Railroads

The Reorganizing of St. Paul

End of a Great Illusion—Problems of Financial Readjustment—Position of the Various Issues Under a Tentative Plan of Exchange

By BENJAMIN GRAHAM

THE appointment of receivers for St. Paul came finally as no surprise, as it had been clearly foreshadowed by several days of precipitate declines in all its securities. Yet in a wider sense the event found the financial community unprepared. Until a few weeks ago it was almost an article of faith in Wall Street that the St. Paul would be saved. Speculators and investors alike were confident that some solution must be found for its insoluble difficulties. An unending crop of rumors, circulating persistently until the very last, gave assurance of aid from a whole series of possible saviours—including the Government, the bankers, Mr. Ford, Mr. Rockefeller and the Great Northern Railway. If the genesis and dissemination of these reports could be traced, they might be found not unrelated to a coincident transfer of large amounts of St. Paul securities from the hands of people who understand the situation to numerous others more credulous than discerning.

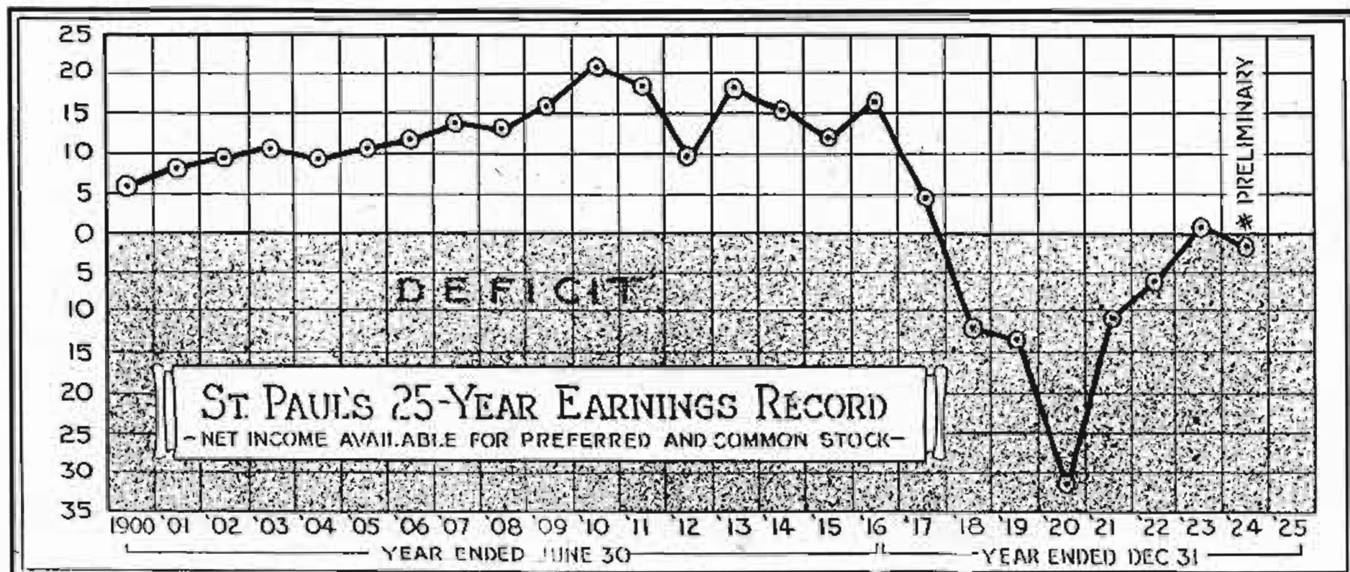
Be that as it may, it is undoubtedly true that what the writer referred to here some years ago as Wall Street's favorite illusion (the St. Pauline theory of the Chosen Railroad), gloriously defied the facts for a good ten years. The public's faith in St. Paul could not be shaken—it had to be exploded.

We risk the charge of bad taste and of "rubbing it in" because the St. Paul epic should prove an object lesson more valuable than volumes of sage counsel. Tradition, sentiment, vague generalizations, unsubstantiated rumors, can never be made the basis of sound investment or intelligent speculation. Now and then large profits are realized on no better foundation—merely proving that sometimes luck laughs at logic.

A host of reasons are being advanced for St. Paul's insolvency, but they all can be summed up in three words—excessive fixed charges. St. Paul's debt is too large for its revenue. How the debt came to be so large is no doubt a long story, with the Puget Sound extension playing a prominent rôle. And why the revenue is no greater has also a varied explanation, including Panama Canal competition, backward territory and relatively low rates.* Since operating expenses and taxes of the average road consume about 82% of gross, it is evident that only a most exceptional carrier could possibly bear indefinitely so heavy an interest burden. For this means that in good years only a negligible surplus can be put back into the property, and in bad years a deficit is inevitable. Hence there is no basis for credit, since credit presupposes an adequate margin of safety. No sensible man will lend at a limited rate unless he knows that his interest is being earned with something substantial to spare.

St. Paul's trouble is the identical ailment which induced most of the railroad demises of the past decade. If we go down the list of receiverships, begining with Alton and ending with Wheeling & Lake Erie, we find topheavy bonded debt at the root of nearly every one. It is important to note that the maturity of an obligation is only the occasion and not the true cause of the insolvency; if the road's credit were not exhausted, its maturities could almost always be refunded. So in the case of St. Paul, the real problem was not whether the 4s of 1925 could be paid off or extended, but whether there were sufficiently good prospects of the business growing up to the fixed charges in

* The salient fact emerges that last year St. Paul's net fixed charges consumed over 16% of gross receipts.



[illegible]ar future. This question the engineers evidently answered in the negative, whereupon the bankers must have been convinced that there was no use in even attempting to handle the 1925 maturity.

The fundamental importance of a reasonable margin of safety above interest charges has received two striking illustrations in recent weeks—the St. Paul receivership is one, and the weakness in Interboro Rapid Transit issues is the other. If the fate of St. Paul should teach investors to listen to the facts rather than fairy tales, the Interboro episode should caution them to mistrust half-way measures and mere palliatives. In the enthusiasm which followed the I. R. T. readjustment, based on the expectation of growing traffic and earnings, most investors ignored the fact that even on the new basis the fixed charges were enormous and the surplus earnings very slender. This weakness can be disguised well enough under favorable conditions, but the least breath of adversity is enough to bring it into disagreeable prominence. Incidentally, those who study the New Haven situation with these considerations in mind will realize that the road still has its problems of capitalization structure, despite its triumphant refunding of this year's maturity.

A Speedy Reorganization?

So much for the past and its lessons. What of the future of St. Paul's securities? Wall Street, indomitably optimistic even in disaster, is cheerfully predicting a speedy reorganization. It is pointed out that St. Paul is not handicapped by the two main causes of protracted receivership—neglected maintenance and a multiplicity of divisional liens, making agreement difficult. It may be remarked, however, that reorganizing a 700 million dollar corporation may not be as simple as one might wish. The mere mechanical labor involved in handling its numerous details is enough to turn the months into years, without allowing for the problems which must inevitably arise in an operation of this magnitude. A few of the considerations which are likely to occupy committees and counsel some little time may be listed as follows:

1. Providing a suitable medium for new financing, in view of the fact that the present General (1st) Mortgage is virtually closed.
2. Handling the 55 million debt to the United States (secured by 76 millions of mixed collateral) including the possible necessity of Congressional action to approve a settlement.
3. Treating with holders of leased lien securities and of Puget Sound 1st mortgage bonds, the value of which to the System may engender some dispute.
4. Apportioning the main sacrifice between the junior bond holders and the stockholders.

Despite prevailing reports that a reorganization can be arranged in six months or so, the writer will venture his inexpert opinion that the new securities are not likely to show their colors before three years are past. It might be remembered that the recently completed Denver readjustment consumed three years, although it touched only a single issue in which the public had a substantial interest.

Whatever delays may be occasioned by such difficulties, the main outlines of the St. Paul reorganization scheme are already clear enough. Its aims must be two-fold: to raise cash and reduce fixed charges. The cash will be provided by the stockholders; the

TABLE I

Tentative Recapitalization Plan

(000 omitted)

Present Capitalization		Exchanged for New Issues							
Issue	Outstanding About	1st & Ref. Bonds %	1st & Ref. Bonds Amount	Adjustment 5s %	Adjustment 5s Amount	6% Preferred %	6% Preferred Amount	Common (No Par) %	Common (No Par) Amount
U. S. Government Notes	$55,000	100	$55,000 (5%)	..	......	..	......	...	....
Leased Line Bonds	24,000	50	12,000 (5%)	50	$12,000	..	......	...	....
Junior Issues: 4s due 1925 and 1934; 4½s due 1932 and 2014; 5s due 2014; Paget Sound 1st 4s	228,000	..	....	50	114,000	50	$114,000	...	....
Preferred Stock / Assessment 20%	116,000 / 23,000	70	16,000 (6%)	30	7,000	..	......	100	1,160,000 sh.
Common Stock / Assessment 25%	117,000 / 29,000	70	20,000 (6%)	30	9,000	..	......	100	1,170,000 sh.
Undisturbed Issues: Underlying Bonds and Equipments	48,000	..	....	..	....	..	......	...	....
General Mtge. & Sec. 6s	114,000	..	....	..	....	..	......	...	....
Total to be Outstanding	$162,000		$103,000		$142,000		$114,000		2,330,000 sh.

TABLE II

Estimated Income Account on New Basis

(000 omitted)

	Amount	% of Gross
Gross	$160,000	100.0%
Maintenance	54,400	34.0
Other Expenses and Taxes	76,800	48.0
Net	28,800	18.0
Rentals Less Other Income	1,500	
Underlying and Gen. Mtge. Int.	7,400	
New 1st and Ref. Int.	5,500	
Total Fixed Charges	14,400	9.0
Adjustment Interest	7,100	4.5
Preferred Dividend Req.	6,840	4.3
Balance for Common	260	2

TABLE III

Comparative Market Prices and Values

New Securities	Est. Value	Old Securities: Issue	Exch. Value	Current Price
1st & Ref. 6s	95	Puget Sound 1st 4s; 4s due 1925, 1932; 4½s due 1932, 2014; 5s due 2014	45	47
1st & Ref. 5s	80			
Adjustment 5s	55			
Preferred Stock	35	Preferred Stock	6.60	10
Common Stock	10	Common Stock	5.75	[illegible]

debt to the fixed charges will be cut through replacing junior bonds by Adjustments and/or preferred stock. Given these basic assumptions, how is the future value of the St. Paul issues likely to compare with present prices? Current levels evidently reflect receivership conditions; have they *over*-discounted the eventual sacrifices, and they hold opportunities of substantial profit for the shrewd and patient? This is, of course, the practical question of the moment. To answer it we must reorganize the St. Paul—a task of some magnitude even for a young and ambitious writer. We crave the reader's indulgence while we make the attempt, for however wide of the mark our conjectures may prove to fall, they may still be of some value in bringing attention to the concrete elements in the situation.

In Table I we summarize the existing securities and indicate our proposed exchange basis for new securities. Table II compares the estimated normal earning power with the interest and other requirements on the reorganized basis. Finally, Table III assigns a market price on each of the new securities, from which is calculated the exchange value of various present issues, for comparison with their current quotations.

The New Mortgage

The providing of a medium for future financing offers somewhat greater difficulties than in the case of other recent reorganizations. The 150 millions of bonds authorized under the General Mortgage have practically all been sold, pledged or reserved, and these enjoy a closed first lien on some 200 miles of the most valuable lines. It will be possible, however, to create a new mortgage with a first claim on the remaining property, about 4,000 miles, and a second lien on that securing the general mortgage. (An endeavor may be made to persuade the General Mortgage bondholders to exchange into this new issue, possibly with the incentive of an additional 1% coupon rate, as was done in the case of M-K-T; but it is doubtful if much can be accomplished along these lines.)

The new issue we designate as "First and Refunding," though it has become fashionable to dignify such mortgages with the euphemistic title of "Prior Lien." Whatever the name, it is by no means certain that bonds of this issue can be immediately sold to the public at a satisfactory price. For this reason we believe that the bankers will provide in the Reorganization Plan itself for whatever capital funds are likely to be needed during the first year or so. Hence the assessment against the stockholders is placed at the tidy sum of 52 million dollars—allocated at the rate of $25 per share of common and $20 per share of preferred. (This was the M-K-T arrangement.) Following the latter precedent further we give the stockholders 70c in New Mortgage 6% Bonds and 30c in Adjustments, for each dollar contributed.

Our plan provides also that $55 million of these First and Refunding bonds will be issued to the Government in exchange for a like amount of notes—secured partly by excellent and partly by dubious collateral. This will release $18,000,000 of General Mortgage 5s which undoubtedly may be sold at a fair price. Our guess is that the United States will be persuaded to accept a 5% interest rate on its new holdings.

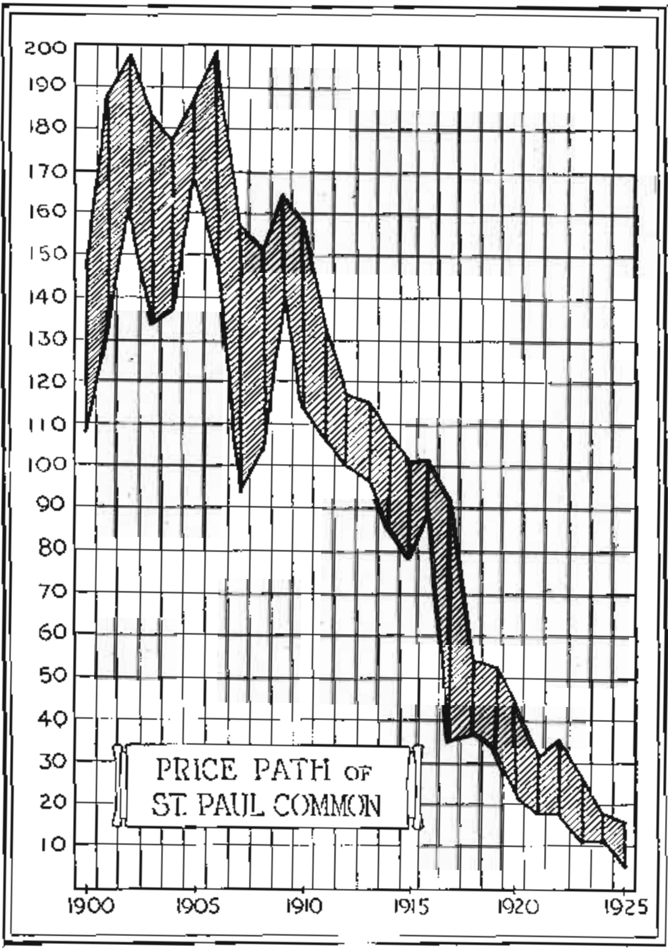
The treatment for the General bonds, including the Puget Sound 1st 4s, is simplicity itself. Without fine distinctions of maturity or interest rate, they are all exchanged, half for new 5% cumulative adjustment bonds, and half for 6% cumulative preferred stock. Incidentally, the $24,000,000 of leased line securities are rather arbitrarily replaced by 12 millions new 1st and Refunding bonds and 12 millions of adjustments.

This completes our re-capitalization scheme, the details of which can be scrutinized in Table I. Then follows a table analyses of the new set-up in relation to estimated earning power. This is based on last year's gross business, and an average percentage for maintenance and other expenses. The rentals are reduced some $1,500,000 to reflect benefits from new equipment. Quite accidentally, the fixed charges are found to be covered exactly twice, which would represent a healthy condition. This would probably admit of payment of interest on the new Adjustments, but dividends on the preferred stock would no doubt be withheld for some years.

In carrying this analysis further the writer may well be accused of seeking to place a hypothetical value on imaginary securities. The financial structure and earnings exhibit presented are based entirely on assumptions; yet even if they were indisputable facts, the market value of the new issues would still be an uncertain quantity. Not only will it depend on the general financial situation and the current vogue or distrust of the railroads, but popular enthusiasm or prejudice toward the particular System often exerts a controlling influence. Admitting the impossibility of an accurate prediction, it is natural to inquire, however, what prices for the new securities would be indicated by a study of similar railroad reorganizations in recent years. The values given in Table III follow these precedents, and are based upon the assumption that the issuance of the new securities finds general conditions essentially the same as now.

The General Mortgage and other undisturbed bonds are not likely to vary much from present levels. Our figures work out to a somewhat smaller valuation for the junior issues, especially the preferred stock. *If the experience of other reorganizations is any guide, St. Paul preferred is likely to sell very close to the common when the plan is announced.*

The results of our study tend to bear out a general investment principle—namely that the prices reached immediately after the appointment of receivers do not afford very attractive profit-making opportunities. The investor may avoid a tiresome wait, and usually makes his purchase on more favorable terms, by deferring his commitment until the receivership is about to be lifted. To this rule the St. Paul issues are likely to prove no exception.



A Speculation in U. S. Governme

Describing a Unique Opportunity for Investors Interested in Long-Range Opportunities

By IRVING GORDON

AS a general rule an investor would not look to the field of U. S. Government securities for speculative opportunities. To state that the premier bonds of the world had speculative possibilities would be regarded as paradoxical. And yet this seeming paradox is true and the writer hopes prove it in this brief article.

The basis of our discussion—and herein lies the speculation—rests upon the assumption that for the next two decades there will be a gradual reduction in interest rates from the high point reached during the war to a level approximately prevailing prior to the war. We can disregard any minor fluctuations that may be occasioned by special conditions in the money market, having in mind only the long-term point of view. If this hypothesis, which is advanced by leading economists, proves correct, interest rates for U. S. Government securities will naturally follow the course of the general rates for money. It is not fanciful, therefore, to expect government bonds to sell eventually on a 3% basis and even lower. In that event, the longest term issue will show the greatest price appreciation.

To illustrate the point, let us compare U. S. Liberty Fourth 4¼s, and the so-called Mellon 4¼s. These are the two longest maturities outstanding—rather, they have the latest callable dates. While Liberty Fourth 4¼s mature in 1938, they may be called in 1933, and Mellon 4¼s mature in 1952, but are callable in 1947. It is obvious that if our theory is correct, the government will take advantage of the call. In the accompanying table we have calculated the prices at which these bonds would sell at various yields from 4% to 3% in any year up to 1933, the callable date of the Fourth 4¼s.

The Advantage of the Switch

From the table, you will observe that in 1929 if government bonds were on a 3% basis, Mellon 4¼s would be worth 117.29 as against only 104.68 for Liberty 4¼
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Comparative Prices of Liberty 4th 4¼s and Mellon 4¼
At Various Yields Over the Next Eight Years to Callable Date of Liberty

LIBERTY 4th 4¼s TO CALLABLE DATE, 1933

BASIS	1925	1926	1927	1928	1929	1930	1931
4.00	101.70	101.51	101.32	101.12	100.92	100.70	100.48
3.90	102.39	102.13	101.36	101.58	101.29	101.98	100.67
3.80	103.08	102.74	102.39	102.03	101.66	101.27	100.86
3.70	103.78	103.37	102.94	102.49	102.03	101.55	101.05
3.60	104.48	103.99	103.48	102.95	102.40	101.83	101.24
3.50	105.19	104.62	104.03	103.41	102.78	102.12	101.44
3.40	105.91	105.26	104.58	103.88	103.15	102.41	101.63
3.30	106.63	105.90	105.93	104.35	103.53	102.69	101.82
3.20	107.36	106.54	105.69	104.82	103.91	102.98	102.02
3.10	108.09	107.19	106.25	105.29	104.30	103.27	102.21
3.00	108.83	107.84	106.62	105.76	104.68	103.56	102.41

MELLON 4¼s TO CALLABLE DATE, 1947

BASIS	1925	1926	1927	1928	1929	1930	1931
4.00	103.64	103.53	103.42	103.31	103.19	103.06	102.93
3.90	105.14	104.99	104.83	104.67	104.50	104.32	104.14
3.80	106.67	106.47	106.26	106.05	105.83	105.60	105.36
3.70	108.23	107.98	107.73	107.46	107.18	106.89	106.60
3.60	102.82	109.52	109.21	108.89	108.56	108.21	107.85
3.50	111.44	111.09	110.72	110.35	109.95	109.55	109.13
3.40	113.09	112.68	112.26	111.83	111.37	110.91	110.42
3.30	114.78	114.31	113.83	113.33	112.82	112.29	111.74
3.20	116.49	115.97	115.42	114.86	114.28	113.69	113.07
3.10	118.24	117.66	117.05	116.42	115.77	115.11	114.42
3.00	120.03	119.37	118.70	118.00	117.29	116.55	115.70