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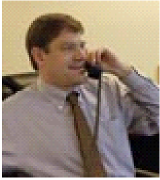

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Portfolio Manager

The Dilution Solution: Rediscovering Equity's Essence as a *Residual* Claim

Ask your typical investor to define what it means to be an equity shareholder, and they're more likely to describe what they think stocks are supposed to *do* (popularly, "get me 10% a year") rather than what they actually *are*.

So what is equity, anyway? First of all, for a going concern, equity is ownership of operating earnings after interest and taxes have been paid – it's a right to net income, whether plowed back into the business and balance sheet as retained earnings or distributed outright as cash dividends. Ultimately and most fundamentally (e.g. in instances of insolvency, liquidation or company sale), equity is a residual claim on the assets of a company after all liabilities are satisfied or shouldered anew. That's it. In either case, whether you're looking at the income statement or the balance sheet, the equity interest takes what's left after everyone else – bond holders, bank credit facilities, employees, vendors, the tax man – gets made whole.

Realizing equity's essence as the *residue* of company fortunes is a necessary step in appraising the risks that stock ownership entails. Too many people are just now discovering what their Depression-hardened parents and grandparents knew in their bones: buying stock is akin to bidding on leftovers, and an uncertain portion of leftovers at that.

Why an uncertain portion? While common stock's position in the capital structure – dead last when it comes to getting paid – is knowable in advance, the proportion of each common share's claim can change as the number of shares itself changes. How's that? Just as companies can issue new debt, they can float more stock to raise cash. And the issuance of new equity shares dilutes the proportionate claim of each existing share – it invites more mouths to crowd the table.

One reason to issue more shares, and a salutary one at that, is to fund the pursuit of attractive opportunities which can't be supported by internal cash flows or for which new debt is deemed suboptimal. Great! But that's not the story behind this year's frenzy of stock issuance by major banks, which has been driven not by growth or opportunity but rather by desperation and survival. In other words, too many companies have been issuing equity for the worst reason: *because they have to*. Their operations won't produce the cash they need to keep going, and the credit markets have tightened up mightily, such that solvency demands equity dilution.

Bank of America, Citigroup, Fannie Mae, Fifth Third, ING, JP Morgan, and Regions have trotted out tens of billions of dollars in new equity – much of it preferred stock that's senior, in fact, to the common shares outstanding. Poster child for the unfortunate dynamic is National City, lately one of the ten largest banks in the country: it issued 1.4 billion new shares on top of some 633 million existing. The result? The stock, which had closed the previous day at $8.33, was discounted by management negotiation (!!!) to $5 a share – a 40% destruction of market value, and a nearly 70% weakening of each share's claim on future earnings and residual assets. As the skipper at National City can tell you, sometimes keeping the ship afloat means throwing overboard everyone who bought tickets in steerage.

The question you should be asking now is, given what I've said so far, why in the world would we own stocks? Some of the reasons might surprise you. I'll answer in words as plain as I can muster, in next month's letter: **Why We Own Stocks**.

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