TABLE 16-3 Companies with Large Amounts of Convertible Issues and Warrants at the End of 1969 (Shares in Thousands)

		Additional Common Stock Issuable			
		On Conversion of			Total
	Common Stock Outstanding	Bonds	Preferred Stock	Against Warrants	Additional Common Stock
Avco Corp.	11,470	1,750	10.436	3,085	15,271
Gulf & Western Inc.	14,964	9,671	5,632	6,951	22,260
International Tel. & Tel.	67,393	190	48,115		48,305
Ling-Temco-Vought	4,410[a]	1,180	685	7,564	9,429
National General	4,910	4,530		12,170	16,700
Northwest Industries[b]	7,433		11,467	1,513	12,980
Rapid American	3,591	426	1,503	8,000	9,929

[a] Includes "special stock."

[b] At end of 1970.

true if the preferred stock had a conversion privilege close to the market. The reverse is generally true at present. As a result there are a considerable number of convertible preferred stocks which are clearly more attractive than the related common shares. Owners of the common have nothing to lose and important advantages to gain by switching from their junior shares into the senior issue.

Example: A typical example was presented by Studebaker-Worthington Corp. at the close of 1970. The common sold at 57, while the $5 convertible preferred finished at 87½. Each preferred share is exchangeable for 1½ shares of common, then worth 85½. This would indicate a small money difference against the buyer of the preferred. But dividends are being paid on the common at the annual rate of $1.20 (or $1.80 for the 1½ shares), against the $5 obtainable on one share of preferred. Thus the original adverse difference in price would probably be made up in less than a year, after which the preferred would probably return an appreciably higher dividend yield than the common for some time to come. But most important, of course, would be the senior position that the common shareholder would gain from the switch. At the *low* prices

of 1968 and again in 1970 the preferred sold 15 points higher than 1½ shares of common. Its conversion privilege guarantees that it could never sell lower than the common package.[2]

Stock-Option Warrants

Let us mince no words at the outset. We consider the recent development of stock-option warrants as a near fraud, an existing menace, and a potential disaster. They have created huge aggregate dollar "values" out of thin air. They have no excuse for existence except to the extent that they mislead speculators and investors. They should be prohibited by law, or at least strictly limited to a minor part of the total capitalization of a company.*

For an analogy in general history and in literature we refer the reader to the section of *Faust* (part 2), in which Goethe describes the invention of paper money. As an ominous precedent on Wall Street history, we may mention the warrants of American & Foreign Power Co., which in 1929 had a quoted market value of over a billion dollars, although they appeared only in a footnote to the company's balance sheet. By 1932 this billion dollars had shrunk to $8 million, and in 1952 the warrants were wiped out in the company's recapitalization—even though it had remained solvent.

Originally, stock-option warrants were attached now and then to bond issues, and were usually equivalent to a partial conversion privilege. They were unimportant in amount, and hence did no harm. Their use expanded in the late 1920s, along with many other financial abuses, but they dropped from sight for long years thereafter. They were bound to turn up again, like the bad pennies they are, and since 1967 they have become familiar "instruments of

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* Warrants were an extremely widespread technique of corporate finance in the nineteenth century and were fairly common even in Graham's day. They have since diminished in importance and popularity—one of the few recent developments that would give Graham unreserved pleasure. As of year-end 2002, there were only seven remaining warrant issues on the New York Stock Exchange—only the ghostly vestige of a market. Because warrants are no longer commonly used by major companies, today's investors should read the rest of Graham's chapter only to see how his logic works.

finance." In fact a standard procedure has developed for raising the capital for new real-estate ventures, affiliates of large banks, by selling units of an equal number of common shares and warrants to buy additional common shares at the same price. *Example:* In 1971 CleveTrust Realty Investors sold 2,500,000 of these combinations of common stock (or "shares of beneficial interest") and warrants, for $20 per unit.

Let us consider for a moment what is really involved in this financial setup. Ordinarily, a common-stock issue has the first right to buy additional common shares when the company's directors find it desirable to raise capital in this manner. This so-called "preemptive right" is one of the elements of value entering into the ownership of common stock—along with the right to receive dividends, to participate in the company's growth, and to vote for directors. When separate warrants are issued for the right to subscribe additional capital, that action takes away part of the value inherent in an ordinary common share and transfers it to a separate certificate. An analogous thing could be done by issuing separate certificates for the right to receive dividends (for a limited or unlimited period), or the right to share in the proceeds of sale or liquidation of the enterprise, or the right to vote the shares. Why then are these subscription warrants created as part of the original capital structure? Simply because people are inexpert in financial matters. They don't realize that the common stock is worth less with warrants outstanding than otherwise. Hence the package of stock and warrants usually commands a better price in the market than would the stock alone. Note that in the usual company reports the per-share earnings are (or have been) computed without proper allowance for the effect of outstanding warrants. The result is, of course, to overstate the true relationship between the earnings and the market value of the company's capitalization.*

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* Today, the last remnant of activity in warrants is in the cesspool of the NASDAQ "bulletin board," or over-the-counter market for tiny companies, where common stock is often bundled with warrants into a "unit" (the contemporary equivalent of what Graham calls a "package"). If a stockbroker ever offers to sell you "units" in any company, you can be 95% certain that warrants are involved, and at least 90% certain that the broker is either a thief or an idiot. Legitimate brokers and firms have no business in this area.

The simplest and probably the best method of allowing for the existence of warrants is to add the equivalent of their market value to the common-share capitalization, thus increasing the "true" market price per share. Where large amounts of warrants have been issued in connection with the sale of senior securities, it is customary to make the adjustment by assuming that the proceeds of the stock payment are used to retire the related bonds or preferred shares. This method does not allow adequately for the usual "premium value" of a warrant above exercisable value. In Table 16-4 we compare the effect of the two methods of calculation in the case of National General Corp. for the year 1970.

Does the company itself derive an advantage from the creation of these warrants, in the sense that they assure it in some way of receiving additional capital when it needs some? Not at all. Ordinarily there is no way in which the company can require the warrant-holders to exercise their rights, and thus provide new capital to the company, prior to the expiration date of the warrants. In the meantime, if the company wants to raise additional common-stock funds it must offer the shares to its shareholders in the usual way—which means somewhat under the ruling market price. The warrants are no help in such an operation; they merely complicate the situation by frequently requiring a downward revision in their own subscription price. Once more we assert that large issues of stock-option warrants serve no purpose, except to fabricate imaginary market values.

The paper money that Goethe was familiar with, when he wrote his *Faust,* were the notorious French assignats that had been greeted as a marvelous invention, and were destined ultimately to lose all of their value—as did the billion dollars worth of American & Foreign Power warrants.* Some of the poet's remarks apply

* The "notorious French assignats" were issued during the Revolution of 1789. They were originally debts of the Revolutionary government, purportedly secured by the value of the real estate that the radicals had seized from the Catholic church and the nobility. But the Revolutionaries were bad financial managers. In 1790, the interest rate on assignats was cut; soon they stopped paying interest entirely and were reclassified as paper money. But the government refused to redeem them for gold or silver and issued massive amounts of new assignats. They were officially declared worthless in 1797.

TABLE 16-4 Calculation of "True Market Price" and Adjusted Price/Earnings Ratio of a Common Stock with Large Amounts of Warrants Outstanding

(Example: National General Corp. in June 1971)

1. Calculation of "True Market Price."

Market value of 3 issues of warrants, June 30, 1971	$94,000,000
Value of warrants per share of common stock	$18.80
Price of common stock alone	24.50
Corrected price of common, adjusted for warrants	43.30

2. Calculation of P/E Ratio to Allow for Warrant Dilution

(1970 earnings) A. Before Special Items.	*Before Warrant Dilution*	*After Warrant Dilution* Company's Calculation	Our Calculation
Earned per share	$ 2.33	$ 1.60	$ 2.33
Price of common	24.50	24.50	43.30 (adj.)
P/E ratio	10.5×	15.3×	18.5×
B. After Special Items.			
Earned per share	$ .90	$ 1.33	$ .90
Price of common	24.50	24.50	43.30 (adj.)
P/E ratio	27.2×	18.4×	48.1×

Note that, after special charges, the effect of the company's calculation is to increase the earnings per share and reduce the P/E ratio. This is manifestly absurd. By our suggested method the effect of the dilution is to increase the P/E ratio substantially, as it should be.

equally well to one invention or another—such as the following (in Bayard Taylor's translation):

FAUST: Imagination in its highest flight
Exerts itself but cannot grasp it quite.
MEPHISTOPHELES (the inventor): If one needs coin the brokers ready stand.
THE FOOL (finally): The magic paper . . . !

Practical Postscript

The crime of the warrants is in "having been born."* Once born they function as other security forms, and offer chances of profit as well as of loss. Nearly all the newer warrants run for a limited time—generally between five and ten years. The older warrants were often perpetual, and they were likely to have fascinating price histories over the years.

EXAMPLE: The record books will show that Tri-Continental Corp. warrants, which date from 1929, sold at a negligible 1/32 of a dollar each in the depth of the depression. From that lowly estate their price rose to a magnificent 75¾ in 1969, an astronomical advance of some 242,000%. (The warrants then sold considerably higher than the shares themselves; this is the kind of thing that occurs on Wall Street through technical developments, such as stock splits.) A recent example is supplied by Ling-Temco-Vought warrants, which in the first half of 1971 advanced from 2½ to 12½—and then fell back to 4.

No doubt shrewd operations can be carried on in warrants from time to time, but this is too technical a matter for discussion here. We might say that warrants tend to sell relatively higher than the corresponding market components related to the conversion privilege of bonds or preferred stocks. To that extent there is a valid argument for selling bonds with warrants attached rather than creating an equivalent dilution factor by a convertible issue. If the warrant total is relatively small there is no point in taking its theoretical aspect too seriously; if the warrant issue is large relative to the outstanding stock, that would probably indicate that the company has a top-heavy senior capitalization. It should be selling additional common stock instead. Thus the main objective of our attack on warrants as a financial mechanism is not to condemn their use in connection with moderate-size bond issues, but to argue against the wanton creation of huge "paper-money" monstrosities of this genre.

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* Graham, an enthusiastic reader of Spanish literature, is paraphrasing a line from the play *Life Is a Dream* by Pedro Calderon de la Barca (1600–1681): "The greatest crime of man is having been born."

COMMENTARY ON CHAPTER 16

That which thou sowest is not quickened, except it die.
—*I. Corinthians,* XV:36.

THE ZEAL OF THE CONVERT

Although convertible bonds are called "bonds," they behave like stocks, work like options, and are cloaked in obscurity.

If you own a convertible, you also hold an option: You can either keep the bond and continue to earn interest on it, or you can exchange it for common stock of the issuing company at a predetermined ratio. (An option gives its owner the right to buy or sell another security at a given price within a specific period of time.) Because they are exchangeable into stock, convertibles pay lower rates of interest than most comparable bonds. On the other hand, if a company's stock price soars, a convertible bond exchangeable into that stock will perform much better than a conventional bond. (Conversely, the typical convertible—with its lower interest rate—will fare worse in a falling bond market.)[1]

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[1] As a brief example of how convertible bonds work in practice, consider the 4.75% convertible subordinated notes issued by DoubleClick Inc. in 1999. They pay $47.50 in interest per year and are each convertible into 24.24 shares of the company's common stock, a "conversion ratio" of 24.24. As of year-end 2002, DoubleClick's stock was priced at $5.66 a share, giving each bond a "conversion value" of $137.20 ($5.66 × 24.24). Yet the bonds traded roughly six times higher, at $881.30—creating a "conversion premium," or excess over their conversion value, of 542%. If you bought at that price, your "break-even time," or "payback period," was very long. (You paid roughly $750 more than the conversion value of the bond, so it will take nearly 16 years of $47.50 interest payments for you to "earn back" that con-

From 1957 through 2002, according to Ibbotson Associates, convertible bonds earned an annual average return of 8.3%—only two percentage points below the total return on stocks, but with steadier prices and shallower losses.[2] More income, less risk than stocks: No wonder Wall Street's salespeople often describe convertibles as a "best of both worlds" investment. But the intelligent investor will quickly realize that convertibles offer less income and more risk than most other *bonds.* So they could, by the same logic and with equal justice, be called a "worst of both worlds" investment. Which side you come down on depends on how you use them.

In truth, convertibles act more like stocks than bonds. The return on convertibles is about 83% correlated to the Standard & Poor's 500-stock index—but only about 30% correlated to the performance of Treasury bonds. Thus, "converts" zig when most bonds zag. For conservative investors with most or all of their assets in bonds, adding a diversified bundle of converts is a sensible way to seek stock-like returns without having to take the scary step of investing in stocks directly. You could call convertible bonds "stocks for chickens."

As convertibles expert F. Barry Nelson of Advent Capital Management points out, this roughly $200 billion market has blossomed since Graham's day. Most converts are now medium-term, in the seven-to-10-year range; roughly half are investment-grade; and many issues now carry some call protection (an assurance against early redemption). All these factors make them less risky than they used to be.[3]

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version premium.) Since each DoubleClick bond is convertible to just over 24 common shares, the stock will have to rise from $5.66 to more than $36 if conversion is to become a practical option before the bonds mature in 2006. Such a stock return is not impossible, but it borders on the miraculous. The cash yield on this particular bond scarcely seems adequate, given the low probability of conversion.

[2] Like many of the track records commonly cited on Wall Street, this one is hypothetical. It indicates the return you would have earned in an imaginary index fund that owned all major convertibles. It does not include any management fees or trading costs (which are substantial for convertible securities). In the real world, your returns would have been roughly two percentage points lower.

[3] However, most convertible bonds remain junior to other long-term debt and bank loans—so, in a bankruptcy, convertible holders do not have prior

It's expensive to trade small lots of convertible bonds, and diversification is impractical unless you have well over $100,000 to invest in this sector alone. Fortunately, today's intelligent investor has the convenient recourse of buying a low-cost convertible bond fund. Fidelity and Vanguard offer mutual funds with annual expenses comfortably under 1%, while several closed-end funds are also available at a reasonable cost (and, occasionally, at discounts to net asset value).[4]

On Wall Street, cuteness and complexity go hand-in-hand—and convertibles are no exception. Among the newer varieties are a jumble of securities with acronymic nicknames like LYONS, ELKS, EYES, PERCS, MIPS, CHIPS, and YEELDS. These intricate securities put a "floor" under your potential losses, but also cap your potential profits and often compel you to convert into common stock on a fixed date. Like most investments that purport to ensure against loss (see sidebar on p. 421), these things are generally more trouble than they are worth. You can best shield yourself against loss not by buying one of these quirky contraptions, but by intelligently diversifying your entire portfolio across cash, bonds, and U.S. and foreign stocks.

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claim to the company's assets. And, while they are not nearly as dicey as high-yield "junk" bonds, many converts are still issued by companies with less than sterling credit ratings. Finally, a large portion of the convertible market is held by hedge funds, whose rapid-fire trading can increase the volatility of prices.

[4] For more detail, see www.fidelity.com, www.vanguard.com, and www.morningstar.com. The intelligent investor will *never* buy a convertible bond fund with annual operating expenses exceeding 1.0%.

UNCOVERING COVERED CALLS

As the bear market clawed its way through 2003, it dug up an old fad: writing covered call options. (A recent Google search on "covered call writing" turned up more than 2,600 hits.) What are covered calls, and how do they work? Imagine that you buy 100 shares of Ixnay Corp. at $95 apiece. You then sell (or "write") a call option on your shares. In exchange, you get a cash payment known as a "call premium." (Let's say it's $10 per share.) The buyer of the option, meanwhile, has the contractual right to buy your Ixnay shares at a mutually agreed-upon price—say, $100. You get to keep the stock so long as it stays below $100, and you earn a fat $1,000 in premium income, which will cushion the fall if Ixnay's stock crashes.

Less risk, more income. What's not to like?

Well, now imagine that Ixnay's stock price jumps overnight to $110. Then your option buyer will exercise his rights, yanking your shares away for $100 apiece. You've still got your $1,000 in income, but he's got your Ixnay—and the more it goes up, the harder you will kick yourself.[1]

Since the potential gain on a stock is unlimited, while no loss can exceed 100%, the only person you will enrich with this strategy is your broker. You've put a floor under your losses, but you've also slapped a ceiling over your gains. For individual investors, covering your downside is never worth surrendering most of your upside.

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[1] Alternatively, you could buy back the call option, but you would have to take a loss on it—and options can have even higher trading costs than stocks.

CHAPTER 17

Four Extremely Instructive Case Histories

The word "extremely" in the title is a kind of pun, because the histories represent extremes of various sorts that were manifest on Wall Street in recent years. They hold instruction, and grave warnings, for everyone who has a serious connection with the world of stocks and bonds—not only for ordinary investors and speculators but for professionals, security analysts, fund managers, trust-account administrators, and even for bankers who lend money to corporations. The four companies to be reviewed, and the different extremes that they illustrate are:

Penn Central (Railroad) Co. An extreme example of the neglect of the most elementary warning signals of financial weakness, by all those who had bonds or shares of this system under their supervision. A crazily high market price for the stock of a tottering giant.

Ling-Temco-Vought Inc. An extreme example of quick and unsound "empire building," with ultimate collapse practically guaranteed; but helped by indiscriminate bank lending.

NVF Corp. An extreme example of one corporate acquisition, in which a small company absorbed another seven times its size, incurring a huge debt and employing some startling accounting devices.

AAA Enterprises. An extreme example of public stock-financing of a small company; its value based on the magic word "franchising," and little else, sponsored by important stock-exchange houses. Bankruptcy followed within two years of the stock sale and the doubling of the initial inflated price in the heedless stock market.

The Penn Central Case

This is the country's largest railroad in assets and gross revenues. Its bankruptcy in 1970 shocked the financial world. It has defaulted on most of its bond issues, and has been in danger of abandoning its operations entirely. Its security issues fell drastically in price, the common stock collapsing from a high level of 86½ as recently as 1968 to a low of 5½ in 1970. (There seems little doubt that these shares will be wiped out in reorganization.)*

Our basic point is that the application of the simplest rules of security analysis and the simplest standards of sound investment would have revealed the fundamental weakness of the Penn Central system long before its bankruptcy—certainly in 1968, when the shares were selling at their post-1929 record, and when most of its bond issues could have been exchanged at even prices for well-secured public-utility obligations with the same coupon rates. The following comments are in order:

1. In the S & P *Bond Guide* the interest charges of the system are shown to have been earned 1.91 times in 1967 and 1.98 times in 1968. The minimum coverage prescribed for railroad bonds in our textbook *Security Analysis* is 5 times before income taxes and 2.9 times after income taxes at regular rates. As far as we know the validity of these standards has never been questioned by any investment authority. On the basis of our requirements for earnings *after taxes,* the Penn Central fell short of the requirements for safety. But our after-tax requirement is based on a before-tax ratio of *five* times, with regular income tax deducted after the bond interest. In the case of Penn Central, it had been paying *no income taxes to speak of* for the past 11 years! Hence the coverage of its interest charges before taxes was less than two times—a totally inadequate figure against our conservative requirement of 5 times.

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* How "shocked" was the financial world by the Penn Central's bankruptcy, which was filed over the weekend of June 20–21, 1970? The closing trade in Penn Central's stock on Friday, June 19, was $11.25 per share–hardly a going-out-of-business price. In more recent times, stocks like Enron and WorldCom have also sold at relatively high prices shortly before filing for bankruptcy protection.

2. The fact that the company paid no income taxes over so long a period should have raised serious questions about the *validity* of its reported earnings.

3. The bonds of the Penn Central system could have been exchanged in 1968 and 1969, at no sacrifice of price or income, for far better secured issues. For example, in 1969, Pennsylvania RR 4½s, due 1994 (part of Penn Central) had a range of 61 to 74½, while Pennsylvania Electric Co. 4⅜s, due 1994, had a range of 64¼ to 72¼. The public utility had earned its interest 4.20 times before taxes in 1968 against only 1.98 times for the Penn Central system; during 1969 the latter's comparative showing grew steadily worse. An exchange of this sort was clearly called for, and it would have been a lifesaver for a Penn Central bondholder. (At the end of 1970 the railroad 4¼s were in default, and selling at only 18½, while the utility's 4⅜s closed at 66½.)

4. Penn Central reported earnings of $3.80 per share in 1968; its high price of 86½ in that year was 24 times such earnings. But any analyst worth his salt would have wondered how "real" were earnings of this sort reported without the necessity of paying any income taxes thereon.

5. For 1966 the newly merged company* had reported "earnings" of $6.80 a share—in reflection of which the common stock later rose to its peak of 86½. This was a valuation of over $2 billion for the equity. How many of these buyers knew at the time that the so lovely earnings were *before* a special charge of $275 million or $12 per share to be taken in 1971 for "costs and losses" incurred on the merger. O wondrous fairyland of Wall Street where a company can announce "profits" of $6.80 per share in one place and special "costs and losses" of $12 in another, and shareholders and speculators rub their hands with glee!†

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* Penn Central was the product of the merger, announced in 1966, of the Pennsylvania Railroad and the New York Central Railroad.

† This kind of accounting legerdemain, in which profits are reported as if "unusual" or "extraordinary" or "nonrecurring" charges do not matter, anticipates the reliance on "pro forma" financial statements that became popular in the late 1990s (see the commentary on Chapter 12).

6. A railroad analyst would have long since known that the operating picture of the Penn Central was very bad in comparison with the more profitable roads. For example, its transportation ratio was 47.5% in 1968 against 35.2% for its neighbor, Norfolk & Western.*

7. Along the way there were some strange transactions with peculiar accounting results.[1] Details are too complicated to go into here.

Conclusion: Whether better management could have saved the Penn Central bankruptcy may be arguable. But there is no doubt whatever that no bonds and no shares of the Penn Central system should have remained after 1968 at the latest in any securities account watched over by competent security analysts, fund managers, trust officers, or investment counsel. *Moral:* Security analysts should do their elementary jobs before they study stock-market movements, gaze into crystal balls, make elaborate mathematical calculations, or go on all-expense-paid field trips.†

Ling-Temco-Vought Inc.

This is a story of head-over-heels expansion and head-over-heels debt, ending up in terrific losses and a host of financial problems. As usually happens in such cases, a fair-haired boy, or "young genius," was chiefly responsible for both the creation of the great empire and its ignominious downfall; but there is plenty of blame to be accorded others as well.‡

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* A railroad's "transportation ratio" (now more commonly called its operating ratio) measures the expenses of running its trains divided by the railroad's total revenues. The higher the ratio, the less efficient the railroad. Today even a ratio of 70% would be considered excellent.

† Today, Penn Central is a faded memory. In 1976, it was absorbed into Consolidated Rail Corp. (Conrail), a federally-funded holding company that bailed out several failed railroads. Conrail sold shares to the public in 1987 and, in 1997, was taken over jointly by CSX Corp. and Norfolk Southern Corp.

‡ Ling-Temco-Vought Inc. was founded in 1955 by James Joseph Ling, an electrical contractor who sold his first $1 million worth of shares to the pub-

The rise and fall of Ling-Temco-Vought can be summarized by setting forth condensed income accounts and balance-sheet items for five years between 1958 and 1970. This is done in Table 17-1. The first column shows the company's modest beginnings in 1958, when its sales were only $7 million. The next gives figures for 1960; the enterprise had grown twentyfold in only two years, but it was still comparatively small. Then came the heyday years to 1967 and 1968, in which sales again grew twentyfold to $2.8 billion with the debt figure expanding from $44 million to an awesome $1,653 million. In 1969 came new acquisitions, a further huge increase in debt (to a total of $1,865 million!), and the beginning of serious trouble. A large loss, after extraordinary items, was reported for the year; the stock price declined from its 1967 high of 169½ to a low of 24; the young genius was superseded as the head of the company. The 1970 results were even more dreadful. The enterprise reported a final net loss of close to $70 million; the stock fell away to a low price of 7⅛, and its largest bond issue was quoted at one time at a pitiable 15 cents on the dollar. The company's expansion policy was sharply reversed, various of its important interests were placed on the market, and some headway was made in reducing its mountainous obligations.

The figures in our table speak so eloquently that few comments are called for. But here are some:

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lic by becoming his own investment banker, hawking prospectuses from a booth set up at the Texas State Fair. His success at that led him to acquire dozens of different companies, almost always using LTV's stock to pay for them. The more companies LTV acquired, the higher its stock went; the higher its stock went, the more companies it could afford to acquire. By 1969, LTV was the 14th biggest firm on the *Fortune* 500 list of major U.S. corporations. And then, as Graham shows, the whole house of cards came crashing down. (LTV Corp., now exclusively a steelmaker, ended up seeking bankruptcy protection in late 2000.) Companies that grow primarily through acquisitions are called "serial acquirers"—and the similarity to the term "serial killers" is no accident. As the case of LTV demonstrates, serial acquirers nearly always leave financial death and destruction in their wake. Investors who understood this lesson of Graham's would have avoided such darlings of the 1990s as Conseco, Tyco, and WorldCom.

TABLE 17-1 Ling-Temco-Vought Inc., 1958–1970 (In Millions of Dollars Except Earned Per Share)

A. Operating Results	1958	1960	1967	1969	1970
Sales	$ 6.9	$143.0	$1,833.0	$3,750.0	$374.0
Net before taxes and interest	0.552	7.287	95.6	124.4	88.0
Interest charges	.1 (est.)	1.5 (est.)	17.7	122.6	128.3
(Times earned)	(5.5 ×)	(4.8 ×)	(54 ×)	(1.02 ×)	(0.68 ×)
Income taxes	0.225	2.686	35.6	*cr. 15.2*	4.9
Special items				*dr. 40.6*	*dr. 18.8*
Net after special items	0.227	3.051	34.0	*dr. 38.3*	*dr. 69.6*
Balance for common stock	0.202	3.051	30.7	*dr. 40.8*	*dr. 71.3*
Earned per share of common	0.17	0.83	5.56	*def. 10.59*	*def. 17.18*
B. Financial Position					
Total assets	6.4	94.5	845.0	2,944.0	2,582.0
Debt payable within 1 year	1.5	29.3	165.0	389.3	301.3
Long-term debt	.5	14.6	202.6	1,500.8	1,394.6
Shareholders' equity	2.7	28.5	245.0†	*def. 12.0**	*def. 69.0**
Ratios					
Current assets/current liabilities	1.27 ×	1.45 ×	1.80 ×	1.52 ×	1.45 ×
Equity/long-term debt	5.4 ×	2.0 ×	1.2 ×	0.17 ×	0.13 ×
Market-price range		28–20	169½–109	97¾–24⅛	29½–7⅛

* Excluding debt-discount as an asset and deducting preferred stock at redemption value.

† As published. *cr.:* credit. *dr.:* debit. *def.:* deficit.

1. The company's expansion period was not without an interruption. In 1961 it showed a small operating deficit, but—adopting a practice that was to be seen later in so many reports for 1970—evidently decided to throw all possible charges and reserves into the one bad year.* These amounted to a round $13 million, which was more than the combined net profits of the preceding three years. It was now ready to show "record earnings" in 1962, etc.

2. At the end of 1966 the net tangible assets are given as $7.66 per share of common (adjusted for a 3-for-2 split). Thus the market price in 1967 reached 22 times (!) its reported asset value at the time. At the end of 1968 the balance sheet showed $286 million available for 3,800,000 shares of common and Class AA stock, or about $77 per share. But if we deduct the preferred stock at full value and exclude the good-will items and the huge bond-discount "asset,"† there would remain $13 million for the common—a mere $3 per share. This tangible equity was wiped out by the losses of the following years.

3. Toward the end of 1967 two of our best-regarded banking firms offered 600,000 shares of Ling-Temco-Vought stock at $111 per share. It had been as high as 169½. In less than three years the price fell to 7⅛.‡

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* The sordid tradition of hiding a company's true earnings picture under the cloak of restructuring charges is still with us. Piling up every possible charge in one year is sometimes called "big bath" or "kitchen sink" accounting. This bookkeeping gimmick enables companies to make an easy show of apparent growth in the following year—but investors should not mistake that for real business health.

† The "bond-discount asset" appears to mean that LTV had purchased some bonds below their par value and was treating that discount as an asset, on the grounds that the bonds could eventually be sold at par. Graham scoffs at this, since there is rarely any way to know what a bond's market price will be on a given date in the future. If the bonds could be sold only at values *below* par, this "asset" would in fact be a liability.

‡ We can only imagine what Graham would have thought of the investment banking firms that brought InfoSpace, Inc. public in December 1998. The stock (adjusted for later splits) opened for trading at $31.25, peaked at

4. At the end of 1967 the bank loans had reached $161 million, and a year later they stood at $414 million—which should have been a frightening figure. In addition, the long-term debt amounted to $1,237 million. By 1969 combined debt reached a total of $1,869 million. This may have been the largest combined debt figure of any industrial company anywhere and at any time, with the single exception of the impregnable Standard Oil of N.J.

5. The losses in 1969 and 1970 far exceeded the total profits since the formation of the company.

Moral: The primary question raised in our mind by the Ling-Temco-Vought story is how the commercial bankers could have been persuaded to lend the company such huge amounts of money during its expansion period. In 1966 and earlier the company's coverage of interest charges did not meet conservative standards, and the same was true of the ratio of current assets to current liabilities and of stock equity to total debt. But in the next two years the banks advanced the enterprise nearly $400 million additional for further "diversification." This was not good business for them, and it was worse in its implications for the company's shareholders. If the Ling-Temco-Vought case will serve to keep commercial banks from aiding and abetting unsound expansions of this type in the future, some good may come of it at last.*

The NVF Takeover of Sharon Steel (A Collector's Item)

At the end of 1968 NVF Company was a company with $4.6 million of long-term debt, $17.4 million of stock capital, $31 million of sales, and $502,000 of net income (before a special credit of $374,000). Its business was described as "vulcanized fiber and plastics." The management decided to take over the Sharon Steel Corp.,

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$1305.32 per share in March 2000, and finished 2002 at a princely $8.45 per share.

* Graham would have been disappointed, though surely not surprised, to see that commercial banks have chronically kept supporting "unsound expansions." Enron and WorldCom, two of the biggest collapses in corporate history, were aided and abetted by billions of dollars in bank loans.

which had $43 million of long-term debt, $101 million of stock capital, $219 million of sales, and $2,929,000 of net earnings. The company it wished to acquire was thus seven times the size of NVF. In early 1969 it made an offer for all the shares of Sharon. The terms per share were $70 face amount of NVF junior 5% bonds, due 1994, plus warrants to buy 1½ shares of NVF stock at $22 per share of NVF. The management of Sharon strenuously resisted this takeover attempt, but in vain. NVF acquired 88% of the Sharon stock under the offer, issuing therefore $102 million of its 5% bonds and warrants for 2,197,000 of its shares. Had the offer been 100% operative the consolidated enterprise would, for the year 1968, have had $163 million in debt, only $2.2 million in tangible stock capital, $250 million of sales. The net-earnings question would have been a bit complicated, but the company subsequently stated them as a net loss of 50 cents per share of NVF stocks, before an extraordinary credit, and net earnings of 3 cents per share after such credit.*

First Comment: Among all the takeovers effected in the year 1969 this was no doubt the most extreme in its financial disproportions. The acquiring company had assumed responsibility for a new and top-heavy debt obligation, and it had changed its calculated 1968 earnings from a profit to a loss into the bargain. A measure of the impairment of the company's financial position by this

* In June 1972 (just after Graham finished this chapter), a Federal judge found that NVF's chairman, Victor Posner, had improperly diverted the pension assets of Sharon Steel "to assist affiliated companies in their takeovers of other corporations." In 1977, the U.S. Securities and Exchange Commission secured a permanent injunction against Posner, NVF, and Sharon Steel to prevent them from future violations of Federal laws against securities fraud. The Commission alleged that Posner and his family had improperly obtained $1.7 million in personal perks from NVF and Sharon, overstated Sharon's pretax earnings by $13.9 million, misrecorded inventory, and "shifted income and expenses from one year to another." Sharon Steel, which Graham had singled out with his cold and skeptical eye, became known among Wall Street wags as "Share and Steal." Posner was later a central force in the wave of leveraged buyouts and hostile takeovers that swept the United States in the 1980s, as he became a major customer for the junk bonds underwritten by Drexel Burnham Lambert.

step is found in the fact that the new 5% bonds did not sell higher than 42 cents on the dollar during the year of issuance. This would have indicated grave doubt of the safety of the bonds and of the company's future; however, the management actually exploited the bond price in a way to save the company annual income taxes of about $1,000,000 as will be shown.

The 1968 report, published after the Sharon takeover, contained a condensed picture of its results, carried back to the year-end. This contained two most unusual items:

1. There is listed as an asset $58,600,000 of "deferred debt expense." This sum is greater than the entire "stockholders' equity," placed at $40,200,000.

2. However, not included in the shareholders' equity is an item of $20,700,000 designated as "excess of equity over cost of investment in Sharon."

Second Comment: If we eliminate the debt expense as an asset, which it hardly seems to be, and include the other item in the shareholders' equity (where it would normally belong), then we have a more realistic statement of tangible equity for NVF stock, viz., $2,200,000. Thus the first effect of the deal was to reduce NVF's "real equity" from $17,400,000 to $2,200,000 or from $23.71 per share to about $3 per share, on 731,000 shares. In addition the NVF shareholders had given to others the right to buy 3½ times as many additional shares at six points below the market price at the close of 1968. The initial market value of the warrants was then about $12 each, or a total of some $30 million for those involved in the purchase offer. Actually, the market value of the warrants well exceeded the total market value of the outstanding NVF stock—another evidence of the tail-wagging-dog nature of the transaction.

The Accounting Gimmicks

When we pass from this pro forma balance sheet to the next year's report we find several strange-appearing entries. In addition to the basic interest expense (a hefty $7,500,000), there is deducted $1,795,000 for "amortization of deferred debt expense." But this last is nearly offset on the next line by a very unusual income item

indeed: "amortization of equity over cost of investment in subsidiary: Cr. $1,650,000." In one of the footnotes we find an entry, not appearing in any other report that we know of: Part of the stock capital is there designated as "fair market value of warrants issued in connection with acquisition, etc., $22,129,000."

What on earth do all these entries mean? None of them is even referred to in the descriptive text of the 1969 report. The trained security analyst has to figure out these mysteries by himself, almost in detective fashion. He finds that the underlying idea is to derive a tax advantage from the low initial price of the 5% debentures. For readers who may be interested in this ingenious arrangement we set forth our solution in Appendix 6.

Other Unusual Items

1. Right after the close of 1969 the company bought in no less than 650,000 warrants at a price of $9.38 each. This was extraordinary when we consider that (*a*) NVF itself had only $700,000 in cash at the year-end, and had $4,400,000 of debt due in 1970 (evidently the $6 million paid for the warrants had to be borrowed); (*b*) it was buying in this warrant "paper money" at a time when its 5% bonds were selling at less than 40 cents on the dollar—ordinarily a warning that financial difficulties lay ahead.

2. As a partial offset to this, the company had retired $5,100,000 of its bonds along with 253,000 warrants in exchange for a like amount of common stock. This was possible because, by the vagaries of the securities markets, people were selling the 5% bonds at less than 40 while the common sold at an average price of 13½, paying no dividend.

3. The company had plans in operation not only for selling stock to its employees, but also for selling them a larger number of *warrants* to buy the stock. Like the stock purchases the warrants were to be paid for 5% down and the rest over many years in the future. This is the only such employee-purchase plan for *warrants* that we know of. Will someone soon invent and sell on installments a right to buy a right to buy a share, and so on?

4. In the year 1969 the newly controlled Sharon Steel Co. changed its method of arriving at its pension costs, and also

adopted lower depreciation rates. These accounting changes added about $1 per share to the reported earnings of NVF before dilution.

5. At the end of 1970 Standard & Poor's *Stock Guide* reported that NVF shares were selling at a price/earning ratio of only 2, the lowest figure for all the 4,500-odd issues in the booklet. As the old Wall Street saying went, this was "important if true." The ratio was based on the year's closing price of 8¾ and the computed "earnings" of $5.38 per share for the 12 months ended September 1970. (Using these figures the shares were selling at only 1.6 times earnings.) But this ratio did not allow for the large dilution factor,* nor for the adverse results actually realized in the last quarter of 1970. When the full year's figures finally appeared, they showed only $2.03 per share earned for the stock, before allowing for dilution, and $1.80 per share on a diluted basis. Note also that the aggregate market price of the stock and warrants on that date was about $14 million against a bonded debt of $135 million—a skimpy equity position indeed.

AAA Enterprises

History

About 15 years ago a college student named Williams began selling mobile homes (then called "trailers").† In 1965 he incorpo-

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* The "large dilution factor" would be triggered when NVF employees exercised their warrants to buy common stock. The company would then have to issue more shares, and its net earnings would be divided across a much greater number of shares outstanding.

† Jackie G. Williams founded AAA Enterprises in 1958. On its first day of trading, the stock soared 56% to close at $20.25. Williams later announced that AAA would come up with a new franchising concept every month (if people would step into a mobile home to get their income taxes done by "Mr. Tax of America," just imagine what else they might do inside a trailer!). But AAA ran out of time and money before Williams ran out of ideas. The history of AAA Enterprises is reminiscent of the saga of a later company with charismatic management and scanty assets: ZZZZ Best achieved a stock-market value of roughly $200 million in the late 1980s, even though its purported industrial vacuum-cleaning business was little more than a telephone and a rented office run by a teenager named Barry Minkow. ZZZZ Best went bust and Minkow

rated his business. In that year he sold $5,800,000 of mobile homes and earned $61,000 before corporate tax. By 1968 he had joined the "franchising" movement and was selling others the right to sell mobile homes under his business name. He also conceived the bright idea of going into the business of preparing income-tax returns, using his mobile homes as offices. He formed a subsidiary company called Mr. Tax of America, and of course started to sell franchises to others to use the idea and the name. He multiplied the number of corporate shares to 2,710,000 and was ready for a stock offering. He found that one of our largest stock-exchange houses, along with others, was willing to handle the deal. In March 1969 they offered the public 500,000 shares of AAA Enterprises at $13 per share. Of these, 300,000 were sold for Mr. Williams's personal account and 200,000 were sold for the company account, adding $2,400,000 to its resources. The price of the stock promptly doubled to 28, or a value of $84 million for the equity, against a book value of, say, $4,200,000 and maximum reported earnings of $690,000. The stock was thus selling at a tidy 115 times its current (and largest) earnings per share. No doubt Mr. Williams had selected the name AAA Enterprise so that it might be among the first in the phone books and the yellow pages. A collateral result was that his company was destined to appear as the first name in Standard & Poor's *Stock Guide.* Like Abu-Ben-Adhem's, it led all the rest.* This gives a special reason to select it as a harrowing example of 1969 new financing and "hot issues."

Comment: This was not a bad deal for Mr. Williams. The 300,000 shares he sold had a book value in December of 1968 of $180,000 and he netted therefor 20 times as much, or a cool $3,600,000. The underwriters and distributors split $500,000 between them, less expenses.

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went to jail. Even as you read this, another similar company is being formed, and a new generation of "investors" will be taken for a ride. No one who has read Graham, however, should climb on board.

* In "Abou Ben Adhem," by the British Romantic poet Leigh Hunt (1784–1859), a righteous Muslim sees an angel writing in a golden book "the names of those who love the Lord." When the angel tells Abou that his name is not among them, Abou says, "I pray thee, then, write me as one that loves his fellow men." The angel returns the next night to show Abou the book, in which now "Ben Adhem's name led all the rest."

1. This did not seem so brilliant a deal for the clients of the selling houses. They were asked to pay about ten times the book value of the stock, after the bootstrap operation of increasing their equity per share from 59 cents to $1.35 with their own money.* Before the best year 1968, the company's maximum earnings had been a ridiculous 7 cents per share. There were ambitious plans for the future, of course—but the public was being asked to pay heavily in advance for the hoped-for realization of these plans.

2. Nonetheless, the price of the stock doubled soon after original issuance, and any one of the brokerage-house clients could have gotten out at a handsome profit. Did this fact alter the flotation, or did the advance possibility that it might happen exonerate the original distributors of the issue from responsibility for this public offering and its later sequel? Not an easy question to answer, but it deserves careful consideration by Wall Street and the government regulatory agencies.†

Subsequent History

With its enlarged capital AAA Enterprises went into two additional businesses. In 1969 it opened a chain of retail carpet stores, and it acquired a plant that manufactured mobile homes. The results reported for the first nine months were not exactly brilliant, but they were a little better than the year before—22 cents a share against 14

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* By purchasing more common stock at a premium to its book value, the investing public increased the value of AAA's equity per share. But investors were only pulling themselves up by their own bootstraps, since most of the rise in shareholders' equity came from the public's own willingness to overpay for the stock.

† Graham's point is that investment banks are not entitled to take credit for the gains a hot stock may produce right after its initial public offering unless they are also willing to take the blame for the stock's performance in the longer term. Many Internet IPOs rose 1,000% or more in 1999 and early 2000; most of them lost more than 95% in the subsequent three years. How could these early gains earned by a few investors justify the massive destruction of wealth suffered by the millions who came later? Many IPOs were, in fact, deliberately underpriced to "manufacture" immediate gains that would attract more attention for the next offering.

cents. What happened in the next months was literally incredible. The company lost $4,365,000, or $1.49 per share. This consumed all its capital before the financing, plus the entire $2,400,000 received on the sale of stock plus two-thirds of the amount reported as earned in the first nine months of 1969. There was left a pathetic $242,000, or 8 cents per share, of capital for the public shareholders who had paid $13 for the new offering only seven months before. Nonetheless the shares closed the year 1969 at 8⅛ bid, or a "valuation" of more than $25 million for the company.

Further Comment: 1. It is too much to believe that the company had actually earned $686,000 from January to September 1969 and then lost $4,365,000 in the next three months. There was something sadly, badly, and accusingly wrong about the September 30 report.

2. The year's closing price of 8⅛ bid was even more of a demonstration of the complete heedlessness of stock-market prices than were the original offering price of 13 or the subsequent "hot-issue" advance to a high bid of 28. These latter quotations at least were based on enthusiasm and hope—out of all proportion to reality and common sense, but at least comprehensible. The year-end valuation of $25 million was given to a company that had lost all but a minuscule remnant of its capital, for which a completely insolvent condition was imminent, and for which the words "enthusiasm" or "hope" would be only bitter sarcasms. (It is true the year-end figures had not been published by December 31, but it is the business of Wall Street houses associated with a company to have monthly operating statements and a fairly exact idea of how things are going.)

Final Chapter

For the first half of 1970 the company reported a further loss of $1 million. It now had a good-sized capital deficit. It was kept out of bankruptcy by loans made by Mr. Williams, up to a total of $2,500,000. No further statements seem to have been issued, until in January 1971 AAA Enterprises finally filed a petition in bankruptcy. The quotation for the stock at month-end was still 50 cents a share bid, or $1,500,000 for the entire issue, which evidently had no more than wallpaper value. End of our story.

Moral and Questions: The speculative public is incorrigible. In