THE REDISCOVERED BENJAMIN GRAHAM *Lectures*

Lecture Number Three

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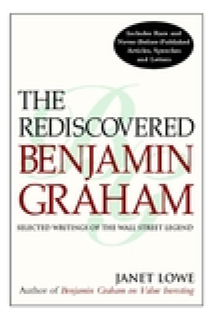

Now there is one other item that came to my attention a few days ago which has a bearing on war accounting and that is a reference to what is known as “Lifo,” which means last in, first out. I presume most of you are familiar with that accounting principle. It has had a rather important effect upon the balance-sheet figures of some corporations, but not quite so important on their income accounts.

Lifo is an accounting method, permitted by new income-tax regulations beginning about 1942, under which instead of considering that the first purchased merchandise is sold or used up in manufacture, the corporation is permitted to assume that the last purchased merchandise is sold or used up. As a result, the inventory is kept down during a period of rising prices because it is not necessary to mark up the value of the quantities of inventory owned at the time that the rising prices began. The result of using that method is (a) to reduce inventory values below market values, and in some cases by a very considerable amount; (b) to reduce accordingly the reported profits; and © and most important, perhaps, to reduce the amount of taxes which have to be paid.

What you have, then, in the balance sheets is either an understatement of the true value of the inventory, if you want to consider it that; or a cushion to absorb declines in inventory values without effecting a cash loss if you wish more conservatively to consider Lifo that way. In the case of the Federated Department Stores, their report which appeared a few days ago gives some details on Lifo, which they find necessary to do because of a tax problem facing them. That company showed that since 1942 they had the benefit of a reduction in inventory and taxable profit of $3,875,000 by using Lifo instead of using the usual first-in, first-out method. That enabled them to reduce their taxes by $2,590,000; and it reduced their profits after taxes for the five and a half years by roughly $1,150,000.

The difficulty that they refer to is the fact that in department stores it is practically impossible to identify the items that are sold in relation to just when they were bought. Consequently the department stores have tried to use something called an “index of retail price changes” to determine what would be the effect of Lifo on their accounting. And they now are in a controversy with the Treasury because the Treasury says that the Lifo section does not permit the use of estimates by means of an index as to what last-in, first-out means, and therefore they must go back to their old method of first-in, first-out.

The significance of Lifo is interesting, when you reflect upon it, because it is very similar to the wartime amortization of plant facilities which we discussed two weeks ago. There, you recall, the companies had the opportunity to write down their fixed assets, which were recently acquired, to zero, and to get the benefit of tax credits, the effect of which, however, was to reduce their earnings somewhat. You have exactly the same effect here in Lifo. You write down your inventory, save a great deal of money in taxes, but reduce your apparent earnings somewhat.

I think that for the analyst the signifay that here is a company that had done a great deal to improve its situation in five years, and the market doesn’t reflect that at all. But on the other hand it is not at all clear that it should reflect it, because now in 1946 the company seems to be back pretty much where it was pre-war, with no substantial earnings.

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That is what I would call a conventional current analysis of Northern Pacific, but I think it is quite superficial. There is a good deal more to that situation.

When you look a little more closely at Northern Pacific you will find that the main factor affecting this company, that does not affect other companies, is its large interest in an affiliated railroad which is not shown in its income account, except in the form of dividends. Northern Pacific owns 48 1/2 per cent of the Burlington, or C.B. & Q. Now, the Burlington is rather paradoxically bigger and a much better railroad than the Northern Pacific. You have thus a rather unusual situation, in which the chief interest perhaps of the stockholders of the Northern Pacific does not appear except in a very indirect and incomplete way in its own reports.

In addition to that interest in the Burlington the Northern Pacific owns 50 per cent of a rather substantial railroad system called the Spokane-Portland-Seattle, which before the war had no earning power but which during the war had quite substantial earnings. In addition to that, the Northern Pacific has a land department which has been productive of rather substantial income over the years. This does not appear in the income account but the proceeds or profits are credited to surplus directly. When you start taking account of these additional interests of the Northern Pacific you find that the picture is quite different than it appeared in the first analysis. In the period 1936-1940 there would be no substantial change, because the Burlington paid out practically all that it earned in that period. Instead of having a small loss on the stock you would have an equally minor profit of about 12 cents a share.

But when you take the war period 1941-1945, you find that to the $6.20 average shown by Northern Pacific there is to be added $3.80 per share in undistributed profits of Burlington; about 86 cents per share representing the earnings of S.P. & S.; and about 60 cents per share representing the land department -- giving you a total of $11.46, which is pretty nearly twice the figures actually reported. These are average earnings per year for five years. Thus you find that there is what used to be called a "hidden equity" of about $26 a share additional in those five years, making a total of about $53 that has gone back into the stockholders' account for Northern Pacific as compared with the pre-war period.

If you look at the Burlington you will see that its own undistributed profits show up in a considerable reduction in funded debt, a reduction of 36 per cent in fixed charges, and a considerable increase in working capital. You would find that the earnings of the Spokane railroad show up in the form of $20-million additional working capital, of which $10-million inures to the Northern Pacific.

When you come to the period of the first eight months of 1946, you find that instead of having earnings only 74 cents a share, the earnings, including the Burlington equity are $2.80 a share for the eight months. The indications are that they will earn about five dollars a share for the full year, including the Burlington equity.

That, of course, is a very different picture from the rather negligible earnings which they reported for the first eight months. You have also some figures that have been put in the

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record with the I.C.C. in connection with the rate-increase application. These show that if they get a ten per cent further increase, (which is more or less the figure that Wall Street is expecting or hoping for,) they might earn about four dollars per share in 1947 on their own income account and perhaps eight dollars a share, including their equity in the Burlington.

Now, those are very substantial figures in relation to the current market price. They indicate the importance of looking at the railroad on the consolidated basis rather than on the basis of the earnings as they were reported.

An interesting further study of Northern Pacific could be carried on by comparing it with some other road. This would give you some idea of its relative position and its attractiveness. I would suggest therefore that we devote a little time to a comparison between Northern Pacific and Southern Pacific. There is a relationship in names there that would make the comparison a natural one.

You might suggest that the comparison should be made with Great Northern, because Northern Pacific and Great Northern have always been grouped together in general railroad analysis, and you know that each of them owns approximately half of the Burlington. However, the Great Northern has managed to put itself into a stronger capital structure position than Northern Pacific, partly through the conversion of bonds into stock. The great Northern belongs somewhat more in the investment category. On the other hand, as we shall see, Southern Pacific is about in the same general financial situation as Northern Pacific with respect to stock and bond capitalization structure. That is a fundamental basis of allocating roads to classes for comparison. As you know, Northern Pacific sells now about 19, and Southern Pacific about 42. There you have a ratio of somewhat more than two to one. If we go back to the superficial earnings, you would see that before the war Southern Pacific averaged $1.27 per share for five years, 1936 to 1940, while Northern Pacific had a very small deficit. In the five years 1941 to 1945 Southern Pacific showed $12.90, against $6.20 for Northern Pacific, which is about our ratio of two to one; and in eight months of 1946, Southern Pacific shows $3.86 against 74 cents for Northern Pacific, which is much better than a two to one ratio.

STUDENT: Does Northern Pacific use its carry-back in the first eight months the way Southern Pacific did?

MR. GRAHAM: That’s a point that I shall come to. We have just spoken now about the figures as they appear in the reported earnings picture per share. Now we make two adjustments for that, one of them being the question of taxes which has just been raised. You find when you study the Southern Pacific figures that in 1946 they have had a tax credit of about $19-million, which is more than the earnings reported for that period. Northern Pacific had a small tax payment of its own and fairly substantial taxes for Burlington; so that they do not use any tax credit but, on the contrary, pay full taxes on their earnings.

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If you compare the situation, putting in Northern Pacific's Burlington interest, you would find that while the 1936-1940 figures remain about the same, for the war period Northern Pacific's earnings rise to $11.46, as compared with $12.90 for Southern Pacific, -- very nearly the same. For the eight months of 1946, Northern Pacific's earnings before taxes without allowances for income tax debit or credit, would be $4.60, while those of Southern Pacific would be a deficit of $1.20.

In a peculiar way, therefore, the situation seems to have been reversed. Whereas before the war Northern Pacific apparently tended toward a deficit and Southern Pacific toward moderate earnings, we now find that under 1946 conditions Southern Pacific seems to be tending toward a deficit and Northern Pacific toward fairly good earnings.

That analysis, of course, calls for much further probing into the situation. You have to ask yourself why it is that you get these diverse developments in the different periods that we are studying. What you find is that Southern Pacific in 1946 has apparently lost control over its expense ratio more seriously than has happened to Northern Pacific and to Burlington. As a matter of fact, the Burlington has been doing a very nice job of maintaining its net earnings even under the unfavorable wage and rate situation which we have had in 1946.

Northern Pacific itself has not done so well, but it has done better than Southern Pacific; and the combination shows up very much better. As you study the figures more carefully, you find that an advantage which Southern Pacific seemed to have developed in its operating ratio during the pre-war and early war years has now seemed to have reversed itself or disappeared; and the advantage is now in the Northern railroads.

If you study the Southern Pacific figures over a period of time, you will see that of course the Southern Pacific derived great advantages out of the war. It increased its surplus and its working capital considerably; it decreased its debt a great deal, and cut its fixed charges by about 20 per cent. That figure is not quite as good as the decrease shown by the Northern Pacific-Burlington combination.

Another factor that should get attention from the security analyst in studying these railroads is the question of rentals and hire of equipment. In the ordinary way in which fixed charges are stated in the manuals, and elsewhere, you would get the impression that the coverage of fixed charges for Southern Pacific is quite a good deal better than that of Northern Pacific -- or was, let us say, up to this year. Actually that is not the case if you consider rentals and hire of equipment, (with payments and receipts), as part of your over-all fixed charge situation.

Those of you who have studied our text on Security Analysis will recall our reference to the "net deductions method" in which you replace fixed charges by a figure representing the difference between the net after taxes and the balance for stock.

On that basis you will find that Northern Pacific has a considerable advantage, because it has regularly received substantial credits from hire of equipment and joint facilities. In

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1945 these were $4,346,000. But Southern Pacific has made very heavy payments for the same purpose; in 1946 they were $24,600,000.

If you restate your fixed charge coverage by allowing for the equipment and joint facility rental payments and also put in Northern Pacific figures its share of the Burlington, you will find this situation is also true for the eight months of 1946. Southern Pacific's net deductions were $24,300,000 in eight months, which was about seven and a half per cent of gross, the latter being around $320-million.

Northern Pacific's net deductions were $9,180,000 on gross of $143-million. This is on a pro-rata consolidated basis, which includes 48 1/2 per cent of Burlington. Thus you would find that the ratio is on the order of six and a half per cent of gross. The relationship to net is better for Northern Pacific than for Southern Pacific, because Northern Pacific's operating ratio is less.

These are factors which I am calling to your attention because they do not enter generally into the analytical presentation of a railroad's showing. And you find that when you allow for these factors you get a very considerable difference in the picture than when you started with the figures that were first available.

*** One very good reason why Southern Pacific sells so much higher than Northern Pacific is because it is paying dividends at the rate of four dollars and Northern Pacific is paying dividends at the rate of one dollar. It is obvious that such a disparity in dividend policies would have a substantial effect on market prices.

A question that we shall have to consider from time to time in the future is how valid is the dividend rate as a determinant of proper market prices. That it actually has a great effect on market price cannot be denied -- certainly in the field of securities that are bought by investors. Two years ago, when we were giving a course here on appraisal of stocks, we had occasion to compare Reading and Pennsylvania. There we found that Reading and Pennsylvania made practically the same showing with regard to earnings and financial strength. But Reading was satisfied to pay a dollar to its stockholders, while Pennsylvania was paying about two dollars and a half. The result was that you had prices averaging $20 for Pennsylvania in 1945, against $24 for Reading. Before that time, I think, the ratio of prices was about two to one, although the ratio of earnings was about the same.

I have also had occasion recently to see rather startling evidence of the effect of dividend policy on prices in a number of the insurance companies. If you take two companies like New Amsterdam Casualty Company and the United States Fidelity & Guaranty, you would find that these companies are almost identical in every respect, in the character of their business and their assets, except that one of them has twice the amount of stock and twice the assets and business. The earnings per share are about the same. But United States Fidelity pays two dollars and New Amsterdam Casualty one dollar, and so you have a relationship in price of $42 for one and $26 for the other.

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There is no doubt, therefore, that the dividend rates of Southern Pacific and Northern Pacific are sufficient to explain the market relationship, even by themselves, without reference to any other questions that the analyst might ask himself.

We must consider later -- but I don't think we shall do it now -- whether the analyst can take advantage of the fact that two companies would be worth, say, approximately the same amount from every standpoint other than dividends, and sell at considerable difference because of dividend policy. The question that would come up is whether you can expect in the normal course of events that the dividend policy will adjust itself to the earnings and that therefore eventually the market price will adjust itself to the earnings and will not be determined by an arbitrary dividend policy. That is a very difficult question to reach a conclusion about, and I prefer to talk about it at some other time.

*** STUDENT: One of the appraisals that I hear is that since Southern Pacific is so largely in the Southwest, Texas, in a territory that is growing much more rapidly that the Northwest territory, that some rail analysts are strong in their preference for Southern Pacific on that basis over Northern Pacific.

MR. GRAHAM: There is an undoubted impression that the future of the Southwest territory is better than that of the Northwest territory. You have some justification for that in the most recent figures of development of gross earnings. I would like to give some figures on that which would show how these companies have developed over the last ten years in relation to volume. In 1937 the gross of Northern Pacific, plus 48 per cent of Burlington, was $113,500,000 and Southern Pacific was $225-million. That is almost exactly two to one.

In 1941, Southern Pacific showed a slight increase in the ratio -- $147.3 for Northern Pacific versus $297.8 for Southern Pacific. By 1944 Southern Pacific had drawn quite a bit ahead of the Northern Pacific combination. In 1944 it was $254-million for Northern Pacific and $597-million for Southern Pacific. And that advantage has persisted up to 1946 for the first eight months.

The question that one would raise about those figures is the extent to which they have reflected the impact of war conditions since 1941, and whether or not they would be expected to continue in the future. Frankly, I don't know what the answer is. Furthermore, I don't know how important such changes with regard to gross earnings may be in the final earning power of the railroads.

One of the anomalous things -- and this is very extraordinary -- that you find in your analysis is the following: In 1937 the net earnings of Northern Pacific after taxes were $15-million on a gross of $133,400,000. (That is railway operating income.) Those of Southern Pacific were $34,100,000 on a gross of $225-million. In other words, Southern Pacific showed up quite a bit better in net than it did in gross; it had a better than two to one ratio as against Northern Pacific.

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In the first eight months of 1946 the net earnings of Northern Pacific before income taxes and depreciation, were $27,700,000, or pretty nearly 20 per cent of its gross; and those of Southern Pacific were only $29,500,000, which was just about nine per cent of its gross. Although Southern Pacific showed a very considerable improvement in its gross earnings as against Northern Pacific, its net earnings before taxes, depreciation charges, and interest charges were very much poorer proportionately. The explanation of that, as I said before, is found in the details of its transportation and maintenance expenditures, which apparently have grown very much more rapidly for Southern Pacific than they have for Northern Pacific-Burlington.

The question that was asked about the general future prospects of one territory as compared with another is certainly very relevant to analysis of railroad securities. Yet I must say that I have found in my own work that you can count very much more dependably upon differences of value which can be established from the earnings and expense picture than you can on those which seem to be inherent in the possibilities of the different territories.

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