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# "WHEN WOULD YOU SEEK EQUITY CAPITAL?"

A TALK

by

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before

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It is very easy to be enthusiastic when the market is up. I know the satisfaction that is experienced when a new issue goes out the window and then a strong demand pushes the price higher and higher. In such times customers are content and receptive; in fact, they sometimes seem almost grateful. The calendar of new issues is full, as management seeks to take advantage of the prevailing market optimism. There is enough business for everyone. Office overhead ceases to be a worry.

What a different picture when the market is down. The share turnover drops below the break-even point; new issues dry up as management hesitates to risk a market test of its securities. Business turns elsewhere for funds - to the banks, or to other credit sources. Expansion plans are curtailed and restricted to funds from internal sources. Public financing is a last resort, undertaken hesitantly, and through debt rather than equity. You can't meet office overhead with that kind of business.

We have been in such a period now for many months. Since the market break of September 3, 1946, the market has kept in a very narrow groove. Since the first of this year the Dow-Jones industrial average has fluctuated in a range of only ten points. Record high corporate earnings and favorable yields create not a stir. The relaxation of margin requirements last month, long urged as a partial panacea for industry doldrums, provided only a brief spurt of prices and volume. The market seems to treat any news, whether good or bad, as bearish. One wonders whether this is just the darkness before dawn, or whether it is the best that can be hoped for.

I am not a market prognosticator. The S. E. C. has 1,137 registered investment advisors. I am not one of them. I don't know any better than you do if the market is going up or down or if it will continue on its present plateau.

I do know that regardless of what the market does, American business will continue to require capital in large amounts to replace and expand its plant. Our figures show that American business anticipates spending 18.3 billions of dollars on new plant and equipment in 1949. This is not much less than 1948's record 19.2 billion dollars.

I also know that a substantial part of this vast sum will have to be raised through the sale of new securities. Last year American industry marketed $4.7 billions of new bonds and $1.2 billions of new preferred and common stock - a total of almost $6 billions of dollars of new money raised from private and institutional investors. We can anticipate about the same volume of new securities this year. We can also expect that the institutional investors this year, as last, will have about $3.5 billions of new funds to invest in corporate securities. They will continue to exert a strong attraction for debt financing and many corporations will succumb to that attraction. But the rest, almost half, will have to come from private investors. What form should this financing take?

For many years now the S. E. C. has served as a sort of financial conscience - constantly putting in a word for the merits of equity financing. Except as to companies registered under the Public Utility Holding Company Act our efforts are necessarily limited to verbal entreaty. But we are not alone in this endeavor. As one commentator has pointed out, "Hardly a week goes by that someone doesn't write an article on some aspect of the problem of the 'shortage of equity capital'." Mr. Winthrop W. Aldrich recently, in speaking about the utilities, phrased the issue this way:

> "If there is a flow of capital - I do not mean debt, I mean equity capital - to the utilities they will exhibit the vigorous economic virtues that go with risk capital. If there is no such flow of equity capital to the utilities, they will be obliged to go further into debt and will run down hill not only in financial health but in their capacity to render those services to the public for which they are chartered."

At the S. E. C. we do not make a fetish of any particular numerical ratio of debt to equity, but we do have touchstones - and we do insist, to the limit of our powers, on a balanced capital structure. A particular ratio which is healthy for one company may be inadequate or overly conservative for another. A certain amount of leeway and flexibility is necessary. The important thing is that there always be a sufficient equity cushion to withstand the shocks of the business cycle.

American industry, overall, has financed its postwar construction program on a highly conservative basis. Over two-thirds of its expenditures have come from internal sources - reserves and undistributed profits - which is, in effect, equity money. However, there has been considerable variation between industry classifications and among companies in the same industry. Industrials, on the whole, have very little debt. Only one of the major auto manufacturers, for example, has any significant amount of long-term debt outstanding. Utilities, on the other hand, can properly handle a sizeable proportion of debt in their capital structures. Their heavy investment in plant, relatively stable earnings, and long-term growth trend makes it feasible for them to undertake a certain amount of fixed charge financing. But even here there is a limit to the degree of inflexibility which can be undertaken without endangering financial soundness.

The utilities have a continuing and constant need for new capital. Mr. Wendell Willkie, when he was President of the Commonwealth & Southern Corporation, explained that need in his characteristically vivid manner some years ago. Let me read from his testimony before the Committee on Interstate and Foreign Commerce during the hearings on the Holding Company legislation:

> ". . . There is no business in the world that requires money, such as the utility business. . supposing you and I are going to organize an automobile factory and we say that $10,000,000 is the capital that we are going to put into that business. Now, there is no necessity, as long as we want to confine ourselves to that particular organization to ever raise a dime

more than the $10,000,000 capital; but in the utility business, every morning that a utility man gets up, he knows that before the day is over he is going to have to make some capital expenditure. I do not mean operating expenses. He has got to put some more money in his plant. Some fellow calls up the service department and says, "I want a connection."

"And, of course, under the law they have to make that extension.

"Here is a new factory that starts up - here is an old factory that starts up - every day, every hour almost, of every utility in the country, they need more capital; whether it be good times or bad times or indifferent times."

We at the Commission have a mounting concern over the tendency for utilities to finance the current expansion program through debt, and we are dismayed at the deterioration in structures which has taken place in some companies which have left our jurisdiction. We are also opposed to the use of financing techniques which obscure from investors the real nature of the transaction and give a false appearance to what is taking place. I am referring particularly to the lease-back device, recently grown so popular in the commercial field, which has appeared in several utility financing projects. The lease-back is designed to increase indebtedness while avoiding the appearance of doing so. Any appraisal of its effect should look beyond the form to its overall effect on the capital structure of the consolidated operation.

The lease-back is an illustration of the lengths some companies will go to avoid facing today's common stock market. Sound financing of a utility construction program should provide for periodic common stock sales and for maintaining the debt-equity balance right along. Overindulgence in debt and neglect of equity means that as the program progresses the pressure to sell stock gets more intense, until finally the time comes when stock must be sold regardless of the state of the market. It is far wiser not to exhaust ones credit and to leave some flexibility for the final stages of the

program. There is no poorer time to sell common stock than when you have to: there is no better time than when you can.

I cannot agree with those persons who take a short-term view that the best way to raise money is the cheapest way at the particular moment. The tax laws and prevailing low interest rates lead these persons to the conclusion that the optimum in financing is a capital structure with a very great amount of debt. But the long-range interests of the company, its security holders, and of our economy as a whole are seldom served by such short-term considerations. Significantly, these same officials will often say that they would like a greater amount of equity if it didn't cost so much to get it.

This, to me, is the heart of the problem of equity financing.

If any of you have tried to sell a used car during the past few weeks, you learned that it was mighty difficult to find anyone who had as fancy an idea of its value as you. You perhaps had a preconceived notion of about what you could get for it, but no one would agree with you. The same is true with most of one's possessions, and certainly it is true of your stock. Management rarely feels that the market adequately reflects the inherent worth of their fine company's securities. Being natural optimists about their particular business and thoroughly imbued with the superiority of their company over all others, they are discouraged when the outside world takes a colder view of things.

It has been my experience that an officer of any company is seldom the best person to give you a fair comparative appraisal of his security as against the rest of the market. Consequently, management usually feels that unless it sells common stock at the very peak of the market, it is giving something away - or, in other words, that selling stock costs too much. Certainly this is the feeling of most existing stockholders, who would much prefer increasing their leverage to sharing their ownership with newcomers.

At the Commission we have watched company after company wrangle with this problem. I know that the answer does not come easily. The pressure on management from existing stockholders is very very great, and not infrequently quite vocal where there is some concentration of ownership. The usual reaction is to say, "Well, let's put it off a while and see." I think this procrastination, and it is nothing more, is a serious mistake. It is based on a single premise of very doubtful validity - on the premise that tomorrow things will be better. All through the spring and early summer of 1946 many companies tried to play the boom by putting off their stock sale "a little longer." Then came the September break and the train pulled out. We hear the same thing in different forms today: "Let's wait until our new higher dividend rate is more firmly established"; or "Let's wait until next year when hydro conditions will be better"; and last fall everyone wanted to wait until after elections!

Management is a trustee of financial affairs as well as of business operations. I believe it a mistake to think in terms only of selling new stock at the extreme high dollar. Experience shows that when management thinks in such terms and fails to satisfy that condition, for some reason or other the stock never does get sold. Management owes it to security holders to bring in new equity capital on a fair basis, rather than seek an unreasonably advantageous basis. Years ago, I had a friend who at the time was selling me merchandise and occasionally in a convivial and emphatic moment, when he felt I was pressing too hard, he would shake his fist in my face and say, "Always remember, the vendor is as important as the vendee." My point is, the new stockholder is as important as the old - as soon as he has put up his money. Alexander Dow, for many years the distinguished president of The Detroit Edison Company, used to say, "I want our stockholders to make a profit on the securities they buy in my company. They always feel better and they

also make better patrons if they should happen to live in our community." Smart management wants its securities to please the holders. If you need capital - sell equity when you can sell it. Waiting for that last fractional point frequently means not getting it at all, or sometimes getting it under price conditions which in the long run can be detrimental to the company's overall financing picture.

Now here is where the investment banker comes in. The investment fraternity bears a joint responsibility with management in such financial matters. We tend to overlook the fact that the investment industry does more than merely distribute and conduct a market in the securities of corporations. Investment bankers are also the counsellors and advisors to business on financial matters. In that capacity they influence not only the timing of new security issues but also the type of security which will be issued and, in some measure, the offering price.

Management, particularly in the case of smaller industrial corporations, relies heavily on the investment banker's intimate knowledge of the market in formulating immediate financial policy. Unfortunately, management has not been accustomed to seek banking advise on those more general aspects of financial policy which in the long run will determine market receptivity to a particular corporation's securities. In my own experience I have known scores of corporation presidents, successful operators of big businesses, who are babes in arms when it comes to financing. Every broker knows what few corporation presidents seem to realize - that the best market for a new security issue lies with persons already owning some of the stock - provided they have had a satisfactory experience with it. But it is next to impossible to sell stock a second time to someone who watched his previous purchase decline because it was overpriced at issuance. A new offering gets favorable response when the securities already outstanding are well thought of.

Those engaged in the sale and distribution of securities are, in a sense, at the mercy of management for quality - and quality will count, in the end, regardless of the business in which one may be. Market quality, like an individual's credit, is not established overnight. It must be carefully and painstakingly nurtured year after year. And, as with individuals, market standing depends not merely upon earning ability, but also upon consistency of performance; the treatment of existing security holders; how others fared who purchased the stock in the past; upon whether, in comparison with alternative investments available, this security will yield a fair return; and, in no small measure, upon whether management runs the corporation for the benefit of all of its security holders, large and small, or for the benefit of only a few.

The investment industry is being given a lot of the blame today for what is commonly called the "inadequacy" of our equity markets. They are charged with failing to adapt themselves to changing times, with continuing to cater to the few large investors rather than to the many small ones, and in general with not performing their assigned function of channelling the nation's savings into the service of American industry.

The past two decades have seen a significant redistribution of wealth taking place in this country. Changing social patterns, combined with our remarkable rate of productivity, and progressive income taxation, have meant that the national income is being spread more evenly among more and more people. As a consequence, more people today have a little more money, and fewer people have a whole lot of money. It also means that the few can no longer supply the vast sums of capital needed to finance American industry. That capital must come from the mass savings of all the people. These are the people to whom equity securities will have to be sold and the investment fraternity has an important educational job to do among them.

Management likewise has a part to play in creating an investment interest in people not now accustomed to investing a portion of their savings in corporate securities. Stockholder relations are an important management function. The small investor to whom industry must look for capital may sometimes be a speculator; more likely he is attracted to common stock investment by the greater return on his savings as compared with insurance, government bonds, or savings deposits. These investors will require a more liberal dividend policy than most industrial companies have followed in the past. How often do we find dividend policy dictated by the individual tax problems of a few large stockholders rather than the overall good of the corporation and the desires of the large number of small stockholders? You and I know that dividend yield is the biggest selling point on new issues. A company that wants new equity capital must be prepared to pay a return on that capital. Here the problem of the utilities tends to differ somewhat from that of other business. While there are some few utilities which can be charged with a niggardly dividend policy, utilities on the whole have a substantially higher pay-out than do other segments of industry. As a consequence, they have very little in the way of internal accumulations with which to finance expansion. It is also true, however, that utilities on the whole sell on a more favorable price earnings basis than do industrials and that utilities can frequently sell common stock in markets which would be closed to other types of businesses.

I have commented on the respective roles of the investment industry and management in the raising of equity capital. But we should not overlook the responsibility of government. Those agencies, federal and local, charged with regulating portions of our national economy must never, in their concern with particular problems of particular companies, lose sight of the larger picture and of the contribution which sound business enterprise makes to the happiness and well-being of our people.

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