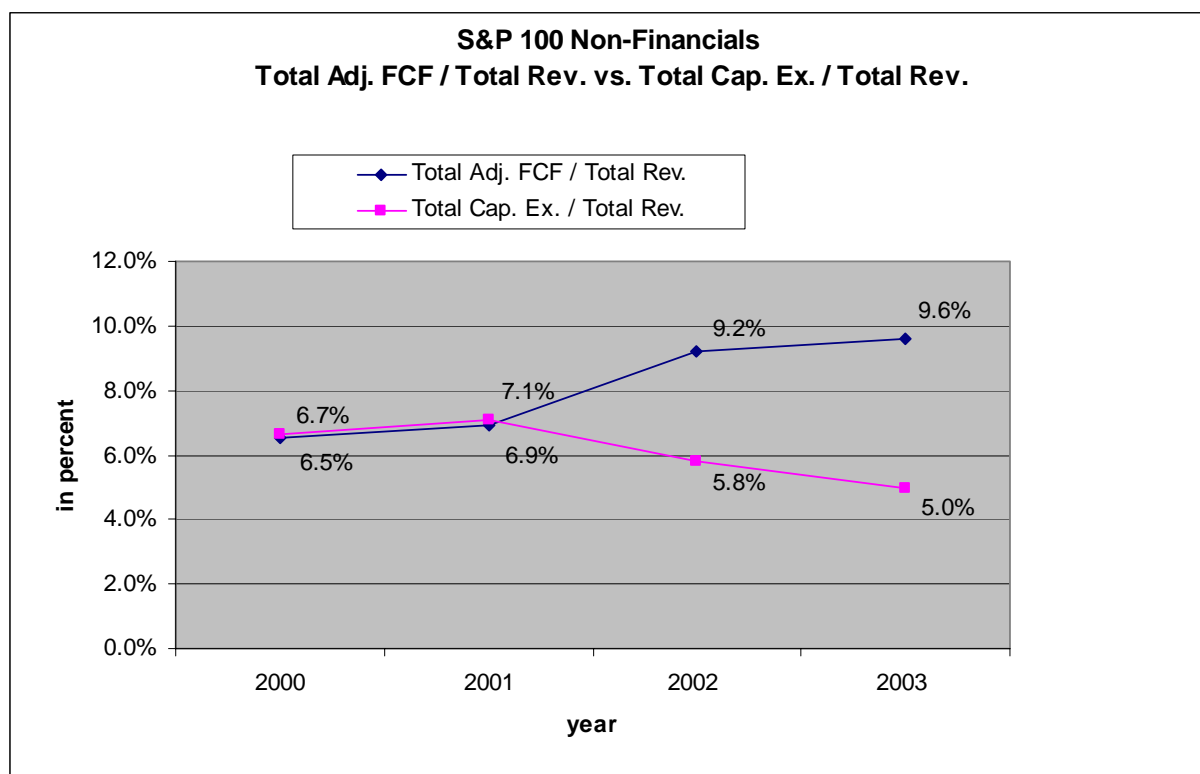
In Chart 1, we see a divergence between adjusted free cash flow and adjusted operating cash flow, with adjusted free cash flow growing more rapidly than adjusted operating cash flow. Helping to explain the divergence is the decline in capital expenditures over the time period studied.

The divergence of total adjusted free cash flow and total capital expenditures is better illustrated in Chart 2. With total adjusted free cash flow and total capital expenditures presented as a percentage of total operating cash flow, we have total adjusted free cash flow increasing from 50.8% of total operating cash flow in 2000, to 66.5% in 2003. Total capital expenditures decreased from 51.7% of total operating cash flow in 2000, to just 34.4% in 2003. (Note: totals may not sum to 100% due to preferred dividends, rounding, and other adjustments for such items as capitalized interest, as discussed earlier.)

Chart 2



The divergence of total adjusted free cash flow and total capital expenditures over the study period is also illustrated in Chart 3. Total adjusted free cash flow and total capital expenditures are both divided by total revenue to determine whether the decrease in capital expenditures is a function of decreased revenues caused by the economic downturn in 2002 and 2003. Total adjusted free cash flow as a percentage of total revenue increased from 6.5% in 2000 to 9.6% in 2003. Total capital expenditures as a percentage of total revenue decreased from 6.7% in 2000 to just 5.0% in 2003.

**Chart 3**

Based on the above tables, it appears that adjusted free cash flow has received what appears to be a temporary boost over the past few years. While we do not expect adjusted operating cash flow and adjusted free cash flow to move in unison, over time we do expect their growth rates to be similar. Over the study period, total adjusted free cash flow increased 58.3% from 2000 to 2003, but total adjusted operating cash flow grew a more modest 20.8%. Looking at the numbers, total adjusted free cash flow grew \$95,284 million from 2000 to 2003. This growth resulted from the \$67,097 million increase in total operating cash flow from 2000 to 2003, and the \$32,724 million *decrease* in total capital expenditures along with other factors such as preferred dividends and adjustments to avoid double counting for such items as capitalized interest. With numerous reports of capital expenditures returning to past levels, or at least increasing from 2002 and 2003 levels, the temporary boost in overall free cash flow for the S&P 100 non-financials could easily disappear over the next few years.

## Productive Capacity Replacement

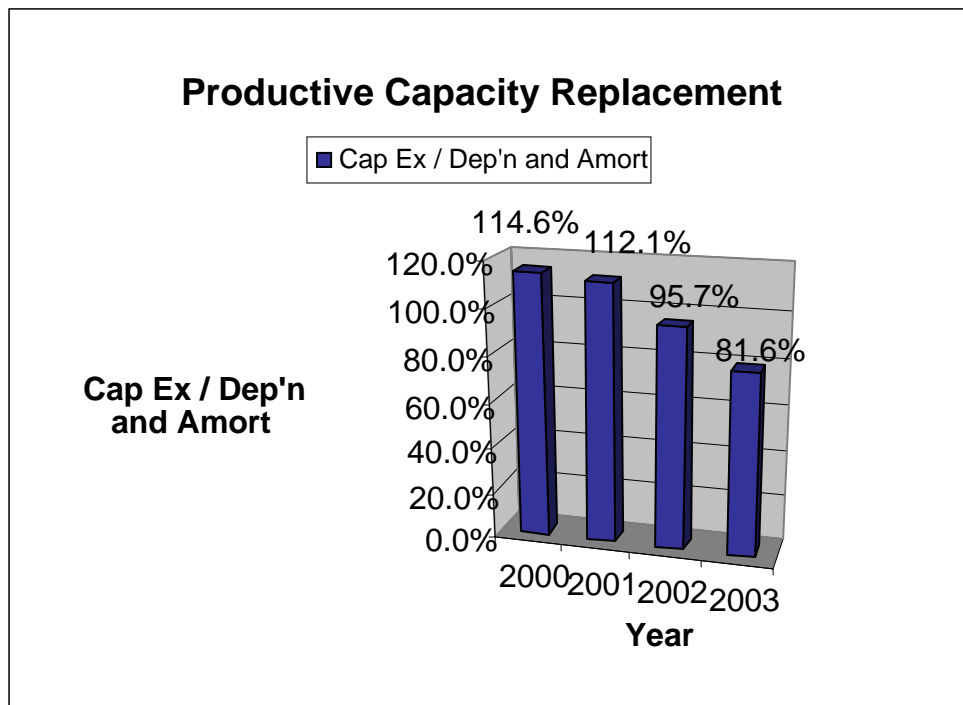
In order to determine whether the non-financials of the S&P 100 as a whole were cutting capital expenditures in what might be considered to be an excessive manner, we calculated the productive capacity replacement for the study years.

Productive Capacity Replacement = (Capital Expenditures / Depreciation and Amortization)

Over time, a company should be expected to replace capital equipment consumed during a period, through depreciation and amortization, with new capital equipment, or capital

expenditures. As a result, the company would be in a position to be as productive at the end of the period as it was in the beginning of the period. If a company replaces all of the capital equipment consumed, the productive capacity replacement would equal 1, or 100%.

**Chart 4**



The productive capacity replacement decreased fairly steadily over the study period. The results are presented in Chart 4. From a high of 114.6% in 2000, the median productive capacity replacement declined to 112.1% in 2001, to 95.7% in 2002, and to 81.6% in 2003. In other words, companies went from more than fully replacing their 'used' capital equipment in 2000 and 2001, to much less than full replacement in 2002 and 2003.

As a whole, the non-financials of the S&P 100 reduced capital expenditures from \$166,612 million in 2000, to \$175,292 million in 2001, to \$145,591 million in 2002, and to \$133,888 million in 2003, or a decrease of 19.6% from 2000 to 2003. Over the same time period, overall depreciation and amortization remained fairly steady at \$152,414 million in 2000, \$167,223 million in 2001, \$152,298 million in 2002, and \$157,042 million in 2003, or a slight increase of 3.0% from 2000 to 2003.

After the stock market crash, and the economic slowdown in 2001 and 2002, we would expect companies to reduce their capital expenditures, along with their other expenses. But, as a result of capital expenditures being reduced over this time period, overall free cash flow appears to have received a temporary boost. Going forward, we can reasonably expect companies to return to at least replacing their capital equipment consumed, or back to 100% productive capacity replacement. When, and if, this occurs, the temporary boost that adjusted free cash flow received over the past few years will be reversed.



## Individual Company Results

Table 1 presents the S&P 100 non-financials ranked by the change from 2000 to 2003 in the productive capacity replacement, or capital expenditures / depreciation and amortization. In addition, the table lists the percentage change in adjusted free cash flow, adjusted operating cash flow, and capital expenditures from 2000 to 2003.

In order to determine whether a company's adjusted free cash flow growth may not be sustainable, we need to look at the company's adjusted operating cash flow and capital expenditures. The source data for the S&P 100 non-financials are found in Table 2, at the end of the report, which presents the totals for 2000 to 2003 for adjusted operating cash flow, adjusted free cash flow, and capital expenditures. In the end, we can determine whether the growth in adjusted free cash flow coincided with growth in adjusted operating cash flow, or if the growth in adjusted free cash was the result of a temporary boost from decreased capital expenditures. In examining the results presented in Table 1, we find several interesting companies to investigate further.

Table 1 S&P 100 Non-Financials Ranked by Capital Expenditures / Depreciation and Amortization 2000 to 2003 Change									
Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03		2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
Home Depot Inc.	595.1%	136.8%	-6.4%		576.2%	427.6%	292.8%	301.4%	-274.8%
The AES Corporation	196.0%	299.3%	-92.9%		285.8%	303.7%	208.0%	18.2%	-267.6%
Delta Air Lines, Inc.	62.2%	-95.7%	-80.2%		309.7%	212.5%	100.4%	59.3%	-250.4%
The Williams Companies, Inc.	110.2%	165.2%	-76.1%		283.5%	269.8%	168.3%	52.6%	-230.9%
Texas Instruments Incorporated	2434.1%	-20.8%	-71.0%		227.1%	111.9%	51.0%	56.0%	-171.2%
Nextel Communications, Inc.	152.7%	551.5%	-47.6%		259.1%	194.8%	116.6%	101.3%	-157.8%
Pfizer Inc.	99.1%	77.7%	25.8%		216.9%	199.9%	169.7%	64.8%	-152.2%
Lucent Technologies, Inc.	47.1%	32.3%	-93.0%		113.3%	47.8%	17.3%	13.6%	-99.7%
EMC Corporation	11.3%	-21.3%	-57.2%		166.0%	133.1%	59.8%	70.4%	-95.5%
American Express Company	-69.0%	-55.3%	6.4%		224.9%	70.0%	57.3%	139.2%	-85.7%
McDonald's Corporation	112.7%	23.9%	-44.2%		162.4%	140.9%	155.5%	79.8%	-82.6%
AT&T Corp.	23.5%	-19.2%	-53.7%		142.6%	124.9%	69.8%	61.5%	-81.1%
Cisco Systems, Inc.	77.7%	44.6%	-34.0%		125.8%	101.6%	135.0%	45.1%	-80.8%
Weyerhaeuser Company	136.2%	24.4%	-79.0%		90.9%	69.7%	72.7%	12.5%	-78.3%
The Gillette Company	167.6%	71.6%	-51.7%		140.6%	111.0%	72.4%	62.8%	-77.8%
H.J. Heinz Company	155.5%	29.4%	-70.5%		133.0%	60.5%	58.3%	56.1%	-76.9%
Avon Products, Inc.	358.3%	146.9%	-20.3%		194.8%	134.9%	94.4%	121.1%	-73.7%
General Electric Company	51.0%	26.3%	-33.0%		142.9%	149.9%	118.2%	69.3%	-73.6%
Computer Sciences	2883.6%	96.2%	-19.2%		138.2%	78.3%	74.5%	69.8%	-68.4%
SBC Communications Inc.	303.0%	-10.9%	-60.2%		134.6%	123.3%	79.4%	66.3%	-68.3%
Merck & Co., Inc.	48.0%	18.6%	-29.8%		213.6%	164.1%	143.0%	145.8%	-67.8%
Intel Corp.	39.9%	-5.4%	-45.2%		138.0%	113.0%	88.0%	72.1%	-65.9%
Toys "R" Us, Inc.	215.1%	2185.0%	-36.3%		138.6%	228.9%	125.6%	73.6%	-65.1%
The Limited, Inc.	124.9%	38.5%	-34.3%		164.6%	136.1%	110.9%	103.5%	-61.0%
Verizon Communications Inc.	8026.8%	28.0%	-32.6%		143.8%	128.5%	90.2%	87.3%	-56.5%

**Table 1 (continued)**  
**S&P 100 Non-Financials**  
**Ranked by Capital Expenditures / Depreciation and Amortization 2000 to 2003 Change**

Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03		2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
The Black & Decker Corporation	212.7%	61.0%	-55.2%		119.5%	78.4%	73.5%	65.8%	-53.7%
The Dow Chemical Co.	991.0%	86.2%	-47.1%		94.5%	79.0%	84.6%	45.7%	-48.8%
Medtronic, Inc.	167.4%	105.2%	10.8%		140.6%	148.1%	117.0%	93.1%	-47.4%
General Dynamics Corporation	97.4%	67.2%	-25.5%		113.8%	98.5%	61.5%	68.6%	-45.2%
Tyco International Ltd.	4.9%	-2.4%	-24.4%		103.2%	184.0%	135.5%	58.4%	-44.8%
United Technologies Corporation	6.7%	-19.3%	-43.4%		109.1%	87.6%	80.6%	66.3%	-42.7%
Minnesota Mining and Manufacturing Co.	141.9%	62.1%	-45.8%		98.6%	80.6%	71.4%	56.8%	-41.8%
Schlumberger N.V.	262.4%	31.8%	-30.9%		93.0%	107.8%	71.1%	51.7%	-41.3%
Hewlett-Packard Company	339.9%	198.5%	24.7%		106.1%	78.9%	63.6%	65.0%	-41.1%
The Procter and Gamble Co.	269.0%	83.1%	-48.5%		118.6%	74.8%	85.8%	78.6%	-40.0%
American Electric Power	150.6%	819.0%	-23.4%		136.5%	129.9%	122.5%	104.5%	-31.9%
The Walt Disney Company	-23.9%	-21.5%	-19.7%		114.3%	168.0%	86.8%	83.4%	-31.0%
FedEx Corporation	7299.4%	16.3%	-8.5%		140.9%	145.5%	116.4%	110.2%	-30.7%
Sears, Roebuck and Co.	-3.3%	-6.6%	-13.6%		120.3%	123.6%	53.4%	95.9%	-24.3%
Anheuser-Busch Companies, Inc.	63.9%	30.2%	-7.6%		133.7%	122.4%	98.5%	113.2%	-20.5%
Alcoa Inc.	-13.4%	-13.6%	-23.0%		92.0%	93.8%	113.0%	71.8%	-20.2%
General Motors Corporation	-94.7%	-79.5%	-24.6%		72.5%	73.4%	62.7%	52.4%	-20.1%
Sara Lee Corporation	43.5%	30.7%	14.1%		145.0%	119.1%	118.0%	125.0%	-20.0%
The Boeing Company	-35.9%	-54.0%	-27.3%		57.9%	59.5%	56.4%	38.3%	-19.7%
Boise Cascade Corp	-76.4%	-40.5%	-17.4%		92.6%	62.5%	76.9%	74.0%	-18.6%
Rockwell International Corporation	-33.6%	-32.9%	-31.0%		81.9%	70.4%	54.3%	63.4%	-18.5%
Eastman Kodak Company	240.0%	80.9%	-28.1%		75.1%	80.8%	67.2%	57.8%	-17.3%
The May Department Stores Company	42.4%	25.0%	-0.2%		115.5%	147.9%	144.7%	98.7%	-16.8%
Wal-Mart Stores, Inc.	260.4%	69.3%	26.7%		270.5%	249.0%	265.6%	255.1%	-15.4%
Baxter International Inc.	66.7%	47.3%	21.8%		160.0%	178.5%	193.2%	144.8%	-15.2%
International Business Machines Corp.	347.1%	119.5%	-13.7%		96.9%	114.3%	104.5%	83.7%	-13.2%
El Paso Corporation	110.2%	2992.6%	-7.9%		216.2%	280.3%	290.7%	203.1%	-13.0%
Colgate-Palmolive Company	21.0%	11.7%	-17.7%		108.6%	101.2%	115.8%	95.6%	-13.0%
PepsiCo Inc.	-5.0%	-2.5%	0.1%		118.5%	122.4%	121.2%	106.1%	-12.3%
Exelon Corporation	313.0%	209.0%	159.8%		123.9%	113.8%	126.4%	113.7%	-10.2%
Amgen Inc.	158.4%	177.9%	209.8%		206.6%	166.2%	147.4%	197.5%	-9.1%
Microsoft Corp.	154.9%	133.6%	1.4%		70.3%	71.8%	71.0%	61.9%	-8.4%
Xerox Corporation	322.8%	5389.6%	-54.2%		32.8%	11.3%	12.3%	25.0%	-7.8%
The Coca-Cola Company	65.3%	47.0%	5.4%		89.0%	84.4%	97.0%	85.3%	-3.7%
Ford Motor Company	-41.0%	-19.4%	-7.2%		57.6%	45.0%	48.1%	54.3%	-3.2%
Harrah's Entertainment, Inc.	61.6%	36.4%	20.1%		118.4%	152.7%	100.0%	116.9%	-1.5%
International Paper Company	-54.3%	-32.5%	-13.8%		70.6%	56.1%	63.6%	70.9%	0.4%
Entergy Corporation	777.2%	27.5%	5.0%		183.1%	191.4%	182.4%	184.6%	1.5%
Unisys Corporation	3990.9%	157.5%	41.0%		70.9%	69.6%	65.8%	73.2%	2.3%
Oracle Corporation	-46.7%	-43.8%	10.6%		83.8%	90.5%	76.6%	89.0%	5.2%
Halliburton Company	-195.0%	-3996.2%	10.6%		73.4%	127.5%	98.6%	78.8%	5.4%
The Southern Company	727.8%	31.7%	-10.0%		166.4%	192.7%	239.2%	172.1%	5.7%
Norfolk Southern Corporation	9.3%	13.0%	8.1%		114.9%	112.0%	124.4%	121.6%	6.7%
Johnson & Johnson	58.4%	50.8%	26.5%		95.7%	97.7%	116.9%	103.1%	7.4%
National Semiconductor Corporation	-84.7%	-52.6%	5.0%		61.0%	98.8%	60.0%	73.8%	12.8%

**Table 1 (continued)**  
**S&P 100 Non-Financials**

**Ranked by Capital Expenditures / Depreciation and Amortization 2000 to 2003 Change**

Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03	2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
Time Warner Inc.	183.3%	1638.1%	-22.4%	33.3%	29.3%	53.7%	48.2%	14.9%
Clear Channel Communications, Inc.	69.9%	80.0%	213.6%	28.0%	19.9%	73.1%	48.1%	20.1%
Viacom Inc.	170.9%	92.9%	-19.0%	29.6%	16.7%	56.8%	53.4%	23.8%
Allegheny Technologies Inc.	-78.9%	-40.2%	16.4%	55.0%	101.0%	44.4%	85.3%	30.3%
Campbell Soup Company	-36.4%	-23.4%	35.2%	76.9%	72.2%	82.8%	107.4%	30.5%
Honeywell International Inc.	59.6%	35.7%	-14.9%	73.0%	89.6%	93.9%	103.9%	30.9%
Bristol-Myers Squibb Company	-19.1%	-9.3%	49.1%	79.0%	131.0%	135.6%	111.3%	32.3%
Burlington Northern Santa Fe Corp.	-37.1%	0.5%	23.4%	156.3%	160.5%	145.9%	189.7%	33.4%
Baker Hughes Incorporated	121.3%	22.9%	-12.4%	63.1%	72.9%	86.6%	96.8%	33.8%
E.I. du Pont De Nemours and Company	-57.8%	-28.2%	38.8%	86.4%	94.0%	83.6%	125.2%	38.8%
Altria Group	-6.5%	-2.8%	17.4%	98.0%	82.2%	150.9%	137.1%	39.1%
Raytheon Company	206.9%	144.0%	5.8%	59.3%	66.8%	122.8%	102.5%	43.2%
HCA Inc.	99.4%	67.1%	59.1%	111.8%	130.7%	170.1%	165.3%	53.5%
Exxon Mobil Corporation	-10.8%	15.0%	295.0%	32.9%	112.2%	104.0%	116.8%	83.9%
RadioShack Corporation	7387.0%	438.6%	59.3%	110.3%	113.0%	103.2%	204.3%	94.1%
MedImmune, Inc.	43.6%	100.5%	1312.5%	114.3%	200.0%	218.9%	297.4%	183.1%
Median Company	87.6%	31.2%	-14.3%	114.6%	112.1%	95.7%	81.6%	-19.8%
Average Company	482.9%	152.2%	9.9%	129.5%	121.7%	106.9%	95.9%	-33.6%

## Large Growth in Adjusted Free Cash Flow

### Verizon Communications, Inc.

Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03	2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
Verizon Communications Inc.	8026.8%	28.0%	-32.6%	143.8%	128.5%	90.2%	87.3%	-56.5%

Verizon Communications, Inc. reported an increase in adjusted free cash flow of 8,026.8% on an increase in adjusted operating cash flow of 28% and a reduction in capital expenditures of 32.6% between 2000 to 2003. Looking at the numbers behind the percentages, adjusted operating cash flow increased from \$17,934 million in 2000 to \$22,949 million in 2003, adjusted free cash flow increased from \$130 million in 2000 to \$10,586 million in 2003, and capital expenditures decreased from \$17,633 million in 2000 to \$11,884 million in 2003. In Verizon's case, the \$10,456 million increase in adjusted free cash flow resulted both from the \$5,749 million decrease in capital expenditures and the \$5,015 million increase in adjusted operating cash flow. Verizon decreased capital expenditures as a percentage of depreciation and amortization from 143.8% in 2000 to just 87.3% in 2003, a drop of 56.5%. While Verizon did not discuss the specific reasons behind the decrease in capital expenditures over the past few years in their annual report, they did state that they planned to spend a similar, or slightly higher, amount on capital expenditures in 2004 as they did in 2003.

**Unisys Corporation**

Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03		2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
Unisys Corporation	3990.9%	157.5%	41.0%		70.9%	69.6%	65.8%	73.2%	2.3%

The results at Unisys Corporation were much different from that of Verizon Communications, Inc. Unisys Corporation reported an increase in adjusted free cash flow of 3,990.9%, on an increase in adjusted operating cash flow of 157.7%, as capital expenditures increased 41.0% between 2000 and 2003. Looking more closely at the numbers, adjusted operating cash flow increased from \$206 million in 2000 to \$530 million in 2003, adjusted free cash flow increased from \$6 million in 2000 to \$252 million in 2003, and capital expenditures increased from \$178 million in 2000 to \$251 million in 2003. In this case, the increase in adjusted free cash flow resulted solely from growth in adjusted operating cash flow and was not due to an unsustainable reduction in capital expenditures.

**Unsupported Improvement in Adjusted Free Cash Flow****Delta Air Lines, Inc.**

Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03		2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
Delta Air Lines, Inc.	62.2%	-95.7%	-80.2%		309.7%	212.5%	100.4%	59.3%	-250.4%

Although it continued to report negative adjusted free cash flow, Delta Air Lines, Inc. reported an improvement in adjusted free cash flow over the study period. However, both adjusted operating cash flow and capital expenditures declined significantly over the same time period. From 2000 to 2003, adjusted free cash flow improved 62.2%, while adjusted operating cash flow decreased -95.7%, and capital expenditures decreased -80.2%. Looking more closely at the numbers, adjusted free cash flow improved from -\$675 million in 2000 to -\$255 million in 2003, adjusted operating cash flow decreased from \$2,986 million in 2000 to \$128 million in 2003, and capital expenditures decreased from \$3,676 million in 2000 to \$729 million in 2003. In this case, the improvement in adjusted free cash flow resulted solely from the decline in capital expenditures. With capital expenditures at Delta now at very low levels, going forward we would not expect to see much, if any, improvement in adjusted free cash flow from a further reduction in capital expenditures.

## Stable Growth in Adjusted Free Cash Flow

### The Coca-Cola Company

Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03	2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
The Coca-Cola Company	65.3%	47.0%	5.4%	89.0%	84.4%	97.0%	85.3%	-3.7%

The Coca-Cola Company was one of the more stable growth companies in the study. The Coca-Cola Company had adjusted free cash flow increase 65.3%, adjusted operating cash flow increase 47.0%, while capital expenditures increased 5.4% from 2000 to 2003. Looking at the numbers behind the percentages, adjusted operating cash flow increased from \$3,808 million in 2000 to \$5,600 million in 2003, adjusted free cash flow increased from \$2,836 million in 2000 to \$4,687 million in 2003, and capital expenditures increased from \$688 million in 2000 to \$725 million in 2003. In Coca-Cola's case, the \$1,851 million increase in adjusted free cash flow resulted mainly from a \$1,792 million increase in adjusted operating cash flow, while the \$37 million increase in capital expenditures was not really a factor. Coca-Cola slightly decreased capital expenditures as a percentage of depreciation and amortization from 89.0% in 2000 to 85.3% in 2003, a drop of -3.7%. In this case, as long as their capital expenditure spending continues to be stable, we would expect that in the future, Coca-Cola's adjusted free cash flow would move closely with their adjusted operating cash flow.

### A Merger to Watch...

Company Name	% change in AFCF '00 to '03	% change in AOCF '00 to '03	% change in Cap Ex '00 to '03	2000 Cap Ex / Depn and Amort	2001 Cap Ex / Depn and Amort	2002 Cap Ex / Depn and Amort	2003 Cap Ex / Depn and Amort	change 2000 to 2003
AT&T Corp.	23.5%	-19.2%	-53.7%	142.6%	124.9%	69.8%	61.5%	-81.1%
SBC Communications Inc.	303.0%	-10.9%	-60.2%	134.6%	123.3%	79.4%	66.3%	-68.3%

In terms of adjusted free cash flow, the pending merger between SBC Communications Inc. and AT&T Corp. will be an interesting one to watch. Although both companies reported an improvement in adjusted free cash flow over the study period, both also experienced a decline in adjusted operating cash flow and a decrease in capital expenditures. From 2000 to 2003, adjusted free cash flow at AT&T Corp. improved 23.5%, while adjusted operating cash flow decreased -19.2%, and capital expenditures decreased -53.7%. At the same time at SBC Communications Inc., adjusted free cash flow improved 303.0%, while adjusted operating cash flow decreased -10.9%, and capital expenditures decreased -60.2%. Looking more closely at the numbers, at AT&T adjusted free cash flow improved from \$4,481 million in 2000 to \$5,536 million in 2003, adjusted operating cash flow decreased from \$11,080 million in 2000 to \$8,950 million in 2003, and capital expenditures decreased from \$6,470 million in 2000 to \$2,994 million in 2003. In this case, the \$1,055 million improvement in adjusted free cash flow was explained by the \$3,476 million decrease in capital expenditures. At SBC Communications, adjusted free cash flow improved from \$2,059 million in 2000 to \$8,298 million in 2003, adjusted operating cash flow decreased from \$15,121 million in 2000 to \$13,480 million in 2003, and capital expenditures decreased from \$13,124 million in 2000 to \$5,219 million in 2003. In this case, the \$6,239 million improvement in adjusted free cash flow

resulted solely from the \$7,905 million decrease in capital expenditures. Again, with adjusted operating cash flow falling over the time period, we would not expect adjusted free cash flow to increase. However, since capital expenditures at both companies were reduced by an amount that exceeded the decline in adjusted operating cash flow, adjusted free cash flow saw an improvement. After the merger, it will be interesting to see if the combined company can continue to increase adjusted free cash flow, or if the temporary boost from declining capital expenditures reverses over the next few years.

## **Conclusions**

Adjusted free cash flow reported by the non-financial companies in the S&P 100 increased markedly over the period between 2000 through 2003. While there were exceptions, we found that many of the firms included in our study may have enjoyed a temporary boost to adjusted free cash flow through reductions in capital expenditures. We found reductions in the absolute amount of capital expenditures and as a percentage of adjusted operating cash flow and revenue. We also noted that, as measured relative to depreciation and amortization, the sample firms were generally not replacing productive capacity consumed by operations. Accordingly, it is not unreasonable to view the recent increase in adjusted free cash flow to be a temporary phenomenon which may reverse as capital spending is increased.



**Table 2**  
**Adjusted Operating Cash Flow, Adjusted Free Cash Flow, and Net Capital Expenditures**  
**for the S&P 100 Non-Financials, 2000 – 2003**

Source Data (\$ Millions)												
Company Name	2000 Adjusted Operating Cash Flow	2001 Adjusted Operating Cash Flow	2002 Adjusted Operating Cash Flow	2003 Adjusted Operating Cash Flow	2000 Adjusted Free Cash Flow	2001 Adjusted Free Cash Flow	2002 Adjusted Free Cash Flow	2003 Adjusted Free Cash Flow	2000 Net Capital Expend.	2001 Net Capital Expend.	2002 Net Capital Expend.	2003 Net Capital Expend.
The AES Corporation	356	1,537	1,587	1,422	(1,492)	(909)	(298)	1,432	1,992	2,609	1,741	142
Alcoa Inc.	2,877	2,425	1,967	2,486	1,714	1,232	630	1,484	1,121	1,172	1,264	863
Allegheny Technologies Inc.	151	123	209	90	85	23	164	18	55	100	40	64
Altria Group	11,151	9,212	11,778	10,840	9,465	7,285	9,538	8,853	1,682	1,922	2,009	1,974
American Electric Power	(339)	2,258	2,179	2,441	(2,123)	602	477	1,074	1,773	1,646	1,685	1,358
American Express Company	6,288	5,077	6,689	2,811	5,469	4,159	5,910	1,697	884	837	545	941
Amgen Inc.	1,176	1,350	1,910	3,269	746	916	1,227	1,927	438	442	659	1,357
Anheuser-Busch Companies, Inc.	2,229	2,355	2,687	2,902	1,174	1,350	1,864	1,924	1,075	1,022	835	993
AT&T Corp.	11,080	10,617	10,682	8,950	4,481	4,851	6,923	5,536	6,470	5,694	3,410	2,994
Avon Products, Inc.	318	727	572	785	130	573	438	596	187	147	117	149
Baker Hughes Incorporated	538	650	628	661	146	399	349	323	386	248	279	338
Baxter International Inc.	995	1,160	1,222	1,465	390	386	353	650	648	787	848	789
The Black & Decker Corporation	364	385	459	587	150	239	333	469	195	119	90	88
The Boeing Company	5,904	3,897	4,215	2,714	5,192	2,706	3,405	3,326	763	1,037	844	555
Boise Cascade Corp	489	430	316	291	195	210	57	46	276	185	236	228
Bristol-Myers Squibb Company	4,337	5,504	2,955	3,932	3,742	4,349	1,858	3,026	589	1,023	997	878
Burlington Northern Santa Fe Corp.	2,286	2,201	2,164	2,297	908	749	813	571	1,399	1,459	1,358	1,726
Campbell Soup Company	1,161	978	1,029	890	972	786	755	618	193	192	264	261
Cisco Systems, Inc.	3,522	5,172	6,698	5,092	2,436	2,724	3,925	4,330	1,086	2,271	2,641	717
Clear Channel Communications, Inc.	1,075	672	1,737	1,935	947	115	1,274	1,608	103	510	454	323
The Coca-Cola Company	3,808	4,296	4,817	5,600	2,836	3,519	3,960	4,687	688	678	782	725
Colgate-Palmolive Company	1,588	1,451	1,557	1,774	1,193	1,092	1,195	1,444	367	340	344	302
Computer Sciences	863	1,382	1,155	1,693	(34)	676	513	953	897	672	639	725
Delta Air Lines, Inc.	2,986	(308)	160	128	(675)	(2,505)	(954)	(255)	3,676	2,727	1,186	729
The Dow Chemical Co.	1,783	1,973	2,139	3,320	228	181	573	2,490	1,642	1,434	1,544	869
E.I. du Pont De Nemours and Company	4,418	5,289	2,815	3,173	3,172	3,664	1,425	1,340	1,222	1,241	1,084	1,696
Eastman Kodak Company	989	2,207	2,408	1,789	338	1,474	1,676	1,149	668	743	550	480
El Paso Corporation	91	2,976	910	2,814	(2,635)	(1,266)	(2,609)	270	2,661	3,868	3,430	2,452
EMC Corporation	1,838	1,425	1,376	1,446	942	515	894	1,048	858	872	391	367
Energry Corporation	1,573	2,252	1,875	2,006	47	848	319	413	1,494	1,380	1,530	1,569
Exelon Corporation	1,100	3,424	3,099	3,400	346	1,302	913	1,430	752	2,088	2,150	1,954
Exxon Mobil Corporation	23,242	22,632	20,046	26,727	20,980	14,055	12,624	18,705	2,676	8,911	8,644	10,569
FedEx Corporation	1,600	2,030	2,126	1,861	(5)	188	618	382	1,627	1,856	1,588	1,489

**Table 2 (continued)**  
**Adjusted Operating Cash Flow, Adjusted Free Cash Flow, and Net Capital Expenditures**  
**for the S&P 100 Non-Financials, 2000 – 2003**

Source Data (\$ Millions)												
Company Name	2000 Adjusted Operating Cash Flow	2001 Adjusted Operating Cash Flow	2002 Adjusted Operating Cash Flow	2003 Adjusted Operating Cash Flow	2000 Adjusted Free Cash Flow	2001 Adjusted Free Cash Flow	2002 Adjusted Free Cash Flow	2003 Adjusted Free Cash Flow	2000 Net Capital Expend.	2001 Net Capital Expend.	2002 Net Capital Expend.	2003 Net Capital Expend.
Ford Motor Company	19,672	31,822	18,926	15,854	18,017	13,487	17,442	10,639	8,348	7,008	7,278	7,749
General Dynamics Corporation	1,036	1,078	1,139	1,732	781	818	1,008	1,542	255	260	131	190
General Electric Company	24,067	29,862	30,346	30,392	16,948	21,123	22,751	25,598	7,200	8,803	7,699	4,822
General Motors Corporation	19,063	23,515	9,830	3,899	12,326	3,479	8,335	654	9,722	8,631	7,443	7,330
The Gillette Company	1,584	2,175	1,922	2,718	851	1,527	1,523	2,277	752	565	362	363
H.J. Heinz Company	771	305	719	997	308	79	538	786	407	181	176	120
Halliburton Company	(19)	1,016	1,450	(776)	(401)	333	882	(1,184)	369	677	498	408
Harrah's Entertainment, Inc.	528	750	706	720	198	255	380	320	334	501	328	401
HCA Inc.	1,628	2,001	2,686	2,720	455	607	957	907	1,155	1,370	1,718	1,838
Hewlett-Packard Company	2,322	3,025	6,159	6,933	1,004	1,731	4,359	4,415	1,317	1,080	1,348	1,642
Home Depot Inc.	2,751	4,801	4,764	6,514	(667)	1,586	2,157	3,302	3,463	3,267	2,644	3,243
Honeywell International Inc.	2,324	2,540	2,960	3,153	1,397	1,480	2,030	2,229	726	830	630	618
Intel Corp.	12,517	7,625	9,642	11,835	5,847	319	4,939	8,179	6,674	7,309	4,703	3,656
International Business Machines Corp.	7,038	13,235	14,662	15,447	2,373	7,969	9,692	10,611	4,562	5,150	4,575	3,935
International Paper Company	2,855	1,983	2,392	1,927	1,437	777	1,243	656	1,352	1,049	1,009	1,166
Johnson & Johnson	6,883	8,870	8,113	10,382	5,380	7,296	6,233	8,523	1,523	1,568	1,943	1,927
The Limited, Inc.	822	1,099	795	1,138	376	719	489	845	446	377	306	293
Lucent Technologies, Inc.	(964)	(2,580)	791	(653)	(2,852)	(4,170)	(695)	(1,508)	1,889	1,213	255	133
The May Department Stores Company	1,336	1,631	1,481	1,670	778	869	652	1,108	550	756	790	549
McDonald's Corporation	2,748	2,706	2,913	3,404	1,116	1,131	1,237	2,374	1,642	1,530	1,634	916
MedImmune, Inc.	173	245	256	347	165	227	181	237	8	18	81	113
Medtronic, Inc.	993	1,998	1,793	2,037	617	1,550	1,395	1,650	343	440	386	380
Merck & Co., Inc.	7,127	8,330	8,623	8,455	4,421	5,931	6,500	6,542	2,728	2,402	2,128	1,916
Microsoft Corp.	6,497	12,959	13,746	15,180	5,605	11,856	12,976	14,289	879	1,103	770	891
Minnesota Mining and Manufacturing Co.	2,342	3,174	3,181	3,797	1,333	2,208	2,313	3,225	1,011	878	681	548
National Semiconductor Corporation	501	506	97	237	340	255	(62)	52	161	240	138	169
Nextel Communications, Inc.	503	1,071	2,486	3,277	(2,920)	(2,521)	615	1,538	3,277	3,401	1,860	1,716
Norfolk Southern Corporation	1,004	755	1,085	1,134	421	175	433	460	594	590	658	642
Oracle Corporation	5,233	1,036	3,236	2,939	4,976	717	2,945	2,653	263	313	278	291
PepsiCo Inc.	4,507	4,050	4,312	4,395	3,188	2,550	2,886	3,029	1,295	1,324	1,348	1,296
Pfizer Inc.	7,841	8,971	10,323	13,936	5,256	6,689	8,447	10,464	2,100	2,135	1,758	2,641
The Procter and Gamble Co.	4,880	6,024	8,238	8,933	1,961	3,985	6,166	7,236	2,599	1,698	1,452	1,339
RadioShack Corporation	117	780	406	630	(6)	649	300	437	118	122	98	188



**Table 2 (continued)**  
**Adjusted Operating Cash Flow, Adjusted Free Cash Flow, and Net Capital Expenditures**  
**for the S&P 100 Non-Financials, 2000 – 2003**

Source Data (\$ Millions)												
Company Name	2000 Adjusted Operating Cash Flow	2001 Adjusted Operating Cash Flow	2002 Adjusted Operating Cash Flow	2003 Adjusted Operating Cash Flow	2000 Adjusted Free Cash Flow	2001 Adjusted Free Cash Flow	2002 Adjusted Free Cash Flow	2003 Adjusted Free Cash Flow	2000 Net Capital Expend.	2001 Net Capital Expend.	2002 Net Capital Expend.	2003 Net Capital Expend.
Raytheon Company	1,060	422	1,461	2,587	530	176	1,662	1,627	381	452	447	403
Rockwell International Corporation	650	368	476	436	493	199	376	327	158	138	100	109
Sara Lee Corporation	1,385	1,872	1,767	1,810	789	1,378	1,149	1,132	583	467	556	665
SBC Communications Inc.	15,121	14,999	15,471	13,480	2,059	3,801	8,699	8,298	13,124	11,189	6,808	5,219
Schlumberger N.V.	1,531	1,083	1,909	2,017	303	(965)	793	1,097	1,174	2,022	1,090	811
Sears, Roebuck and Co.	2,703	2,379	(319)	2,524	1,683	1,282	(871)	1,627	1,009	1,067	467	872
The Southern Company	2,349	2,349	2,816	3,093	133	(251)	119	1,101	2,225	2,617	2,717	2,002
Texas Instruments Incorporated	2,826	2,071	2,020	2,238	53	29	1,158	1,351	2,762	1,790	802	800
Time Warner Inc.	329	2,554	5,546	5,715	(3,346)	(772)	2,418	2,786	3,560	3,047	2,843	2,761
Toys "R" Us, Inc.	(38)	575	574	793	(464)	(201)	176	534	402	705	398	256
Tyco International Ltd.	5,734	6,415	5,564	5,594	3,988	2,278	2,645	4,182	1,696	4,021	2,825	1,283
Unisys Corporation	206	300	356	530	6	66	103	252	178	199	196	251
United Technologies Corporation	2,451	2,797	2,706	1,979	1,566	2,092	2,222	1,672	937	793	586	530
Verizon Communications Inc.	17,934	19,497	22,100	22,949	130	2,262	10,066	10,586	17,633	17,371	11,984	11,884
Viacom Inc.	1,775	3,150	2,980	3,424	1,062	2,585	2,386	2,877	659	515	537	534
Wal-Mart Stores, Inc.	9,428	10,295	12,844	15,963	1,728	2,340	3,989	6,228	7,758	8,037	8,934	9,827
The Walt Disney Company	3,675	3,074	2,358	2,883	2,654	1,351	1,494	2,019	1,100	1,658	886	883
Weyerhaeuser Company	1,468	1,062	1,471	1,827	727	466	651	1,718	786	611	891	165
The Williams Companies, Inc.	(880)	1,311	(1,148)	574	(2,324)	(88)	(2,325)	237	1,474	1,422	1,114	353
Xerox Corporation	37	2,215	2,372	2,048	(695)	1,752	1,868	1,549	408	150	127	187
Overall Totals	322,262	373,906	369,662	389,359	163,565	171,953	231,164	258,849	166,612	175,292	145,591	133,888
Overall Improvement year to year		51,645	(4,244)	19,696		8,387	59,212	27,685		8,680	(29,701)	(11,704)
Overall Percentage Improvement year to year		16.0%	-1.1%	5.3%		5.1%	34.4%	12.0%		5.2%	-16.9%	-8.0%
Overall Total % Change '00 to '03				20.8%				58.3%				-19.6%
Median Company	1,702	2,204	2,171	2,556	780	859	1,211	1,540	1,010	1,058	846	795
Median Year to Year Change		29.5%	-1.5%	17.7%		10.1%	41.1%	27.1%		4.8%	-20.0%	-6.1%
Average Company	3,747	4,348	4,298	4,527	1,902	1,999	2,688	3,010	1,937	2,038	1,693	1,557
Average Year to Year Change		16.0%	-1.1%	5.3%		5.1%	34.4%	12.0%		5.2%	-16.9%	-8.0%
Percentage of Adjusted OCF					50.8%	46.0%	62.5%	66.5%	51.7%	46.9%	39.4%	34.4%