Chapter 18

A Comparison of Eight Pairs of Companies

Introduction

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.

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

- REI 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.

- REC 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.

- 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.

- The issue of REI may have been somewhat overpriced at its record high in 1968, but the shareholders have been honestly and well served by their trustees. The REC 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)

• "Products" is a newer 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.

• Air Products sold at 16 1⁄2 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.

• 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? Whether this preference is to prove right or wrong is more likely to depend on the unpredictable future than on any demonstrable investment principle.

• Sequel: Air Products stood up better than Air Reduction in the 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."

- 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.

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%

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

- Home offered 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?

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

• 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 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.

• **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. By contrast the analyst should have had little difficulty in recommending Blue Bell as a fine company, quite conservatively priced.

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

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.”

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; 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.)

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%

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

- 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.
- By contrast, McGraw Edison seemed quoted at a reasonable price in relation to the (high) general market level and to the company's overall performance and financial position.
- McGraw-Hill continues to be a strong and prosperous company. But its price history exemplifies—as do so many other cases—the speculative hazards in such stocks created by Wall Street through its undisciplined waves of optimism and pessimism.

Pair 7: National General Corp. (a large conglomerate) and National Presto Industries (diverse electric appliances, ordnance)

•The determination of the true market value of General's common stock capitalization presents an interesting problem for security analysts and has important implications for anyone interested in the stock on any basis more serious than outright gambling. The relatively small $4 1⁄2 convertible preferred can be readily taken care of by assuming its conversion into common, when the latter sells at a suitable market level.

•This simple technique of adding the market price of the warrants to that of the common has a radical effect on the showing of National General at the end of 1968, as appears from the calculation in Table 18-7. In fact the "true market price" of the common stock turns out to be more than twice the quoted figure. Hence the true multiplier of the 1968 earnings is more than doubled—to the inherently absurd figure of 69 times.

TABLE 18-7. Pair 7.

	National General 1968	*National Presto Industries 1968*
Price, December 31, 1968	44¼	38⅝
Number of shares of common	4,330,000[a]	1,478,000
Market value of common	$192,000,000	$58,000,000
Add market value of 3 issues of warrants	221,000,000	—
Total value of common and warrants	413,000,000	—
Senior issues	121,000,000	—
Total capitalization at market	534,000,000	58,000,000
Market price of common stock adjusted for warrants	98	—
Book value of common	$31.50	$26.30
Sales and revenues	$117,600,000	$152,200,000
Net income	6,121,000	8,206,000
Earned per share, 1968	$1.42 (December)	$5.61
Earned per share, 1963	.96 (September)	1.03
Earned per share, 1958	.48 (September)	.77
Current dividend rate	.20	.80
Dividends since	1964	1945
Ratios:		
Price/earnings	69.0 ×[b]	6.9 ×
Price/book value	310.0%	142.0%
Dividend yield	.5%	2.4%
Net/sales	5.5%	5.4%
Earnings/book value	4.5%	21.4%
Current assets/liabilities	1.63 ×	3.40 ×
Working capital/debt	.21 ×	no debt
Growth in per-share earnings		
1968 versus 1963	+48%	+450%
1968 versus 1960	+195%	+630%

[a] Assuming conversion of preferred stock.
[b] Adjusted for market price of warrants.

Pair 7: National General Corp. (a large conglomerate) and National Presto Industries (diverse electric appliances, ordnance)

- These figures appear the more anomalous when comparison is made with those of Presto. One is moved to ask how could Presto possibly be valued at only 6.9 times its current earnings when the multiplier for General was nearly 10 times as great. All the ratios of Presto are quite satisfactory—the growth figure suspiciously so, in fact. But, on balance, Presto met all the requirements of a sound and reasonably priced investment, while General had all the earmarks of a typical "conglomerate" of the late 1960s vintage, full of corporate gadgets and grandiose gestures, but lacking in substantial values behind the market quotations.

- If the investor could now find ten such issues (like Presto), for diversification, he could be confident of satisfactory results.

Pair 8: Whiting Corp. (materials-handling equipment) and Willcox & Gibbs (small conglomerate)

The company with smaller sales and earnings, and with half the tangible assets for the common, sold at about four times the aggregate value of the other. The higher-valued company was about to report a large loss after special charges; it had not paid a dividend in thirteen years. The other had a long record of satisfactory earnings, had paid continuous dividends since 1936, and was currently returning one of the highest dividend yields in the entire common stock list.

Table 18-8A. Pair 8.

	Whiting 1969	*Willcox & Gibbs 1969*
Price, December 31, 1969	17¾	15½
Number of shares of common	570,000	2,381,000
Market value of common	$10,200,000	$36,900,000
Debt	1,000,000	5,900,000
Preferred stock	—	1,800,000
Total capitalization at market	$11,200,000	$44,600,000
Book value per share	$25.39	$3.29
Sales	$42,200,000 (October)	$29,000,000 (December)
Net income before special item	1,091,000	347,000
Net income after special item	1,091,000	*def. 1,639,000*
Earned per share, 1969	$1.91 (October)	$.08[a]
Earned per share, 1964	1.90 (April)	.13
Earned per share, 1959	.42 (April)	.13
Current dividend rate	1.50	—
Dividends since	1954	(none since 1957)
Ratios:		
Price/earnings	9.3 ×	very large
Price/book value	70.0%	470.0%
Dividend yield	8.4%	—
Net/sales	3.2%	0.1%[a]
Earnings/book value	7.5%	2.4%[a]
Current assets/liabilities	3.0 ×	1.55 ×
Working capital/debt	9.0 ×	3.6 ×
Growth in per-share earnings		
1969 versus 1964	even	decrease
1969 versus 1959	+354%	decrease

[a] Before special charge. *def.*: deficit.

Pair 8: Whiting Corp. (materials-handling equipment) and Willcox & Gibbs (small conglomerate) – cont.

Willcox & Gibbs showed a small operating loss for 1970. Its price declined drastically to a low of 4½, recovering in typical fashion to 9½ in February 1971. It would be hard to justify that price statistically. Whiting had a relatively small decline, to 16¾ in 1970. (At that price it was selling at just about the current assets alone available for the shares). Its earnings held at $1.85 per share to July 1971. In early 1971 the price advanced to 24½, which seemed reasonable enough but no longer a “bargain” by our standards.

TABLE 18-8B. Ten-Year Price and Earnings Record of Whiting and Willcox & Gibbs

	Whiting Corp.		*Willcox & Gibbs*	
Year	Earned Per Share[a]	Price Range	Earned Per Share	Price Range
1970	$1.81	22½–16¼	$.34	18½–4[illegible]
1969	2.63	37–17¾	.05	20⅝–8[illegible]
1968	3.63	43⅛–28¼	.35	20⅛–8[illegible]
1967	3.01	36½–25	.47	11–4¾
1966	2.49	30¼–19¼	.41	8–3¾
1965	1.90	20–18	.32	10⅜–6[illegible]
1964	1.53	14–8	.20	9½–4½
1963	.88	15–9	.13	14–4¾
1962	.46	10–6½	.04	19¾–8[illegible]
1961	.42	12½–7¾	.03	19½–10[illegible]

[a] Year ended following April 30.

General Observations

• The issues used in these comparisons were selected with some malice aforethought, and thus they cannot be said to present a random cross-section of the common-stock list. Also they are limited to the industrial section, and the important areas of public utilities, transportation companies, and financial enterprises do not appear. But they vary sufficiently in size, lines of business, and qualitative and quantitative aspects to convey a fair idea of the choices confronting an investor in common stocks.

• In studying the stock list for the material in this chapter, we were impressed once again by the wide difference between the usual objectives of security analysis and those we deem dependable and rewarding. Most security analysts try to select the issues that will give the best account of themselves in the future, in terms chiefly of market action but considering also the development of earnings. We are frankly skeptical as to whether this can be done with satisfactory results. Our preference for the analyst's work would be rather that he should seek the exceptional or minority cases in which he can form a reasonably confident judgment that the price is well below value. He should be able to do this work with sufficient expertness to produce satisfactory average results over the years.