

A CRITIQUE OF ISSUES OF INTEREST

by "RIO DE ORO"

ADAPS HOLDINGS LIMITED

Issue

Public offer of 450,000 ordinary shares of 50c each, at \$1.00 per share payable in full on application, in terms of a Prospectus dated 7/11/69. The issue was underwritten and fully subscribed, and arrangements made for listing on Melbourne and Sydney stock exchanges.

Background

The Company is newly incorporated in Victoria, having been formed to acquire a computer software and service group, Adaps Pty. Ltd. and Magtape Services Pty. Ltd. As at 30/6/69 this group had, according to its unaudited but "tested" accounts, net tangible assets of \$80,376 (following a loss of \$87,080 in the year ending on that day) but the consideration to the vendors comprised —

- (1) The allotment of 1,049,998 fully paid ordinary shares at par, with a nominal value of \$524,999, and
- (2) The grant of assignable options over a further 80,000 shares at an exercise price of \$2.00 per share and exercisable up to 15/10/74.

In addition options over a further 75,000 shares, at an exercise price of \$1.00 per share but also assignable and exercisable up to 15/10/74, have been granted to interested parties for a total consideration of \$8.

Comment

If the issue price of \$1.00 be taken as the pre-listing value of shares in the knowledge of the dilution by options, the then commercial value of each option exercisable at \$1.00 would, according to Graham, Dodd & Cottle's "Security Analysis", be about 40c to 60c per share. On the more sophisticated basis discussed in the June 1969 issue of the Journal, the commercial value per share option would be 37c, 81c or \$1.25, at antici-

pated opening share prices of \$1.00, \$1.50 and \$2.00 respectively, with 37c as the corresponding commercial value per share option in this range of anticipated opening prices for options with an exercise price of \$2.00. In a state of pre-listing ignorance, perhaps 75c and 37c would be fair commercial values of the options exercisable at \$1.00 and \$2.00 respectively.

The effect of the grant of the options is that the real consideration for the original net tangible assets of \$80,376 (from which a forecast loss in 1969/70 could be deducted) is greater than the \$1,049,998 that the consideration shares alone would be worth at the public issue price of \$1.00 per share. An amount of approximately \$1,000,000 has seemingly been paid for the existing group's organization and goodwill, in a very competitive field where losses are currently being made and where it is relatively easy for new competitors to arise. If our experience follows that of North America we will soon have a large number of computer software and service companies enjoying very mixed results in a general state of stock market euphoria.

The net tangible asset backing per share after the public issue at \$1.00 per share is only 24c per share. This figure excludes the "deferred asset" formed by capitalizing certain expenditure on programs, etc.; the investigating accountants have verified the existence of this asset to the best of their ability but advise that firm contracts with customers assure only "some" of the future earnings needed for its full recovery.

The grant of options for a nominal consideration is a cost to shareholders. At the abovementioned figure of 75c per share option, the pre-listing commercial value of the 76,000 options exercisable at \$1.00 per share would

be \$57,000, an excess of \$56,992 over the total consideration of \$8. As in the case of the Silverton issue of shares discussed in the September issue of the Journal, there could be problems relating to stamp duties, turnover tax and even gift duties in this issue of options at below their apparent commercial value. This, however, is of minor importance in relation to the amount being paid for goodwill, whatever the opening share price may be.

— 21st November, 1969.

By way of postscript it can now be added that the last sales on the opening day of share trading, 27/11/69, were at \$2.30 in Sydney and \$2.25 in Melbourne, the day's turnovers being 15,600 and 12,000 shares respectively. As compared with a net tangible asset backing per share of 24c (to be reduced by current year's losses to date) the market price appears somewhat naive for an industry of easy entry and severe competition. The influence of that Texan in the notorious "Fortune" article has ranged far afield!

McPHERSON'S LIMITED

Issue

Private placement of 4,250,000 stock units of nominal value of 50c each with The Broken Hill Proprietary Company Limited in exchange for 200,000 of the latter's shares of nominal value of \$2 each. The announcement of the issue was made on 5/11/69, but the terms of issue to be used for accounting and fiscal purposes were not advised.

Background

McPherson's is a distributor of B.H.P. steel and its Chairman is a director of that company. The industry is in a disturbed position generally, on the one hand because of the intended entry of new steel producers and on the other because of the realignments of steel distribu-

tors now in progress. McPherson's itself was in course of acquiring another steel merchant whilst an associate of B.H.P. recently acquired an interest in a further steel merchant to prevent its take-over by still another steel merchant.

The announcement stated: "McPherson's Ltd. apart from being important steel distributors are also large users of steel in the manufacturing field particularly in the faster industry. The exchange of shares referred to above will serve to strengthen the existing relationships between the two companies." Commercial circles immediately accepted the "exchange of shares" as a typical "share swap" designed to prevent McPherson's shareholders selling their shares to a take-over offerer. Outstanding shares can only be compulsorily acquired if not less than 90% of total shares have been acquired, and possession by B.H.P. of 10% of McPherson's capital could therefore inhibit any offer being made even if likely to be viewed favourably by the holders of a great majority of McPherson's shares.

Comment

This comment is not directed to the issue in its relationship to the business of steel distribution but to the issue as an example of the "share swap" arranged by directors of a company without reference to shareholders for their approval or otherwise. Whatever advantages may be thought to flow from such an arrangement, in normal circumstances there is an immediate fall in market prices of shares because the possibility of receiving a relatively high cash offer on take-over has been reduced. Many factors enter into the determination of prices in a free securities market and this is only one of them, but it may be important to some shareholders and potential shareholders.

The position of McPherson's Limited is complicated by its concurrent take-over of Dawborn Steels Ltd., and the following figures are based on McPherson's financial position as at 30/6/69 in order to illustrate the effect of the B.H.P. share swap without regard to the Dawborn and any other capital dealings since 30/6/69.

Net Tangible Assets as at 30/6/69	\$36,803,608
Number of Ordinary Shares (50c units)	35,661,508
Net Tangible Assets per share	\$1.03217
1968/69 Earnings per share	\$0.05569
1968/69 Dividends per share	\$0.04167
Number of Shares issued to B.H.P.	4,250,000
Number of B.H.P. Shares acquired	200,000
Necessary B.H.P. Values for Unaltered McP. Values—	
Net Tangible Assets per Share	\$21.934
Earning Rate per Share	\$ 1.183
Dividend Rate per Share	\$ 0.885

In actual fact B.H.P.'s net tangible asset backing per share based on its book value is only \$6.31, but even if the current market value of about \$14 to \$15 per share was to be treated as a tangible asset value the net tangible asset backing per McPherson share would still decline as a result of the share swap. Present earnings per B.H.P. share are much less than the above necessary figure but this is of much less importance than the present dividend rate of \$0.210 per share. Whatever views may be held as to the future course of B.H.P. dividend rates there is an immediate problem for McPherson's. At present levels B.H.P. dividends will

provide less than one-quarter of what is required to maintain McPherson's rate, and this in a situation where the latter's dividend cover is low. It is primarily in this area where public criticism has, very properly, been directed against the share swap.

Criticism has not, however, been limited to the arithmetic of the case but more than any other recent example it has drawn attention to the illogicalities and undesirable features of share swaps and has hastened the likelihood of legislative protection to shareholders.

— 1st December, 1969.

CORRECTION

In the September issue of the Journal a letter headed "Accounting for Inflation" was shown as signed by F. J. Finn, B. Com., A.A.S.A. (Senior), Lecturer in Accountancy, Melbourne. This should have read "Lecturer in Accountancy, University of Queensland, Brisbane."

ADVERTISING

The Society is interested in promoting advertising in this journal. Any member with positive suggestions in this regard is invited to contact the Secretary/Treasurer, Box 5085, G.P.O., Sydney.

PACIFIC INCOME FUND

Issue

In terms of a Prospectus dated 28/10/69 this Company, which has been incorporated as an unlimited company with the result that there is no limit on the personal liability of each shareholder, has offered shares of unspecified denomination at an initial selling price of 50 cents per share. The amount of the issue and even the authorized capital of the Company are not stated in the Prospectus, and the issue is not underwritten. There is no reference to listing or otherwise on stock exchanges, but shares in an unlimited liability company do not come within the rules for listing.

Background

Several unlimited liability companies have recently been incorporated in Australia to act as investment media for the public. Normal companies receive two material statutory benefits, incorporation and limited liability. The latter benefit involves a relative rigidity of capital structure; capital cannot be reduced at will, and listing on a stock exchange means that realisation value is determined directly by market forces. An unlimited liability company is not listable and therefore does not have to meet stock exchange listing requirements, it is not quite so subject to critical observation so that its controllers have a somewhat freer hand, its capital may be increased or decreased at will, and the buying and selling of shares is almost wholly in the hands of its controllers and not of member firms of stock exchanges.

Investment media may be formed as unit trusts, e.g., the recently formed Fund of Australia. As compared with a unit trust, an unlimited liability company can withhold distribution of earnings and has the advantage of incorporation. Apart from Pacific Income Fund, recent examples of this form are Australian Mutual Growth Fund, The

Australian Fund of Funds and Option Traders Income Fund Inc. Their main disadvantages are a greater present liability to income tax and, of course, the unlimited liability.

The incidence of the personal unlimited liability can be modified by restricting the powers of the Company through the Memorandum or the powers of the Directors through the Articles of Association. Theoretically there can be limitations on powers of investment and restrictions on powers of borrowing, so that the likelihood of shareholders being called upon to meet company liabilities is reduced. It is understood that no company in New South Wales has been declared to be an investment company and therefore made subject to statutory restrictions upon its investments; it is also understood that in some cases in New South Wales an undertaking has been sought and obtained, at the time of registration, with much the same effect but without publicity.

Comment

The Prospectus of the Pacific Income Fund does not report any restrictions upon borrowing powers or investment powers, whether arising out of the constitution of the Company or through an undertaking given to the Registrar of Companies. Moneys in the Fund are to be used to purchase shares in listed companies and "to underwrite options on certain stock, as decided by the management". The Fund is to be managed by Montgomery, Hughes Pty. Ltd., a firm of Stock and Share Option Brokers, which is to be remunerated by quarterly fees totalling $\frac{1}{2}\%$ per annum on the Fund and to be entitled to retain brokerage and commission for acting as brokers.

As well as lack of any reference to authorized capital, par value of shares and amount of the issue, the Prospectus does not refer to the personal responsibility of shareholders for any company debts. The only reference to unlimited liability is in one sentence on page 5 — "The Pacific Income Fund is incorporated as an unlimited company

and is thus able at any time to repay capital by directors' resolution." However, all citizens are presumed to know the law, and the definition in Section 5 of the uniform companies acts is quite clear — "Unlimited company" means a company formed on the principle of having no limit placed on the liability of its members. An applicant for shares agrees in writing "to be bound by the Memorandum and Articles of Association of Pacific Income Fund" and paragraph 19 of the Additional Statutory Information does say that these (along with copies of the Management Agreement and the N.S.W. Companies Act) may be inspected during business hours at the registered office of the Company. Nevertheless, some applicants in this and other funds may not appreciate the nature of their personal liability.

Buying and selling prices need to be examined carefully in all such investment media. In this case the Directors can add up to 8% to the calculated net asset value per share for service expenses and purchase charges in arriving at a sale price to the public; selling and redemption prices per share are adjusted to the nearest cent **above** and nearest cent **below** respectively, resulting in an average additional charge of about 1% on both selling and buying. The various unlimited liability companies vary between themselves in such details.

Whilst unit trusts are required to have an approved trustee to hold investments, there is no statutory requirement in respect of an investment medium in the form of an unlimited liability company. Being incorporated, whether or not it has "Incorporated" or "Inc." in its name, it can conveniently hold securities in its own name; on the other hand the use of a custodian trustee would avoid publicity as to shareholdings. Whilst The Australian Fund of Funds uses a custodian trustee the Pacific Income Fund apparently does not.

— 12th December, 1969.