

FROM THE THOUGHTFUL BUSINESSMAN

FROM:

Walter J. Schloss, General Partner
Walter J. Schloss Associates

RE:

"Repurchase Stock to Revitalize Equity," by Charles D. Ellis, HBR July-August 1965

I have read Mr. Ellis' article carefully and am in agreement with his objectives. I would like to comment on one phase of this problem, however.

I can understand the reluctance of management to repurchase its stock at, say, \$30 a share when the company's stock has a \$10 book value. For example, assume a company has 2,000,000 shares of stock which have a book value of \$10 and earn \$3 a share. To repurchase 500,000 shares at \$30 a share would cost the company \$15,000,000, and assuming it could borrow some of the money to finance the purchase, the 1,500,000 shares remaining would have a book value of \$3.33. Not a very prepossessing figure, despite the fact that earnings would now approach \$4 a share. It also assumes good earnings for the future, which are never guaranteed.

Assume, however, a company's stock has a \$100 book value, selling at \$45 and earning \$3 a share, with 2,000,000 shares outstanding. If the company repurchased 1,000,000 shares at \$50 a share, the book value for the remaining shares would increase to \$150 a share, and the earnings would increase to close to \$6 a share.

My point is that a large book value would help the company repurchase its stock, since it would give it a bigger base from which to operate. It would also increase

book value for the remaining shareholders, instead of decreasing it.

I cite the above example because it is typical of what Crane Company has done. I think Ellis should have discussed this phase in his study. In fact, those companies with large book values in relation to market prices offer the stockholder the greatest rewards, and this is the one area that I don't think Ellis covered. ●

FROM:

Charles D. Ellis, Financial Analyst
Rockefeller Brothers, Inc.

RE:

"Repurchase Stock to Revitalize Equity," by Charles D. Ellis, HBR July-August 1965, and the preceding letter from Walter J. Schloss

Given the examples provided in Mr. Schloss's letter, I would agree that a company whose shares are selling below book value might find share repurchasing highly appropriate, particularly when substantial nonoperating liquid assets are available. Many casualty insurance companies and some closed-end investment companies clearly fall within Schloss's observation. In general, however, I believe that an emphasis on book value is not appropriate for decision making in nonfinancial companies.

First, book value is often misleading because historic acquisition costs ignore rising values of long-lived assets and sizable expenditures to maintain the efficiency and the value of facilities. Moreover, accelerated depreciation is often deducted. Consequently, book value is typically substantially understated. On the other hand, trademarks, patents, management capability, and consumer franchises — all vital to corporate earning power and often worth far more than capital goods — are excluded from book value.

Second, the mere presence of substantial assets may be irrelevant to repurchasing if they are (a) illiquid or (b) necessary for continued operations. On the other hand, many companies whose

shares sell far above book value have substantial liquid assets and/or unused debt capacity available for repurchasing.

Third, while asset values are surely of primary importance in privately held firms, in publicly held companies the investors exercise no direct control over assets (cannot sell them, etc.) and must, therefore, concentrate on the profits which are generated from them.

Finally, a corporation buying its own shares is not buying an asset. The company is making a single present payment in exchange for the termination of the stockholder's "right" to participate in future earnings of the enterprise. Consequently, the relevant analysis of repurchasing is not present assets, but future earnings. ●

Reprinted from

Harvard Business Review

November-December 1965

FROM:

Walter J. Schloss, General Partner
Walter J. Schloss Associates

RE:

"Repurchase Stock to Revitalize Equity," by Charles D. Ellis, HBR July-August 1965, and the preceding letters by Walter J. Schloss and Charles D. Ellis

I am not convinced by Mr. Ellis' arguments that book value is unimportant in the repurchase policy of corporations except in the case of the repurchase of insurance and closed-end investment companies at a discount. While I realize that he places his emphasis on earnings, it is also true that earnings are much more likely to fluctuate than are book values, and therefore estimating longer term earnings than, say, the next year or so can be subject to serious error. For example:

If the management of Alpha Portland Cement had repurchased 800,000 shares of its stock at \$30 a share in 1960 when it was earning \$2.66 a share, it could subsequently be criticized for its policy when a few years later earnings took a tumble due to severe competition and the stock sold down to \$11 a share in 1965. To say that the stock market erred in its estimate of the future is really not answering the question, because the cement industry has a brilliant future ahead of it. In 1956 Alpha sold as high as \$47 with earnings of \$3.45, and in 1958 sold over \$42 a share, earning \$3.06 the following year.

My point is that if the assets are large enough, the stockholders benefit by repurchases at discounts from book value and that the purchase of stocks above book value in times of prosperity can be later criticized if earnings decline through no fault of management but simply because of vicissitudes in the industry.

It is true that value should be determined by what a company can earn in the future, but the fact that this is an objective should not allow managements to ignore book value. The fact that book values tend to be understated in terms of today's prices is another reason to give some weight to large book values in industrial companies. ●