

## W3: Page

The required book reading for this module is chapters 8, 9, and 10.

In case the book is not yet available where you live, the section below is the summary of the required reading. Whether or not you read it, please be sure to scroll down to the bottom of this page for the case assignment for this module.

Thank you.

Besides *capital employed*, there are five other *key numbers* that we can extract from the financial statements. Recall that we'll later use the key numbers to calculate *performance metrics*. Those, in turn, will tell us whether or not a business has been *historically good*.

### Operating Income

Operating income can be found right on the income statement. No math is required. It sometimes appears as *operating earnings* or *operating profit*. Operating earnings measures the profitability of a business without regard for the capital structure or tax regime in which it is trapped.

### Free Cash Flow

Unlike operating income, free cash flow does require some calculation. At a very basic level, it equals *cash flow from operations* minus *capital expenditures*. Therefore, it's derived from the cash flow statement. Free cash flow is a measure of the amount of cash that a company *throws off* just by operating. With this cash, a company could *do* things. To get a better grip on these possibilities, let's dive deeper into capital expenditures.

Recall that a **capital expenditure**—also called *capex*—is the purchase of a noncurrent asset. There are two types: maintenance capex and growth capex. **Maintenance capex** is the purchase of equipment that will succeed equipment that is wearing out. It's *replacement*. It's a kind of expense that a company incurs just to *maintain* its level of operations. **Growth capex** is an expense incurred to *expand* operations. It results in a *bigger* enterprise.

To calculate free cash flow well, we would ideally like to deduct only *maintenance* capex from operating cash flow. After all, it's the cash-generating power of *current* operations that we're trying to measure. We'd hate to *underestimate* the performance of a business by subtracting *all* capex. The problem is that financial statements make it hard to see which portion of capex is just maintenance.

### Book Value

Earlier, we used this term to describe the *purchase price less depreciation of a noncurrent asset*. When applied to a whole company, book value means *equity*. It appears right on the balance sheet. It might be thought of as the company's worth from a formal accounting perspective.

## Tangible Book Value

Tangible book value is simply *book value* minus *intangible assets*. It might be thought of as the company's worth from an *even stricter* formal accounting perspective. Not only does it disregard the value of ongoing operations, it disregards the value of any patents, trademarks, and other assets that aren't physical.

## Shares

Many of the metrics we will calculate will be expressed on a *per-share basis*. This helps us to capture the dilutive effect of an increase in the number shares, or the concentrating effect of a decrease in the number of shares.

How should we count the number of shares? An annual report often puts forth several different measures. One is **shares outstanding**. This is the number of shares that people, investment funds, and other entities hold.

Another is **fully diluted shares**. It's equal to shares outstanding plus the number of shares that *could* become shares outstanding if other securities issued by the company were *exercised* or *converted*. For example, the exercise of a *warrant* could lead to an increase in the number of shares outstanding, as could the conversion of a *convertible bond*. An employee exercising stock options would have a similar effect.

Still, a third measure is **authorized shares**. That's the number of shares that a company is *allowed* to issue according to its charter. It equals shares outstanding plus shares authorized but not yet issued.

Which to choose? When considering the *purchase* of a stock, there turns out to be great merit to using fully diluted shares. The fundamental reason for this is that in a successful company, anything that *can* become a share *will* become a share.

Using authorized shares would be overkill. It's a major decision for a company to issue new shares that it doesn't have to because of a conversion or an exercise. It doesn't naturally happen in the normal course of events.

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## Numis Corporation PLC.

Please review the [2016 Annual Report and Accounts of Numis Corporation PLC](http://www.numiscorp.com/financialreports/NU3367%202016%20Annual_Combined_FINAL.pdf) ([http://www.numiscorp.com/financialreports/NU3367%202016%20Annual\\_Combined\\_FINAL.pdf](http://www.numiscorp.com/financialreports/NU3367%202016%20Annual_Combined_FINAL.pdf)).

In the discussion section that follows, I would be interested in your answer to the following questions:

- What does Numis do?
- For the most recently ended fiscal year, what was Numis's capital employed, operating income, free cash flow, book value, tangible book value, and number of shares?

**Thank you**