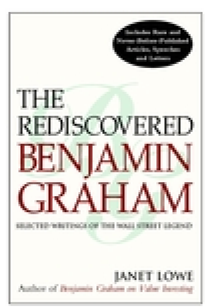
THE REDISCOVERED BENJAMIN GRAHAM *Lectures*

Lecture Number Four

This is a transcript of a lecture from the series ***Current Problems in Security Analysis*** presented by **Benjamin Graham** at the **New York Institute of Finance** from **September 1946 to February 1947**. This content is found in abridged form in *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (Wiley, April 1999) by Janet Lowe. Alternatively, full html versions for all ten lectures are available on the publisher's website.



I find one of the students presents me with a question which I shall be glad to answer for his benefit and for the benefit of the class. He quotes a statement made in "Security Analysis," page 691, which ways, "Judging from observations made over a number of years, it would seem that investment in apparently undervalued common stocks can be carried on with a fair degree of over-all success, provided average alertness and good judgment are used in passing on the future prospect question, and provided also that commitments are avoided at the times when the general market is statistically too high."

That is our statement, and his question is: "That, after reading the article in the Financial Chronicle which we distributed, one reaches the conclusion that you consider 185 for the Dow-Jones Average statistically very high. In general, above what Dow-Jones Average price would you consider it high and between what ranges would you consider it normal?"

That certainly is a very direct and leading question, but I would like to start with a correction. If I recall the article of October, 1945, in the Financial Chronicle, in which we discussed the then level of stock prices, it was not our conclusion that the level of one-eight-five was statistically very high. The conclusion, was that it was historically very high. That is quite a difference. We pointed out that in the past the market had not been able to go beyond that level without getting into dangerous territory.

As far as the statistical discussion was concerned, I think we found that 185 or thereabouts would appear to be a normal valuation for the Dow-Jones Average as of last year, and that on a statistical basis there was no particular reason to be afraid of the stock market there. Our point was, though, that historically there was reason to be afraid of it, and we were inclined to advise caution for that reason. As near as we are able to determine a central value for the Dow-Jones industrials, we are inclined to believe that somewhere around the present level or a little bit higher perhaps might be a central level in the future. The figure we gave provisionally in that article was 178 as so-called "appraisal value." For that reason there would be no special cautionary factor in the current general level, working against the purchase of under-valued securities. The only caution we would want to add to that is this: If by any chance you are still going through the usual alternations of bull markets and bear markets, -- which is by no means unlikely -- then there is no particular reason to believe that when the market has receded to about its average value it would necessarily have stopped going down. Experience in former markets indicates that just as they are too high in bull markets, they get too low in bear markets. If we are going through a similar experience now, the historical analogies would point to lower prices, simply because in bear markets securities sell for less than they are worth, just as they sell for more than they are worth in bull markets. Whether that means that a person should avoid a bargain security because he thinks the general market is going down still further is quite another question; and I think that is largely a personal matter. Our opinion is that for the investor it is better to have his money invested than it is to feel around for the bottom of the securities market. And if you can invest your money under fair conditions, in fact under attractive specific conditions, I think one certainly should do so even if the market should go down further and even if the securities you buy may also go down after you buy them. That is rather a long answer to this question, but it is an interesting one.

I might add another introductory statement: By a coincidence last week I noticed a news item with regard to the Taylorcraft Corporation, which was a company of which we gave a brief and unfavorable analysis at our first meeting. That company, you know, sold some stock on terms which we regarded as rather outrageous last summer. I find now they are in financial difficulties, and that trustees have been appointed. That is a rather extreme example of the value of security analysis. (Laughter.)

Our purpose tonight is to start our discussion of the factor of future earnings in the analysis of securities. In the past two lectures we spoke more or less exclusively about the analysis of the past earnings. Of course, volumes can be written on that question now before us. It is not our purpose to cover it in a comprehensive way, starting from scratch, but rather to assume that you are familiar with the general treatment of the future earnings component which we gave in "Security Analysis", and to subject it to a further scrutiny, particularly with respect to what may have happened in the last few years in that sector.

I would like to start with something that would appeal to at least two members of this class, and that is with a definition of the term "earning power." That term has been used so loosely that I am ready to start a movement for its official abolition in Wall Street. When somebody asserts that a stock has an earning power of so much, I am sure that the person who hears him doesn't know what he means, and there is a good chance that the man who uses it doesn't know what it means.

My suggestion is that we use two phrases: One is "past earning power," and the other is "future earning power." Past earning power is certainly definite enough and it should mean the average earnings over a stated period which would ordinarily be identified in the discussion. But if not so identified it would be some representative period such as five or seven or perhaps ten years in the past. That would be the meaning of "past earning power."

When you are talking about future earning power, you should mean the average expectable earnings over some period in the future. I think most of us ought to think pretty much alike as to the period that we would talk about. My suggestion is that it would be a five-year period, and that when we speak of future earning power of a company, we should have in mind ordinarily the average earnings over the next five years. I say "ordinarily" because you have situations in which a company may be subject to abnormal conditions affecting earning power for some years to come; and there it may be desirable to make a further distinction. We shall talk later about the analysis of a building company stock, in which you might very well make some distinction between the earning power for a boom period, which is ahead perhaps for several years to come, and the earning power for a normal period, if there is such a thing in the building company industry. But apart from some special type of situation such as that, (and a war period such as we have gone through,) I think the use of "future earning power" to mean earnings expected for the next five years would be useful as a general expression.

As far as the use of earning power or earning prospects in Wall Street is concerned, let me point out that in most of the current thinking earning power is not considered along the lines of an average over a period of time of medium duration. It is either considered as the earnings that are being realized just now, or those right around the corner, such as the next twelve months; or else the earnings are considered in terms of the long and almost endless future. A company with good prospects, for example, is supposed to be a company which will go on and on, more or less indefinitely increasing its earnings; and therefore it is not necessary to be too precise about what earnings you are talking about when you are considering the company's future. Actually that idea of the long-term future of companies with good prospects shows itself, not in the use of any particular earnings, but in the use of the multiplier which is applied to the recent earnings or to the average earnings of the past.

I am reminded of an analysis that we used in this course in 1939, in their very first lecture, which I believe illustrates that pretty well. We put on the board three companies: A, B, and C. Two of them, which we did not name, showed earnings of practically identical amounts for the last five years -- $3.50 a share in each case. The earnings year by year were closely similar. The only difference was that one stock was selling at 14 and the other was selling at 140. The stock that was selling at 140 was Dow Chemical; the one that was selling at 14 was distillers Seagrams.

Obviously, the difference between 14 and 140 meant that the market believed that the prospects for Dow Chemical were very good and those for Distillers Seagrams were indifferent or worse than that. This judgment showed itself in the use of a multiplier of four in one case and a multiplier of 40 in the other.

I think that represents a very dangerous kind of thinking in Wall Street, and one which the security analyst should get as far away from as he can. For if you are going to project Dow's earnings practically to the year 2000 and determine values that way, then of course you can justify any price that you wish to. In fact, what actually happens is that you take the price first, which happens to be not only the present market but some higher price if you are bullish on the stock, and then you determine a multiplier which will justify that price. That procedure is the exact opposite of what a good security analyst should do.

I think if a person had tried to project the earnings of Dow Chemical for a five-year period and the earnings of Distillers Seagrams for a five-year period, and compared them, he could not have gotten values which would have justified the price differential as great as ten to one in the two companies. It is always an advantage to give examples of this sort that have such a brilliant sequel; because I notice that this year Distillers Seagrams sold as high as 150 as compared with its earlier price of 14, and Dow Chemical sold as high as about 190, against 140 -- which is quite a difference in relative behavior.

We have been trying to point out that this concept of an indefinitely favorable future is dangerous, even if it is true; because even if it is true you can easily overvalue the security, since you make it worth anything you want it to be worth. Beyond this, it is particularly dangerous too, because sometimes your ideas of the future turn out to be wrong. Then you have paid an awful lot for a future that isn't there. Your position then is pretty bad. There will be other examples of that sort which we may take up as we go along.

Let me now get back a little more closely to the work of the security analyst, and ask the question, "What is the relationship of this concept of future earning power to the day-to-day, careful work of the security analyst, and his attitude toward security values?" That relationship has developed gradually over a period of years, and at a somewhat more significant rate in the last few years.

It is interesting to go back in one's thinking to the elements from which we started our ideas of the value of securities, -- say, a generation ago or more than that. When I came down to the Street, the thing everybody started with in valuations was par value. That did not mean, of course, that a stock was worth its par value. It might be worth more or less. But it was considered as being worth a percentage of its par value. So much was this true -- I don't know how many of you are aware of this -- that prior to about 1916 stocks were regularly quoted on the stock value. Westinghouse and Pennsylvania would sell, say, at 150, which meant they were selling at $75 a share -- because their par value was 50. I suppose we have gotten so far away from par values now that the only people who are interested in them are those who calculate transfer taxes on securities. Because of that tax reason, one-cent par values are regarded as a very smart procedure in Wall Street today.

I can imagine the attitude of the old-fashioned investor were he to buy a stock for $50 and looked at the certificate and found its par value was one cent. He would probably have fallen in a faint. Well, through many stages in a long period of development from that rather naive attitude toward the central point of value, you have come now to what might seem to be the ultimate stage where the central point of value is the future earnings power, -- something which you cannot read on any certificate. In fact, you cannot read it anywhere.

There is often a question in my mind whether we have really made so much progress in moving on from the physical to the almost metaphysical in this way; but be that as it may, we have. And now it is the law of the land that the values of securities, if they must be determined for the purpose of judging fairness of any kind of transaction, will be based primarily on the capitalization of expected future earnings. That is the burden of the famous Consolidated Rock Products case that you see referred to all the time in SEC proceedings, and in other cases of similar character. When the Supreme Court says it is a fact that the value depends upon future earning power, that does not mean that the test of the value that the Supreme Court has laid down as the law on this subject has therefore become the proper test for us security analysts. I think rather that we have laid down the law to the Supreme Court. That is to say, the Supreme Court has said that the values are now to be determined primarily in relation to future earning power, because it has observed that values have actually been determined by buyers and sellers of securities more and more in relation to such expected earnings.

The Supreme Courts had lagged behind the times for quite a while in that matter, and it just caught up. I think perhaps that it is still lagging behind the times in some other respects.

The concept that investment value is dependent upon expected future earnings is undoubtedly a more persuasive and a more logical one than thinking of value in relation to past earnings only, or in relation to the par value printed on the certificate, or any other stage in between. But I must emphasize to you that this concept does not make the job of the security analyst easier. On the contrary, it makes it a great deal harder, and it places him in a serious dilemma, for now the past earnings, with which he can become very closely familiar and which he can study with a great deal of skill and ingenuity, -- those past earnings unfortunately are not determinative of value. And the element which is determinative of value, the future earnings, is just the thing which he cannot analyze with any real feeling of assurance as to the correctness of his conclusions.

That would be a very sad dilemma indeed for us security analysts if it were not for that principle of continuity that I tried to emphasize in the first lecture. While it is true that it is the expected future earnings and not the past that determines value, it is also true that there tends to be a rough relationship or continuing connection between past earnings and future earnings. In the typical case, therefore, it is worthwhile for the analyst to pay a great deal of attention to the past earnings, as the beginning of his work, and to go on from those past earnings to such adjustments for the future as are indicated by his further study.

You all know, of course, that the dependability of past earnings as a guide to the future is sufficient to make it possible to rely almost exclusively on them in the selection of a high grade investment ??? bond or preferred stock. We have said, in fact, that you cannot properly buy such an investment security on the basis of expected earnings, where these are very different from past earnings -- and where you are relying on new developments, as it were, to make the security sound, when it would not have been sound on the basis of the past.

But you may say, conversely, that if you buy it on the basis of the past and the new developments turn out to be disappointing, you are running the risk of having made an unwise investment. We find from experience, though, that where the past margin of safety that you demand for your security is high enough, in practically every such case the future will measure one. This type of investment will not require any great gifts of prophesy, any great shrewdness with regard to anticipating the future. In fact, it would be a very unfortunate thing if you could not get two and three-quarters per cent on your money without having to be something of a soothsayer as far as the future earnings of corporations is concerned.

When I make that statement, of course I do not mean to lay down the inflexible rule that any company that gives you a sufficiently great margin in its past earnings can be regarded as having sound securities for investment. If the investor has occasion to be fearful of the future of such a company, it is perfectly logical for him to obey his fears and pass on from that enterprise to some other security about which he is not so fearful. But the point I am making -- and I hope you can understand it, -- is that in the selection of high-grade securities you start with a demand for an adequate coverage in past earnings; and in the typical case that is sufficient to justify the selection of the bond. I think I might pause there to see whether any questions have arisen in your mind on that point, before I go on from that rather simple application to its more complicated application to the valuation of common stocks.

In the case of common stocks the technique of security analysis has made rather important progress from the rather hit-and-miss method of taking past earnings as a guide and then saying, "Well, I think the future is pretty good here, so I'll multiply the earnings by a higher than average multiplier." Or in the converse case: "I think the future is not so good, so I'll multiply these past earnings by a lower amount."

It is now becoming approved practice in any really good analysis to work out the future earning power along somewhat independent lines, -- by considering afresh the most important factors on which the earning power will depend. These factors in the ordinary case are not very numerous. They consist, first, of the physical output or volume of business that you expect from the company. Secondly, the price, or unit price, that it will get. Thirdly, its unit cost; and then, fourth, the tax rate. We now have a standard technique by which you go through these various motions and set up these successive figures, -- all of which are estimates, of course. By this operation you arrive at a conclusion as to future earning power. That is regarded, and should be regarded, as a better technique than the simple one of merely taking the past earnings over a period of time.

Consequently, when you undertake a full-scale analysis of a security and want to determine whether it should be bought or not -- I should say, frankly, whether it should be bought or sold -- your proper technique should consist of estimating the future earning power along the lines that I have mentioned, and then applying a multiplier to it which is influenced in part by your subjective ideas as to the security, but which has to be kept within a reasonable range of variation.

It is not, I assure you, admissible security-analysis technique to say, "I don't like this company, so I will multiply the future earnings by four; but I do like the other company so I will multiply the future earnings by 40." You will not get a passing grade on a security-analysis test if you do anything of that kind. But naturally there is room for some variation in your multiplier as applied to these earnings. When you use that multiplier, you arrive at a valuation which can be a guide to you in your attitude toward the stock.

I was going to go on with some other examples of that method, but I find that I have left out a little note that I put on one of my pages headed "The Digression." This was intended to contribute somewhat to your amusement and edification.

You may recall that I have been emphasizing the difficulty of peering into the future and coming through with some good ideas as to what will happen. Let me now indicate to you the position of somebody who really could have looked in the crystal ball and derived a good deal of dependable information about the future. Let us see how well he would have fared. I am assuming that each of you was one of these fortunate investors who really had a crystal ball, and could foretell in 1939 that different groups of stock would expand their business in the percentages that we show on the blackboard here.

Now, we say, suppose you were also told that in September 1946 the general level of industrial prices (as shown by the SEC calculations) would be 29 per cent higher than they were in January 1939. That happens to be true. Consequently the stocks in these groups would vary around a center of a 29 per cent advance. Suppose, then, you were asked back in 1939, "What would be the change in the prices of these securities by 1946?" Here, for example, is Aircraft Manufacturing, which is expanding 31 times in volume, from 1939 to 1944. Here is Aviation Transport, which is expanding two and a half times. I could, for our amusement, ask you to make what you would regard as a reasonable estimate of the change in market prices from January 1939 to September 1946; but instead of going through that rigmarole I shall merely give you the results.

At September 16, 1946, the Aviation Transport securities were up 274 per cent from January 1939 -- which was pretty good, I should say, compared with 240 per cent increase in business. But the aircraft manufacturing companies were down 74 per cent. I do not think you would have expected that if you had known the relative change in sales. Amusement stocks and Tobacco products both benefited just about the same in gross from the war conditions. But the difference was that the Amusement stocks advanced 242 per cent and the Tobacco stocks declined 10 1/2 per cent, -- which is quite a difference.

The Tire and Rubber companies did not do as well as Electric Manufacturing in sales, but in price they went up 85 per cent while the electric machinery equipment went up only two per cent.

Metal and Metal Mining did not do quite as well as paper in sales expansion. But the difference here is also rather surprising, because the Paper and Allied Products stocks increased 107 per cent in value, and the Metal Mining stocks declined six per cent during that period.

You see that the discrepancies in market movement are so great that they should add an extra note of caution in our attitudes toward our future calculations. For even if we knew what was going to happen to a company, in terms of its business and its earning power, we might not be able to make too good a prediction as to what was going to happen to it in the market price, which interests us a good deal. That is just an added reason for being either as cautious as possible in regard to our own decisions on security purchases, or else protecting ourselves as much as we can in our own thinking and in our statements by qualifying comments, whenever we begin to make predictions as to the future.

Now I should like to go on and give you a detailed example of the kind of analysis which is now being made, that centers around an estimate of future earnings and works on from there to a valuation. I have two examples here. One of them relates to the Childs Company. That happens to be rather convenient because here we have our good friend, the Securities and Exchange Commission, sweating through a valuation of the Childs Company which is based primarily upon their estimate of future earnings. They do this because they have to. They are required to find out the comparative values of the preferred and common stocks in their report to the court on the fairness of the proposed reorganization plans. The only way they know of determining the comparative value is by getting the total value of the enterprise and then comparing that with the claim of the preferred stock. And so they go through an elaborate technique in order to value the Childs Preferred and Common shares.

It might be worthwhile to take a little time and see just how they have done it. Perhaps I should make the matter a little clearer to you. The Childs Company, most of you know, has been in trusteeship. The company is now evidently solvent, and can easily take care of its debts. So the problem of reorganization actually turns upon giving the proper amounts of new securities to the old preferred and common stock.

The SEC, in its wisdom, decided that the capitalization of the preferred and common stock should be changed from what it was before. It is thus necessary to determine what proportion of a new common-stock issue, if that is to be the only stock, should go to the preferred and what to the common. The problem before the SEC, then, was to determine what the whole enterprise was worth. If the preferred stock claim was 75 per cent of such value, for example, they would then allot 75 per cent of the stock to the preferred and the balance to the common.

What they did was to start with a projection of the sales of Childs, which they took at $18-million, somewhat less than the figures for 1945, -- they assuming that business would not be as good in the long-term future as it was under war conditions. They then took a percentage of profit of six per cent before taxes. That was based upon a study of profit margins both for this company and for other restaurant companies; and I do not believe that analysts would be likely to differ very much with them. So they got a net before taxes of $1,100,000.

Then they subtracted the expected average tax rates. Here the SEC decided to cut down the current rate of 38 per cent to 35, -- a very valiant gesture of guessing. The main question, in estimating the tax rate, was whether it was likely that the great pressure to eliminate double taxation on corporations would be effective in the future in such a way, perhaps, as to relieve corporations of either all or most of the tax. Their guess, and mine too, was that such was not likely to happen, desirable as it might be.

So the net after tax was estimated at $715,000. That is the future earning power, and you can see that is a relatively simple calculation. It represents smaller earnings than Childs had during the war period before taxes, but considerably more than in the pre-war period.

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QUESTION: How do they estimate the future sales?

MR. GRAHAM: Well, here is sort of a summary of a rather long discussion about the effect of retaining some restaurants, closing others and opening up others. They say, "Considering the record of the 53 units" -- which includes some which would be closed -- "and giving weight to the various factors that affect future sales to the chain, we believe that the management forecast of $20-million restaurant sales for the average future years is excessive. For such a figure to be achieved, the chain would have to average in good years and bad years sales which would be ten per cent higher than those achieved by the 53 restaurants in 1945, which in turn were higher than in any previous recent year for more than a decade. It is true that in 1946, with the first six months' results known, the management estimated that the sales will exceed $21,400,000. However, it must be recognized that the company is experiencing extraordinarily high retail sales and Childs' current high sales level cannot be considered to correspond to the level which may reasonably be forecast for a normal year in the future." "We believe however, even giving consideration to normal retail business, that the chain can reasonably be anticipated to average sales of $18-million, which was the amount realized in 1945 by the 53 restaurants --" The conclusion is a rather interesting point of technique. Rather than take a figure completely out of the air, you go back to the earnings of a past year which you think will correspond to a typical future year and arrive at the figures that way.

QUESTION: Wouldn't the common stock holders have a basis of argument about the sales and therefore throw out the whole business?

MR. GRAHAM: You mean can they argue against that?

QUESTION: Yes. Well, they can say it is higher; it should be 21 million, or whatever it was in 1946.

MR. GRAHAM: Well, your point is perfectly right. The common stock holders can say that, and so could the SEC have said it -- but they didn't. And when you get down to the judicial question on which this matter turns, here is what the courts say on a matter of that kind: They would say that the SEC is competent and impartial; that their guess is probably a better guess than one advanced by an interested party such as a common-stock holder. But if the common stock people could adduce very convincing evidence, -- not merely an insistent argument -- which would show that the estimate is out of line with normal expectancy, then the SEC's figures could be reflected by the court. QUESTION: Did the trustee represent the common stockholder's viewpoint here?

MR. GRAHAM: No, a trustee wouldn't normally represent just the common stock. The SEC assumed Child's Trustee's views were too liberal. In other cases, the Commission has considered the Trustee's estimate as not liberal enough.

QUESTION: Didn't the SEC introduce the price level in their computations somewhere?

MR. GRAHAM: Not in any explicit calculation.

QUESTION: By using the 1945 level they might discount what they consider to be a bulge in food prices right now.

MR. GRAHAM: Perhaps they do refer to the fact, in their analysis of merchandise costs; that there has been a scarcity of supplies, and that the opportunities to purchase food and liquor at bargain prices have disappeared during war years.

QUESTION: Let me ask another question, then: From your observation isn't retail merchandising, whether it is a restaurant chain or anything else, strictly a matter of percentages? In other words, give them a price level, they work both their costs and selling prices up and down accordingly.

MR. GRAHAM: It generally works out that way. This six per cent figure which they give for net before taxes is based pretty much upon average experience in the past. I presume that is the percentage you are referring to. We know, for example, that food in the typical restaurant represents anywhere between one third and 40 per cent of the total sales check. Once a stable price level has been established, that percentage tends to be established again, even if it was set aside for a while because of sudden changes in price level. For Child's merchandise costs have risen from 34.7 per cent in 1938 to 38.5 per cent in 1945.

QUESTION: No question that the prevailing prices that this chain has to deal with in '46 would be higher than in '45? No question in your mind, is there?

MR. GRAHAM: No.

QUESTION: And that automatically would govern in actual volume of sales, wouldn't it?

MR. GRAHAM: It would unless for some reason the customers were driven away from restaurants, which so far I don't think the figures show. But '46, of course, is not regarded necessarily as a typical postwar year by the SEC, and probably correctly so.

These questions are really good questions, not so much as criticisms of what the SEC does, as they are indications of the necessary degree of uncertainty involved in any such procedure. The only thing you can say in favor of it is that something of this kind must be done. The SEC must do it as intelligently as they can; and you as security analysts must also do it intelligently. But don't ever think that because you go through some very careful operations and work things out to two or three decimal places, as I sometimes see it done, that you have got an accurate and precise idea as to what will happen in the future. You just don't have any such thing. It isn't there.

*** QUESTION: I would like to raise the question of working with post-tax margins rather than pre-tax margins to avoid the dilemma of estimating what the tax rate will be, on the theory that competition will drive the post-tax margin down to about what it was.

MR. GRAHAM: There has been a great deal of discussion in academic circles on the incidence of the corporation tax, -- as to whether it is really paid by the consumer or whether it is paid by the prosperous corporation as compared with a non-profitable corporation that couldn't have to pay any tax. That matter is still very controversial, and apparently the SEC prefers to follow the assumption that the margin should be calculated before tax. In practice, it didn't make much difference, since they use practically the current tax.

*** We are really going on further in the Childs' matter, than the mere matter of estimating future earnings; because I think we ought to follow it through to its conclusion by the SEC, and perhaps by ourselves as sitting in judgment on the SEC.

They next came to the multiplier and they said that their multiplier should be 12 1/2. That is to say, a capitalization rate of eight per cent, which gave them a value of about $9-million for the company on an earnings basis. I don't think much was said that would illuminate the question of why they selected a multiplier of 12 1/2. They reject the Trustees' multiplier of ten. That is the first thing they do. Then they add one of those precious clauses that you find in the Tax Court almost always, and in the SEC frequently. They say, "Giving consideration to all the factors, including rates of capitalization which have prevailed for other restaurant chains, it is our conclusion that estimated net earnings of $1,100,000 before income taxes and $715,000 after income taxes can fairly be capitalized at rates approximately 12 per cent and eight per cent respectively, resulting in a capitalized earnings figure of about $9-million.

That means that using their best judgment they will multiply the earnings after taxes by 12 1/2. I assure you that the alternative capitalization of earnings before taxes was figured out at a rate to correspond with their capitalization of the earnings after taxes. I think it was put in there, because in the McKesson and Robbins case they were led by the Trustees' calculations there to do some valuation of earnings before taxes -- something that had never been done before, as far as I know. Their capitalization rate, of course, is pretty much an arbitrary matter, and yet I assume that most analysts would not get very far away from their multiplier.

QUESTION: They use a lower times multiplier that the trustees. Is that the effect of that?
MR. GRAHAM: No, a higher multiplier. They cut down his earnings somewhat, and they increase his multiplier so I think they end up pretty near the same evaluation.

QUESTION: You said eight times, didn't you?

MR. GRAHAM: No, an eight per cent figure. That eight per cent is 12 1/2 times. The trustee had used a multiplier of ten.

QUESTION: And they were giving arguments against the use of the ten per cent by the trustee?

MR. GRAHAM: Yes, but the matter is too complicated to take up here. The Trustee had used what he called a "segmental method", in which he considered that part of it was equivalent to bonds, another part to preferred stock, another part to common stock, and the SEC argues about it. Incidentally, you should know that the SEC goes at these things very seriously. I mean, their valuation isn't so much of a rule of thumb way as you may think from my description, -- though I have a little mental reservation on that, and believe that you might get pretty much the same results by rule of thumb method. But they certainly don't do it that way. When they start with analysis of estimates of earnings, they have a discussion of about three pages on the management factor. Then they have three pages on the sales, half a page on merchandise cost, half a page on labor costs, then paragraphs on other costs, on building operating profits, on depreciation and rentals, on overhead. Then, after all those discussions, they reach this calculation of six per cent of the sales of $18-million. Evidently, a great deal of work of the staff went into this. Thus they got a valuation of $9-million, based upon earning power. Then they went through some motions after that, on some of which I part company very definitely with the SEC. First they figure out some tax savings due to carrybacks and things of that sort, and they say they will get $1,200,000 from that. Then they say they have to spend $1,800,000 for rehabilitation of the restaurants, so they subtract that. And therefore they reduce their $9-million by $600,000 net and get $8,400,000. That is their net value by the earnings method.

Then they add excess working capital and unneeded real estate to that figure. From their calculations these amount to $5,100,000, and so they get a final total of $13,500,000. They have to deduct from this $13,500,000, the funded debt of $3,200,000. So they get a net value for stock of $10,300,000. They value the preferred stocks' claim at par and back dividends, amounting to $7,649,000. Thus the balance left for common would be $2,656,000.

Consequently they reach the conclusion that, if one class of stock is to be issued, then somewhere between 70 and 75 per cent of the total should be given to the preferred stock and somewhere between twenty-five and thirty per cent should be given to the common. That happens to be an unusually modest type of conclusion for the SEC. In the past they have generally come out with an elaborate calculation and said: "We believe that 72.45 per cent of this company should go to the preferred and the balance of 27.55 per cent to the common." But I think they are getting a little mellow and are realizing that their calculations are pretty much estimates and should be turned into round amounts.

As a practical matter it turned out that the reorganization is now being carried through on close to the SEC's basis, although the original plans which were proposed by the Trustee and by a number of other people for the most part departed very substantially from these proportions. I won't take the time to tell you what the different plans were; but the Trustee now allocates 76 2/3 per cent of the new stock to the preferred.