W2: Page

The required book reading for this module is chapters 6 and 7.

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.

The second step in the model is another fundamental question: is it good? In other words, is the business in which we may become an owner worth owning at *some* price? This question breaks into three sub-questions. First, has the business been *historically* good? And if so, is it likely to remain good in the *future*? And finally, is it *shareholder-friendly*?

The first question—has it been historically good—is easier to answer because we have financial statements that clearly report on how well the business has performed in the past. To tackle those statements, we first need to make sure that we're fluent in *the language of accounting*. This will be easy. Even if you're already skilled in accounting, you may find it useful to review the nature of financial statements from the simplistic perspective of a value investor.

A **financial statement** is a *quantitative description of a business*. We'll focus on three: income statement, cash flow statement, and balance sheet.

Income Statement

An income statement describes a business over a period of time, such as a month or a year. It's sometimes called a *consolidated statement of operations*, a *profit and loss statement*, or simply a *P&L*. The income statement first reports **revenue**, which is the sum of a business' sales during the period. Revenue is sometimes called *turnover*. An income statement also reports **cost of goods sold**, which is the sum of expenses the business incurred to produce sales. The income statement then measures **operating expenses** during the period, which is the sum of costs incurred by the business *regardless of what was sold*. Finally, the income statement measures **income**, which, generally speaking, is revenue minus cost of goods sold.

Cash Flow Statement

Like the income statement, the **cash flow statement** describes a business over a period of time. It measures **cash flow**, which is the net amount of money coming into or out of a business. Cash flow is sometimes called *net cash flow*. **Net cash flow** is **cash inflow** (cash coming into a business) minus **cash outflow** (cash going out of a business).

The cash flow statement divides cash flow into three types. Each type has its own cash inflows, cash outflows, and net cash flow.

- **Cash flow from operations** generally is the cash flow that results from the business *doing what it does*. Consider a wholesale beverage distributor that buys bottled drinks for fifty cents each from a manufacturer and does nothing but sell the bottles to supermarkets for one dollar each. Its cash flow from operations would include the cash it receives from supermarkets; the cash it pays to manufacturers; and the cash it pays employees to receive, sort, and deliver bottles. Cash flow from operations is sometimes called *operating cash flow* or *cash flow from operating activities*.
- **Cash flow from investments** generally includes the purchase or sale of equipment that will last for multiple years. Think again about the wholesale beverage distributor. If it paid $500,000 in cash to buy a warehouse, then cash flow from investments would go down by $500,000. If it sold one of its delivery trucks for $10,000, then cash flow from investments would go up by $10,000. Cash flow from investments is sometimes called *cash flow from investing activities*.
- **Cash flow from financing** is sometimes called *cash flow from financing activities*. A company borrowing money from a bank or selling half of itself to investors for cash are examples of cash inflows from financing. A company paying the bank back or paying a dividend to the investors are examples of cash outflows from financing.

Cash flow statements can be prepared by either the direct method or the indirect method. The difference shows up only in the top third of cash flow statements, *cash flow from operations*. The **direct method** is simpler. Under it, the section begins with cash inflows from operations, proceeds to cash outflows from operations, and ends with net cash flow from operations. Under the **indirect method**, the section begins with the net income line from the income statement. It then shows adjustments necessary to yield the ending net cash flow from operations line. Most listed companies use the indirect method.

Balance Sheet

While an income statement and a cash flow statement both look at a business over a period of time, a balance sheet looks at a business at a single point in time. A balance sheet shows what a business *owns*, what a business *owes*, and the *difference between the two*. What a business owns is called **assets**, what a business owes is called **liabilities**, and the difference between the two is called **equity**. If a business has more liabilities than assets, it has *negative equity*.

- **Assets**, the first section of the balance sheet, are things that a business *controls*, *finds valuable*, and *bought*. There are two kinds of assets: current assets and noncurrent assets.
  - **Current assets** are, generally, any asset that could be used within a year, including cash. Consider again the wholesale beverage distributor. Bottled drinks that it buys from a manufacturer, but has not yet delivered to supermarkets are current assets. Specifically, the bottled drinks are a type of current asset called **inventory**. Inventory is also called *stock-in-trade*.
  - **Non-current assets** generally take more than a year to use. A delivery truck owned by the wholesale beverage distributor is a noncurrent asset. Assume that the distributor buys a new truck for $30,000 in cash. On the cash flow statement, cash flow from investments decreases by $30,000 and net cash flow decreases by $30,000. On the balance sheet, current assets decrease by $30,000 and noncurrent assets increase by $30,000.

    Now, assume that the truck will last for three years. After three years, it will be worthless. In other words, the distributor will "use" one-third of the truck's price each year. Each year, the distributor will probably decrease the book value of the truck by $10,000 on the balance sheet and recognize a $10,000 operating expense on the income statement. This process of decreasing the book value of a noncurrent asset by recognizing an operating expense on the income statement is called **depreciation**.

If the noncurrent asset is intangible, the same process is called **amortization**. Examples of intangible noncurrent assets are patents and logos.

If a noncurrent asset does not lose value over time, it is not depreciated. Land is the best example of a noncurrent asset that is not depreciated. The purchase of a noncurrent asset is the same as a *capital expenditure*.

Sometimes a business buys an asset that will last for many years, but the business does not *capitalize* the asset. That is, the business recognizes the full price as an operating expense on the income statement at the time of purchase. This happens when the price of the asset is small. For example, an $8 pencil sharpener may last for many years, but because $8 is small, the business will expense it when it is purchased. In other words, the price is not *material*. Another way to think about it is that because the pencil sharpener fails the *materiality test*, it is *depreciated all at once*.

- **Liabilities** is the second section on the balance sheet. Money borrowed from a bank is a liability because it must be paid back. If the distributor receives a delivery of bottled drinks from the manufacturer and has not yet paid for it, the money that the distributor owes to the manufacturer is a liability. Specifically, it is a type of liability called an *account payable*.
- **Equity** is the third section on the balance sheet. It is sometimes called *shareholders' equity, owners' equity,* or *net assets*. Equity equals assets minus liabilities.

Generally, a business is said to *make money* if it shows positive income on its income statement. If this income is *retained*—that is, not paid out as *dividends*—then equity increases by that amount. Income that is kept in the business is called **retained earnings**.

After assets, liabilities, and equity, the balance sheet has a final line called *liabilities and equity*. This line provides no new information; it just proves that liabilities plus equity equals assets. Sometimes the line is called *total liabilities and shareholders' equity*.

Now we turn to extracting *key numbers* from the financial statements. Later, we'll use these key numbers to calculate *performance metrics.* Those, in turn, will tell us whether or not a business has been *historically good*.

The first key number is called *capital employed*.

Capital Employed

Capital employed might be thought of as a company's *required financial base*. It's the capital invested that has to be there in order for the company to *maintain its current level of operations*.

One way to calculate capital employed is to start with *total assets* and then subtract *excess cash*, *non-interest bearing current liabilities,* and possibly *goodwill*. So, capital employed is calculated from the balance sheet.

Determining how much cash is truly excess is difficult. Absent any specific guidance, one useful approach is to calculate two versions of capital employed: one with *all* cash subtracted and one with *no* cash subtracted.

The formula for calculating capital employed also calls for the subtraction of *non-interest bearing current liabilities*. This includes *accounts payable*, *deferred income*, and *accrued expenses*.

Goodwill will may also be subtracted. Here's what goodwill is. Assume that the balance sheet equity of company B is $1,000,000. Company A acquires company B for $1,500,000 in cash. Immediately after the acquisition, company A increases the goodwill on its balance sheet by $500,000. That is, goodwill equals *acquisition price in excess of equity*.

Sometimes calculating capital employed also requires *adding* some items. A company may have entered into obligations not fully represented on the balance sheet. But they could rightly be seen as effectively increasing both assets and liabilities and, as such, should be included in capital employed. One example is property leases. Another is aircraft leases, as with airlines.

This is not a topic that we tackle too aggressively in this introductory course, but should you go on in value investing, please know that this is a subject worth mastering. The key phrase related to this concept is *capitalizing operating leases*.

Store Capital Corp.

Please review the **2016 10-K of Store Capital Corp (http://ir.storecapital.com/file.aspx?IID=4553160&FID=38225209&O=3&OSID=9)** .

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

- Using the six-parameters approach, how would you describe what Store Capital does?
- For the most recently ended fiscal year, what was Store Capital's revenue, operating cash flow, and equity?
- For the most recently ended fiscal year, what was Store Capital's capital employed?

Thank you