DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: Registration for Manufacturing Companies

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MR. BLACKSTONE: After this program is finished, I should like to get from each of you your own reaction and comments as to what the weak points or the strong points of the course have been to help us in future sessions, so that we can be working towards a better and better training program each year.

Our session this morning is the first in a series of sessions we are going to have on detailed analyses of different types of registration statements. Our speakers will all welcome questions as we go along with these discussions. Up to now many of our sessions have necessarily been general in nature to give you a general indoctrination, and we hope now to be able to get more concrete problems to give you a better feel of how to handle particular situations.

Our session today is on the **analysis** of a registration statement for a manufacturing company.

MR. KING: There is one thing you will have to remember when we are analyzing a registration statement. It is prepared as a basis for selling securities. Because of that it is necessarily a selling **document**, and it, by nature, is sometimes such that the good points are put forward in the best light, while the unfavorable factors are sometimes buried or omitted altogether. For that reason it is necessary for the analyst to be alert -- continuously alert -- to be inquisitive, to be skeptical of the information in the prospectus.

The presentation varies from company to company. Some companies are quite straightforward but unfortunately some are not quite so straightforward and try to hide things. Sometimes there are too many cooks who spoil the stew. A good example of this, a leading attorney of a good law firm in New York had a case with me one time where there were no underwriters. He said, "What a pleasure it is to write this registration statement without an underwriting concern breathing down my neck when I am preparing it." It cannot be stressed too much that you be continuously alert to what you read in the prospectus.

Now the factors having a material effect on the business of a manufacturing company can be conveniently divided into two classes: the external factors, the internal factors of the company. The external factors are the general economic conditions. On general economic conditions, the subject really becomes fascinating because we have here the various phases of our economy -- the economy that has made us the world's greatest power. Manufacturing companies, as a whole, of course, are more sensitive to declines in business, the business cycle, than other companies that will be discussed here. Even then there is great variance on how sensitive they are. The luxury goods manufacturers, of course, are subject to a decline in business, and the **manufacturers** of semifabricated material also are the first to feel it. One thing an analyst should do when he looks at a company is to see just how subject they are to such conditions. At this point I should like to stress, and I'll stress again, the importance of finding out and keeping abreast of what is happening in the business world. Any recent declines should be properly reflected in the prospectus. It is a tendency for companies, when there is a change in business conditions that are not quite evident to people, to get a registration statement in before the bad news breaks. It is perfectly legitimate, there is nothing wrong about that particularly, but there have been numerous cases where companies have filed registration statements, the analyst has looked into the business statistics for the industry, and found that a decline had set in just before the registration statement was filed with no mention of that condition is the prospectus.

Another thing that the analyst must look at is a determination of these unfavorable conditions of the industry or industries in which the company operates. The first one could be a determination that the company is in a declining industry. The symptoms of that are, among other things, over-**capacity**, declining sales, and cut-throat competition. I am going to read an excerpt from Houdaille Industries which at that time was in the auto parts industry. That, along with the railway and textile equipment, have been declining industries in the post-war period. This is what is said: "Automotive: In 1954 the dollar volume of sales of the corporation were affected by several factors. The low level of automobile production for the greater part of the year, and materially reduced prices on its various parts brought about by increasing competitive pressure on the part of the automotive manufacturers." That was a polite way of saying that the automobile manufacturers were beginning to manufacture their own parts. "The future prospects for the sale of automotive parts will be dependent on two major factors: the general level of automobile production and the integration policies of the larger automobile manufacturers. Should these manufacturers decide to produce more of the parts which are now being purchased from outside suppliers, it will result in more intensive competition for the smaller quantities of parts remaining to be purchased." That is exactly what happened to this. Ford, General Motors, and others are beginning to make more parts, and the automobile parts manufacturers had to fight for every nickel of the market left to them. A lot of them have gone out of business in the last couple of years.

Another thing is the determining of the present status of production in the industry. In Olympic Radio and Television's registration statement, we found from recent industry figures that recent material declines in the production of TV sets had not been described in the statement. This is the comment we put in our letter. "Reference is made to the statement hereunder, that because the television receiver business has shown an indication of developing seasonal characteristics the operating results for the three months ended March 31, 1950, are not necessarily indicative of the results for the entire year. Information on file with the Commission indicates a lessening of demand for television receivers has recently occurred. Any such lessening of demand should be disclosed under this caption. If the registrant is presently producing, or intends to produce television receivers at a lower rate than in the first three months of 1950, a brief discussion should be included." That is where we caught them really flat-footed. The latest industry figures, by the way, we had obtained from the Trade Association in Washington. They weren't even available in Standard & Poor's but we had the feeling they were declining, so we got the latest figures which showed a substantial decline.

Another method used is to not show the seasonal impact. We had a registration statement that O. A. Sutton filed. They had an interim period in their summary of earnings for seven months, I believe, but the joker was that the seven months was when practically all the production was done because of the seasonal factor; the other five months the company operated at a substantial loss. We got them to make proper disclosure, and it made an entirely different picture.

A classic example of that, perhaps the best known, are the figures on automobile car dealer inventories. They were discussed pro and **con**. When they reach an all-time high, any analyst of an automobile production company, or any related supplier -- auto parts, steel company that has or is dependent upon the light weight sheets that are used in the automobile industry -- has to watch for and get a disclosure of the inventory situation because it is dangerous. Invariably production drops in the automobile industry and its suppliers when car dealer inventories are high. Another one is the TV inventory figures. This was taken from Standard & Poor's industry survey -- a recent one -- and it discloses a situation that should be in a prospectus if a radio-TV registration statement came to us. "Television production in 1956 was geared to meet moderately higher demand which did not develop. Consequently, inventories at all distribution levels rose to 408,000 sets year to year despite an 8% decline in retail shipments. As a result factory production could well decline in 1957 to around 6,000,000 units from the 7,387,000 indicated in 1956."

Then we have the information in Standard & Poor's as to appliances, and this is what they say about the current situation. "Most manufacturers are currently operating at 50 to 66% capacity, making higher costs. Price increases are in effect on most **1957 lines**, but in view of over-capacity it is not certain that these prices will hold throughout the year."

Then we have problems as to disclosure of competition. That can be divided into two classes: from the manufacturers of identical products, and from the manufacturers of competing materials. In all cases where we have severe competition it should be emphasized. Sperry-Rand in a recent prospectus put it very nicely, brief and to the point. "**In general**, in the instrumentation and controls, business competition is now and is expected to continue to be active and intense." Now using Olympic Radio again, we cited an instance as to competition where it really had become cut-throat, and we put this in our letter: "if, as we understand, competitive conditions in recent months have been characterized by severe price cutting, it would appear that disclosure of that fact and the effect thereof on the registrant's business should be made. In this connection, it is noted from news sources that major manufacturers recently announced reductions of $70 in the price of two models, to $159 for the 12-1/2 inch tube table model and to $259 for a 16 inch tube console model." Note that we read it in the newspapers in this case and confronted them with it.

Now as to the manufacturer of competing materials, Owens-Corning had this to say (this was just a recent case that was cleared): "Low profit margins resulted from lower prices in certain lines, particularly residential building products where results were adversely affected by increased competition from competing materials in the building field primarily attributable **to a decline** in the new housing field."

Then we have a problem of the size and impact on the market of larger producers in industry. The classic example of that can be found in the automobile industry again where General Motors, Ford and Chrysler account for most of the production, and anybody else has a really rough time. We recently had a company called Transition Metals and Chemicals where this statement was made that covers the point: "The Electro Metallurgical Division of Union Carbide and Carbon Corporation was for many years a sole producer and is now the only important producer of ferrotantalum-columbium and ferro-columbium in the United States." That is clear enough -- they are the sole producer. "One or two other companies have recently entered or have indicated an intention to enter this field." Note the emphasis on just one or two other companies are going in -- very innocent. "The company believes that under conditions now prevailing it will be able to meet competition in the sale of ferrotantalum-columbium and ferrocolumbium." Now what is wrong with the paragraph? Upon investigation we found out that Electro Metallurgical had enormous advantages in this case over anybody else trying to get into the field. For example, they offer the complete line of ferro alloys instead of a single alloy. They have local warehouses throughout the United States where items are stocked and available for immediate delivery, which the registrant concerned didn't intend to have, as far as we could find out. They maintain stock piles of ore and have dependable sources of high-grade ore which in this case was very important. They had excellent good will, highly efficient technical staff, and excellent record of meeting specifications. And then we found that Electro Metallurgical was not the only important producer. It was true that one or two other companies were entering the field, but look who the other two companies were: One of them was Vanadium Corporation, a large company that had spent two years and an enormous amount of money in research to get this process; the other was Molybdenum Corporation. In addition to this we also found that there was severe competition from foreign sources. In fact it was so severe that Union Carbide was being forced to reduce its prices substantially in the near future. Nothing of that nature was in the prospectus. In addition to that, we found that there was another metal, ferro-tantalium, which is a competing product, sales of which were actually larger than the product the company expected to process.

Then we have the old chestnut that has been used for 30 or 40 years, I guess as far back as sales to the public became popular. That is, to point to a company like General Electric and state that H. M. Buster (or some such person) put $1,000 in this company 40 years ago, and that his investment is now worth several hundred-thousands of dollars. They invariably try to use the successful corporation as an example of the fact that buying stock in a new company will lead to untold profits to the investor if he invests in the new company. That crops up every once in a while in these prospectuses, particularly with people who are not too familiar with our work.

Now as to the internal factors involving analysis of a manufacturing company, the first thing (and this may sound a little silly, but it is a problem) is the determination as to whether the company is manufacturing legitimate products, or products of doubtful validity or having major shortcomings. In promotions this problem comes up very often, and sometimes in other companies. Transition Metals & Chemicals, which I have cited before, had a very interesting statement. They said that they expected that the major part of the company's output in magnesium would be sold to the Armed Services and to other Government agencies. Upon inquiry to all three of the Armed Services, we got the same reply, namely, that they were not purchasing this type of magnesium product. It was discontinued. So the company had no chance of selling its magnesium products to the Government. We checked also with the A.E.C. (which was the other major purchaser of magnesium products) and found out that there was a hitch there too. The A.E.C. purchases a year's supply at a time under contract, and if the company had, by any chance, been successful in getting the bid, their capacity was such that it would take them seven years to fill a one year's A.E.C. supply. In addition to that, we found out that the successful bidder on this case was in a class by himself. Nobody could touch him because his last bid was six cents a pound against a range of 40 cents and upwards for all the others (including a predecessor company of Transition). So their chance of getting any business whatsoever was nil.

Then we had a company called Thomascolor several years ago. That company proposed to manufacture devices for color photography -- motion pictures particularly. Thomascolor listed its technique as a new process. We found out that this process in fact had been known for years and had been abandoned for more practical processes. But in the meantime the Thomascolor promoter had been making a very lush living, had sold millions of dollars in securities in some predecessor companies, in fact be liked his living so well he persisted after the stop-order and the last I knew he was in jail.

Then we had a company called Pipelife Corporation. That was formed to exploit a process to coat pipelines internally in place. We checked on this, and the results were very interesting. I called up an officer in a very large corporation that I knew would have some information about this process. They immediately got in touch with their engineers in another part of the country and asked them to check. Although they were selling to registrant the raw material for this process, they came up with an unfavorable report which could be summarized thus: The use of internal coating is limited and declining because it is of use only with sour gas, production of which has declined. To cap it all, they said there was a serious question of the feasibility of coating old pipelines in place. Incidentally, in connection with the registrant we found that they had been willfully violating the Securities Act, selling over a million dollars worth of stock without an effective registration statement. They had been informed that it was a violation, but they went blithely on.

Then we had a company that was going to manufacture caskets out of a plastic material which they said would protect "the dear ones forever from the cruel elements." I got a little skeptical of this. To illustrate how you can find out things just by inquiring around, I tried this prospectus out on a neighbor across the street who is a chemist for the patent office. I showed him these claims about protection from the cruel elements. He looked into it and found out that the plastic composing the vault and the casket would disintegrate due to the chemical reaction of the elements in the earth. So there we had a claim about protecting the dear ones which wasn't true. That statement later became effective but with the substance of what my chemist friend reported prominently set forth in an introductory paragraph, with a lot of other things, and the president of the company tried two or three times to get it out of there. He said it would kill the venture. Well, it did kill the company. They are no longer in existence.

Then we have problems of disclosure of distinct multi-line products. Item 9 of S-1 requests information as to the relative importance of each class of products contributing more than 15 per cent of the gross volume. A common method of meeting this requirement is to give in tabular form for the last five years a percentage of sales for each distinct line. We sometimes have a problem in this connection as to whether the company does have a distinct line. Some companies don't like to reveal such figures because of competitive reasons. So you will have to determine whether it is a related line, or is it distinct, or what it is. Particularly where there are cases of lines that are very unfavorable for the business, that are highly competitive, we insist on disclosure on that. Particularly so where it is essential to an understanding of the business.

The next question is as to the profitableness of each distince line. There we really run into trouble because companies are fearful of competitive angles, and rightfully so, if they reveal figures as to profit margins on each distinct product. We get around that generally by asking in general terms the relative profitableness of each line, and particularly where we find the profit margins vary greatly; we find that some lines are being carried at very low profit. However, in particular cases where it is important to understand the business and the effect of a particular line on the business, we do get a disclosure. Anaconda Company became effective a couple of months ago and this is what they said about the matter (at our request): "Since 1952 the company has been engaged in the mining and treatment of uranium ores and is believed at present to be the largest domestic producer of uranium ores and concentrates. In 1954 the company began production of aluminum fabricated products, and in 1955 the production of aluminum from purchased alumina. This diversification made a material contribution to the operating results for 1956. Uranium concentrate production <u>principally</u>, together with aluminum production, accounted for approximately 18% of the combined net income of the company and of Anaconda Wire and Cable for 1956."

Now there is also disclosure we ask in the price range in a class of products, particularly when the company is a manufacturer of luxury products, for the reason, as I have pointed out before, that they are very sensitive to declines in business.

Then we come to analysis of raw materials of manufacturing companies. The first thing is availability of supply. This problem comes up in numerous prospectuses, depending on the economy and shortages of raw materials. Rotary Electric Steel put this very nicely, as to the shortage of raw materials which hampers operation: "Nickel, one of the alloying elements which is used in the production of slightly over 1/3 of the company's stainless steel output is in short supply as a result of Government stock piling. It is the only raw material which the company is presently unable to obtain in sufficient quantities to meet current requirements. To the extent available the company purchases nickel in virgin form from commercial producers. However, approximately 60% of the nickel used is presently purchased as scrap at a considerably higher cost." That was a real problem with this company and still is. In Transition Metals, which I have used as an example quite a bit, it was found that ore was available in small lots only and the grade was undependable. This resulted in a situation where their competition would be uneconomical because they had to stockpile in major amounts lesser desirable metal. Electro Metallurgical could do this because they had the resources, they had the means of distribution, and they could sell it at lower prices. Poor old Transition would be up against something really rough in a short time and need a lot more money to carry on.

We require disclosure of the effect of a rise in prices of material. Owens Corning pointed this out by saying, "lower profit margins resulted in part from higher labor, materials and transportation costs, which were not passed on by the company in higher prices."

We require disclosure in the case of adverse affect of wide variations in the price of raw materials. H. W. Lay very nicely disclosed this (at our request again): "A large part of the raw materials used by the company consists of farm commodities which are subject to precipitous change both in price and supply. Often it is difficult to adjust package weights and selling prices to meet these fluctuations. As a result the profits of the business may be adversely affected at times." Their principal product was potato chips and both the price and supply of potatoes were bothering them.

Capacity problems come up occasionally. We had one case called Gold Seal Products. They stated in their prospectus that their capacity was twice its present production. However, we found that this statement was false because the present production was at a seasonal low, and the difference between seasonal low and high was quite a bit. Actually they didn't have much excess production. It is tricks like that that are put in for selling gimmicks.

Then we require disclosure in case of excess or unused capacity. That would, of course, appear in a company operating in a declining industry. That is one thing you should look for in a case of that kind.

Then we have the problem of the analysis of the markets. The principal problem comes up when a large customer takes a substantial amount of output. That occurs quite often with companies that sell to Sears Roebuck, Ford and General Motors. Where sales to one customer amount to more than 15% of net sales our policy has been to require disclosure in the prospectus of the name of the customer and the amount sold to it. Where there are two or more customers, the problem becomes more difficult because of competitive reasons. We generally settle for the aggregate of the purchases and the names of the companies to which the registrant is selling its goods. Houdaille Industries handled it this way in that situation: "The corporation supplies some parts to practically all manufacturers and for the five years ended December 31, 1954, its sales to Ford Motor Company (its principal customer), General Motors Corporation, and Chrysler Corporation in the aggregate have ranged from 59% to 72% of the corporation's total sales." We, of course, inquired into what Ford Motor sales were, and actually it was its principal customer, but they pleaded with us not to give Ford sales because of the really rough competitive business in motor manufacturers. They find out these sales and use the information to lower the price of other products. They were doing it, too. They were playing one against another. So we settled for this disclosure. You have to look at every particular case and listen to valid reasons. We have to protect the company and the investor. The thing is to see that the investor gets to know the vital facts.

In companies that have international sales we require disclosure of foreign sales where they are substantial. Anaconda, when they first came in, didn't say a thing about their foreign business. However, this was put in later. "The company's proportion of income of the subsidiaries operating in South America and Mexico, principally Chile, represents approximately 45% of the combined net income of the company and Anaconda Wire & Cable Company for the nine months ending December 31, 1956." Now note the volume of foreign business which the company did not put in. They also gave the locations which we likewise requested. It makes a difference whether you do business with hard currency countries or soft currency countries, so for that reason we like to get location of sales.

Then we require full disclosure of falling prices of raw materials. That sometimes becomes very important I am using Anaconda again. Anaconda showed a table of copper prices for the last 10 years which showed an increase substantially year by year in the high, the low and the average price, which made a very pretty table. It looked like Anaconda was really on the up and up. However, we looked into what had happened to copper prices during 1956 and subsequent to the first of the year, and we found a situation that gave an entirely different picture than this table gave. What was the principle I am illustrating? A recent development that had not been reflected in the prospectus -- a recent development that was material because it had a material affect on the future business of the company and its earnings. In fact I just read a statement yesterday about the president of Anaconda saying that we cannot make money at 30 cents per pound in the industry as a whole.

We come to the problem of the analysis of the management. Management is the heart of the running of a company. It is particularly important in companies you have never heard of or seen before. It is essential to check all Commission files as to each officer and director, promoter, or any other person named in a registration statement. This procedure has uncovered some startling things in our files. We have a wealth of information about some people. Criminal court proceedings, particularly violations of the Securities Act, series stockjobbing by persons involved -- things of that nature.

For example, a company filed a registration statement and we found that the president of the company had a criminal record. He had been a notorious gambler and he had violated the Securities Act before with impunity. We found in Transition Metals that certain of the officers, directors, and the underwriter had been in a series of suspect deals. They were all companies that were set up but never got into operation such as Magic Metals, a detergent company. About the time it became effective the stock was boosted up way over the offering price and then fell flat on its face and in some cases there were no quotes whatsoever. In some cases they get some reputable person to be the chairman of the board or some other high executive office. Investors have lost quite a bit of money on those deals.

That brings me to the use of reputable persons as officers to give the air of respectability to some of these companies. That is something you will have to watch out for. It seems as though college professors, doctors, automobile dealers, and persons of that type who know **nothing** about the business that the company is supposed to be engaged in, end up on the board of directors. Having leading citizens and reputable persons, listed in such positions, the persons reading the prospectus would think the company is all right. A classic recent example of this is

American Investors Corporation, set up as an insurance business. We went to stop-order proceedings. Jimmie Davis, former governor of Louisiana, George Preston Marshall, president of the Washington Redskins, Eddie Arnold, Webb Pierce and Faron Young, well-known hill-billy singers, were listed as directors. In addition, the company indicated it proposed to set up an advisory board, three members of which were to be Bobbie Dodd, Jim Tatum and Paul Bryant, well-known football coaches (particularly in the South where they intended to sell these securities). We inquired into that and found out that some of these fellows were promised stock options -- that is how some of them got into it. Don't be fooled by leading names in **promotional and lesser known** companies because they don't always mean anything.

Then we have trouble with the use of management owned companies for profitable transactions with the registrant. After persistent questioning in the W. H. Nicholson case we found out there was a company partly owned by the management that was receiving a fee of 2-1/2% on a material amount of the sales. Nothing was in the prospectus, and it was only reluctantly admitted after persistent questioning.

Another quite common thing in promotional companies is a sale of assets to the registrant by promoters in exchange for enough stock to give them control. That is done practically all the time. They like to hide the actual cost of those assets to the promoters. You have to question every phase of it and go into every phase of it as to how those assets were acquired.

Then we come down to the financial analysis of a manufacturing company. Principal problems arise when a company is in poor current position. We generally get disclosure in an introductory statement. A company in this condition generally has other things wrong with it, which also go into the introductory statement. A company may be short of cash, receivables and inventories, and some times plant and equipment are in hock. When a company is in that shape, it just has to be pointed up. In U. S. Air Conditioning, a recent case, we got this disclosure: "The company and its subsidiary, Jordan Refrigerator Co., have only a nominal amount of cash. They have borrowed substantial amounts of receivables, inventories, machinery and equipment [in other words, everything]. Virtually all such items are subject to lien. As of September 30, 1956, the company's accounts payable, Jordan excluded, amounted to $607,000, of which $108,000 was overdue for periods in excess of 30 days, and $184,500 for periods in excess of 60 days." They say this about Jordan, and this becomes important as I shall explain later: "Jordan's trade accounts payable amounted to $178,000, of which $24,000 was more than 30 days overdue, and $115,000 was overdue for periods in excess of 60 days." This statement was later withdrawn. We kept after them until we got letters from creditors to see what the creditors were saying. Shortly after the withdrawal I read a very interesting item in the Wall Street Journal that said Jordan's creditors were getting together with Jordan to make an arrangement as to payment. It would have been a fine thing if that statement had become effective and that had happened about a week or two after the effective date.

Then we have disclosures necessary when there is a working capital deficit or a small amount of working capital. In that case we get disclosure and sometimes we call for the amount of the deficit to be pointed up.

There is the problem of a substantial amount of inventories, or where inventories are a substantial amount of current assets. When you see that in a registration statement, you have to be careful because more than one company has gone into bankruptcy because of the large amount of inventories backed up which they cannot sell. There are all kinds of possibilities. The first thing you do when you notice that is to check the turnover of industry. Most of the balance sheets give inventories for the last several years. You check that against the sales to see what the turnover is. Then you should get information as to why.

Then the profit and loss statement. In my section I insist that industrial companies be analyzed on P. and L. for at least the following items: The ratio of sales to cost of sales; the ratio of selling, general and administrative expenses to sales; and the ratio of operating profit to sales. If these ratios show unfavorable trends over a 5-year period or over a recent one, you will have to get at it. That again is the old principle where we require disclosure or a satisfactory explanation of a recent unfavorable development. Sometimes it is just a fluke. There may be good reasons for a ratio being unfavorable and the trend may no longer exist. On the other hand, the unfavorable conditions may be continuing in the present and into the future. Then we get an explanation.

Now I have here what I think is a very good explanation by Ownes Corning showing at our request just what happens as to unfavorable changes in these ratios. It shows in a very able fashion: "The decrease in earnings for 1956 was due to lower earnings in the last half of the year. Consolidated net sales for the last half of 1956 were approximately 11% higher than for the first half of the year. However, consolidated net income for the last half of 1956 was approximately 17% less than for the first half, and this downward trend in net income was accelerated in the first part of 1957." There is a case where it is continuing. "Lower profit margins resulted in part from higher labor, materials, and transportation costs which in general were not passed on by the company in higher prices, and from lower prices in certain lines, particularly residential building products where results were adversely affected by increased competition from competing materials in the building field primarily attributable to a decline in new housing construction. These adverse factors were only partially offset by increased sales volume and increased productivity level."

I might add something as to the method of finding out a lot of this material. There are, of course, the services. The industry surveys of the company which you are examining are very important and should be read. For the most prominent companies there is an individual card on each company in the library. Then there are the other Government agencies. Then there is the private industry information available through trade associations and other services but be careful not to consult a company's competitor.