FUND-RAISING BY COMPANIES

These notes dated 22nd May 1969, have been prepared by Mr. A. M. Parker, Chairman of Universal Flexible Trusts Limited, and contain a number of new ideas for the protection of investors. It is hoped that they will stimulate discussion, and for its part this Journal will be pleased to consider contributions in the form of Letters to the Editor.

Funds can be raised either in the form of listed investments—those quoted on the Stock Exchange—or unlisted securities. Broadly, they are in two classes:

(a) Ordinary shares, and
(b) Fixed-interest investments.

Ordinary shares to be listed

This class can be divided into three main groups:

(a) Issues by companies whose previous ordinary shares are listed.
(b) Issues by an existing company whose shares are unlisted, in order to obtain listing.
(c) Issues by entirely new companies.

(a) Issues by existing listed companies

These issues normally do not require a prospectus under current legislation.

The issues may, in general, be made to existing shareholders in set proportion to holdings (“rights” issue), or to a select few investors (“placement”), or to the shareholders of another company being acquired or to people whose assets are being acquired (both “takeovers”).

Further protection is needed.

In the usual “rights” issue—an issue below the market price—due equity is preserved between existing shareholders. A statement is frequently issued to shareholders “that the money from the issue is required for general expansion of the business”, or some such vague remark. Sometimes that is what it is used for, but sometimes it may be required to repay a loan (for example, an overdraft which the bank regards as too high for its own security), and if so may markedly reduce the earnings rate on the enlarged capital and lead to a fall in the market price of the shares.

“Rights” issues of the one new for five or more old type present little difficulty, but it is the one-for-one issue, or the one-for-two issue, where snags occur. These are relatively substantial issues, and I am inclined to think that prospectuses might well be a very useful safeguard (the one for five or more variety is the rule rather than the exception, so that this suggestion would not impede normal growth).

In any event, in a “rights” issue, it should be a requirement that the company state specifically what the money is required for and—most important—it should make at least a one-year forecast of the earnings (profits after company tax) the company expects after the issue and show these expected earnings as a percentage of the enlarged ordinary share capital and as a percentage of the enlarged ordinary shareholders’ funds.

In a “rights” issue, not only are existing shareholders to be considered, but also the purchasers of the “rights”.

A “rights” market should always be made for a “rights” issue, because if “rights” are made non-renounceable, as sometimes happens, existing shareholders who cannot find the necessary money are deprived of part of their equity.

In a “rights” issue, the price at which the shares are issued is immaterial, but this is not so when a private “placement” is made. If the price is 5, 10, 20, 30% . . . below the current market value, the existing shareholders are deprived of part of their equity. It is even worse if some of the people with whom the “placement” is made are connected with the company, for example, majority shareholders or executives. An issue at par to the staff pension or benefit scheme, although usually relatively small, falls into this category, even though the formality of having it approved by shareholders is adopted.

A variant of this was recently publicly denounced by Universal. An option to issue shares at any time at par, that is, 30% below the then market price, was granted by shareholders called to an extraordinary general meeting. It was granted for the simple reason that it was the majority shareholders who were granted the option. Universal had a good “press” indicating the need for reform. It needs little imagination to envisage the effect of this kind of thing, if it became general. The Victorian Registrar has been written to about another possible example of “oppression”.

There are few, if any, reasons why “placements” or options shall be given to anybody other than the existing shareholders in proportion to their holdings.

A “takeover”, or “merger” or “amalgamation” affects the future prospects of existing shareholders. Usually very little information is given to them on this vital subject. Again, at the very least, the effect on shareholders’ earnings and assets (by the issue of shares to one or the other company or merely where cash passes in exchange for assets) should be given on the basis of last available results. But preferably, at least a one-year forecast of what earnings the company expects to make should be given, together with shareholders’ capital and funds, and percentage of earnings to capital and funds.

It is a not uncommon practice for a company taking over another first to sell off part of the assets (land, property, stocks, debts) at a loss, debit that loss to the company being taken over, and thus acquire “clean” profit-earning assets for the purpose of incorporation in the consolidated accounts. There is nothing wrong with selling off loss-producing assets at a loss, but the final picture presented to shareholders of the “takeover” company is one of a high-profit-earning-on-asset company having been taken over, the losses on sale of assets having discreetly been forgotten. If the “takeover” company shares are standing at high enough a premium (through the circular evidence of high earnings on assets), this sort of process can go on for quite a while until time catches up with the company. To meet this situation, I suggest that assets and earnings “as is” should be incorporated in consolidated accounts, before any doctoring is allowed.

(b) Issues to obtain listing

Capital Structure

The normal issue is for a private company “going public”. Current legislation requires a prospectus.

Sometimes the whole of the capital is issued to the public. Sometimes only part. Sometimes options are issued to the vendors or others giving them the right within a prescribed period to subscribe at the issue price for further shares.

This is not at present always concisely stated in a single part of the prospectus, but scattered over it. The capital structure in money after the share issue, and also after the option share issue, if exercised, should be shown in tabular form, showing ownership in broad classes as between vendors, holders of options and the public (who may also be entitled to options).

Where shares are issued partly paid, there should be a further breakdown in terms of money by showing the capital structure after the issue, and also as if fully paid.

My remarks about options to the public and partly paid shares apply more to (c) below than to this section, but they may still be applicable.

The purpose of these suggestions, while not wildly important, would be to show the total amounts that could be involved. They involve no more than can be done by anyone who indulges in a little arithmetic.

Gearing

A most important feature of capital structure is “gearing”. If ordinary shareholders’ funds are high in relation to all interest-bearing loans (including the special example of an interest-free loan) and preference shares, the equity is said to be “low-g geared”, and vice versa. In most industrial companies the ratio of earnings on ordinary shareholders’ funds to earnings on total funds is greater than 50%, but in certain classes of companies—for example, hire purchase—the ratio is much lower and can get down to 10%. In Universal’s investigation of this matter, there are currently 46 companies out of the largest 600 non-mining companies where the ratio is less than 50%.

The importance of “gearing” lies in the fact that total earnings are made from the use of money, wherever it comes from. This means that should total earnings rise or fall 10%, this can have a very different effect on shares where the “gearing” is low and high respectively. Skilled investment analysts take account of “gearing”, but have to probe for it.

A prospectus should make clear the degree of “gearing” by showing in a simple table not only the shareholders’ funds, but also loan indebtedness (including overdrafts), and, of course, when dealing with earnings, show a similar split.

Calibre of Management

In a listed company the calibre of the management is usually reflected in the published profits, and there is usually reasonable continuity of management performance.

But where a private company becomes a listed company, it is often found that the vendors—who have produced the prospectus profits—cease to be actively engaged in management because they receive large capital sums from the issue or they have reached an age when the drive which brought them to the top is fast diminishing.

The prospectus, therefore, should give information about the ages of the directors and top management (general manager, secretary, accountant, sales manager, marketing manager, production manager, etc.) and any recent changes in management (with particulars of both the old and the new), and also any proposed changes following the issue, say, up to five years as far as is known or can reasonably be assumed.

The prospectus should give a potted biography of these people, including their other directorships and managerial interests. (Ideally, what is required is an indication of their performance in other financial fields. A very revealing clue to the worth of an issue is a man’s past record in other financial ventures.) How far you can go in this direction I would not presume to say, but the more financial probing there is the better.

In short, in a company flotation, quality of management is often more important to the intending investor than the past financial figures of the company.

Prospectus Profits and Assets

Current legislation requires accounts for the preceding five years. This is reasonable. The profits are linked to the dividend rates. This is not helpful.

What is required for the information of the prospective ordinary share investor, is the rate of profit earned on the ordinary shareholders’ funds, expressed as a percentage. It wouldn’t hurt (but isn’t necessary) if the dividend paid was also shown as a percentage of the ordinary shareholders’ funds.

The reason for this is that dividend rates on capital can be most
misleading. It is quite possible for a company to earn 20% on capital, but only 5% on shareholders' funds. What part of earnings has been paid out in dividends is a matter of policy, and may not be a guide to the future.

According to Universal’s researches, the average rate earned on shareholders’ funds for 600 of Australia’s largest non-mining companies has for some years been between 8 and 9%. The range is approximately plus 30% to minus 20%. As a guide to a company’s earning capacity, it is this ratio which is all-important.

There are snags even with this ratio, particularly with a private company becoming a listed company. What I have in mind is the not uncommon situation where a private company has been built up by means of loans from all sources, including large loans from the owners-cum-directors. Usually these loans are repaid (or will soon be repaid) out of the proceeds of the issue, thereby replacing loan capital with share capital. This has an immediate devastating effect on the future earnings on shareholders’ funds (and shareholders’ capital). To get over this problem, either the prospectus should show adjusted earnings on adjusted shareholders’ funds or (and this would be a preferable addition to information for all flotations) the total earnings, before deduction of any interest, should be shown as a ratio to combined loan capital of all kinds and shareholders’ funds. This would be the truest guide to the company’s earning capacity on money. And it is what the prospective investor needs to know.

The prospectus should show, for the last five years, the earnings and shareholders’ funds and the percentage ratio of earnings to shareholders’ funds.

The prospectus should include at least a one-year (following the issue) forecast of figures of earnings, dividends, shareholders’ funds, capital, and their corresponding ratios. It is not intended that directors should necessarily be considered guilty of misrepresentation or fraud if the actuality turns out to be different to the forecast. The forecast would take account of changes in capital structure, and should take account of conditions known by the directors likely to affect the company and the industry of which it is part, at the time of the issue and for some time ahead. Should actual profits be markedly less than forecast profits the directors would immediately be put on the defensive, and the shareholders on guard. Which is as it should be.

On the question of the basis on which profits should be computed I believe wholeheartedly in the importance of proper comparison between one company and another. Amidst all the arguments that go on about depreciation based on cost or replacement value, treatment of stock and bad or doubtful debts, and so on, the investor can be misled unless all companies adopt, for one particular set of figures, the same basis. (By all means let any company make further adjustments to the profits and assets in the light of what it considers necessary or desirable. These adjusted figures form an additional set of figures.) To ensure true comparability, then, companies should adopt the same accounting basis. This is an ideal situation, and is not completely practical. But there is one set of figures which is more comparable than any other, and that is the figures sent to the Taxation Commissioner. (They may be altered by him, but any adjustments should be shown in the next set of figures.) In the United States all company taxation returns are on file in Washington, and can be inspected by anyone. There is no reason at all why taxation return figures should not be disclosed, and many reasons why they should be.

Every skilled investment analyst has the problem of trying to get comparability between companies on the basis of insufficient information. He has difficulty. How much more has the ordinary private investor?

As a practical solution, the prospectus and ordinary company accounts should contain two sets of figures, one on the basis of the taxation return and one on the basis of what the auditor and directors consider is necessary or desirable. No more work than now is required, because both sets of figures are available in every company.

Certain Special Features in Company Accounts

Most company operations are short-term, but others run for a longer period. For example, a hire-purchase company may lend over a period of two years, and sometimes up to as long as 10 years. Goods may be purchased with the object of being sold over the next few months, but some may, perhaps inadvertently, be held for some years. Debts for goods sold may be on a monthly account basis, but some may take years to settle one way or the other. Contracts for work done, roads, houses, development projects of all kinds, may take years to complete, and until the work is completed final profit may not be known.

It follows that in all these examples—and a specific list would probably run into hundreds—a company, at the end of each financial year, has to (or should) make an estimate of the total profit from a particular transaction and how much of it has accrued at that time.

A great many company failures are the result of, in the first place, reasonably correct estimates not having been made before ever these longer-term transactions were entered into, and, in the second place, reasonably correct estimates not having been made during the course of these transactions.

Governments in all countries have recognised the necessity for these
reasonably correct estimates for the life assurance industry, and have set up special legislation to ensure this reasonably correct valuation.

Between the cash type transaction and the long-term type transaction of the life assurance office there is a grey area which badly needs investigation. Over the past few years, largely because of instalment credit, this grey area has become much larger.

Professionally and traditionally, the cash type transaction has been in the accountant's field and the longer-term type is the actuary's. By default, the grey area is anybody's, and this is certainly the area where the company troubles of recent years have occurred.

They will keep on occurring unless this problem of estimate and valuation is squarely met. No amount of restrictive company legislation along the lines of recent years will have any effect, because the true problem hasn't been properly recognised, and consequently no solution put forward.

There are three types of experts who may all be needed to deal with the problem—not separately, but in consultation with each other. The first is the company expert who knows the business, the second is the accountant, and the third is the actuary who is used to dealing with contingencies based on probabilities and the financial discounting involved.

Coming to practical politics. I suggest that all transactions at the end of a financial year which have over a year to go before completion and all transactions at the end of a financial year which have not been completed (designedly or inadvertently) within the last year, should be the subject of a special certificate of valuation. By "all transactions" is not meant "each individual transaction" (unless special circumstances such as the large size of a single transaction is involved) but valuation in broad groups by type of transaction and period. It is certainly not sufficient for this certificate to be given by, for example, the managing director. Valuation experts should be employed, and these experts should have the necessary professional qualifications.

I feel I have only touched on the fringe of this problem. Nevertheless, it is the big problem which demands the gravest consideration because, given normal honesty in business, its solution would give far greater protection to investors than now, and might well have the side-effect of making unnecessary—because useless—some of existing company legislation.

**Asset Re-valuation**

Apart from the "grey area" referred to above, many companies re-value their assets (in particular land and buildings) from time to time, and usually at the time of a company flotation.

The trouble, once again, is that investors are not properly able to compare one company with another because the basis of asset valuation is not consistent. The whole purpose of publishing prospectus figures is to enable the prospective investor to make comparisons. Unless he can make proper comparison, he is not being properly protected. At all times he has a choice of investment, and an essential element is comparison. Absolute figures by themselves are useless.

As with profit figures the solution is to insist both in prospectus and ordinary company accounts issued to shareholders, on two sets of figures, one based on taxation returns (which implicitly boils down to historical cost less depreciation as laid down by the Taxation Department) and one based on those figures adjusted as the auditor and directors consider necessary or desirable.

**What Does the Company Do?**

The prospectus usually contains some vague reference to the company's activities. They may be referred to as engineers (which is as vague as can be), or heating engineers (which is still vague), or as engineers specialising in a particular size electrical unit for home-heating by oil purposes (which is better), or they may really go into detail. A company's activities may cover a broad range, with no indication (or even worse, misleading indication) of the company's main or large profit earning areas.

What the prospective investor wishes to know is how he can relate the business of the company with statistical information released by the Commonwealth Statistical Department and any other Government Departments, information contained in trade journals, and special research studies by individuals or universities.

If, somehow or other, these can be tied together, the investor would be further protected.

**Use of Money Raised by Issue**

A company must know, after vendors are paid off, how the balance of money from the issue is going to be used. Vague phrases such as "for the expansion of the business" are the usual order of the day.

First of all, the precise amount of extra working capital should be stated.

Secondly, some precision should be required about its expected use. If it is to be used to pay off loans, this should be stated. If it is to be used to enlarge existing factories, put up extra factories, or buy more plant for its traditional activities, this should be said. (Figures such as factory space will be increased from "x" square feet to "y" square feet are desirable.) If the money is to be used for purposes other than traditional activities, then a very great deal of detail should be insisted upon, because there are plenty of examples where successful companies in one line of business have been brought to ruin by embarking upon other lines of business far removed from the original.

To summarise section (b):

Details of

(1) Capital structure and "gear-
(2) Details of management as guide to quality.
(3) Earnings and shareholders' funds, with ratio, for last five years and one-year forecast.
(4) Two sets of figures, for profits and assets, one derived from taxation returns, and the other as company thinks fit.
(5) Special valuation for designed and inadvertent transactions over a period longer than one year.
(6) Company activities tied to industry figures.
(7) Specific proposed use for money raised by issue.

(c) Issues by entirely new companies

New manufacturing companies are almost non-existent, except to the extent that they are developments of overseas companies. Finance companies are sometimes formed as off-shoots of existing companies.

This leaves new companies almost exclusively in the mining and oil exploration fields. These issues are highly speculative, lead to the occasional fortune, but usually result in the long-term holder losing most of his money.

Because luck can play such a large part, the great difficulty is to distinguish between the sound and unsound issue. By “sound” I mean the issue where a genuine attempt will be made to develop Australia's natural resources, and by “unsound” I mean an issue where the promoters “couldn’t care less”, provided large initial sums and income flow to them personally from the issue.

These issues are like taking tickets in a lottery, and the curious thing is that the Government, by its taxation concessions, underwrites, so to speak, both the “sound” and “unsound” issues. It is not as if these issues involve small sums of money. Currently, oil exploration issues are being made to bring in far more money (many millions of dollars) than almost all the industrial company flotations of the last year or so.

I stress the word “new”. There are a number of highly regarded mining companies, etc., which are new in the sense of listing being sought, but which have established a viable enterprise before doing so. (These issues would be included in section (b) above.)

In view of the almost certain future demise of the “unsound” companies, how do you stop people investing in them? Full prospectus disclosure, certainly, but I can’t help feeling that even more important would be informed and published press opinion. I have been told, but can’t check on its accuracy, that financial editors are not allowed to write a critical column devoted to new issues, as is done overseas. I understand that the reason, and again I can’t check, is for fear of a libel suit being brought against the newspaper in the event of a damaging critique to the issue being made. If this is accurate, the best way of giving protection to the investing public would be to allow the press full freedom to publish judgments on all new issues, with recommendations, hedged about with reservations about the type of investor in mind, to invest or not to invest. In time, such judgments would come to be highly regarded from some newspapers, and perhaps not so highly from others. It does mean that newspapers, in order to provide such judgments, would have to employ highly skilled and informed people, either full time or in a consultative capacity. Such judgments should deal not only with the possibility of a quick “stag” profit, but also take a longer view.

Sharebrokers and other people near to the market should also be allowed to express opinions, without repercussions.

Otherwise, I see little hope of the ordinary private investor forming any worthwhile view on a subject so complicated and esoteric as mining and oil exploration.

Perhaps two suggestions might help. The first is to legislate against the simultaneous issue of shares and options. It is well known that the issue of options is a “sweetener”. Options appeal to gambling instincts. The second is to legislate against partly paid shares. In boom markets, the lure of a 20% paid share can be well-nigh irresistible to those used to seeing these shares open in the market at very high premiums. If more money is later required, let there be further issues, when more information is available.

It could be argued that it is only every five years or so that market conditions are favourable for the type of issue being considered, and that if some of the gambling appeal is taken away it will be more difficult to raise money for Australia’s natural resources development. This argument may well have had force in former days when companies of this type were the only means of raising money for mining development, but I am somewhat doubtful if this is true today. If all the mining and oil exploration successes of recent years are considered, it will be found that the companies concerned are not “new” in the sense under discussion.

It is the “little man” who gets hurt. How to protect him? The information suggested in section (b) should be sought, but in place of past years’ profits, etc., which are not available, the following could be helpful and revealing: Show the financial and stock exchange record (distributions, initial and current prices, etc.) of all companies with which the directors, underwriter and brokers were involved. At least the prospective investor would know what had happened to past issues. The inference he would draw might or might not be correct. The facts are simple enough to provide.

To summarise section (c):

(1) Full freedom to press, sharebrokers, etc., to pass judgment.
(2) Fully paid shares only to be issued. No options. No partly paid shares.
(3) Financial and stock exchange records of companies connected with promoters, etc., to be given.
Debentures, Unsecured Notes, Deposits to be Listed

The great bulk of these issues are by hire-purchase or finance companies, or companies dealing with developmental projects where real property of some kind is held. An increasing number of fixed-interest issues are also being made by some of Australia's largest companies.

The Reserve Bank's publication "Flow of Funds, Australia" shows what persons and unincorporated enterprises invested in debentures, notes and deposits as one group, and preference and ordinary (mainly ordinary) shares as another group as follows:

<table>
<thead>
<tr>
<th>Year to June 30</th>
<th>Debentures, Notes, Deposits</th>
<th>Pref. and Ordinary Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954</td>
<td>$22 million</td>
<td>$86 million</td>
</tr>
<tr>
<td>1955</td>
<td>18 million</td>
<td>132 million</td>
</tr>
<tr>
<td>1956</td>
<td>80 million</td>
<td>98 million</td>
</tr>
<tr>
<td>1957</td>
<td>96 million</td>
<td>54 million</td>
</tr>
<tr>
<td>1958</td>
<td>104 million</td>
<td>14 million</td>
</tr>
<tr>
<td>1959</td>
<td>200 million</td>
<td>4 million</td>
</tr>
<tr>
<td>1960</td>
<td>320 million</td>
<td>-62 million</td>
</tr>
<tr>
<td>1961</td>
<td>164 (154) million</td>
<td>10 (20) million</td>
</tr>
<tr>
<td>1962</td>
<td>76 (75) million</td>
<td>58 (56) million</td>
</tr>
<tr>
<td>1963</td>
<td>156 (157) million</td>
<td>-105 (-105) million</td>
</tr>
<tr>
<td>1964</td>
<td>129 (134) million</td>
<td>57 (57) million</td>
</tr>
<tr>
<td>1965</td>
<td>108 (83) million</td>
<td>44 (78) million</td>
</tr>
<tr>
<td>1966</td>
<td>43 million</td>
<td>81 million</td>
</tr>
</tbody>
</table>

(Bracketed figures are those shown in December, 1966, Supplement.)
(Later unbracketed figures are those shown in January, 1968, Supplement.)

For "persons and unincorporated enterprises" the fixed-interest group has grown both in absolute figures, and relatively to the shares group. Probably some of the notes included up to 1960 were of the convertible note class, and more truly should have been included in the Share group. Most of the debenture, etc., group would be new issues, whereas the Share group would be mainly existing shares. It follows that from the point of view of fund raising and prospectuses and the private investor, the fixed-interest group may need to be reviewed in the light of, for example, the provisions of the 1961 (Victorian) Companies Act and the 1963 (Victorian) Companies (Public Borrowings) Act.

So far as fraud, misrepresentation, or laxity is concerned, the provisions of the Act as they stand go a long, long way. It might be held that in some respects they go too far in this direction, in putting obstacles in the way of reputable borrowers. On the other hand, so far as safety resulting from the normal conduct of a business is concerned, the Act achieves little.

Basically the Act provides for a Trustee and Trust Deed because a holder of fixed-interest capital has no vote or say in the affairs of the company. By far the simplest way of giving him protection is to let him have this vote, and to lay it upon directors that they must protect his interests as well as those of shareholders. If it is argued that this is not the reason that legislation is required to give him "safety", how much more so is "safety" required for the shareholder. Why shouldn't the shareholder have a Trust Deed and Trustees? If it is held that the interests of fixed-interest holders and shareholders are opposed, the same argument (except for votes) can be applied as between preference and ordinary shareholders.

If it is still maintained that fixed-interest holders and shareholders need two different sets of people to look after their interests, it would still be possible to appoint fixed-interest directors and share directors. These fixed-interest directors (appointed by fixed-interest holders) would be far closer to the company's activities than ever any Trustee company would. They would have all the rights and privileges of share directors—attendance at board meetings, access to all accounts and activities and executives at all times—and not only be in a position to look at possible fraud, misrepresentation, and laxity, but also to consider the underlying financial safety of the company's fixed-interest obligations. They would make a separate report to fixed-interest holders, and could be given necessary legal powers to apply to the Court, etc.

As the Act stands, a Trustee can normally only come from three classes of company. It is doubtful if the Minister would consider any other company. What is the position if a company cannot find a Trustee on financial and other terms suitable to itself? Has it any redress, or is it forced to accede to punitive demands? Could not a wider choice of company be given? Better still, make the ordinary directors trustees, or appoint a special class of fixed-interest directors, as outlined above.

Under the Act, the Trustee has the heavy responsibility of making application to the Minister for an order if at any time the Trustee is of the opinion the company's assets are insufficient, or likely to become insufficient, to discharge the loan. I am somewhat doubtful of the ability of some Trustees to act as fast as is desirable, firstly because statutory information perforce is somewhat out of date, secondly because a lot of financial and technical expertise may be required, and thirdly because discussions with the company may go on too long a time.

The Trust Deed has to be lodged with the Registrar, but presumably does not require his approval. (For "interests", including Unit Trusts, approval is required by the Registrar, so that unnecessary and undesirable discrimination is currently—but not prospectively, it is hoped—being applied against Unit Trusts.)

The underlying safety of debentures, notes, and deposits depends on the earnings and assets. This underlying safety varies a great deal, depending mainly on two things—the amount of shareholders' funds in relation to loan funds, and the variability of earnings arising out of the nature of the business. This, quite apart from quality of management. For example, given the same type and size of business, a loan where the interest is covered twice by earnings and the loan capital is covered twice by assets would not be considered so safe as one covered thrice by earnings and thrice by assets. A
Higher rate of interest on the twice covered might compensate for this lower safety. On the other hand, if the company with the thrice covered loan had powers to borrow further in the same class of security so that it could arrive at a position when the loan might later be covered only 1.1 times (purely as the result of further loan borrowing), the position would be very different.

There is nothing in the Act, so far as I can see, to stop a company borrowing more than is prudent. Where a prudent man would draw the line necessarily differs according to circumstances, but what I suggest is strongly desirable is that prospectus figures should be in set form, so that immediate comparisons between different years and other companies could be made at a glance. Such figures should also show the estimated position if maximum powers of borrowing were exercised.

Universal, in the course of its investment research, records the ratio of earnings on ordinary shareholders' funds to total earnings on the total of loan funds and preference and ordinary shareholders' funds. For the largest 600 non-mining companies the latest figures are:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Number</th>
<th>Approx. “all times interest cover” for loan funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 9</td>
<td>2</td>
<td>1.1</td>
</tr>
<tr>
<td>10 - 19</td>
<td>14</td>
<td>1.2</td>
</tr>
<tr>
<td>20 - 29</td>
<td>4</td>
<td>1.3</td>
</tr>
<tr>
<td>30 - 39</td>
<td>13</td>
<td>1.5</td>
</tr>
<tr>
<td>40 - 49</td>
<td>13</td>
<td>1.8</td>
</tr>
<tr>
<td>0 - 49</td>
<td>46</td>
<td></td>
</tr>
<tr>
<td>50-100</td>
<td>534</td>
<td>2.0 or greater</td>
</tr>
<tr>
<td>Total</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

The proper way to show the “cover” for a fixed-interest investment is to use either the “priority percentage” method, or the “all times cover” method. An illustration is as follows:

- Total earnings before tax: $100,000
- Interest on Fixed Interest: $50,000
- Security Priority 1: $10,000
- Security Priority 2: $30,000

The same comment applies to Preference Shares. The base should be earnings before any interest or dividend deduction.

A table for assets would also show the position under either the “priority percentage” method, or the “all times cover” method.

All interest-bearing liabilities (including the very special case where the loan carries a nil interest rate), including bank overdrafts, should be shown in the tables, regardless of the particular loan being issued.

As indicated above, a most important part of the underlying safety is the possible effect of powers being held to issue more of a security ranking either in priority or equality. The only real way in which this can be brought home to the prospective investor is to give illustrative figures, based on the assumption that these powers will be exercised. A difficulty arises because it is not known what the additional money raised would bring in earnings. A possible practical way would be to assume that the additional money would earn (net of expenses) the same or not very different rate as that on the loan, unless the rate was very low or very high. This difficulty applies only to interest “cover”, not asset “cover”.

A nice point arises over the question of different maturity dates for loans. Consider two 10-year loans, one with a few months to maturity with first priority, and the second now about to be issued with second priority. In the absence of information, a prospective investor might reasonably feel that this second priority issue would become the first priority on maturity of the issue with but a few months to repayment. It may or may not. What powers does the company have to make a cash or conversion issue on the first priority issue? Can it, for example, make the maturity date before that of the issue now being made? Can it, because the Trust Deed is no longer applicable, increase the size of the loan to any extent it wishes? In other words, can the safety of any new issue be later affected by company action on further issues of any kind? Unless the prospectus goes fully into these contingencies, the investor is not being properly protected.

In discussing ordinary shares, I referred to the real need for two sets of earnings and assets figures—taxation return and company adjusted. The same remarks apply to fixed-interest securities.

Similarly, last five years’ figures are required plus at least a one-year forecast.

I am not sure how completely current legislation deals with the holding company and its subsidiaries. The ideal position is that loans of all kinds are made only to the holding company (which may also have normal business activities), and that the earnings and assets of all subsidiaries are made available for these loans, as if, in fact, there were one company only.

To summarise this section (including some from other sections):

1. Full freedom to press, sharebroker, etc., to pass judgment.
2. Give fixed-interest holders a vote and/or appoint fixed-interest directors, or widen Trustee choice.
3. Details of management as guide to quality.
4. Earnings and assets, with priority percentages, or all-times cover.
5. Two sets of figures, for earnings and assets, one derived from taxation returns, and the other as company thinks fit.
6. Company activities tied to industry figures.
7. Specific proposed use for money raised by issue.
8. Earnings and assets, based on assumption that powers held were exercised, including position arising on maturity of any issue.
Market Prospects of Listed New Issues

In the course of our investment researches we analyse the largest 600 industrial companies listed on the Stock Exchange, recording the income plus capital movement (up or down) in a year as a percentage of the market price at the beginning of the year. In a typical year, taking 100 as the average, the best performed share rises to 200 and the worst performed share falls to 20. There may be a 100% gain. There may also be an 80% loss.

It is just not realised how risky an investment in a single company share can be. And the risk is not confined to small companies. In these 600 companies the smallest shareholders' funds are nearly $2 million. Even the shares of a company like B.H.P., the largest in Australia (the shares account for 10 to 20% of company share market capitalisation), can cause a buyer very considerable loss. From a peak in 1968 of 25.60 to a low in 1969 of 15.55, the fall in price was 39%, and if brokerage and stamp duty is taken into consideration, as it should be, the loss is 43%.

Suppose the very rare bird is considered who invests in 50 companies. It might be thought that this would iron out the gains and losses. Not necessarily so. In the 600 companies, in a single year, the top 50 companies show a gain of 57% over the average performance, and the bottom 50 show a loss of 41%.

It is inevitable that in the light of these figures a great many individual share investors show poor—even disastrous—results.

What applies to ordinary industrial shares listed on the market still applies to some degree in single company debentures, notes and deposits, and to a much greater degree in mining and oil exploration shares.

If single share investments, or two or three, or even up to 50, are considered, it can be seen that share investment is a very risky business. Every prospectus should contain such a statement, leaving the prospective investor in no doubt that he can lose a lot of money as well as gain a lot of money. It is of little use to quote share indices because these are based either on a large number of companies, or a lower number of the largest companies. In statistical terms, the dispersion from the mean is wide. The institutional investor, which invests over a large number of companies, has much greater prospects of achieving the long-term average gain which studies show has happened in the past.

So far as fixed-interest investments are concerned, there can be no gain in the capital at maturity, and there may be losses. In every fixed-interest investment the risk of loss before or at maturity exists. As a listed issue, there may be a capital gain or loss on sale before maturity—also payment of selling commission and stamp duty—depending on the results of the company and the course of interest rates—the greater the currency of the loan, the greater the variation in price. (Even Commonwealth Government loans at one time showed a heavy discount on par.) There is also the fact that the turnover in the market is very small (much smaller than non-mining turnover which itself averages only 4% every year of total shares on issue), which can lead to delay in selling and maybe a reduction in price from the nominal market price.

If only one fixed-interest investment is held, and there is default, this often means disaster for those who can ill-afford it. There is relative safety in numbers, but this makes only more probable some loss, but a smaller loss on average. Every prospectus should contain the statement that the prospect of loss before or at maturity exists, and that a loss as well as a gain is possible on sale in the market.

Unlisted Issues

The great defect of the normal unlisted investment is the lack of a market. Depending on the type of investment, the sale price for a “willing seller” might be anything up to 50% discount on the sale price of a comparable listed investment. This would not apply to a fixed-interest investment maturing in a reasonably short period of time.

Nor would it apply where there is a guarantee that some person or some company would buy the unlisted investment on a prescribed basis of value within a limited period of time. This guarantee has to be a real one, backed by independent liquid funds and/or by overdraft facilities and/or by assets behind the investment which can be easily realised.

Any prospectus of the unlisted investment should therefore carry:

1. The warnings suggested above for listed investments.
2. The warning that there is no Stock Exchange market; and/or
3. A guarantee with teeth in it in substitution for a Stock Exchange market.

No public issue should be allowed without these provisions.

Advertising

If the suggestions in these notes were adopted, particularly those relating to the unlisted investment, I see no reason why advertising should not be allowed in any form the promoters wish—always subject to there being penalties for fraud or misrepresentation.

It is the prospectus and accompanying application form which governs the situation, not the advertisement.

There is an old saying about investment selling which has merit—“freedom with publicity”. State the facts, state the risks as well as the possible gains, state them in no uncertain language, make the penalties for fraud or misrepresentation as stiff as for stealing, but otherwise allow investment to be sold, because, after all, productive investment makes for the betterment of the community, whereas in gambling, for example, which is, unfortunately, actively encouraged, the winner can win only what the loser loses—after deduction of expenses and taxes. 22nd May, 1969.