Chapter 17

Four Extremely Instructive Case Histories

Four Extremely Instructive Case Histories

• **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

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.

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.
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.

The Penn Central Case – cont.

4. Penn Central reported earnings of $3.80 per share in 1968; its high price of 861⁄2 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 861⁄2. 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.
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 (operating 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.

The Penn Central Case – conclusion

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-overheels 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.

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. The figures in our table speak so eloquently that few comments are called for.

Ling-Temco-Vought Inc. – cont.

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.

Ling-Temco-Vought Inc. – Moral

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.

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). The management decided to take over the Sharon Steel Corp., 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.

1. First Comment: Among all the takeovers effected in the year 1969 this was no doubt the most extreme in its financial disproportions.
2. 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.
3. The Accounting Gimmicks: When we pass from this pro forma balance sheet to the next year's report we find several strange-appearing entries.
4. Other Unusual Items

AAA Enterprises

• History: About 15 years ago a college student named Williams began selling mobile homes (then called “trailers”). 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.

• Comment: 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.

• Subsequent History: The year’s closing price of 8 1⁄8 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.

• Final Chapter: in January 1971 AAA Enterprises finally filed a petition in bankruptcy

AAA Enterprises - Moral and Questions

The speculative public is incorrigible. In 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.

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?