BetterInvesting™
Space Coast Chapter

Tips, Tricks, & Techniques

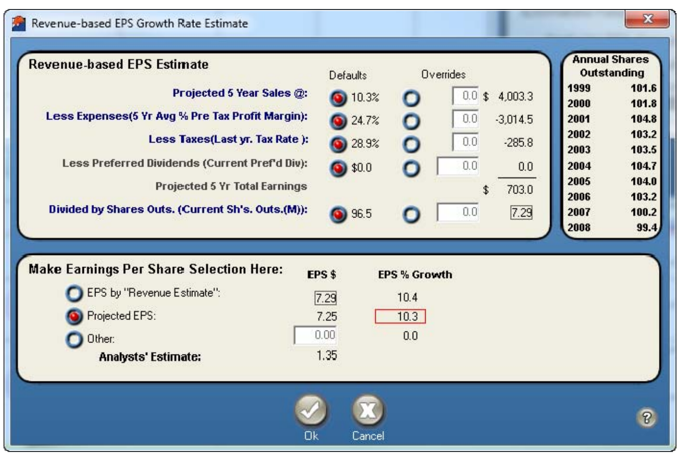
Diluted Earnings per Share & Diluted Shares

Today the Earnings per Share (EPS) reported by companies are the diluted EPS. This is calculated as if all outstanding convertible preferred shares, convertible debentures, warrants, and stock options are included in the count of Shares Outstanding.

This is a conservative metric of company performance as it is not likely that all conversions will be executed. However, the result is a lower Diluted EPS than the conventional EPS.

Earnings per Share reported by Value Line, S&P, and Morningstar are all Diluted EPS.

Those of us who use the Revenue-based EPS Estimate {aka Preferred Procedure} in completing our Stock Studies should consider using the Diluted Shares in our study. So now the rub is, "Where do we find the Diluted Shares?"



First let us look at the Revenue-based EPS Growth Rate Estimate from Toolkit 6. Without using any of the Overrides, the EPS by "Revenue Estimate" is much in agreement with our Projected EPS using the current Shares Outstanding. However, with the company buying back shares, let us take a look based on the Value Line estimate of the number of shares 3 to 5 years out.

Now we will move on to determine the Diluted Shares based on Value Line estimates 3 to 5 years down the road for Net Profit and Diluted Earnings per Share. We will then use these estimates to estimate the number of Diluted Shares. The first time or two that you do this, it does tend to make your hair hurt but hang in as it is really quite simple.

Diluted Earnings per Share & Diluted Shares (continued)

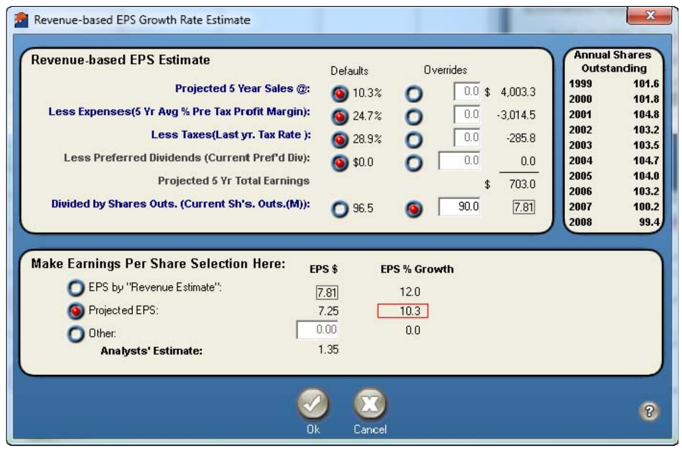
05	2006	2007	2008	2009	2010	© VALUE LINE PUB., INC.	12-14
33	19.25	21.98	24.67	**26.60**	**31.90**	Sales per sh	**42.80**
.76	4.14	4.85	5.50	**6.15**	**7.00**	"Cash Flow" per sh	**9.40**
03	3.29	3.84	4.44	**5.05**	**5.75**	Earnings per sh A	**7.80**
.50	.54	.58	.62	**.68**	**.76**	Div'ds Decl'd per sh E■	**.94**
93	.68	.51	.70	**.70**	**.85**	Cap'l Spending per sh	**1.20**
.77	16.46	13.44	19.89	**19.55**	**22.90**	Book Value per sh C	**39.25**
01	103.16	100.19	99.39	**95.00**	**92.50**	Common Shs Outst'g D	**90.00**
20	22.3	21.7	20.5	*Bold figures are*	*Value Line*	Avg Ann'l P/E Ratio	**18.0**
.17	1.20	1.15	1.23	*estimates*		Relative P/E Ratio	**1.20**
%	.7%	.7%	.7%			Avg Ann'l Div'd Yield	**.7%**
3	1985.5	2202.0	2452.1	**2525**	**2950**	Sales ($mill)	**3850**
%	27.7%	26.9%	30.0%	**30.4%**	**29.0%**	Operating Margin	**29.0%**
3.8	74.9	30.0	90.9	**91.5**	**93.5**	Depreciation ($mill)	**115**
.4	351.8	406.4	455.4	**495**	**555**	Net Profit ($mill)	**735**
%	27.5%	25.6%	28.9%	**27.0%**	**27.0%**	Income Tax Rate	**27.0%**
5%	17.7%	16.5%	18.6%	**19.6%**	**18.8%**	Net Profit Margin	**19.0%**
5	838.0	930.3	1081.1	**890**	**1060**	Working Cap'l ($mill)	**1390**
.8	150.6	119.8	148.8	**150**	**150**	Long-Term Debt ($mill)	**150**
.1	1698.0	1848.0	1977.2	**1855**	**2115**	Shr. Equity ($mill)	**3530**
7%	19.5%	20.6%	21.7%	**25.0%**	**24.5%**	Return on Total Cap'l	**20.0%**
.3%	20.7%	22.0%	23.0%	**26.5%**	**26.0%**	Return on Shr. Equity	**21.0%**
9%	17.4%	16.7%	19.9%	**23.0%**	**23.0%**	Retained to Com Eq	**18.5%**
6%	16%	15%	14%	**13%**	**13%**	All Div'ds to Net Prof	**12%**

The footnote, "A" for the Earnings per share indicates that the values shown are diluted for all values since 1996.

For 3 to 5 years out Value Line estimates:

1. That there will be 90.00M Common Shares Outstanding
2. The Net Profit will be $735M
3. The Diluted EPS will be $7.80 per Share

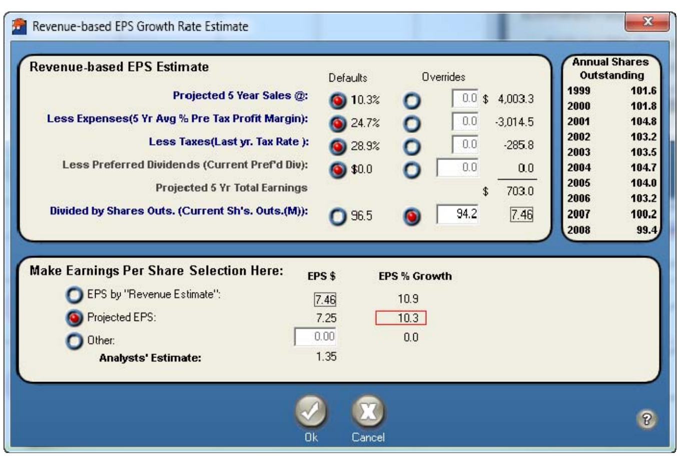
We will use these numbers as we proceed.



Were we to Override the Shares Outstanding with the Value Line estimate of 90.00M shares, we would see the EPS by "Revenue Estimate" rise to 12.0% growth. With the buy back somewhat evident, this might be a wise choice. However, these are not Diluted Shares.

We are able to calculate the number of Diluted Shares by dividing the estimated Net Profit by the estimated Diluted Shares.

Diluted Shares = $735M / $7.80 per share = 94.23M Diluted shares



Using Diluted Shares drops the EPS% Growth estimate to 10.9% EPS Growth from 12.0% using the Outstanding Shares.

The additional 4 ¼ M shares is but a 4% difference in the number of shares but the effect is a 9% change in the EPS Growth estimate.

Should you decide to look ahead using 3 to 5 year figures from Value Line, we suggest that you always choose to use the calculated Diluted Shares.

For additional information on Diluted Shares and Earnings, Google the subject. Investopedia has good explanation of items that could, and probably will, be converted to common shares should the company do well in the near future. Search:

- Debenture
- Preferred stock
- Warrant (finance)

Should there be a larger difference between the projected number of outstanding shares and the derived diluted shares, please consider this to be a Red Flag. This is a characteristic that will cause investors and analysts to shun the company.

By the way, just in case you wondered the company used in this example is Bard, C.R. (BCR) and were this my study I would have remained with my original EPS Growth estimate of 10.3%.

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