# Should Rich Corporations Return Stockholders' Cash?

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***FORBES* presents herewith the second in this spectacular series of articles on the maladjustment between finances of corporations and their owners.**

In our first article, the present disparity between the cash asset position of many companies and the price of their stocks was ascribed in part to the huge issues of additional shares which transferred money from stockholders' pockets into corporate treasuries. According to the New York Stock Exchange's compilation, the funds so absorbed by listed companies alone, between 1926 and 1930, amounted to no less than five billion dollars.

The total sale of corporate securities to the public in this period exceeded twenty-nine billions, of which a small part perhaps was turned over to private individuals, but the major portion was paid into the businesses, and either expended in plant additions or added to working capital.

It must not be forgotten that other enormous sums have also been accumulated in the form of undistributed earnings. After this tremendous influx of cash it is no wonder that corporate treasuries are still bulging, despite all the money that has been spent, or lost, or paid in dividends.

But what of the people who supplied the bulk of this money; the investor who bought new offerings; the stockholder who subscribed to additional shares? They are not rolling in wealth to-day, nor burdened with a plethora of idle funds. They stripped themselves of cash to enrich their corporations' treasuries; they borrowed heavily in order that these corporations might be able to pay off their debts.

The grotesque result is that the people who own these rich American businesses are themselves poor, that the typical stockholder is weighed down with financial problems while his corporation wallows in cash. *Treasurers are sleeping soundly these nights, while their stockholders walk the floor in worried desperation.*

True, the public has more stock certificates to represent the new shares which it paid for, and each certificate carries ownership in the cash held by the company. But somehow this doesn't help the stockholder very much. He can't borrow from the bank, or margin his existing loans, on the basis of the cash behind his shares. If he wants to sell he must accept the verdict of the ticker. If he should appeal to the officers of the company for a little of his won cash, they would probably wave him away with a pitying smile. Or perhaps they may be charitable enough to buy his stock back at the current market price–which means a small fraction of its fair value.

Meanwhile, the prodigal transfer of cash by the public to corporations in the new-era days has not only made infinite trouble for the security holder, but it has seriously demoralized our banking structure. Commercial loans have always been the heart and the bulwark of our credit system. Loans on securities have been secondary in volume and drastically subordinated in their standing.

But what have the corporations and the public done between them in recent years? They have paid off the cream of the country's commercial borrowings and substituted security loans in their place. Instead of lending directly to big business, the banks have been forced to lend to their stockholders against pledges of their shares, or to purchase securities on their own account.

Some idea of the extent of this shift of banking accommodation can be gleaned from the comparative figures of the reporting Member Banks of the Federal Reserve System:

**Change in the Composition of Banking Resources–1920-1932 (In Millions)**

| | Commercial Loans | Loans on Securities | Total |
|---|---|---|---|
| Oct., 1920 | $9,741 | $7,451 | $17,192 |
| May, 1932 | $6,779 | $12,498 | $19,277 |

The whole development has proved most disastrous to stockholders and most embarrassing to the banks. The best form of borrowing has been replaced by the worst. The safety of the loans, and to some extent the solvency of the banks making them, has been placed at the mercy of stock market fluctuations, instead of resting on the financial strength of our large corporations.

Thousands of stockholders–*the owners of their company's business*–find themselves to-day in an absurd position. The market value of their stock may be, for instance, only ten millions, its borrowing value at best eight millions. Yet not only may the company have fifteen millions in the treasury, but it could borrow large additional amounts against its many millions of other quick assets. If the owners of the business really controlled such a company, they could draw out not only the fifteen millions in cash but another five millions from bank loans, and still have a business in sound condition with substantial equities.

The very banks which hesitate to lend ten dollars per share on a stock would probably be glad to lend the company itself enough to enable it to pay out fifteen dollars per share to the stockholders.

Consider on the one hand a typical standard business with its enormous cash and credit resources; and then consider the people who own this business and who poured millions into its treasure, unable to realize or borrow more than a miserable fraction of the cash value of their own property.

This is the result of undue generosity by stockholders towards their corporations in good times–and of undue parsimony by the corporations towards the stockholders to-day.

The banks may seem like co-villains in such a situation, but in fact they, too, are victims of circumstance–handicapped by a soundly conceived system which is out of harmony with the actualities of the present situation. They have been educated, and they are directed, to give first consideration to commercial loans.

But who now are the commercial borrowers? Strong corporations with good past (if not recent) records, requiring money for seasonal requirements? Not at all. Such corporations don't need the banks; they raised all the money they could use from the stockholders when the raising was good.

There are left three classes of bank borrowers: (a) Small or privately owned enterprises–maybe good, maybe not; (b) Large industrial corporations with poor records even in the late prosperity; (c) Railroads and utilities needing temporary (?) accommodation, to be paid off by permanent financing–a fruitful source of trouble for all concerned.

It must be recognized, therefore, that the replacement of good commercial loans by vulnerable loans on stock collateral has been harmful alike to our banking system and to the vast army of stockholders. Is there a remedy for this condition? There certainly is, and a very simple one.

*Let corporations return to their stockholders the surplus cash holdings not needed for the normal conduct of their business.*

The immediate result of such a movement would be to benefit the individual stockholder by placing funds in his hands to meet his urgent needs or to use as he sees fit. The secondary result would be to improve the price of the shares affected and the stock market generally, as the public is made aware in this forceful fashion of the enormous cash values behind American business to-day. The third result would be to improve the balance of our banking structure, making for a larger proportion of sound commercial loans (especially when business again expands) and permitting the repayment of a certain quantity of frozen security loans.

How should this return of cash be accomplished? Preferably by the direct retracing of the financial steps which have led to the present predicament. Instead of rights to buy stocks, let companies offer their stockholders the right to sell stock in a fixed proportion and at a stated price. This price should be above the current market but in most cases below the net quick assets per share and therefore far below the book value. From the corporation's point of view the result of such repurchases at a discount will be an increase both in the surplus and in the net current assets per share of stock remaining.

A few corporations have followed this procedure, one of the earliest being Simms Petroleum. Recently Hamilton Woolen has offered to buy one-sixth of the outstanding shares pro rata at $65, which is about equal to the net quick assets and considerably above the previous market price This represents the return of a large portion of the new money paid in by stockholders in 1929.

Other companies have returned surplus cash to stockholders in the form of special distributions without cancellation of stock. Peerless Motors is a case in point, and another is Eureka Vacuum Cleaner, which accompanied its action by a statement recommending a similar move to other corporations as an aid in relieving the depression. A few companies, notably the Standard Oil pipe lines and some New England mills, have returned surplus cash capital to shareholders by reducing the par value of the stock.

All these methods accomplish the same purpose and the differences between them are largely technical. The repurchase of shares pro rata, which we recommend, is more practical in most cases than a reduction in par value, and it has certain bookkeeping advantages over a straight special dividend. Furthermore, as a direct reversal of the process of taking money from stockholders by issuing subscription rights, this method undoubtedly has a strong logical appeal.

A sizable number of enterprises have been employing surplus funds to acquire stock by purchase in the open market. This also represents a transfer of corporate funds to stockholders. It is undoubtedly helpful to the market price and hence to those constrained to sell, and the repurchase of shares at bargain prices presumably benefits the surviving stockholders. Certainly corporations using excess cash in this manner are acting more liberally than those who hold on like grim death to every dollar in bank.

But this form of procedure is open to objections of various kinds. If the price paid turns out to have been too high, the directors are subject to criticism from those whom they still represent, while those they have benefited are no longer interested in them or in the company. If, to avoid this danger, they buy only when the price is exceedingly low, they cannot avoid the appearance of having taken unfair advantage of the necessities of their stockholders. Furthermore, such undisclosed market operations may afford opportunities for questionable profit by directors and insiders.

The Bendix Aviation Company recently passed its dividend and concurrently announced its intention of purchasing a large block of shares in the open market. Other companies rich in cash have followed the same policy, though generally without even this saving grace of revealing their plan to buy in stock. Such a procedure contains possibilities of grave injustice to the shareholders. When there is an accumulated surplus and excess cash on hand, the directors' first duty is to use the free cash to maintain a reasonable dividend.

The prime reason for accumulating the surplus in good years was to make possible the continuance of dividends in bad years. Hence the absence of earnings is in itself no justification for stopping all payments to shareholders. To withhold the owners' money from them by suspending dividends, and then to use this same money to buy back their stock at the abnormally low price thus created, comes perilously close to sharp practice.

Such considerations should make it clear why the writer does not regard open-market purchases as the best method of returning corporate cash to stockholders. Retirement of stock pro rata involves no conflict of interest between those selling out and those staying in; and it provides no opportunity for errors in judgment or unfair tactics on the part of the management.

Examination of the partial list on page 21 of companies selling in the market for less than their net current assets, as well as reference to the table offered in our first article last issue, will disclose many instances in which the cash holdings are clearly excessive. If stockholders will bring sufficiently strong pressure upon their managements, they can secure the return of a good part of such surplus cash, with great benefit to their own position, to stock market sentiment, and to the general banking situation.

In order to obtain these desirable results, stockholders must first be aware that surplus cash exists; and therefore they must direct at least a fleeting glance to their company's balance sheet. In recent years financial writers have been unanimous in pointing out how unimportant are asset values as compared with earning power; but no one seems to have realized that both the ignoring of assets and the emphasis on earnings can be–and have been–carried too far, with results of the most disastrous kind.

The whole “new-era” and “blue chip” madness derived from this exclusive preoccupation with the earnings trend. A mere $1 increase in profits, from $4 to $5 per share, raised the value of a stock from 40 to 75, on the joyous assumption that an upward trend had been established which justified a multiple of 15 instead of 10. The basis of calculating values thus became arbitrary and mainly psychological, with the result that everyone felt free to gamble unrestrainedly under the respectable title of “investment.”

It was this enticement of investors into rampant speculation which made possible the unexampled duration and extent of the 1928-1929 advance, which also made the ensuing collapse correspondingly disastrous, and which–as later appeared–carried the business structure down into ruin with the stock market.

A peculiar offshoot of the obsession with earnings is the new practice of writing fixed assets down to $1, in order to eliminate depreciation charges and thus report larger profits. The theory is that by destroying asset values we can increase earning power and therefore enhance the market value. Since no one pays any attention to assets, why carry any assets on the books? This is another example of Alice in Wonderland financial logic.

It is in amusing contrast with the much berated stock watering practice of a generation ago. In those days fixed assets were arbitrarily written up, in order to enlarge the book values, and thus facilitate a fictitious market price. In place of watering of assets, we now have watering of earnings. The procedures are directly opposite, but the object and the underlying deception are exactly the same.

Because of the superstitious reverence now accorded the earnings statement by both investors and speculators, wide variations in market prices can be occasioned by purely arbitrary differences in accounting methods. The opportunities for downright crookedness are legion, nor are they ignored.

One company, listed on the New York Stock Exchange, recently turned an operating loss into a profit by the simple expedient of marking up its goodwill and adding the difference to earnings, without bothering to mention this little detail. The management apparently relied, and not unreasonably, on the fact that stockholders would not examine the balance sheets closely enough o detect their charming artifice.

The disregard of assets has also introduced some new wrinkles into reorganizations and mergers. Creditors are no longer permitted to receive the cash directly available to pay off their claims; stockholders are forced into consolidations which give other securities a prior claim on cash which formerly was theirs.

The Fisk Rubber Co., for example, showed around $400 in cash on hand for each $1,000 of overdue debt, and nearly $900 in net quick assets, excluding the extensive factories, etc. Yet the proposed reorganization plan offers these creditors no cash at all, but only stock in a new company.

Similarly, while Prairie Pipe Line stockholders were taking comfort from the fact that there had lately appeared to be $12 per share in cash equivalent behind their stock, they suddenly found themselves owners of shares in another company which had no cash at all directly applicable to their holdings, this new stock, moreover, having a total market value equal to less than half the cash equivalent alone which they formerly owned.

In the writer's view, all these strange happenings flow from the failure of the stockholder to realize that he occupies the same fundamental position and enjoys the same legal rights as the part-owner in a private business. The panoply and pyrotechnics of Wall Street have obscured this simple fact. If it only could be brought home to the millions of investors the country over, a long step would be taken in the direction of sounder corporate practices and a saner attitude towards stock values.

**Treasurers Sleep Soundly While Stockholders Walk the Floor!**

Why is the stockholder poor to-day?

Because he borrowed from the banks in 1929 to put more cash into the companies he owns. Where is that cash now? Much of it is still held intact by his company. Does the stockholder need that money more than his company? You bet he does. Has he done anything to get it? No. He thinks his company is broke because stock prices say so. He has forgotten asset value. He has forgotten that his officers and directors are supposed to be his own representatives, working for his own best good. He has forgotten that he is a part-owner and manager of the company in which he owns stock.

*The third article:* *Should Rich But Losing Corporations Be Liquidated?*