Free Cash Flow in the Age of AI Hyperscalers: Time for an Update?

Free Cash Flow: Redefined (Slightly)

Free Cash Flow: Time for an Update?

Since I have an exciting social life with many hobbies and interests, I often spend my **free time** reading about accounting and finance…

…and I came across this article from Footnotes Analyst that recommend some adjustments to traditional FCF.

Free Cash Flow: Time for an Update?

They recommend starting with the normal definition (CFO – CapEx) and then deducting the Full Lease Expense and Stock-Based Compensation…

…and using something called "Effective CapEx" to treat Leased Assets as normal CapEx.

Free Cash Flow: Time for an Update?

We'll look at all these points here, and I'll walk you through two examples for **Amazon** (U.S. GAAP) and **SAP** (IFRS).

You'll understand **the subtleties** around "Free Cash Flow" and why it has become more complex over time, especially for Big Tech companies.

Free Cash Flow: Time for an Update?

If you want this tutorial in writing, along with screenshots, PDFs, and the Excel model, go to this URL (**pinned in the comments**):

https://breakingintowallstreet.com/kb/financial-statement-analysis/free-cash-flow/

The Short Answer…

- **Free Cash Flow** = Cash Flow from Operations – CapEx

- **YES:** Deduct the full Lease Expense from Operating and Finance Leases (use the CFF section to find Lease Principal Repayments)

- **YES:** Deduct the full Stock-Based Compensation expense, so CFO is lower (other variants possible in some contexts)

- **CALL ME MAYBE:** Reverse (some of) the Cash Lease Expense and count the value of the New Leased Assets as “Effective CapEx”

The Short Answer…

- **AND:** Keep in mind *the purpose* of your analysis and that FCF is usually not a "comparison metric"

- **More Useful:** Screening companies, M&A/LBO models, credit analyses, and variations in valuations (UFCF)

- **So:** The "proper" adjustments depend on the context as well

- **Amazon vs. SAP:** "Growth" vs. "Value," and a good illustration of some common adjustments in the FCF calculation

Free Cash Flow in the AI Age: Outline

Part 1: What Does Free Cash Flow Mean?

- **Standard:** Tells you the company's "discretionary cash flow," or how much cash it generates after paying for required business activities, re-investments, and interest on Debt/other funding

- **Cash Flow Statement:** Most items in CFO are required, but most of CFI and CFF are "optional" except for CapEx

- **Cash Flow from Operations Guidelines:** Should deduct Cash Taxes, reflect the Change in WC, reflect the Cash Net Interest Expense, reverse the proper non-cash items, and have nothing related to CapEx, Debt, or Equity

Part 1: What Does Free Cash Flow Mean?

- **Amazon:** FCF is clearly declining, no matter which version you use, due to much higher CapEx on AI data centers and infrastructure

- **But:** Not necessarily negative because it's also growing Revenue, Net Income, and CFO quickly (but is that *due to* the CapEx?)

- **SAP:** It's spending far less on CapEx while still growing Revenue, Net Income, and CFO at high rates

- **Questions:** Long-term vs. short-term and CapEx effectiveness

Part 2: The Full Lease Expense

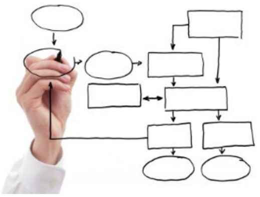
- **All Leases:** Full expense should be deducted in all metrics (FCF, UFCF, and LFCF) because it represents an operational cash outflow required to run the business

- **U.S. GAAP:** Keep the Rent deduction on the IS, keep the Finance Lease Interest deduction, and deduct Finance Lease Principal Repayments (or remove Lease D&A as an add-back)

- **IFRS:** Deduct Lease Principal Repayments in CFF and make sure that the full Lease Interest is properly deducted in CFO! IFRS-based companies often make weird reclassifications

Part 3: Lease Additions and "Effective CapEx"

- **Footnotes Analyst Approach:** Add back a portion of the Operating Lease Expense, do **not** deduct Finance Lease Principal Repayments, and count New Assets Leased as "CapEx"



- **PROBLEM #1:** Consistency issues – why add back only some of these Lease Expenses?

- **PROBLEM #2:** New Assets Leased is not a cash outflow, a dilutive item, or even a long-term commitment (can be cancelled early)

- **PROBLEM #3:** To normalize, use metrics like EBITDAR

Part 4: Stock-Based Compensation

- **All Forms of FCF:** Should *not add back* Stock-Based Comp. (treat it as a normal cash operating expense)

- **Why:** If you own a house worth $1 million and give the maintenance/repairs person 1% of the home's equity each year rather than paying them $10K in cash, that 1% isn't "free"!

- **Other Approaches:** Could also keep it as a non-cash add-back but then increase the share count over time, but harder to get right

- **SAP:** Seems to have a "Total SBC" and then a "Cash-Settled SBC"; we modify this so FCF still deducts the Total SBC

Recap and Summary

- **Part 1:** What Does Free Cash Flow Mean?



- **Part 2:** The Full Lease Expense

- **Part 3:** Lease Additions and "Effective CapEx"

- **Part 4:** Stock-Based Compensation