
VALUE WIZARD INSIGHTER - July 2000

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1. Hong Kong Link
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Global Value Investing with Stock Valuation was selected by the Securities and Futures Commission (SFC) of Hong Kong, the second largest financial market in Asia, to be listed in the HKeIRC web site launched on 29 June 2000. The two hyperlinks to us can be found by starting on the HKeIRC main page directory and browsing:

[Hong Kong Electronic Investor Resources Centre](#)

or by clicking the following direct links:

[Investing Basics: Invest - Numeraire.com](#)

[Investment Techniques: Fundamental Analysis: Value \(#Models\) - Numeraire.com](#)

The Hong Kong electronic Investor Resources Centre (HKeIRC) sent us the following emails to request and thank us for two links to Global Value Investing with Stock Valuation. Their website is an outstanding example of investor education and public service. We urge you to visit it, beginning with their Site Map.

-----Original Message-----

From: eirc@hksfc.org.hk <eirc@hksfc.org.hk>
To: Global Value Investing <bob@numeraire.com>
Date: June 30, 2000 4:09 AM
Subject: Launch of eIRC

Dear Sir/Madam

The Securities and Futures Commission (SFC) is pleased to announce the launch of the electronic Investor Resources Centre, "eIRC", (<http://www.HKeIRC.org>) on the Internet on 29th June 2000.

The SFC wishes to express its appreciation of your organization's agreement for the eIRC to establish a hyperlink to your website. The SFC welcomes a reciprocal arrangement, i.e. setting up a link from your site to the eIRC, provided there is no framing of any contents on it.

Once again, thank you for your support to the SFC's investor education work.

Yours sincerely
(name withheld)
Securities and Futures Commission, Hong Kong

-----Original Message-----

From: eirc@hksfc.org.hk <eirc@hksfc.org.hk>

To: Numeraire <bob@numeraire.com>

Date: April 17, 2000 1:33 AM

Subject: Request for consent to establish hyperlinks to your website Numeraire.com

Mr Bob Coleman
Numeraire.com

Dear Mr Coleman

The Securities and Futures Commission (SFC) is a regulator of the securities and futures markets in Hong Kong. We plan to establish a separate website for the local investors to learn about investing and to obtain useful information related to investments. This will be part of the SFC's investor education efforts to help investors understand the nature and risks of their investments.

The new website will be named "eIRC", which stands for "Electronic Investor Resources Centre". To enhance its appeal to the investing public, the eIRC will not only provide information, but will also have direct links to other websites that contain useful information.

As we find the information on your website very useful, especially the sections on "Invest" and "Value", we would like to get your consent to establish hyperlinks to your website.

As the SFC intends to launch the eIRC in mid-2000, we shall be grateful for your early response by e-mail to eirc@hksfc.org.hk.

Thank you very much for your attention.

Yours sincerely
(name withheld)
Securities and Futures Commission, Hong Kong

2. Wealth Effect

In microeconomic price theory, the wealth effect is like the income effect on prices determined by supply and demand. If a person has an increase in wealth, then he or she has a greater propensity to spend. To the extent this is an accurate description of human behavior, then it might contribute to inflation due to more money chasing the same goods.

The major flaws in this putative connection between wealth and inflation is that first, wealth is ambiguous, and second, wealth is difficult to measure or operationalize. In the visible monetized economy, the most meaningful measure of wealth is not the mere accounting recognition of income or "profit on paper," but rather the realization of income or capital gains. If the common stock you purchased increases in market price, then following the "mark to market" principle of accounting, an increase in wealth is *recognized* on the books. But no gain is *realized* unless and until there is a sale transaction or other taxable event and cash changes hands. In the invisible non-monetized barter economy, a.k.a. the underground economy, the most meaningful measure of wealth is cash.

In a stock market characterized by a greater than usual degree and frequency of price fluctuations, the "mark to market" rule can mean following the popular delusions and madness of crowds. In short, fantasies may be recognized, but only true wealth is realized. Fantasies are not inflationary -- effective demand is defined as demand by willing purchasers who have the means to pay.

3. Stock Splits

Stock splits merely divide a company into a different number of shares with no economic consequences. The distinction between stock splits and stock dividends is arbitrary, but usually a split that increases the number of shares by 20 percent or less is called a stock dividend. Reverse splits result in fewer rather than more shares outstanding. A 2-for-1 stock split results in twice as many shares that are worth one-half as much. A reverse 1-for-2 stock split results in one-half as many shares that are worth twice as much. At some of the online stock charting services, splits may be spotted on historical price graphs for quick reference.

There is no reason to value a company differently because of a split in its stock. Stock splits sometimes signal a concomitant cash dividend increase, but this does not always obtain. Stock splits may be associated with higher average returns in the theoretical capital asset *pricing* model (CAPM), but they are not necessarily causally related to persistent higher risk-adjusted returns. Results of academic studies based on the CAPM depend on the specific sample of stocks and time periods chosen.

“Stock Splits and Stock Dividends in No-par Stock.—In the case of common stocks in no-par value, a split up or a stock dividend leads to exactly the same results, and to all practical purposes they are indistinguishable. While a stock dividend requires the transfer of a certain sum on the books from surplus to capital, the infinite latitude in accounting permitted by no-par stock may make this transfer a purely nominal affair. ...

“Objections to Extraordinary Stock Dividends and Split-ups.—Extraordinary stock dividends and stock split-ups are both open to the serious objection that their declaration exercises an undue influence upon market prices, and hence that they afford an avenue for manipulation and for unfair profits by insiders. It is obvious that in theory a large stock dividend gives the stockholder nothing that he did not own before. His two pieces of paper now represent the same ownership formerly expressed by one piece of paper. ... In practice, however, a stock dividend may readily be given exceptional speculative importance. For stock speculation is largely a matter of *A* trying to decide what *B*, *C*, and *D* are likely to think—with *B*, *C*, and *D* trying to do the same. Hence a stock dividend, even if it has no real significance of any kind, can and does serve as a stimulus to that *mutual attempt at taking advantage of each other* which often lies at the bottom of speculators’ activities.”

From pp. 340-341 of *Security Analysis: The Classic 1934 Edition*, by Benjamin Graham and David Dodd, reprint 1996, New York: McGraw-Hill Book Company, Inc.

4. Shares Outstanding

The intrinsic value per share (VPS) is a ratio of two numbers. The numerator is the estimate of intrinsic value of the total company (V), and the denominator is the number of shares (S).

$$\text{VPS} = \text{V/S}$$

V and S both determine VPS. A proportional change in V or the same inverse proportional change in S will have the same impact on VPS. For example, multiplying V by two is mathematically equivalent to multiplying S by one-half, the inverse of two. V is estimated from several factors which impact VPS only indirectly through their impact on V. A proportional change in one of these factors will have a smaller impact on VPS than the same inverse proportional change in S. Thus, it is important to determine S as accurately as possible because VPS is more sensitive to equal proportional changes in this factor than any other factor.

In stock valuation, we are interested in the total number of common shares outstanding, or alternatively, the total number of common shares potentially outstanding due to stock option grants, convertible preferred stock issued and outstanding, and other common equivalents, whether or not dilutive.

Dilution refers to an increase in the number of shares of common stock in a company without an equal or greater proportional increase in earnings, thereby resulting in a decrease in earnings per share. Different events can lead to an increase in the number of shares outstanding, but not all such events dilute earnings. Stock option grants, when exercised, may or may not be dilutive. Rights offerings, secondary offerings after the initial public offering dilute earnings, and conversions of convertible preferred stock dilute earnings. Company common stock exchanged for the common stock of another company in a merger or acquisition may or may not dilute earnings.

How many shares of common stock does a company have? That question has different answers, and the right answer depends on the purpose of the number. Some of the answers include the following:

1. Authorized (by Company certificate of incorporation and bylaws).
2. Issued (held by stockholders and held by Company as treasury stock as reserve for convertible securities and stock option grants).
3. Outstanding (held by stockholders and receives dividend payments).
4. Float or shares available to investors in the market (float excludes Company treasury stock, restricted stock, and some shares owned by insiders such as Company founders; free-float market capitalization excludes block holdings of individuals, other companies or governments that each exceed 5%).
5. Used for basic and fully-diluted per share calculations (usually a weighted average over the fiscal quarters).
6. Outstanding plus Common Equivalent Shares.

Yahoo Inc. is used in the following example to illustrate various points about stock valuation because it is a well known worldwide company in the currently popular Internet industry, and it has a widely held stock which may seem to defy traditional approaches to valuation. Full disclosure: No one at Numeraire has ever had a position in Yahoo Inc. stock.

Let's see what the number of shares of common stock outstanding is for Yahoo Inc. for each of its unaudited quarters in fiscal year 1999 and for its audited fiscal year 1999. Selected annotated portions of Forms 10-Q and Form 10-K are copied below for quick reference, followed by comments and analysis.

YHOO Form 10-Q filed 5/17/99:

YAHOO! INC. Condensed Consolidated Statements of Operations
(unaudited, in thousands except per share amounts)

	Three Months Ended	
	March 31, 1999	March 31, 1998
Net income	\$ 16,435	\$3,270
Net income per share - basic	\$0.08	\$0.02
Net income per share - diluted	\$0.07	\$0.02
Shares used in per share calculation - basic	201,531	172,578
Shares used in per share calculation diluted	237,111	213,866

YHOO Form 10-Q filed 8/16/99:

YAHOO! INC. Condensed Consolidated Statements of Operations
(unaudited, in thousands except per share amounts)

	Three Months Ended		Six Months Ended	
	June 30, 1999	June 30, 1998	June 30, 1999	June 30, 1998
Net loss applicable to common stockholders	\$ (15,062)	\$ (14,847)	\$ (9,419)	\$ (15,867)
Net loss per share ---basic and diluted	\$ (0.07)	\$ (0.08)	\$ (0.04)	\$ (0.09)
Shares used in per share calculation ---basic and diluted	227,461	181,352	225,753	178,138

Yahoo Form 10-Q filed 11/12/99:

YAHOO! INC. Condensed Consolidated Statements of Operations
(unaudited, in thousands except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30, 1999	September 30, 1998	September 30, 1999	September 30, 1998
Net income (loss)	\$ 14,862	\$ 4,249	\$ 16,395	\$ (16,514)
Net income (loss) per share---basic	\$ 0.06	\$ 0.02	\$ 0.06	\$ (0.08)
Net income (loss) per share---diluted	\$ 0.05	\$ 0.01	\$ 0.06	\$ (0.08)
Shares used in per share calculation---basic	259,530	232,404	255,820	211,669
Shares used in per share				

Note 1: Stock Split. During January 2000, the Company's Board of Directors approved a two-for-one Common Stock split which was effective on February 14, 2000. Stockholders' equity has been restated to give retroactive recognition to the stock split for all periods presented by reclassifying from additional paid-in capital to common stock, the par value of additional shares issued as a result of the splits. In addition, all references to the number of shares, per share amounts, stock option data, and market prices in the financial statements and notes thereto for all periods presented have been restated to reflect the stock split.

Note 11: Increase in Authorized Shares. At the Company's Annual Meeting of Stockholders which is scheduled for May 12, 2000, stockholders will vote to amend the Company's certificate of incorporation by increasing the number of authorized shares of Common Stock from 900 million to five billion.

Exhibit 10-2:

YAHOO! INC. 1995 STOCK PLAN (MAY 1999 AMENDMENT)

Purposes of the Plan. The purposes of this 1995 Stock Plan are to attract and retain the best available personnel for positions of substantial responsibility, to provide additional incentive to Employees and Consultants of the Company and its Subsidiaries and to promote the success of the Company's business. Options granted under the Plan may be incentive stock options(as defined under Section 422 of the Code) or nonstatutory stock options, as determined by the Administrator at the time of grant of an option and subject to the applicable provisions of Section 422 of the Code, as amended, and the regulations promulgated thereunder. Stock purchase rights may also be granted under the Plan.

Item 8: Table 5:

	Available for Grant	Options Outstanding	Weighted Average Price per Share
Balance at December 31, 1998	25,722	129,203	10.61
Additional shares reserved	80,000	--	--
Options granted	(37,428)	37,428	82.07
Options exercised	--	(33,355)	6.99
Options canceled	8,706	(8,706)	11.20
Options forfeited	(7,340)	--	--
Balance at December 31, 1999	69,660	124,570	\$ 32.45

Item 8: Table 6:

Range of Exercise Prices	Number Outstanding	Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
Less than \$0.01	12,009	5.6	\$ 0.00	11,977	\$ 0.00
\$0.02 - \$0.84	12,805	6.2	0.43	10,851	0.43
\$0.84 - \$1.67	8,160	6.6	1.34	4,139	1.35
\$1.67 - \$6.74	21,220	7.7	4.64	5,634	4.81
\$6.74 - \$18.05	11,895	8.3	12.19	2,485	11.67
\$19.63 -	21,276	8.8	36.64	4,379	38.53

\$49.50					
\$50.98 -	2,771	9.2	57.31	277	51.89
\$63.75					
\$65.75 -	16,924	9.6	71.44	98	68.41
\$71.91					
\$73.14 -	17,510	9.5	93.37	35	115.19
\$195.13					

	124,570	8.1	\$ 32.45	39,875	\$ 6.53

Comment and Analysis:

At http://docs.yahoo.com/info/investor/split_faq.html in a Yahoo website page for Frequently Asked Questions about their latest stock split, we find the Current total shares outstanding: 266,378,488 on December 31, 1999, prior to adjustment for the two-for-one stock split. The post-split number of shares outstanding would be twice that amount or 532,756,976 on December 31, 1999.

The stock split is the fourth by Yahoo, with ex-dates as follows:

3 for 2 *September 2, 1997*
2 for 1 *August 3, 1998*
2 for 1 *February 8, 1999*
2 for 1 *February 14, 2000*

The exercise prices of the stock options range from a low of less than 1/2 cent per share after adjustment for the 2-for-1 stock split on 14 February 2000 to a high of \$195.13 per share or \$97.57 per share adjusted for the 2-for-1 stock split. The weighted average exercise price ranges from a low of less than 1/2 cent per share (approaching zero cent per share) to a high of \$46.69 per share adjusted for the 2-for-1 stock split.

In a prior issue of *Insighter*, the intrinsic value per share of YHOO common stock under generous growth assumptions was estimated to be about \$95 per share based on fiscal year 1999 data. Thus, the highest exercise prices of \$73.14 to \$97.57 per share for 17,510 shares (about 14% of the total option shares outstanding) has a maximum that is approximately equal to the estimated optimistic intrinsic value. About 86% of the option shares outstanding have an exercise price less than \$71.44, offering a safety margin of about 25% below the \$95 price.

Those investors who hold options with an exercise price of less than one-half cent a share were probably A-stage (first round) investors. The T-stage (turkey round) investors at the final venture capital financing before the initial public offering paid more. Since these options have an average remaining contractual life of 5.6 years and the Company is almost 5 years old, some of these options have a original contractual life of 10 years or more. One of the fallacies of blindly following insider buying activity is that the insiders are often buying stock at effective prices that are much lower than the currently quoted stock market prices.

At <http://docs.yahoo.com/info/investor/> in a Yahoo website page for investors, we find that the current shares outstanding is 539.0 million, and the float is estimated at 321.9 million.

The weighted-average number of common shares outstanding for second quarter, third quarter, and fourth quarter (fiscal year-end) may be calculated using the number of common shares outstanding for the component quarters of each period. A weighted average number of shares can be calculated by different methods which may give different results, but the biggest unknown variable is the number of shares at the end of each quarter that are dilutive. There does not appear to be sufficient information in the 10-Qs and 10-K for fiscal year 1999 to determine the method and replicate the calculation of weighted average number of shares for the final three quarters (the first quarter has no weighted averaged). Nevertheless, we can observe the various factors impacting this calculation and be alert to

significant departures that might distort the number we use for the total number of shares of common stock outstanding at fiscal year-end.

End of Quarter	1Q (3 mos)	2Q (3 mos)	3Q (3 mos)	4Q (3 mos)
Shares - basic	201,531	227,461	259,530	not reported
Shares - diluted	237,111	227,461	296,336	not reported
Weighted Average	1Q (3 mos)	2Q (6 mos)	3Q (9 mos)	4Q (12 mos)
Shares - basic	201,531	225,753	255,820	515,948* (257,974)
Shares - diluted	237,111	225,753	296,860	596,790* (298,395)

Reflects the two-for-one stock split effective February 2000.

Comparing the 432,672 diluted shares at end of 1999 (865,344 shares post-split) to the number of shares reported by the Company of 532,757 (thousands) post-split as of 31 December 1999 indicates an increase of 100,085 common stock equivalent shares or 23% dilution. Let's compare this 23% to the dilution implied by the reported numbers.

Dilution calculated for each cumulative period:

Weighted Average	1Q (3 mos)	2Q (6 mos)	3Q (9 mos)	4Q (12 mos)
Dilution Shares	35,580	-0-	41,040	40,421
Dilution %	17.7%	0%	16.0%	15.7%

Convertible Preferred Stock	??
Common Stock Options	249,140 (124,570 x 2)
Warrants (long-term stock options)	??
Total common stock equivalent shares	??

If the total outstanding stock option shares of 124,570 (000) at December 31, 1999, doubled to adjust for the two-for-one stock split or 249,140 (000), is added to the 532,756,976 post-split total shares outstanding at 31 December 1999, we get a total of 781,896,116, an increase of 31.9%, which is more than twice the 15.7% weighted average dilution for 4Q (12 mos) 1999. The increasing trend of total outstanding shares diluted is masked by the weighted average which is also a moving average that damps or smoothes the curve. This topic will be continued in the August issue when Yahoo's first and second quarter 2000 Form 10-Q's will be available.

Another technique to estimate number of shares outstanding is the market capitalization divided by last trade price. Basic shares outstanding on 1 April 2000 is 526,480 (thousands). Assuming the same level of dilution at end of fiscal year, diluted shares outstanding on 1 April 2000 is 526,480 times 1.157 (an increase of 15.7%) which equals 609,137 shares.

Which figure for number of shares is best to use in calculations of intrinsic value? The ideal figure for the upper limit is the number of common shares at fiscal year end plus the number of total dilutive common shares. The second best is the closest approximation to this ideal, given the available information, which may be sufficient for decision making.

Concerning the subject of total shares outstanding, the proposed increase in authorized shares from 900 million to 5,000 million (see Note 11) is highly significant. If approved by Yahoo Inc. shareholders, it will provide a large war chest of relatively cheap takeover currency to go big game hunting among attractive targets including so-called old economy stocks with bricks and mortar.

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