

WHO BOUGHT THE ST. PAUL?

Some Reflections on Corporate Reorganization

By Preston S. Krecker

A subscriber writes:

How can the court of justice that is worthy of the name approve and sanction the sale of a property for \$140,000,000 that is actually worth \$650,000,000 to \$700,000,000?

I refer to the sale of the Chicago, Milwaukee and St. Paul railways. If this sale is finally approved by the Supreme Court, the way it looks to me is that the bankers who buy in the property will have cleaned up about \$500,000,000 profit.

I should like to see some editorial comment from your able pen about this.

Our correspondent is evidently under a misapprehension regarding the essential facts in the foreclosure of the Chicago, Milwaukee & St. Paul Railway. As others also may have misunderstood them an explanation may be timely.

Our correspondent has fallen into two errors. The first concerns the role the bankers played in the foreclosure, and the second the price paid for the property.

With regard to the bankers, the fundamental error is the assumption that they bought the road for themselves. As a matter of fact the bankers bought it, not for themselves, but for the account of the bondholders.

The foreclosure of a mortgage on a railroad is exactly the same in principle as the foreclosure of a mortgage on any other piece of property such as a farm or a dwelling. The property is sold for the benefit of creditors. However, the corporate organization of a railroad, with its thousands of widely scattered security holders, creates complications not found in an ordinary foreclosure sale. The usual procedure in the foreclosure of a railroad is first to bid the property in for the account of the holders of defaulted bonds and, second, to transfer or assign the property to a new company, which in turn issues new securities given in exchange for the old.

That procedure is being followed in the case of the St. Paul. The holders of the defaulted bonds will receive new bonds secured by a mortgage to be issued by the new company. Stockholders, on payment of assessments, will receive new stock for old and thus will acquire an equity in the new company. They will be, as before the receivership, the owners of the road.

The bankers mentioned in newspaper dispatches as the buyers of the St. Paul are merely agents or managers acting for the holders of defaulted securities. Instead of cleaning up half a billion dollars, as our correspondent assumes, the bankers will receive a fee for their services of about one million dollars. That fee is determined on a percentage basis. It works out about an average of 25 cents a share on the securities involved. As the services will cover a period of more than two years, the fee is not to be regarded as extravagant. As a matter of fact it is said to be the smallest fee in proportion to the volume of securities involved ever charged for reorganizing a railroad.

The entire expense of the reorganization, it is estimated, will be not more than \$5,000,000. That is but seven-tenths of one per cent of the capitalization of the old company. As the cost of a reorganization is largely determined by the way in which it is handled by the managers, the low expense in this instance is a tribute to the bankers who have undertaken the task. Just to cite one point, the bankers saved several hundred thousand dollars for the company by incorporating in Delaware instead of Wisconsin.

The second error our correspondent has fallen into is in assuming that the Chicago, Milwaukee & St. Paul Railway was actually worth several hundred million dollars more than the purchase price. That was perhaps a natural mistake. The old St. Paul company was capitalized at \$703,000,000. One reads in the papers that bankers bid it in for \$140,000,000. However, the

papers perhaps failed to state that the purchase of the St. Paul was subject to underlying mortgages of about \$200,000,000 which of course had to be assumed by the buyers with the result that the latter actually paid \$340,000,000 instead of only \$140,000,000 for the road. The price paid also was \$17,500,000 better than the upset price of \$122,500,000 fixed by the federal court.

Of course, even if all that is taken into account, the price paid for the St. Paul property at the foreclosure sale was low in comparison with the capitalization of the old company. It works out at about 49 cents on the dollar. But that, on the other hand, is not an unusual percentage in case of foreclosures, regardless of what the nature of the property involved may be. On the contrary, it may be considered a fair price. For it must be borne in mind that neither physical valuation, nor reproduction cost nor capitalization has anything at all to do with the price which can be paid for a railroad sold at foreclosure. The question is what it is worth as a going concern.

The controlling factor in the sale of the St. Paul was the market price at which the company's securities were selling and the market for them in the last analysis was determined by the earnings of the road. It is well known that the St. Paul was not earning its fixed charges. The average earnings of the road for the last four years, after deducting interest on the undisturbed or underlying bonds already mentioned, show a return of less than 6 per cent on the \$140,000,000 paid over and above those bonds. In the ordinary case nobody would buy a railroad on the basis of but 6 per cent on the equity after fixed charges.

In figuring the value to them of the St. Paul the reorganization managers took the market for the refunding mortgage bonds, which were in default, as the basis. Those bonds were selling at a price a little over 50, equivalent to \$500 on the \$1000 bond. The bankers' bid was equivalent to 48 or 480 on the \$1,000 bond. That was a comparatively good price, taking other reorganizations into account. It is said that virtually all of the judicial foreclosure sales in the past have been made at prices ranging from 50 to 60 per cent of the market value of the defaulted bonds. Those low prices are paid in order that non-assenting bondholders will not get an opportunity to hold up the assenting security holders by exacting high prices for their bonds. When the St. Paul was sold only 80 per cent of the bondholders had accepted the reorganization plan. The other 20 per cent were holding out for a settlement. The \$140,000,000 paid for the property means that those who stay out can settle their claims against the company for \$480 cash per \$1000 bond.

Had the reorganization managers paid the substantially higher price for the road certain non-assenting bondholders demanded, it would have been necessary for the assenting bondholders to raise the additional funds, which in this case would have amounted to \$25,000,000. Formation of an underwriting syndicate would have been unavoidable and such a syndicate's fees would have amounted to about \$1,400,000, which of course would have come out of the treasury of the company. The only actual beneficiaries of such a policy would have been the hold-out bondholders.

On the other hand the upset price of \$122,500,000 fixed by the court worked out at only 42 or 420 per \$1,000 bond, which would have been \$60 per bond less than the price actually paid. The reorganization managers wanted to be fair to the bondholders while at the same time not penalizing the company.

Were it not for dissenting bondholders the price paid at the foreclosure sale would be of no importance.