financial terms it cannot count beyond 3. It will buy anything, at any price, if there seems to be some "action" in progress. It will fall for any company identified with "franchising," computers, electronics, science, technology, or what have you, when the particular fashion is raging. Our readers, sensible investors all, are of course above such foolishness. But questions remain: Should not responsible investment houses be honor-bound to refrain from identifying themselves with such enterprises, nine out of ten of which may be foredoomed to ultimate failure? (This was actually the situation when the author entered Wall Street in 1914. By comparison it would seem that the ethical standards of the "Street" have fallen rather than advanced in the ensuing 57 years, despite all the reforms and all the controls.) Could and should the SEC be given other powers to protect the public, beyond the present ones which are limited to requiring the printing of all important relevant facts in the offering prospectus? Should some kind of box score for public offerings of various types be compiled and published in conspicuous fashion? Should every prospectus, and perhaps every confirmation of sale under an original offering, carry some kind of formal warranty that the offering price for the issue is not substantially out of line with the ruling prices for issues of the same general type already established in the market? As we write this edition a movement toward reform of Wall Street abuses is under way. It will be difficult to impose worthwhile changes in the field of new offerings, because the abuses are so largely the result of the public's own heedlessness and greed. But the matter deserves long and careful consideration.*

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* The first four sentences of Graham's paragraph could read as the official epitaph of the Internet and telecommunications bubble that burst in early 2000. Just as the Surgeon General's warning on the side of a cigarette pack does not stop everyone from lighting up, no regulatory reform will ever prevent investors from overdosing on their own greed. (Not even Communism can outlaw market bubbles; the Chinese stock market shot up 101.7% in the first half of 1999, then crashed.) Nor can investment banks ever be entirely cleansed of their own compulsion to sell any stock at any price the market will bear. The circle can only be broken one investor, and one financial adviser, at a time. Mastering Graham's principles (see especially Chapters 1, 8, and 20) is the best way to start.

COMMENTARY ON CHAPTER 17

> The wisdom god, Woden, went out to the king of the trolls, got him in an armlock, and demanded to know of him how order might triumph over chaos. "Give me your left eye," said the troll, "and I'll tell you." Without hesitation, Woden gave up his left eye. "Now tell me." The troll said, "The secret is, 'Watch with both eyes!' "
>
> —*John Gardner*

THE MORE THINGS CHANGE . . .

Graham highlights four extremes:

- an overpriced "tottering giant"
- an empire-building conglomerate
- a merger in which a tiny firm took over a big one
- an initial public offering of shares in a basically worthless company

The past few years have provided enough new cases of Graham's extremes to fill an encyclopedia. Here is a sampler:

LUCENT, NOT TRANSPARENT

In mid-2000, Lucent Technologies Inc. was owned by more investors than any other U.S. stock. With a market capitalization of $192.9 billion, it was the 12th-most-valuable company in America.

Was that giant valuation justified? Let's look at some basics from Lucent's financial report for the fiscal quarter ended June 30, 2000:[1]

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[1] This document, like all the financial reports cited in this chapter, is readily available to the public through the EDGAR Database at www.sec.gov.

FIGURE 17-1 Lucent Technologies Inc.

	For the quarter ended . . . June 30, 2000	June 30, 1999
Income		
Revenues	8,713	7,403
Income (loss) from continuing operations	(14)	622
Income (loss) from discontinued operations	(287)	141
Net income	(301)	763
Assets		
Cash	710	1,495
Receivables	10,101	9,486
Goodwill	8,736	3,340*
Capitalized software development costs	576	412
Total assets	46,340	37,156

All numbers in millions of dollars. * Other assets, which includes goodwill.
Source: Lucent quarterly financial reports (Form 10-Q).

A closer reading of Lucent's report sets alarm bells jangling like an unanswered telephone switchboard:

- Lucent had just bought an optical equipment supplier, Chromatis Networks, for $4.8 billion—of which $4.2 billion was "goodwill" (or cost above book value). Chromatis had 150 employees, no customers, and zero revenues, so the term "goodwill" seems inadequate; perhaps "hope chest" is more accurate. If Chromatis's embryonic products did not work out, Lucent would have to reverse the goodwill and charge it off against future earnings.
- A footnote discloses that Lucent had lent $1.5 billion to purchasers of its products. Lucent was also on the hook for $350 million in guarantees for money its customers had borrowed elsewhere. The total of these "customer financings" had doubled in a year—suggesting that purchasers were running out of cash to buy Lucent's products. What if they ran out of cash to pay their debts?
- Finally, Lucent treated the cost of developing new software as a "capital asset." Rather than an asset, wasn't that a routine business expense that should come out of earnings?

CONCLUSION: In August 2001, Lucent shut down the Chromatis division after its products reportedly attracted only two customers.[2] In fiscal year 2001, Lucent lost $16.2 billion; in fiscal year 2002, it lost another $11.9 billion. Included in those losses were $3.5 billion in "provisions for bad debts and customer financings," $4.1 billion in "impairment charges related to goodwill," and $362 million in charges "related to capitalized software."

Lucent's stock, at $51.062 on June 30, 2000, finished 2002 at $1.26—a loss of nearly $190 billion in market value in two-and-a-half years.

THE ACQUISITION MAGICIAN

To describe Tyco International Ltd., we can only paraphrase Winston Churchill and say that never has so much been sold by so many to so few. From 1997 through 2001, this Bermuda-based conglomerate spent a total of more than $37 billion—most of it in shares of Tyco stock—buying companies the way Imelda Marcos bought shoes. In fiscal year 2000 alone, according to its annual report, Tyco acquired "approximately 200 companies"—an average of more than one every other day.

The result? Tyco grew phenomenally fast; in five years, revenues went from $7.6 billion to $34 billion, and operating income shot from a $476 million loss to a $6.2 billion gain. No wonder the company had a total stock-market value of $114 billion at the end of 2001.

But Tyco's financial statements were at least as mind-boggling as its growth. Nearly every year, they featured hundreds of millions of dollars in acquisition-related charges. These expenses fell into three main categories:

1) "merger" or "restructuring" or "other nonrecurring" costs,
2) "charges for the impairment of long-lived assets," and
3) "write-offs of purchased in-process research and development."

For the sake of brevity, let's refer to the first kind of charge as MORON, the second as CHILLA, and the third as WOOPIPRAD. How did they show up over time?

[2] The demise of the Chromatis acquisition is discussed in *The Financial Times,* August 29, 2001, p. 1, and September 1/September 2, 2001, p. XXIII.

FIGURE 17-2 Tyco International Ltd.

	Fiscal year	MORON	CHILLA	WOOPIPRAD
	1997	918	148	361
	1998	0	0	0
	1999	1,183	335	0
	2000	4175	99	0
	2001	234	120	184
Totals		2,510	702	545

All figures are as originally reported, stated in hundreds of millions of dollars.
"Mergers & acquisitions" totals do not include pooling-of-interests deals.
Source: Tyco International annual reports (Form 10-K).

As you can see, the MORON charges—*which are supposed to be nonrecurring*—showed up in four out of five years and totaled a whopping $2.5 billion. CHILLA cropped up just as chronically and amounted to more than $700 million. WOOPIPRAD came to another half-billion dollars.[3]

The intelligent investor would ask:

- If Tyco's strategy of growth-through-acquisition was such a neat idea, how come it had to spend an average of $750 million a year cleaning up after itself?
- If, as seems clear, Tyco was not in the business of making things—but rather in the business of buying other companies that make things—then why were its MORON charges "nonrecurring"? Weren't they just part of Tyco's normal costs of doing business?
- And with accounting charges for past acquisitions junking up every year's earnings, who could tell what next year's would be?

[3] When accounting for acquisitions, loading up on WOOPIPRAD enabled Tyco to reduce the portion of the purchase price that it allocated to goodwill. Since WOOPIPRAD can be expensed up front, while goodwill (under the accounting rules then in force) had to be written off over multi-year periods, this maneuver enabled Tyco to minimize the impact of goodwill charges on its future earnings.

In fact, an investor couldn't even tell what Tyco's *past* earnings were. In 1999, after an accounting review by the U.S. Securities and Exchange Commission, Tyco retroactively added $257 million in MORON charges to its 1998 expenses—meaning that those "nonrecurring" costs had actually recurred in that year, too. At the same time, the company rejiggered its originally reported 1999 charges: MORON dropped to $929 million while CHILLA rose to $507 million.

Tyco was clearly growing in size, but was it growing more profitable? No outsider could safely tell.

CONCLUSION: In fiscal year 2002, Tyco lost $9.4 billion. The stock, which had closed at $58.90 at year-end 2001, finished 2002 at $17.08—a loss of 71% in twelve months.[4]

A MINNOW SWALLOWS A WHALE

On January 10, 2000, America Online, Inc. and Time Warner Inc. announced that they would merge in a deal initially valued at $156 billion.

As of December 31, 1999, AOL had $10.3 billion in assets, and its revenues over the previous 12 months had amounted to $5.7 billion. Time Warner, on the other hand, had $51.2 billion in assets and revenues of $27.3 billion. Time Warner was a vastly bigger company by any measure except one: the valuation of its stock. Because America Online bedazzled investors simply by being in the Internet industry, its stock sold for a stupendous 164 times its earnings. Stock in Time Warner, a grab bag of cable television, movies, music, and magazines, sold for around 50 times earnings.

In announcing the deal, the two companies called it a "strategic merger of equals." Time Warner's chairman, Gerald M. Levin, declared that "the opportunities are limitless for everyone connected to AOL Time Warner"—above all, he added, for its shareholders.

Ecstatic that their stock might finally get the cachet of an Internet

[4] In 2002, Tyco's former chief executive, L. Dennis Kozlowski, was charged by state and Federal legal authorities with income tax fraud and improperly diverting Tyco's corporate assets for his own use, including the appropriation of $15,000 for an umbrella stand and $6,000 for a shower curtain. Kozlowski denied all charges.

darling, Time Warner shareholders overwhelmingly approved the deal. But they overlooked a few things:

- This “merger of equals” was designed to give America Online’s shareholders 55% of the combined company—even though Time Warner was five times bigger.
- For the second time in three years, the U.S. Securities and Exchange Commission was investigating whether America Online had improperly accounted for marketing costs.
- Nearly half of America Online’s total assets—$4.9 billion worth—was made up of “available-for-sale equity securities.” If the prices of publicly-traded technology stocks fell, that could wipe out much of the company’s asset base.

CONCLUSION: On January 11, 2001, the two firms finalized their merger. AOL Time Warner Inc. lost $4.9 billion in 2001 and—in the most gargantuan loss ever recorded by a corporation—another $98.7 billion in 2002. Most of the losses came from writing down the value of America Online. By year-end 2002, the shareholders for whom Levin predicted “unlimited” opportunities had nothing to show but a roughly 80% loss in the value of their shares since the deal was first announced.[5]

CAN YOU FLUNK INVESTING KINDERGARTEN?

On May 20, 1999, eToys Inc. sold 8% of its stock to the public. Four of Wall Street’s most prestigious investment banks—Goldman, Sachs & Co.; BancBoston Robertson Stephens; Donaldson, Lufkin & Jenrette; and Merrill Lynch & Co.—underwrote 8,320,000 shares at $20 apiece, raising $166.4 million. The stock roared up, closing at $76.5625, a 282.8% gain in its first day of trading. At that price, eToys (with its 102 million shares) had a market value of $7.8 billion.[6]

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[5] Disclosure: Jason Zweig is an employee of Time Inc., formerly a division of Time Warner and now a unit of AOL Time Warner Inc.

[6] eToys’ prospectus had a gatefold cover featuring an original cartoon of Arthur the aardvark, showing in comic style how much easier it would be to

What kind of business did buyers get for that price? eToys' sales had risen 4,261% in the previous year, and it had added 75,000 customers in the last quarter alone. But, in its 20 months in business, eToys had produced total sales of $30.6 million, on which it had run a net loss of $30.8 million—meaning that eToys was spending $2 to sell every dollar's worth of toys.

The IPO prospectus also disclosed that eToys would use some proceeds of the offering to acquire another online operation, BabyCenter, Inc., which had lost $4.5 million on $4.8 million in sales over the previous year. (To land this prize, eToys would pay a mere $205 million.) And eToys would "reserve" 40.6 million shares of common stock for future issuance to its management. So, if eToys ever made money, its net income would have to be divided not among 102 million shares, but among 143 million—diluting any future earnings per share by nearly one-third.

A comparison of eToys with Toys "R" Us, Inc.—its biggest rival—is shocking. In the preceding three months, Toys "R" Us had earned $27 million in net income and had sold over 70 times more goods than eToys had sold in an entire year. And yet as Figure 17-3 shows, the stock market valued eToys at nearly $2 billion *more* than Toys "R" Us.

CONCLUSION: On March 7, 2001, eToys filed for bankruptcy protection after racking up net losses of more than $398 million in its brief life as a public company. The stock, which peaked at $86 per share in October 1999, last traded for a penny.

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buy tchotchkes for children at eToys than at a traditional toy store. As analyst Gail Bronson of IPO Monitor told the Associated Press on the day of eToys' stock offering, "eToys has very, very smartly managed the development of the company last year and positioned themselves to be the children's center of the Internet." Added Bronson: "The key to a successful IPO, especially a dot-com IPO, is good marketing and branding." Bronson was partly right: That's the key to a successful IPO for the issuing company and its bankers. Unfortunately, for *investors* the key to a successful IPO is earnings, which eToys didn't have.

FIGURE 17-3 A Toy Story

	eToys Inc. Fiscal year ended 3/31/1999	Toys "R" Us, Inc. Fiscal quarter ended 5/1/1999
Net sales	30	2,166
Net income	(29)	27
Cash	20	289
Total assets	31	8,067
Market value of common stock (5/20/1999)	7,780	5,650

All amounts in millions of dollars.

Sources: The companies' SEC filings.

CHAPTER 18

A Comparison of Eight Pairs of Companies

*I*n this chapter we shall attempt a novel form of exposition. By selecting eight pairs of companies which appear next to each other, or nearly so, on the stock-exchange list we hope to bring home in a concrete and vivid manner some of the many varieties of character, financial structure, policies, performance, and vicissitudes of corporate enterprises, and of the investment and speculative attitudes found on the financial scene in recent years. In each comparison we shall comment only on those aspects that have a special meaning and import.

Pair I: Real Estate Investment Trust (stores, offices, factories, etc.) and Realty Equities Corp. of New York (real estate investment; general construction)

In this first comparison we depart from the alphabetical order used for the other pairs. It has a special significance for us, since it seems to encapsulate, on the one hand, all that has been reasonable, stable, and generally good in the traditional methods of handling other people's money, in contrast—in the other company—with the reckless expansion, the financial legerdemain, and the roller-coaster changes so often found in present-day corporate operations. The two enterprises have similar names, and for many years they appeared side by side on the American Stock Exchange list. Their stock-ticker symbols—REI and REC—could easily have been confused. But one of them is a staid New England trust, administered by three trustees, with operations dating back nearly a century, and with dividends paid continuously since 1889. It has kept throughout to the same type of prudent investments, limiting its expansion to a moderate rate and its debt to an easily manageable figure.*

The other is a typical New York-based sudden-growth venture, which in eight years blew up its assets from $6.2 million to $154 million, and its debts in the same proportion; which moved out from ordinary real-estate operations to a miscellany of ventures, including two racetracks, 74 movie theaters, three literary agencies, a public-relations firm, hotels, supermarkets, and a 26% interest in a large cosmetics firm (which went bankrupt in 1970).† This conglomeration of business ventures was matched by a corresponding variety of corporate devices, including the following:

1. A preferred stock entitled to $7 annual dividends, but with a par value of only $1, and carried as a liability at $1 per share.
2. A stated common-stock value of $2,500,000 ($1 per share), more than offset by a deduction of $5,500,000 as the cost of 209,000 shares of reacquired stock.
3. Three series of stock-option warrants, giving rights to buy a total of 1,578,000 shares.
4. At least six different kinds of debt obligations, in the form of mortgages, debentures, publicly held notes, notes payable to banks, "notes, loans, and contracts payable," and loans payable to the Small Business Administration, adding up to over $100 million in March 1969. In addition it had the usual taxes and accounts payable.

Let us present first a few figures of the two enterprises as they appeared in 1960 (Table 18-1A). Here we find the Trust shares selling in the market for nine times the aggregate value of Equities stock. The Trust enterprise had a smaller relative debt and a better

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* Here Graham is describing Real Estate Investment Trust, which was acquired by San Francisco Real Estate Investors in 1983 for $50 a share. The next paragraph describes Realty Equities Corp. of New York.

† The actor Paul Newman was briefly a major shareholder in Realty Equities Corp. of New York after it bought his movie-production company, Kayos, Inc., in 1969.

TABLE 18-1A. Pair 1. Real Estate Investment Trust vs. Realty Equities Corp. in 1960

	Real Estate Investment Trust	*Realty Equities Corp. of New York*
Gross revenues	$ 3,585,000	$1,484,000
Net income	485,000	150,000
Earned per share	.66	.47
Dividend per share	none	.10
Book value per share	$20.	$4.
Price range	20–12	5⅜–4¾
Total assets	$22,700,000	$6,200,000
Total liabilities	7,400,000	5,000,000
Book value of common	15,300,000	1,200,000
Average market value of common	12,200,000	1,360,000

ratio of net to gross, but the price of the common was higher in relation to per-share earnings.

In Table 18-1B we present the situation about eight years later. The Trust had "kept the noiseless tenor of its way," increasing both its revenues and its per-share earnings by about three-quarters.* But Realty Equities had been metamorphosed into something monstrous and vulnerable.

How did Wall Street react to these diverse developments? By paying as little attention as possible to the Trust and a lot to Realty Equities. In 1968 the latter shot up from 10 to 37¾ and the listed warrants from 6 to 36½, on combined sales of 2,420,000 shares. While this was happening the Trust shares advanced sedately from 20 to 30¼ on modest volume. The March 1969 balance sheet of Equities was to show an asset value of only $3.41 per share, less than a tenth of its high price that year. The book value of the Trust shares was $20.85.

* Graham, an avid reader of poetry, is quoting Thomas Gray's "Elegy Written in a Country Churchyard."

TABLE 18-1B. Pair 1.

	Real Estate Investment Trust	*Realty Equities Corp. of New York*
Price, December 31, 1968	26½	32½
Number of shares of common	1,423,000	2,311,000 (March '69)
Market value of common	$37,800,000	$75,000,000
Estimated market value of warrants	—	30,000,000[a]
Estimated market value of common and warrants	—	105,000,000
Debt	9,600,000	100,800,000
Preferred stock	—	2,900,000
Total capitalization	$47,400,000	$208,700,000
Market value per share of common, adjusted for warrants	—	45 (est.)
Book value per share	$20.85 (Nov.)	$3.41
	November 1968	March 1969
Revenues	$6,281,000	$39,706,000
Net for interest	2,696,000	11,182,000
Interest charges	590,000	6,684,000
Income tax	58,000[b]	2,401,000
Preferred dividend		174,000
Net for common	2,048,000	1,943,000
Special items	245,000 cr.	1,896,000 dr.
Final net for common	2,293,000	47,000
Earned per share before special items	$1.28	$1.00
Earned per share after special items	1.45	.20
Dividend on common	1.20	.30
Interest charges earned	4.6 ×	1.8 ×

[a] There were warrants to buy 1,600,000 or more shares at various prices. A listed issue sold at 30½ per warrant.

[b] As a realty trust, this enterprise was not subjected to Federal income tax in 1968.

The next year it became clear that all was not well in the Equities picture, and the price fell to 9½. When the report for March 1970 appeared the shareholders must have felt shell-shocked as they read that the enterprise had sustained a net loss of $13,200,000, or $5.17 per share—virtually wiping out their former slim equity. (This disastrous figure included a reserve of $8,800,000 for future losses on investments.) Nonetheless the directors had bravely (?) declared an extra dividend of 5 cents right after the close of the fiscal year. But more trouble was in sight. The company's auditors refused to certify the financial statements for 1969–70, and the shares were suspended from trading on the American Stock Exchange. In the over-the-counter market the bid price dropped below $2 per share.*

Real Estate Investment Trust shares had typical price fluctuations after 1969. The low in 1970 was 16½, with a recovery to 26⅝ in early 1971. The latest reported earnings were $1.50 per share, and the stock was selling moderately above its 1970 book value of $21.60. The issue may have been somewhat overpriced at its record high in 1968, but the shareholders have been honestly and well served by their trustees. The Real Estate Equities story is a different and a sorry one.

Pair 2: Air Products and Chemicals (industrial and medical gases, etc.) and Air Reduction Co. (industrial gases and equipment; chemicals)

Even more than our first pair, these two resemble each other in both name and line of business. The comparison they invite is thus of the conventional type in security analysis, while most of our other pairs are more heteroclite in nature.† "Products" is a newer

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* Realty Equities was delisted from the American Stock Exchange in September 1973. In 1974, the U.S. Securities and Exchange Commission sued Realty Equities' accountants for fraud. Realty Equities' founder, Morris Karp, later pleaded guilty to one count of grand larceny. In 1974–1975, the overindebtedness that Graham criticizes led to a financial crisis among large banks, including Chase Manhattan, that had lent heavily to the most aggressive realty trusts.

† "Heteroclite" is a technical term from classical Greek that Graham uses to mean abnormal or unusual.

company than "Reduction," and in 1969 had less than half the other's volume.* Nonetheless its equity issues sold for 25% more in the aggregate than Air Reduction's stock. As Table 18-2 shows, the reason can be found both in Air Reduction's greater profitability and in its stronger growth record. We find here the typical consequences of a better showing of "quality." Air Products sold at 16½ times its latest earnings against only 9.1 times for Air Reduction. Also Air Products sold well above its asset backing, while Air Reduction could be bought at only 75% of its book value.† Air Reduction paid a more liberal dividend; but this may be deemed to reflect the greater desirability for Air Products to retain its earnings. Also, Air Reduction had a more comfortable working-capital position. (On this point we may remark that a profitable company can always put its current position in shape by some form of permanent financing. But by our standards Air Products was somewhat overbonded.)

If the analyst were called on to choose between the two companies he would have no difficulty in concluding that the prospects of Air Products looked more promising than those of Air Reduction. But did this make Air Products more attractive at its considerably higher relative price? We doubt whether this question can be answered in a definitive fashion. In general Wall Street sets "quality" above "quantity" in its thinking, and probably the majority of security analysts would opt for the "better" but dearer Air Products as against the "poorer" but cheaper Air Reduction. Whether this preference is to prove right or wrong is more likely to depend on the unpredictable future than on any demonstrable investment principle. In this instance, Air Reduction appears to belong to the group of important companies in the low-multiplier class. If, as the studies referred to above†† would seem to indicate, that group *as a*

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* By "volume," Graham is referring to sales or revenues—the total dollar amount of each company's business.

† "Asset backing" and book value are synonyms. In Table 18-2, the relationship of price to asset or book value can be seen by dividing the first line ("Price, December 31, 1969") by "Book value per share."

†† Graham is citing his research on value stocks, which he discusses in Chapter 15 (see p. 389). Since Graham completed his studies, a vast body of scholarly work has confirmed that value stocks outperform *(cont'd on p. 453)*

whole is likely to give a better account of itself than the high-multiplier stocks, then Air Reduction should logically be given the preference—but only as part of a diversified operation. (Also, a thorough-going study of the individual companies could lead the analyst to the opposite conclusion; but that would have to be for reasons beyond those already reflected in the past showing.)

SEQUEL: Air Products stood up better than Air Reduction in the

TABLE 18-2. Pair 2.

	Air Products & Chemicals 1969	*Air Reduction 1969*
Price, December 31, 1969	39½	16⅜
Number of shares of common	5,832,000[a]	11,279,000
Market value of common	$231,000,000	$185,000,000
Debt	113,000,000	179,000,000
Total capitalization at market	344,000,000	364,000,000
Book value per share	$22.89	$21.91
Sales	$221,500,000	$487,600,000
Net income	13,639,000	20,326,000
Earned per share, 1969	$2.40	$1.80
Earned per share, 1964	1.51	1.51
Earned per share, 1959	.52	1.95
Current dividend rate	.20	.80
Dividend since	1954	1917
Ratios:		
Price/earnings	16.5 ×	9.1 ×
Price/book value	165.0%	75.0%
Dividend yield	0.5%	4.9%
Net/sales	6.2%	4.25%
Earnings/book value	11.0%	8.2%
Current assets/liabilities	1.53 ×	3.77 ×
Working capital/debt	.32 ×	.85 ×
Growth in per-share earnings		
1969 versus 1964	+59%	+19%
1969 versus 1959	+362%	decrease

[a] Assuming conversion of preferred stock.

1970 break, with a decline of 16% against 24%. However, Reduction made a better comeback in early 1971, rising to 50% above its 1969 close, against 30% for Products. In this case the low-multiplier issue scored the advantage—for the time being, at least.*

Pair 3: American Home Products Co. (drugs, cosmetics, household products, candy) and American Hospital Supply Co. (distributor and manufacturer of hospital supplies and equipment)

These were two "billion-dollar good-will" companies at the end of 1969, representing different segments of the rapidly growing and immensely profitable "health industry." We shall refer to them as Home and Hospital, respectively. Selected data on both are presented in Table 18-3. They had the following favorable points in common: excellent growth, with no setbacks since 1958 (i.e., 100% earnings stability); and strong financial condition. The growth rate of Hospital up to the end of 1969 was considerably higher than Home's. On the other hand, Home enjoyed substantially better profitability on both sales and capital.† (In fact, the relatively low rate of Hospital's earnings on its capital in 1969—only 9.7%—raises the intriguing question whether the business then was in fact a highly profitable one, despite its remarkable past growth rate in sales and earnings.)

When comparative price is taken into account, Home offered

(cont'd from p. 451) growth stocks over long periods. (Much of the best research in modern finance simply provides independent confirmation of what Graham demonstrated decades ago.) See, for instance, James L. Davis, Eugene F. Fama, and Kenneth R. French, "Characteristics, Covariances, and Average Returns: 1929–1997," at http://papers.ssrn.com.

* Air Products and Chemicals, Inc., still exists as a publicly-traded stock and is included in the Standard & Poor's 500-stock index. Air Reduction Co. became a wholly-owned subsidiary of The BOC Group (then known as British Oxygen) in 1978.

† You can determine profitability, as measured by return on sales and return on capital, by referring to the "Ratios" section of Table 18-3. "Net/sales" measures return on sales; "Earnings/book value" measures return on capital.

TABLE 18-3. Pair 3.

	American Home Products 1969	*American Hospital Supply 1969*
Price, December 31, 1969	72	45⅛
Number of shares of common	52,300,000	33,600,000
Market value of common	$3,800,000,000	$1,516,000,000
Debt	11,000,000	18,000,000
Total capitalization at market	3,811,000,000	1,534,000,000
Book value per share	$5.73	$7.84
Sales	$1,193,000,000	$446,000,000
Net income	123,300,000	25,000,000
Earned per share, 1969	$2.32	$.77
Earned per share, 1964	1.37	.31
Earned per share, 1959	.92	.15
Current dividend rate	1.40	.24
Dividends since	1919	1947
Ratios:		
Price/earnings	31.0 ×	58.5 ×
Price/book value	1250.0%	575.0%
Dividend yield	1.9%	0.55%
Net/sales	10.7%	5.6%
Earnings/book value	41.0%	9.5%
Current assets/liabilities	2.6 ×	4.5 ×
Growth in per-share earnings		
1969 versus 1964	+75%	+142%
1969 versus 1959	+161%	+405%

much more for the money in terms of current (or past) earnings and dividends. The very low book value of Home illustrates a basic ambiguity or contradiction in common-stock analysis. On the one hand, it means that the company is earning a high return on its capital—which in general is a sign of strength and prosperity. On the other, it means that the investor at the current price would be especially vulnerable to any important adverse change in the company's earnings situation. Since Hospital was selling at over four times its book value in 1969, this cautionary remark must be applied to both companies.

CONCLUSIONS: Our clear-cut view would be that both companies were too "rich" at their current prices to be considered by the investor who decides to follow our ideas of conservative selection. This does not mean that the companies were lacking in promise. The trouble is, rather, that their price contained too much "promise" and not enough actual performance. For the two enterprises combined, the 1969 price reflected almost $5 billion of good-will valuation. How many years of excellent future earnings would it take to "realize" that good-will factor in the form of dividends or tangible assets?

SHORT-TERM SEQUEL: At the end of 1969 the market evidently thought more highly of the earnings prospects of Hospital than of Home, since it gave the former almost twice the multiplier of the latter. As it happened the favored issue showed a microscopic *decline* in earnings in 1970, while Home turned in a respectable 8% gain. The market price of Hospital reacted significantly to this one-year disappointment. It sold at 32 in February 1971—a loss of about 30% from its 1969 close—while Home was quoted slightly above its corresponding level.*

Pair 4: H & R Block, Inc. (income-tax service) and Blue Bell, Inc., (manufacturers of work clothes, uniforms, etc.)

These companies rub shoulders as relative newcomers to the New York Stock Exchange, where they represent two very different genres of success stories. Blue Bell came up the hard way in a highly competitive industry, in which eventually it became the largest factor. Its earnings have fluctuated somewhat with industry conditions, but their growth since 1965 has been impressive. The company's operations go back to 1916 and its continuous dividend record to 1923. At the end of 1969 the stock market showed no enthusiasm for the issue, giving it a price/earnings ratio of only 11, against about 17 for the S & P composite index.

By contrast, the rise of H & R Block has been meteoric. Its first

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* American Home Products Co. is now known as Wyeth; the stock is included in the Standard & Poor's 500-stock index. American Hospital Supply Co. was acquired by Baxter Healthcare Corp. in 1985.

published figures date only to 1961, in which year it earned $83,000 on revenues of $610,000. But eight years later, on our comparison date, its revenues had soared to $53.6 million and its net to $6.3 million. At that time the stock market's attitude toward this fine performer appeared nothing less than ecstatic. The price of 55 at the close of 1969 was more than 100 times the last reported 12-months' earnings—which of course were the largest to date. The aggregate market value of $300 million for the stock issue was nearly 30 times the tangible assets behind the shares.* This was almost unheard of in the annals of serious stock-market valuations. (At that time IBM was selling at about 9 times and Xerox at 11 times book value.)

Our Table 18-4 sets forth in dollar figures and in ratios the extraordinary discrepancy in the comparative valuations of Block and Blue Bell. True, Block showed twice the profitability of Blue Bell per dollar of capital, and its percentage growth in earnings over the past five years (from practically nothing) was much higher. But as a stock enterprise Blue Bell was selling for less than one-third the total value of Block, although Blue Bell was doing four times as much business, earning 2½ times as much for its stock, had 5½ times as much in tangible investment, and gave nine times the dividend yield on the price.

INDICATED CONCLUSIONS: An experienced analyst would have conceded great momentum to Block, implying excellent prospects for future growth. He might have had some qualms about the dangers of serious competition in the income-tax-service field, lured by the handsome return on capital realized by Block.[1] But mindful of the continued success of such outstanding companies as Avon Products in highly competitive areas, he would have hesitated to predict a speedy flattening out of the Block growth curve. His chief

* "Nearly 30 times" is reflected in the entry of 2920% under "Price/book value" in the Ratios section of Table 18-4. Graham would have shaken his head in astonishment during late 1999 and early 2000, when many high-tech companies sold for hundreds of times their asset value (see the commentary on this chapter). Talk about "almost unheard of in the annals of serious stock-market valuations"! H & R Block remains a publicly-traded company, while Blue Bell was taken private in 1984 at $47.50 per share.

TABLE 18-4. Pair 4.

	H & R Block 1969	*Blue Bell 1969*
Price, December 31, 1969	55	49¾
Number of shares of common	5,426,000	1,802,000[a]
Market value of common	$298,000,000	$89,500,000
Debt	—	17,500,000
Total capitalization at market	298,000,000	107,000,000
Book value per share	$1.89	$34.54
Sales	$53,600,000	$202,700,000
Net income	6,380,000	7,920,000
Earned per share, 1969	$.51 (October)	$4.47
Earned per share, 1964	.07	2.64
Earned per share, 1959	—	1.80
Current dividend rate	.24	1.80
Dividends since	1962	1923
Ratios:		
Price/earnings	108.0 ×	11.2 ×
Price/book value	2920 %	142 %
Dividend yield	0.4 %	3.6 %
Net/sales	11.9 %	3.9 %
Earnings/book value	27 %	12.8 %
Current assets/liabilities	3.2 ×	2.4 ×
Working capital/debt	no debt	3.75 ×
Growth in per-share earnings		
1969 versus 1964	+630%	+68%
1969 versus 1959	—	+148%

[a] Assuming conversion of preferred stock.

concern would be simply whether the $300 million valuation for the company had not already fully valued and perhaps overvalued all that one could reasonably expect from this excellent business. By contrast the analyst should have had little difficulty in recommending Blue Bell as a fine company, quite conservatively priced.

SEQUEL TO MARCH 1971. The 1970 near-panic lopped one-quarter off the price of Blue Bell and about one-third from that of Block. Both then joined in the extraordinary recovery of the general market. The price of Block rose to 75 in February 1971, but Blue Bell advanced considerably more—to the equivalent of 109 (after a three-for-two split). Clearly Blue Bell proved a better buy than Block as of the end of 1969. But the fact that Block was able to advance some 35% from that apparently inflated value indicates how wary analysts and investors must be to sell good companies short—either by word or deed—no matter how high the quotation may seem.*

Pair 5: International Flavors & Fragrances (flavors, etc., for other businesses) and International Harvester Co. (truck manufacturer, farm machinery, construction machinery)

This comparison should carry more than one surprise. Everyone knows of International Harvester, one of the 30 giants in the Dow Jones Industrial Average.† How many of our readers have even heard of International Flavors & Fragrances, next-door neighbor to Harvester on the New York Stock Exchange list? Yet, *mirabile dictu,* IFF was actually selling at the end of 1969 for a higher aggregate market value than Harvester—$747 million versus $710 million. This is the more amazing when one reflects that Harvester had 17 times the stock capital of Flavors and 27 times the annual sales. In

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* Graham is alerting readers to a form of the "gambler's fallacy," in which investors believe that an overvalued stock must drop in price purely because it is overvalued. Just as a coin does not become more likely to turn up heads after landing on tails for nine times in a row, so an overvalued stock (or stock market!) can stay overvalued for a surprisingly long time. That makes short-selling, or betting that stocks will drop, too risky for mere mortals.

† International Harvester was the heir to McCormick Harvesting Machine Co., the manufacturer of the McCormick reaper that helped make the midwestern states the "breadbasket of the world." But International Harvester fell on hard times in the 1970s and, in 1985, sold its farm-equipment business to Tenneco. After changing its name to Navistar, the remaining company was booted from the Dow in 1991 (although it remains a member of the S & P 500 index). International Flavors & Fragrances, also a constituent of the S & P 500, had a total stock-market value of $3 billion in early 2003, versus $1.6 billion for Navistar.

TABLE 18-5. Pair 5.

	International Flavors & Fragrances 1969	*International Harvester 1969*
Price, December 31, 1969	65½	24¾
Number of shares of common	11,400,000	27,329,000
Market value of common	$747,000,000	$710,000,000
Debt	4,000,000	313,000,000
Total capitalization at market	751,000,000	1,023,000,000
Book value per share	$6.29	$41.70
Sales	$94,200,000	$2,652,000,000
Net income	13,540,000	63,800,000
Earned per share, 1969	$1.19	$2.30
Earned per share, 1964	.62	3.39
Earned per share, 1959	.28	2.83
Current dividend rate	.50	1.80
Dividends since	1956	1910
Ratios:		
Price/earnings	55.0 ×	10.7 ×
Price/book value	1050.0%	59.0%
Dividend yield	0.9%	7.3%
Net/sales	14.3%	2.6%
Earnings/book value	19.7%	5.5%
Current assets/liabilities	3.7 ×	2.0 ×
Working capital/debt	large	1.7 ×
Interest earned	—	(before tax) 3.9 ×
Growth in per-share earnings		
1969 versus 1964	+93%	+9%
1969 versus 1959	+326%	+39%

fact, only three years before, the *net earnings* of Harvester had been larger than the 1969 *sales* of Flavors! How did these extraordinary disparities develop? The answer lies in the two magic words: profitability and growth. Flavors made a remarkable showing in both categories, while Harvester left everything to be desired.

The story is told in Table 18-5. Here we find Flavors with a sensational profit of 14.3% of sales (before income tax the figure was 23%), compared with a mere 2.6% for Harvester. Similarly, Flavors had earned 19.7% on its stock capital against an inadequate 5.5% earned by Harvester. In five years the net earnings of Flavors had nearly doubled, while those of Harvester practically stood still. Between 1969 and 1959 the comparison makes similar reading. These differences in performance produced a typical stock-market divergence in valuation. Flavors sold in 1969 at 55 times its last reported earnings, and Harvester at only 10.7 times. Correspondingly, Flavors was valued at 10.4 times its book value, while Harvester was selling at a 41% *discount* from its net worth.

COMMENT AND CONCLUSIONS: The first thing to remark is that the market success of Flavors was based entirely on the development of its central business, and involved none of the corporate wheeling and dealing, acquisition programs, top-heavy capitalization structures, and other familiar Wall Street practices of recent years. The company has stuck to its extremely profitable knitting, and that is virtually its whole story. The record of Harvester raises an entirely different set of questions, but these too have nothing to do with "high finance." Why have so many great companies become relatively unprofitable even during many years of general prosperity? What is the advantage of doing more than $2½ billion of business if the enterprise cannot earn enough to justify the shareholders' investment? It is not for us to prescribe the solution of this problem. But we insist that not only management but the rank and file of shareholders should be conscious that the problem exists and that it calls for the best brains and the best efforts possible to deal with it.* From the standpoint of common-stock selection, neither issue would have met our standards of sound, reasonably attractive, and moderately priced investment. Flavors was a typical brilliantly successful but lavishly valued company;

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* For more of Graham's thoughts on shareholder activism, see the commentary on Chapter 19. In criticizing Harvester for its refusal to maximize shareholder value, Graham uncannily anticipated the behavior of the company's future management. In 2001, a majority of shareholders voted to remove Navistar's restrictions against outside takeover bids—but the board of directors simply refused to implement the shareholders' wishes. It's remarkable that an antidemocratic tendency in the culture of some companies can endure for decades.

Harvester's showing was too mediocre to make it really attractive even at its discount price. (Undoubtedly there were better values available in the reasonably priced class.)

SEQUEL TO 1971: The low price of Harvester at the end of 1969 protected it from a large further decline in the bad break of 1970. It lost only 10% more. Flavors proved more vulnerable and declined to 45, a loss of 30%. In the subsequent recovery both advanced, well above their 1969 close, but Harvester soon fell back to the 25 level.

Pair 6: McGraw Edison (public utility and equipment; housewares) McGraw-Hill, Inc. (books, films, instruction systems; magazine and newspaper publishers; information services)

This pair with so similar names—which at times we shall call Edison and Hill—are two large and successful enterprises in vastly different fields. We have chosen December 31, 1968, as the date of our comparison, developed in Table 18-6. The issues were selling at about the same price, but because of Hill's larger capitalization it was valued at about twice the total figure of the other. This difference should appear somewhat surprising, since Edison had about 50% higher sales and one-quarter larger net earnings. As a result, we find that the key ratio—the multiplier of earnings—was more than twice as great for Hill as for Edison. This phenomenon seems explicable chiefly by the persistence of a strong enthusiasm and partiality exhibited by the market toward shares of book-publishing companies, several of which had been introduced to public trading in the later 1960s.*

Actually, by the end of 1968 it was evident that this enthusiasm had been overdone. The Hill shares had sold at 56 in 1967, more than 40 times the just-reported record earnings for 1966. But a small decline had appeared in 1967 and a further decline in 1968. Thus the current high multiplier of 35 was being applied to a company that

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* McGraw-Hill remains a publicly-traded company that owns, among other operations, *BusinessWeek* magazine and Standard & Poor's Corp. McGraw–Edison is now a division of Cooper Industries.