Children of the boom

Of the many characteristics of the present Australian Stock Exchange boom, there are two features which are becoming increasingly widespread, particularly in the more speculative end of the market—

(1) the "pyramiding" of company structures,
(2) the issuing of marketable options.

"Pyramiding" of Company Structures

This term can embrace a number of variations, though refers basically to the practice of existing companies "hiving-off" part of their activities to a newly-formed company in exchange for a (usually substantial) share interest in that company. The share interest acquired does not generally involve any actual cash payment, but merely forms the consideration for having transferred certain "assets" to the newly-formed company. Examples of this practice abound, including Planet Gold and Planet Metal (formed by Planet Oil), Central Pacific Minerals and Southern Pacific Petroleum (Magellan), Abroaths (Longreach), Ardlethan Tin, Greenbushes, Cleveland Tin (Aberfoyle) and Project Mining Corporation (Project Development). The case of Hamersley (CRA and Kaiser Steel) is of a more special nature, since this was designed specifically to give local shareholders a greater equity interest in the operation. Similar considerations will probably apply when CRA later floats off its Comalco interest to a separate entity.

In August, 1966, the Board of Planet Oil in explaining why it planned the formation of Planet Gold and Planet Metal, stated it had "decided that it should separately finance its search for petroleum, gold and other metals and minerals and thereby enable stock and shareholders (of Planet Oil) to have the choice of investing in all or any one of these activities". In addition, Planet Oil's taxation consultants had advised "that the formation of separate companies to explore the Planet Group's gold interests and certain of the Group's other mineral prospects (was) necessary to provide the maximum taxation benefits to shareholders". Nowadays no "justification" is given for the formation of a new company. Thus, for example, Project Mining Corporation Limited was incorporated simply "for the purpose of taking over the mining and exploration activities previously carried on by Project Development Corporation Limited". In these circumstances there is logically no end to which this could occur. Any corporation which has diversified away from its original basic activities could form a myriad of separate companies, each for the purpose of taking over the A, B, ..., X, Y activities previously carried on by the company whose specialty operation was Z (e.g., Hooker Corporation, National Consolidated and Queensland United Foods).

Of perhaps greater significance to security analysts, however, is the effect that this "pyramiding" can have on the share prices of the respective companies involved. It is generally the case that the market capitalisation of the final off-shoot company (often with only a limited percentage interest in some key lease or mining operation, yet having an issued capital of many million, usually partly paid, shares) is such that an altogether unrealistic theoretical valuation is obtained for the whole of the lease or mining operation when the minority interest valuation is grossed up at the appropriate rate.

Alternatively, assuming that estimated values can be attributed to individual parts of a parent company's operations, based on the existing share price of the parent company, it is common for the valuation of the off-shoot company's interest in some aspect of the parent company's operations to be out of all proportion to its "theoretical" valuation. This is usually because the off-shoot company provides the most direct avenue of investment or speculation, and also because its share price is generally the cheapest, thereby providing maximum "leverage" should favourable developments occur.

However, whilst the largest proportionate gains under favourable circumstances have, from empirical observations, gone to the off-shoot companies, the system is inherently unstable under unfavourable circumstances since the off-shoot companies or those at the bottom of the pyramid tend to collapse in price whilst the parent company (at the top of the pyramid) may not move in price to any appreciable extent at all. Since booms do not generally last indefinitely, it would not seem desirable to permit the unrestrained growth of off-shoot companies since the simultaneous collapse in price of numerous such companies could result in a major loss of investor confidence, with possible consequent repercussions on the level of equity prices generally and the ability of firms to raise further capital.
The Issuing of Marketable Options

Whilst non-marketable stock options have been popular for a long time, particularly with respect to share options granted to employees of companies, there has been a recent trend towards the issuing of marketable options as a “sweetener” in conjunction with:

(i) a takeover offer (e.g., Hooker Corp. Peko)
(ii) a new cash issue (e.g., Exoil, Kamilaroi, Project Development, and Planet Gold placements)
(iii) a new company flotation (e.g., Basin Oil, Selected Securities, Planet Gold and Planet Metals).

Such marketable options are usually issued free of charge, and entitle the holder to subscribe for a further ordinary share (usually at par) in the short to medium term future.

So far as the issuing company is concerned, there is little doubt that the presence of an attaching marketable option facilitates the raising of new capital, whether by an existing company or by a newly-formed company. However, such a transitory benefit could be offset by the later disadvantage of an unwieldy capital structure, assuming all the options were duly exercised, if (i) the company had no particular use for the extra funds at that time, or (ii) the company’s earning rate on equity funds employed was already below industry average (indicating that an alternative type of new finance could be more appropriate).

In addition, companies should logically consider the potential effects of the possible exercising of options on the price of its existing shares in so far as this factor influences its ability to raise fresh equity capital or even new borrowings in the period up to the option exercise date. Investors would generally be expected to shy away from companies whose capital was likely to be increased by, say, 50% in the near future upon the exercising of marketable options. (This could well apply also to non-marketable options, though in this case investors are not generally as aware of the number of outstanding options.)

In view of the dampening effects that outstanding marketable options can have on the price of existing shares under certain circumstances, it is rather surprising that some companies in the past have extended the date on which such options can be exercised. This has usually occurred in cases where the company’s ordinary shares were quoted below par, and where as a consequence rational investors would not have exercised their options (ignoring tax considerations on mining company shares). These extensions of options have generally tended to favour the option holder (by granting a further forlorn opportunity in which profitably to exercise the option) at the expense of the existing shareholders who may have welcomed the prospect of all outstanding options lapsing.

Concluding Remarks

It would seem desirable to control the growth of off-shoot companies in view of the inherent stock market instability which can accompany their unchecked growth. Unfortunately under present circumstances most stockholders would probably tend to approve such company formations if they were given the opportunity to vote on the subject. Equally in the case of the issue of marketable options little restraining influence could be expected from stockholders, the main beneficiaries of such issues. As the benefits in each case can only be realised upon Stock Exchange listing, perhaps the Stock Exchanges concerned should become more discriminating in approving the quotation of new classes of marketable securities.

It does not seem good enough for a Stock Exchange to grant listing without commenting on the merits or otherwise of the company in question. The present “standard” statement in company prospectuses—“the fact that . . . Stock Exchanges have agreed to list shares is not to be taken as an indication of the merits of the company or of the shares now offered for subscription”—is totally inadequate in this regard as to many investors it would, in fact, imply implicit approval of the company in question.

Invitation to U.S. Conference

The Financial Analysts’ Federation of America will hold its twenty-second Annual Conference from May 11th to 14th, 1969, at St. Louis, Missouri. Melvin C. Bahle, General Chairman of that Conference, has extended an invitation to members of the Australian Society of Security Analysts to attend. The possibility of participation of the Society’s members in the educational programme has been raised with the suggestion that the subject matter for discussion could be the operations of the Australian Stock Markets, outlook and characteristic stock recommendations.

The Conference Programme would be a most extensive one embracing lectures, field trips, subject forums, discussion and workshop groups. For example, the 1968 Annual Conference Programme offers field trips to twenty-one companies.

To enable the planners of the Conference sufficient time to consider Australian members’ participation it is essential that advice of attendance be forwarded to reach the above address prior to 31st December, 1968.