Why Some Holders Of Tobacco Firm May Feel Burned

HEARD ON THE STREET

By Roger Lowenstein
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NEW YORK—Shareholders of **Brooke Group** Ltd. must be pinching themselves in disbelief.

Until last week, the maker of Liggett cigarettes was a cash cow with sharply increasing earnings and twice as much cash on its balance sheet as debt. But last week the company was transformed beyond recognition in a sudden maneuver by Bennett S. LeBow, the company's chairman and majority stockholder.

What Mr. LeBow did was to ladle onto Brooke Group's balance sheet a number of other investments, notably his holdings in troubled **Western Union** Corp. and **MAI Systems**, both of which are turnaround projects of Mr. LeBow gone sour. He also saddled Brooke Group with $300 million in costly, high-yield debt. Mr. LeBow "took an equity investment and turned it into a junk bond," complains David Katz, a portfolio manager at Matrix Asset Advisors who, in response, dumped his Brooke Group stock.

Bennett S. LeBow

According to a terse statement released the Monday before Thanksgiving, Brooke Group "completed a restructuring which has resulted in its becoming the parent company of Brooke Partners L.P." The latter is Mr. LeBow's private investment vehicle.

"The only way to interpret this is that it's a way to bail Ben LeBow out," says Claude Carmichael, a portfolio manager at W.R. Lazard who holds a small stake in Brooke Group. "It's incredibly audacious."

In plain terms, the 52-year-old financier has caused Brooke Group, which has been cruising along and which is 16%-owned by the public, to merge with a debt-plagued vehicle that previously belonged to him and his partners alone. "Liggett has been doing fairly well and generating a lot of cash," says Maryann Yacullo, an analyst at Smith Barney. "They took a company that was debt-free and whacked a lot of debt on it."

Mr. LeBow and his partners previously held 84% of Brooke Group via their ownership of Brooke Partners; they now have an equal stake in the merged company.

On the day the restructuring was announced, Brooke Group also announced that earnings in its most recent quarter surged 195%, with strong performances from tobacco as well as from its newer business in sports-trading cards. Absent the restructuring, its stock might well have risen. But when trading resumed, the following day, its shares promptly plunged, to 9¼ from 12; the price has since fallen to 7½.

A look at Brooke Group's balance sheet shows why. On Sept. 30, Brooke Group had a net worth of $105 million. However, on its "pro forma" balance sheet, which accounts for the merger with Brooke Partners, long-term debt balloons to $453 million from zero. And net worth, or assets minus liabilities, collapses, to a negative $104 million.

Brooke Partners' assets—mostly securities in MAI and in Western Union—provide it with practically no cash. Thus, the merger could reduce Brooke Group's pretax cash flow by the amount of interest needed to service Brooke Partners' junk—about $45 million a year.

Mr. LeBow, in an interview, says the transaction is fair to his public shareholders. In fact, he adds, investors are likely to come out ahead.

Brooke Group says it has designed a new wrinkle specifically to protect public investors, who own close to four million of Brooke's 24 million shares. The company is distributing to those investors senior, se-

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Some Holders of Brooke Group Tobacco Firm May Feel a Bit Burned as Profit Picture Cools

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cured "contingent value rights," or CVRs, which will trade independently and be redeemed in three years.

The CVRs will entitle holders to whatever amount of money needed so that holders of Brooke Group's stock have an annualized, total return of 15% from the date of the announcement. (A $12 asset, growing at 15% a year, would compound to $18.25 in three years). Thus, if Brooke Group's stock, adjusted for dividends, is at $16.25 in November 1993 the CVRs would be redeemed for $2. If the stock is at or above $18.25, the CVRs would be worthless.

Mr. LeBow says holders thus come out ahead—assured of a 15% return. The CVRs will be backed—but only in part—by collateral of cash and marketable securities. Richard Ressler, vice chairman of Brooke Group, says the formula was arrived at after "long and hard thought" with the interests of public shareholders in mind.

Brooke Group also obtained an opinion from Oppenheimer & Co. "that the transaction is fair from a financial point of view to public shareholders of Brooke Group."

However, no sooner was the ink dry on Oppenheimer's opinion than Joseph Frazzano, Oppenheimer's security analyst, yanked his buy recommendation from Brooke Group's stock. "They changed the nature of the business," Mr. Frazzano explains, adding: "And there are very few businesses as good as the tobacco business."

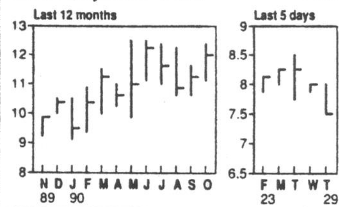
At first blush, the CVRs have a seductive appeal. However, any payment made to holders of CVRs would deplete Brooke Group's value to its continuing shareholders. Another hitch is that the CVRs can be called early—at any time of Brooke Group's choosing, beginning next May—according to the same 15% formula.

Thus, if Brooke Group's stock—spurred by a sudden bull market, or a well-timed announcement, or anything else—should recover for a 20-day period, the CVRs could be redeemed for little or even zero.

Another problem is that the CVRs offer protection only on the downside. If Brooke Group's stock rises—but more slowly than it would have without the restructuring—the CVRs won't help.

And in fact, given where Brooke's stock was trading, a 15% return may be no big deal. Mr. Frazzano was forecasting net of $1.75 for the fiscal year ending next March. During the first six months of that year, Brooke Group's net was 81 cents a share, up from 37 cents a year earlier. Thus, at $12 a share, Brooke was trading for less than seven times estimated earnings and paying a dividend yield of almost 5%. In a word, it was cheap.

Brooke Group Ltd
(NYSE; Symbol: BGL)



Business: Cigarettes
Year ended March 31, 1990:
Sales: $572.9 million
Net income: $25.5 million; $1.06 a share
Second quarter, Sept. 30, 1990:
Per-share earnings: 43 cents vs. 15 cents
Average daily trading volume: 11,026 shares
Common shares outstanding: 23.9 million

John Maxwell, an analyst at Wheat First Securities, says Liggett's low-priced Pyramid brand "is one of the most successful cigarettes introduced recently." While Liggett's estimated 3.3% market share is small, that share has risen two years in a row, Mr. Maxwell says. And despite the decline in numbers of smokers nationwide, Liggett's unit volume rose 10% in the first half of its fiscal year. Sales of its newer sports-trading cards are soaring.

Mr. Katz says it doesn't seem unreasonable that—absent the restructuring—Brooke Group shares would have risen to $15 or $16 apiece in not too much time. Brooke Group may be "guaranteeing" a 15% return to holders who otherwise might have received 20% or 30%. The company's Mr. Ressler concedes that holders "could have gotten more of the upside" potential from Brooke Group without the deal.

But, he adds, "the company had to change." It had to diversify out of tobacco. Shareholders agree—but was there no other merger candidate besides Mr. LeBow's private turnaround vehicle? "Most people bought this as a tobacco company—not as a vulture fund," says Lazard's Mr. Carmichael.

Mr. LeBow, asked why the deal was done, says it was costing him dearly to pay interest at Brooke Partners out of after-tax dividends received from Brooke Group. By consolidating, he can pay the interest pretax. But that is hardly a concern of public holders.

An alternative way of accomplishing Mr. LeBow's aim—and one which would have provided for public holders, too—would have been for Mr. LeBow to simply buy out the public's stake and then merge. But then, the premium surely would have been greater than 15%.