ANALYZING INTERNET STOCKS: CASH FLOW AND THE BURN RATE

By John Bajkowski

The analysis of a company's cash position and its free cash flow helps to reveal whether it is self-sustaining and provides an indication of the need for future financing. As an investor, be careful around a firm with a high burn rate. Your investment may end up turning to ashes.

The rush for investment riches from the "new economy" has led to the hurried formation of a wide range of Internet stocks. Insatiable demand assigned rich premiums to these new economy stocks and created a strong market for initial public offerings (IPO).

However, the rapid flow of information and instant and dramatic re-evaluation of company prospects has shifted the pace of investment decision-making into high gear. The initial sentiment of allowing Internet stocks to attempt to establish a foothold and grow sales at any cost is moving toward one of greater scrutiny and accountability. Easy and cheap access to capital has been cut off for many Internet companies, and the struggle for market dominance has changed to a struggle for existence. Attention has turned toward available cash levels and the rate of cash consumption known as the burn rate. A number of firms will be forced to sell out to stronger rivals or simply go out of business.

Cash is financial power, and an analysis of a stock is not complete without evaluating a company's cash flow. Companies and industries go through a predictable and often repeated blueprint of development, growth, cash consumption and cash generation that can be attributed to its stage in the life cycle. A firm's position within its life cycle helps to identify its risks, needs, and growth potential.

THE BUSINESS LIFE CYCLE

Companies and industries typically go through a pattern of formation, accelerated growth, growth, maturity and possibly decline in their life cycle. In the first stage of formation, a firm is started to produce and sell a product or service. Usually money from the founders or a venture capital group provides fuel for the development and expansion during this formation stage. Promising companies often go through a few rounds of venture capital infusion during the development stage as the company begins to implement its business plan. Sales growth may be strong during this stage, but earnings may be low or non-existent as the company experiences high start-up costs.

Generally, most start-up companies fail and never get far beyond the formation stage. Some firms have growth and profit potential and move on to the accelerated growth stage. As in the formation stage, the company's demand for expansion capital is great, but with a positive sales track record and the promise of even stronger sales and earnings, an initial public offering is common. The IPO proceeds are used to raise capital for the firm and reward venture capital investors for their seed money. IPO proceeds, business cash flow, and cash borrowing fuel expansion at this aggressive growth stage.

Once a firm's growth rate slows but remains strong, it enters the growth stage. In this stage, most companies are able to finance expansion from internal cash generation and by issuing long-term debt. Usually in this stage a firm is expanding at a supportable rate that is still normally greater than and largely independent of the rate of overall economic expansion. A token cash dividend may be paid, but most generated cash flow will be reinvested in the

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firm until the late stages of growth, when cash flow is still strong but the number of profitable capital expenditure opportunities decrease.

If new products are not created and markets are not expanded, the company enters a mature stage in which it grows at roughly the same growth rate as the overall economy. Dividend payouts are typically high during this stage. If the market for a company's goods and services diminishes and no new prospects exist, the company enters a period of decline.

FINANCING OPTIONS

The majority of pure-Internet stocks are at the development or accelerating growth stage—a stage traditionally associated with rapid and increasing growth rates in sales and earnings. Internal cash flow is often not sufficient to support the growth at early stages of the life cycle, so firms must seek out additional equity or debt financing.

During bullish times, it is easy to issue additional shares to the public through a private placement. In a private placement, shares are sold directly to an institutional investor. A private placement does not have to be registered with the SEC if the securities are purchased for investment as opposed to resale. Additional shares, however, dilute the ownership of existing shareholders.

The unpredictable long-term cash flows and high risks of stocks in the development and accelerating growth stage limit borrowing options for these stocks. The long-term debt market is typically not an option. Most firms have to rely on credit from vendors along with shorter-term lines of credit from financial institutions. Some of the more established growth stocks are able to issue convertible bonds or preferred stock, which pays interest at levels approaching bonds, but also allows the holder to convert the debt into common stock at a predetermined conversion rate.

CASH FLOW

Cash flow is power, flexibility, and time for a company. The analysis of a company is not complete without evaluating its cash flow.

Income statements and earnings do not paint a clear cash flow picture. They include a number of non-cash expenses such as depreciation and amortization that reduce earnings, while ignoring the immediate cash impact of capital expenditures.

The income statement and balance sheet are based upon the principles of accrual accounting. Accrual accounting attempts to match expenses to revenues when the revenues can be expected to be recognized. For example, cash used to build up inventory will not be reflected as an expense on the income statement until the inventory is sold. The income statement spreads the cost of buying a machine across its useful life, not when cash was used to acquire the machine.

Accrual accounting requires many interpretations and estimates by management. Decisions regarding the capitalization of expenses, the recognition of revenue, and the creation of reserves against losses, are examples of just a few of the factors that may vary from firm to firm. Many of these issues are factors that relate to the "quality" of a firm's earnings. (See my 1999 series on financial statement analysis, available at www.aaii.com under Investor Pathways.)

STATEMENT OF CASH FLOW

Companies are required to provide a statement of cash flow that discloses the direct uses and sources of cash during an accounting period. The statement divides company uses and sources of cash into three primary segments—operating, investing, and financing cash flows.

The operating cash flow segment is designed to measure a company's ability to generate and consume cash from day-to-day operations as it provides goods and services to its customers. It considers factors such as cash from the collection of accounts receivable, the cash incurred to produce any goods or services, payments made to suppliers, labor costs, taxes, and interest payments. A positive cash flow from operations implies that a firm was able to generate enough cash from continuing operations without the need for additional funds. A negative cash flow from operations indicates that additional cash inflows were required for day-to-day operations.

The investing segment of the cash flow statement attempts to capture the company's investment in the long-term capital of the firm. Factors such as purchase of property, plant, and equipment; investment or sale of marketable securities; and investments or divestitures in unconsolidated subsidiaries can be recorded in this segment.

The financial segment of the cash flow statement examines how the company finances its endeavors and how it rewards its shareholders through dividend payments. Factors such as cash received from the issuance of new shares of stock or debt, payment of dividends to stockholders, and the cash used to repurchase stocks or to retire debt are summarized by this segment.

FREE CASH FLOW

Ideally, a company should not only cover the costs of producing its goods and services but also produce excess cash flow for reinvestment or for its shareholders.

AAII's fundamental stock screening and research program, *Stock Investor Professional*, tracks over 9,000 stocks. Nearly 700 stocks can be tied very closely to the Internet. However, only 17% of these companies have positive cash flow from operations. In contrast, 96% of the S&P 500 firms have positive cash flow from operations.

TABLE 1. REPRESENTATIVE INTERNET STOCKS

Company (Exchange: Ticker)	Burn Rate: No. of Months Until Burnout	Cash & Marketable Securities per Share ($)	Free Cash Flow per Share ($)	Earnings per Share ($)	Annual Sales Growth 3yr (%)	Annual EPS Growth 3yr (%)	Consensus 3-5 Year Annual EPS Growth Estimate (%)	Price to Sales (X)	Industry Price to Sales (X)	Industry
Auctions										
Bid.Com (M: BIDS)	nmf*	0.41	na	–0.29	na	–278.0	na	10.0	0.7	Business Services
eBay (M: EBAY)	214	3.57	–0.20	0.09	725.1	na	65.1	69.7	0.7	Business Services
Hardware										
Aware (M: AWRE)	nmf*	1.66	0.06	0.21	57.0	175.9	42.7	30.5	3.1	Commun's Equip
Sun Microsystems (M: SUNW)	nmf*	2.83	1.22	0.91	18.2	28.1	20.9	9.2	0.6	Computer Hardware
Internet Advertising										
24/7 Media (M: TFSM)	11	1.92	–2.07	–1.92	291.5	32.9	69.0	4.1	3.3	Advertising
DoubleClick (M: DCLK)	28	1.48	–0.64	–0.42	241.2	–93.9	58.6	47.3	3.3	Advertising
Internet Financial Services										
Charles Schwab Corp. (N: SCH)	nmf*	2.97	0.93	0.70	28.7	34.1	22.0	8.4	1.7	Investment Services
E*TRADE Group (M: EGRP)	33	4.09	–1.50	–0.30	115.0	–192.4	36.4	6.3	1.7	Investment Services
Internet Publishing										
MarketWatch.com (M: MKTW)	7	1.03	–1.75	–4.56	na	na	66.7	11.5	5.7	Computer Services
TheStreet.com (M: TSCM)	53	4.76	–1.07	–1.70	na	–81.4	50.0	10.1	5.7	Computer Services
Internet Retailing										
Amazon.com (M: AMZN)	22	2.09	–1.16	–2.18	370.9	–318.6	65.6	9.7	0.3	Retail (Spec'ty Non-Appar)
eToys (M: ETYS)	13	1.84	–1.72	–1.72	na	na	65.0	4.2	0.3	Retail (Spec'ty Non-Appar)
ISP/Hosting										
America Online (N: AOL)	nmf*	1.35	0.39	0.41	63.4	146.6	50.3	21.7	5.7	Computer Services
Exodus Commun's (M: EXDS)	35	5.74	–1.95	–0.77	327.4	–42.4	75.9	62.6	5.7	Computer Services
Multimedia										
Launch Media (M: LAUN)	11	4.47	–4.75	–6.92	128.0	8.2	na	7.7	5.7	Computer Services
RealNetworks (M: RNWK)	nmf*	2.35	0.10	0.03	82.5	26.4	54.5	34.2	4.4	Software & Programming
Portal										
At Home Corp. (M: ATHM)	nmf*	1.40	0.09	–4.14	683.7	–228.5	65.0	24.2	5.7	Computer Services
Yahoo! (M: YHOO)	nmf*	1.65	0.29	0.22	201.4	91.3	55.9	104.2	5.7	Computer Services
Security										
RSA Security (M: RSAS)	185	35.32	–2.29	3.98	36.2	132.2	32.3	7.5	4.4	Software & Programming
VeriSign (M: VRSN)	nmf*	1.48	0.07	0.03	292.7	30.3	55.0	122.0	4.4	Software & Programming
Software										
Macromedia (M: MACR)	nmf*	2.69	0.24	0.16	8.7	–9.3	32.9	9.2	4.4	Software & Programming
Spyglass (M: SPYG)	338	4.51	–0.16	1.32	9.9	–34.7	40.0	15.8	4.4	Software & Programming
Training/Education										
Prosoft Training.com (M: POSO)	14	0.24	–0.21	–0.43	113.0	–13.8	na	15.3	1.1	Schools

**nmf: not a meaningful figure— free cash flow is positive*
na: not available

Source: AAII Stock Investor Pro/Market Guide, Inc. and IBES. Data as of April 14, 2000.

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

Cash flow from operations represents a good starting point for this type of analysis. Beyond current production, a growing company must reinvest its cash to maintain its operations and expand. While management may neglect capital expenditures in the short term, there are fundamental negative long-term growth implications to such neglect.

Free cash flow refines the measure of cash flow from operations by considering capital expenditures and dividend payments to shareholders. While you can argue that dividend payments are not required, they are expected by shareholders and they are paid in cash, so they must be subtracted from cash flow to calculate a free cash flow figure. While only five of the 700 Internet stocks

TABLE 2. INTERNET STOCKS WITH NEGATIVE FREE CASH FLOW

Company (Exchange: Ticker)	Burn Rate: No. of Months Until Burnout	Cash & Marketable Securities per Share ($)	Free Cash Flow per Share ($)	Earnings per Share ($)	Annual Sales Growth 3yr (%)	Annual EPS Growth 3yr (%)	Consensus 3-5 Year Annual EPS Growth Estimate (%)	Price to Sales (X)	Industry Price to Sales (X)	Industry
Fatbrain.com (M: FATB)	0	0.10	–2.59	–2.58	na	–206.5	52.3	2.6	0.3	Retail (Spec'ty Non-Appar)
Greg Manning Auctions (M: GMAI)	1	0.10	–1.07	–0.22	–1.3	–5.9	na	5.2	0.7	Business Services
Network-1 Security Sol. (M: NSSI)	2	0.30	–1.63	–1.83	na	na	na	15.6	4.4	Software & Programming
OnHealth Network Co. (M: ONHN)	2	0.47	–2.51	–2.58	–26.3	–25.7	40.0	17.8	4.4	Software & Programming
HyperFeed Tech (M: HYPR)	3	0.10	–0.42	–0.62	24.9	–11.9	na	1.6	5.7	Computer Services
drkoop.com (M: KOOP)	4	0.77	–2.55	–5.24	na	na	30.0	12.9	5.7	Computer Services
HomeCom Commun's (M: HCOM)	4	0.39	–1.26	–1.86	122.4	na	na	3.0	4.4	Software & Programming
eFax.com (M: EFAX)	4	0.37	–1.16	–2.02	18.4	–64.6	na	0.9	1.5	Computer Peripherals
CDnow (M: CDNW)	4	0.68	–2.10	–4.28	185.9	–206.5	50.0	0.7	0.3	Retail (Spec'ty Non-Appar)
HomeSeekers.com (M: HMSK)	5	0.30	–0.78	–0.77	na	na	na	15.8	5.7	Computer Services
Women.com Networks (M: WOMN)	5	1.96	–5.07	–2.94	250.0	20.9	60.0	7.2	1.4	Printing & Publishing
Tickets.com (M: TIXX)	5	2.34	–6.04	–10.16	236.9	–73.2	na	2.7	0.7	Recreational Activities
Peapod (M: PPOD)	6	0.73	–1.54	–1.61	63.3	–17.1	50.0	0.8	0.7	Retail (Cat/Mail Order)
MyPoints.com (M: MYPT)	6	0.87	–1.69	–2.72	na	–606.7	50.0	15.5	5.7	Computer Services
CyberCash (M: CYCH)	6	0.76	–1.43	–2.01	482.8	10.0	45.0	8.4	4.4	Software & Programming

na: not available

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

Source: AAII Stock Investor Pro/Market Guide, Inc. and IBES. Data as of April 14, 2000.

pay a dividend, 79% of S&P 500 stocks pay a dividend. Free cash flow is calculated by subtracting capital expenditures and dividend payments from cash flow from operations.

Seventy-four or 11% of the Internet stocks have positive free cash flow. Seventy percent of the S&P 500 stocks have positive free cash flow.

BURN RATE

Firms with a cash flow deficit must consume cash on hand or obtain additional financing. The ability to raise cash and refinance existing debt is dependent upon the risk and return prospects of the company as well as the overall market environment. Overall, it seems to be more difficult for Internet firms to secure additional financing.

A study of a company's current cash levels and its free cash flow can help to reveal the financial independence of a firm and may indicate the need for additional financing.

In the November 1999 *AAII Journal*, Kenneth J. Michal examined Internet stock investing options in an article titled "Cyber-Investing: An Intro to Internet Stocks as an Investment," (the article can also be found at our Web site www.aaii.com). Table 1 lists the Internet companies profiled in that article broken down by the segment in which they operate.

Cash levels and cash flows can be studied on a total dollar or per share basis. We used a per share basis because it can be directly related to stock price.

Cash and marketable securities generally represent the funds available to meet immediate cash needs. Elements within the marketable securities segment can vary widely from firm to firm. While most firms classify investments that mature within one year such as bank CDs, commercial paper, Treasury bills and notes in this segment, others can classify shares of common stock as marketable securities if they are not viewed as a long-term capital investment.

Cash per share is determined at a point in time. Table 1 reports the cash and marketable securities at the end of the most recently available fiscal quarter. Since company fiscal quarters normally coincide with calendar quarters, most of our figures are as of December 31, 1999.

Closely coupled to the cash level is the free cash flow. With strong free cash flow, debt can be retired, new products developed, stock repurchased, dividend payments made or increased, or cash accumulated.

Negative free cash flow means that the company must spend cash reserves, sell off investments, improve profitability, reduce capital expenditures, or raise additional cash from outside sources by issuing debt or stock.

Free cash flow per share measures the use or generation of cash over a period of time. Quarterly or annual figures can be used. We used free cash flow per share over the last four quarters (trailing 12 months) in

order to capture the cash needs and generation over the course of a complete year. A single quarterly figure would be more timely, but less meaningful and subject to seasonal fluctuation.

Thirteen of the firms had negative free cash flow, nine had positive free cash flow, and one firm did not have four quarters reported to compute the free cash flow figure.

The burn rate indicates the net amount of cash a firm is consuming in its operation and development. By relating the negative free cash flow to the level of available cash we can provide a rough estimate of how long a company can operate before requiring additional financing. The months until burnout column indicates the number of months of operation supported by cash levels tied to the free cash flow deficit. It was computed by dividing the cash level by free cash flow and multiplying the result by 12 to equate it to a monthly level. Companies with positive free cash flow do not burn cash but create cash, so we could not compute a figure for those firms.

Low months to burnout do not necessarily indicate that the firm will run out of cash, simply that unless operational elements do not improve, the company will need to seek additional financing.

According to Table 1, MarketWatch.com has the fewest months until burnout with a figure of seven months as of 12/31/1999. MarketWatch.com was founded as partnership of CBS broadcasting and Data Broadcasting Corp. Running low on cash, in March 2000 both of these original founders agreed to invest an additional $56 million in cash to allow the company to continue its operation.

The trailing 12 months' earnings per share figure is provided to help gauge how these firms rate using traditional earnings figures. Generally the earnings per share figure closely tracks the free cash flow figure. Most firms with negative free cash flow have negative earnings.

The three-year annual sales growth figure illustrates the strong recent growth of these firms. Many of the firms sport three-digit annual sales growth. Unfortunately, this top-line growth has not translated to bottom-line earnings or earnings growth. However, expectations remain high for these firms. The consensus estimate of long-term annual growth indicates expectations over the next three to five years. The lowest expected annual growth rate for this group is 20.9%, while a number of firms have expected growth rates in earnings per share above 50%. Rates this high are clearly not sustainable for long and while some of these firms will deliver these high growth rates, historically few companies can match expectations this high.

With many new economy stocks reporting negative earnings, investors have turned to the price-to-sales ratio to gauge valuation levels. Acceptable price to sales levels normally vary by industry, growth prospects and risk, so an industry median price-to-sales level is also provided along with its industry designation. Generally the high growth expectation of these stocks is reflected in price-to-sales figures. For example, Yahoo! is trading at 104.2 time sales, a rich measure by almost any historical standard.

Table 2 goes beyond the list of representative companies profiled in the November 1999 article, and lists a sample of the current Internet stocks with only a few months until burnout. The list contains a number of prominent Internet firms with only a few cash flow problems. The auditors of drkoop.com indicated that there was "substantial doubt about its ability to continue as a going concern" in its SEC filing. CDNow had also indicated that its auditor made a similar disclosure. CDNow "has suffered recurring losses from operations, has a working capital deficiency and significant payments due in 2000 related to marketing agreements that raises substantial doubt about its ability to continue as a going concern." The stock prices of both companies fell sharply on the disclosure of their auditors' opinions. Both firms are actively pursing strategic options and new sources of funding. Peapod lost a commitment of $120 million in financing when it announced that its chairman would be stepping down for health reasons.

CONCLUSION

Many Internet-related companies were rushed to the market as IPOs in the last few years because of the strong demand and rich valuations given to new economy stocks. Many firms went public at an earlier stage of their life cycle than would have been allowed 10 years ago. While both the companies and venture capital firms obtained high cash rewards for going public, the cash buildup from the IPO was not always sufficient to allow the company to mature into a self-sustaining entity.

The analysis of a company's cash position and its free cash flow can be very revealing. The high valuations awarded to many of the new economy stocks allowed them to raise cheap capital and attract employees with the promise of stock options. A weak stock price can lead to employee defections and investor disappointment, and cut off a firm's ability to easily raise cash. Free cash flow and cash levels help to reveal whether any company is self-sustaining and provide an indication of the need for future financing. As an investor, be careful around a high burn rate firm; your investment may turn to ashes. ✦