DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

Fifteenth Session -- April 11, 1957

Subject: Registration Statement for Retail Companies

Speaker: Mr. Fitch K. Bishop, Section Chief
Division of Corporation Finance

MR. BISHOP: Our subject this morning is analysis of registration statements of wholesale or retail companies.

A section's examination of such registration statements does not differ essentially from its examination of other types. There are first the formal requirements to be given attention: is it on the right **form, is it** signed, is the fee correct, are all exhibits and consents there which are said to be there or which ought to be there, are all of the applicable items of the form answered, etc., etc.? From there on common sense takes over. Is the registration statement as a whole and in all of its parts informative from an investment standpoint. What question would arise if your mind as a prospective investor which do not seem to have been answered? **(Of** course the main question – will or will not this security go up and provide me with a nice capital gain – you will look in vain for the answer, or at any rate I hope you will, for if the answer is there even by implication it will have to be deleted).

Nevertheless I would like, with your indulgence, to point out a few things we watch for in registration statements of department stores, **chain stores,** and other merchandising companies.

The financial statements will tell the story mainly, and point out the way. There are few out-and-out promotions in businesses of this sort and therefore most will have a record of operations going back a considerable time. In general there is less fluctuation in earnings of merchandising companies than in the average industrial concern. By and large they handle essential goods – things people must have. Violent fluctuation in earnings is therefore a signal that there is something unusual in the operation and it would be well to seek the reasons, asking the registrant directly if the reasons are not apparent. Particularly if there has been a sudden jump in earnings which makes the prospectus look good it would be well to look for some extraordinary and non-recurring event which might be responsible, and to have it high-lighted in the prospectus. "Lifo" (or last in first out inventory treatment) has become popular among merchants, and **this** tends even more to minimize fluctuations, particularly those due to price changes. Inventory profits are eliminated when prices are going up and in times of falling prices it operates in reverse-income goes up to allow for the lower cost of replacing inventories. Always note among the first things in your examination whether your registrant is a lifo company. It will help you to understand the trends shown by its record of operations.

This is not to say that merchandising companies will go along on an even keel year after year. Many forces induce fluctuation. Increases and decreases in disposable income of the general population, for example, have a direct and immediate impact -- much more so than in the case of the average industrial concern which may react more **slowly or** subtly. Inflation or the threat of inflation will stimulate buying, for obvious reasons, and of course if prices are falling the reverse will occur - people will put off buying hoping for even greater bargains. Well, it follows that if you have a registration statement of this type of business and times are good but the business is not doing very well, some extra disclosure will probably be necessary in the prospectus, explaining what causes this particular business to deviate from the norm. Do not carry this too far **however**. Nothing in our forms require a registrant to contrast its record of operations with those of other similar businesses. Such contrasts could be highly misleading. Disclosure should take the form of pointing out any unusual circumstances or happening in a particular business, especially if it is adverse, although it would also be important to **explain** a windfall. Conversely if we are in a mild recession no particular alarm need be registered if it is reflected immediately in sales and earnings. Probably a falling off of volume and earnings under these circumstances would call for no comment.

In a sense registration statements of merchandising companies are easier to analyze than a number of others because the business is apt to be relatively free of direct **artificial stimuli.** There are housing programs, road building programs, defense programs of various sorts, and a host of others which accidentally or by design cause an abnormal flurry in particular industries. Of course these react indirectly on merchants but in general it is a question of good times or hard times and I trust you all read the papers.

But good times or hard times it is always changing times, and merchants are as sensitive to changes and as inventive as any others. As you all know, what we have always called **"downtown"** (the traditional location of stores and shops) seems to face an uncertain future. I bring this up because the question will undoubtedly occur to you as you examine merchandising registration statements, particularly those of established department stores. But I have no answers for you in this connection. Branch stores in outlying areas are not a new thing but it has not been proved that they are essential. The latest **figures I** could dig up are for 1955. Then 43 of 95 large stores had no branches. Branches undoubtedly increase sales but there seem to be no particular economies realized according to industry **analysts.** The **single** great store operation may yet prove to be the most economical and profitable. So it would not necessarily be pertinent to comment, in terms of lack of progressiveness, on a store which has held off from opening suburban branches.

The theory is, of course, that the well-to-do move out from the city and are replaced **by the poor** whose less exacting demands for quality as well as their slimmer pocket-books cause the character of the downtown store to change. This hasn't actually happened yet, to the degree expected. Housewives in various areas and in various income brackets have been polled by the industry and it seems that in general they still like a big **downtown store** where they feel they have a wider choice and find better quality at more advantageous prices.

Another aspect of merchandising which has not been fully assessed as yet is the discount house. I could not find any registration statements by discount houses. They seem to be popular and it would be logical to suppose that they are cutting into somebody's business but the industry is thus far of the impression that large, established merchandising outlets have not been greatly affected by them. The means used to combat them have been some lowering of prices, non-promotion of the articles most favored by discount houses such as appliances, jewelry, sporting goods and housewares, and the introduction of private brands plus more polite service – in other words snob **appeal**. I think that you will find most registration statements of merchandising companies do not have much to say about the competition offered by discount houses beyond a brief mention and that is probably all right at least up to now. Very recent, we have seen the rise of the complete department store purporting to be a discount house. We have one here in Washington. Its impact should of course be watched in the future.

It is somewhat surprising to find that mail order business has not been driven to the wall by the automobile, good roads, shopping centers and such developments in our way of life. On the contrary, mail order business has shared in the general prosperity. Sears as you know has a vast number of retail stores and these now account for about 76% of its business has shared in the general prosperity. Sears as you know has a vast number of retail stores and these now account for about 76% of its business, but the mail order business has not declined, as I believe even Spiegel and Aldens which are third and fourth of the mail order houses followed suit with retail shops but found that their mail order business was prospering to a degree which did not warrant the shops and now are substantially out of the retail shop business, concentrating on mail order business. This is substantially the story of department stores and suburban branches, which we just discussed. That is, it would not necessarily be a good point to make, in connection with a registration statement of a mail order house, that the company does not seem very **progressive since it has stuck to mail orders and eschewed retail stores.** Speaking of progressiveness, the mail order houses have been thinking up gimmicks on their own in the competition for volume. You can now telephone a mail order for example.

The ratio of earnings to sales is generally higher for mail order houses than for department stores. About 7 as compared to 4. On the other hand in a recession or depression mail order houses are apt to be hit the harder because department stores are quick to cut prices and advertise the fact, and they attract the bargain hunters.

Nearly all merchandising companies have had to face the fact that profit margins are narrowing due to constantly rising costs. The prospering companies have been able to combat this so far by increasing volume. Whether or not volume has been tending upwards is therefore something to look for. In the scramble for volume, credit and installment sales are on the way up. The present average for department stores is about 42% charge accounts, 13% installment sales and 45% cash. For mail order houses it is somewhat lower. Credit sales of Montgomery Ward, for example, are something like 30%. There are some companies where the percentage is much higher, however. Kay Jewelry Stores, for example, which cater to the lower income segment of the population on the basis of nothing down and a long time to pay, sells about 88% on credit. Their sales are about $25,000,000 or better and credit losses about $1,000,000, which I suppose is not bad considering that they are selling diamonds to people who probably shouldn't have them.

Alarm has been publicly expressed concerning the widespread use of credit by all sorts of people. However, I don't think we can draw any conclusions useful for our purposes. Kay Jewelry, to which I just referred started in 1916 and has never experienced a net loss in any year of operations. That would seem to be the order side of the argument on the dangers of selling on **credit**. Heretofore I mentioned that merchandising companies are relatively free of artificial forces. I had better make an exception on the score of credit selling. If artificial forces were brought to bear materially curtailing selling on credit and on the installment plan it would be a material fact with regard to nearly all merchandising companies. However, we cannot make predictions or cause them to be made in registration statements.

Chain stores have turned more and more towards self service in the effort to beat down rising costs. As to food stores, well you probably know from personal experience. About trading stamps; they are a gimmick which has provoked interest and seems to have stimulated sales, but they are an expensive gimmick. I would suggest that no stress on the advantage, sales wise, of using trading stamps (should you encounter it in a registration statement) be accepted at face value. Bring up the question of how much this stimulant costs.

Another thing about chain stores is the lease situation. Once it was thought that securing long term leases on what appeared to be advantageous spots was a smart thing. But neighborhoods change and populations shift and shopping habits along with them. Long leases have proved something of a hazard for the chains and relatively short ones are now considered preferable. There will always be more information in the registration statement about leases. If you feel that more is needed it may be a very good point to raise.

Getting back to the financial statements (and one always does), a word of caution before you draw conclusions as to earnings trends from any interim financial statements which may be included in registration statements of merchandising companies, particularly retail stores; the two months November and December can reasonably be expected to account for 25% of the year's business, and the profit will be correspondingly disproportionate. Spring-summer buying is considered to begin February and run through July, with pre-Easter buying **the heaviest. Fall-winter buying begins in August and runs through January. The February-July period in general accounts for 43% of the year's business, with profits about 2-1/2% of sales, and the August-January period for 57% of the business with profits often better than 6% of sales.**

"Sale and lease-back" does not ordinarily present problems in connection with registration statements of merchandising companies any more than it does in the case of other companies. There are various reasons for stores to be attracted by "sale and lease-back." Sometimes they want the money taken out of fixed assets and put into operations where they believe they can put it to work at a greater return. There may also be a tax advantage in paying rent instead of owning premises. Sometimes there is a psychological advantage as well as tax advantage in divorcing the ownership of property from the operation of a going business. This is usually claimed when ownership is lodged in a subsidiary. It was claimed by May Department Stores when it transferred certain store properties to a subsidiary although, as we know quite well, there were more practical and compelling reasons (having nothing to do with psychology or taxes) for making the transfer.

About this "sale and lease-back" of May Stores, and the registration statement which resulted therefrom, I should like to discourse at some length because it raised a highly controversial point and the point was not settled to our entire satisfaction. While we are not concerned, all things considered, that the May registration statement is misleading we are concerned that the type of disclosure used in the registration statement may be adopted by other registrants where it could be misleading, and the registrant will counter your objections with the usual "You permitted May Stores to do it so we must be permitted too" and all the rest of the argument about precedent, which does indeed put us in an awkward position. So I think you should know about this case and be prepared.

Our registrant was not actually May Department Stores Company, the parent company, but its specially created subsidiary, May Stores Realty Corporation to whom it sold certain of its store properties under the "sale and lease-back" arrangement. The subsidiary proposed to issue general mortgage bonds to obtain the funds necessary to pay for the properties. Before we go further I might as well answer your question "Why all this complication? Why didn't May Department Stores do the public financing directly instead of through a specially created sub?" The answer is not important to this discussion but for your information it had very little to do with the psychological factor and tax savings which I mentioned before, and a great deal to do with the fact that under its existing indentures the parent could not issue secured bonds without equally and ratably securing all of its outstanding debentures; and this it was unwilling to do. Well, to get back to the transaction between the parent and the sub and the public offering of mortgage bonds: the price paid by the sub for the properties was book value, some $17,800,000, and against this property it proposed to issue mortgage bonds in the amount of $25,000,000. Quite a difference! Reading further in the prospectus we discovered an appraisal by Ford Bacon & Davis in which they attributed a "fair market value" to the properties of better than $37,000,000. Now it may be possible in some cases to establish "fair market value" of a piece of property, but the company admitted that in the case of a department store building there is no way to match such a building against sales prices fetched by equivalent buildings in equivalent locations because department store buildings just are not bought and sold like, say houses or land. As to the land under the buildings the appraisers had actually determined a fair market value, and then had added to this their determination of reproduction cost new of the buildings, making allowances for depreciation and certain economic considerations such as the neighborhood, obsolescence, etc. where necessary. Now obviously adding market value of the land as if vacant (and of course it was not in fact vacant) to reproduction cost of the buildings would not result in "fair market value," meaning what the property as a whole could be expected to fetch if put on the market; and we did not want purchasers of the bonds to get the impression that the property securing their bonds could be marketed for such a figure. Our advice, just as obviously, was "throw it out."

The company countered, however, that it could not then hope to sell the bonds to institutional investors in New York (on whom they were depending for successfully sale of the issue) because a New York statute forbade certain institutional investors investing in mortgage bonds unless (a) the issuer could show an earnings record or (b) there was an appraisal of the mortgaged property. The statute does not say what kind of appraisal. It just says appraisal.

Well, the registrant had just been created and of course it had no earnings record, so it was necessary to fall back on the appraisal.

There were numerous and lengthy conferences. Some before the Commission and more in the assistant director's and section chief's offices. Finally we agreed (but without enthusiasm) to their showing estimated reproduction cost new, less depreciation, of the buildings as one figure and appraised value of land as if vacant (in effect market value of land) as another figure, but without totaling the figures and without any reference to "fair market value" of the whole. In addition we insisted on disclosure on the same page of cost figures both as to buildings and land. We permitted also the showing of insurance coverage on buildings, which was greater than the cost figure.

Well, the door has now been opened a crack to permit the introduction of appraisal figures in connection with mortgage bonds. Attempts will surely be made to widen the crack, using the <u>May</u> case as a precedent, but I hope you will be able to prevent it and perhaps even close the crack; and good luck to you in this and in all of your endeavors in the Division of Corporation Finance of the Securities and Exchange Commission.

I see we have some time left so I should like to make a couple of observations regarding the examination of registration statements, not particularly related to registration statements of merchandising companies although as much to them as to any others.

First as to the literal requirements of the registration forms. These mean what they say but they should not be regarded as a check sheet and substituted for common sense, bearing in mind that what we want is clear disclosure of <u>material</u> facts. I have noticed over the years a tendency on the part of examiners (especially new ones) to make the forms a sort of Procrustes' bed. In case you are rusty on your Greek mythology, Procrustes was a legendary character who had a bed for the accommodation of wayfarers. Well, accommodation is hardly the word. Procrustes insisted that the traveler fit his bed. If he was too tall Procrustes chopped him off, if he was too short he put him on the rack and stretched him out. Now let's take the very first item of Form S-1 and call it Procrustes' bed. The item says that on the first page of the prospectus there shall be a table showing price to the public of the securities being offered, underwriting commissions, and proceeds to the registrant. Sometimes it happens that there is no set price at which the securities will be offered. Perhaps the price will be the market at time of sale or perhaps it will be based on a formula, and perhaps there will be no underwriting commissions involved. In such case the registrant will very likely substitute for the table a narrative description of how the offering is to be made. Now, I have actually seen examiners cite it as a "deficiency" under these circumstances that there was no table showing price to public, underwriting commissions, and net proceeds. In other words Item 1 is Procrustes' bed. If they don't have the sort of offering that fits into the table prescribed by Item 1, they had just better change the offering so that it does fit. If they haven't hired an underwriter and don't want one or don't need one, for example, that is just too bad. Item 1 contemplates an underwriter in the picture and an underwriter there must be.

Second there is the question of how far one should go in requiring disclosure of all profits or things of value received by promoters where the securities being offered represent a new issue by a promotional company. The item states that the nature and amount of anything of value received directly or indirectly by the promoter shall be given and goes on to state that as to property the price paid by the registrant, who determined that that would be the price, and how it was determined, and the cost to the promoter or his associate of the property shall be disclosed.

In this connection I want to read you a little squib written not by me but by one of our talented examiners, who alas is no longer with us. He was often more exacting than I might agree was necessary but there was nothing doctrinaire about his approach as I think you will discern. This was written after a discussion with me and although intended to be humorous it is also sharply pointed. He says:

"Here is a horrible example of the lengths to which one can go following the literal requirements of the form with an essentially uncritical approach; that is, without bearing in mind what the real purpose of disclosure is -- to inform the investor what his chances might be if he purchases the securities. In the case of promoters it is most important for him to know what stake the promoters have in the enterprise compared with his own. That is, if the enterprise makes money how much will be siphoned off to reward promoters who took large chunks of stock for 'services' (so called) or for cash contributions way out of proportion to the contribution the public investors are asked to make. Similarly, it is important for him to know how much of the capital being raised will actually be put to use as capital and how much will go to promoters as rewards and 'reimbursements' of one sort and another. He doesn't really need to know much else about that phase of the venture. Little human-interest stories about the promoters involving small sums or having doubtful bearing on the investment merits of the enterprise, even though seemingly called for by the form, <u>obscure</u> and do not aid essential disclosure. If the stories are complicated or obtusely told they will confuse the reader. If they are clearly told, they will fascinate him at the expense of the really important facts, the impact of which may be dulled by the lengthier and much more readable disclosure of the small-scale or side-issue shenanigans of the promoters.

<u>Deficiency (or 'comment') – hypothetical</u>

It is noted that an item of equipment (a pick-up truck) was purchased from a Mrs. Jack Vincent. If as appears probable this Mrs. Vincent is an 'associate' of Jack Vincent, named in the registration statement as one of the promoters, any profit in the transaction to her, and therefore directly or indirectly to Mr. Vincent, should be disclosed.

<u>Disclosure in Prospectus</u>

The company on September 3, 1956, purchased for use as a pick-up truck a used station wagon belonging to Mrs. Jack Vincent. Mrs. Vincent is the wife of Jack Vincent, one of the promoters of the registrant. The company paid $2,000 for the station wagon which had cost Mrs. Vincent $3,600 approximately 2 years prior to September 3, 1956. Investigation has shown that comparable station wagons are being offered by second-hand dealers at prices ranging from $1,800 to $2,100. It is not known at what price Mrs. Vincent might have been able to sell her station wagon to a second hand dealer but it is reasonable to suppose that the price would have been less than the $2,000 she received from the registrant. Therefore it appears that a profit of several hundred dollars may have been realized by Mrs. Vincent in the transaction. Mrs. Vincent has no connection with the registrant except through her husband. Mrs. Vincent has stated upon inquiry that she bought the station wagon which with what she claims was her own money and does not intend to divide the proceeds of its sale with her husband. From Mrs. Vincent's tone it has been derived that relations between Mr. and Mrs. Vincent are somewhat strained over this and it cannot presently be stated with certainty what the outcome will be. However, it has also been derived from Mrs. Vincent that had she not sold the station wagon she might have had to ask her husband for extra money with which to pay for her new coat. Therefore it is possible that an indirect benefit from sale of the station wagon to the registrant may have been realized by Mr. Vincent in any case.

Further Deficiency

"The cost of the coat should be stated."