SECOND BOARD FUNDING — THE GROWING ALTERNATIVE

by

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The development of the Second Board markets in Australia has heralded an entrepreneurial surge in Australia while providing investors with strong, and sometimes spectacular returns.

The pace of growth, as detailed later in this article, has surprised even the most optimistic believers in the Second Board (including the writers) and exposed the regulatory environment to increased competitiveness amongst the States, workload pressures and calls for reform.

Given Australia's current economic problems, ASBC is concerned that any review of the controls over fund raising by smaller growth oriented companies should:

- have a *primary* aim of encouraging appropriate companies to expand within a balanced framework to ensure investors are adequately, but not overly, protected;
- examine closely what is happening in the market place at large rather than highlight isolated abuses or indulge in broad generalisations;
- understand the interaction between the alternative fund raising methods available including takeovers, private and public offers, main board and second board listings, secondary issues, company or trust structures and backdoor listings. The usual approach in the past has been to segment these areas from a regulatory viewpoint when in fact the corporate adviser is usually faced with the need to evaluate all these alternatives;
- understand the character of the investors in the market place.

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It is all too easy to criticise new concepts or successful initiatives in Australia. Generalised statements such as the following in a recent business magazine are common:

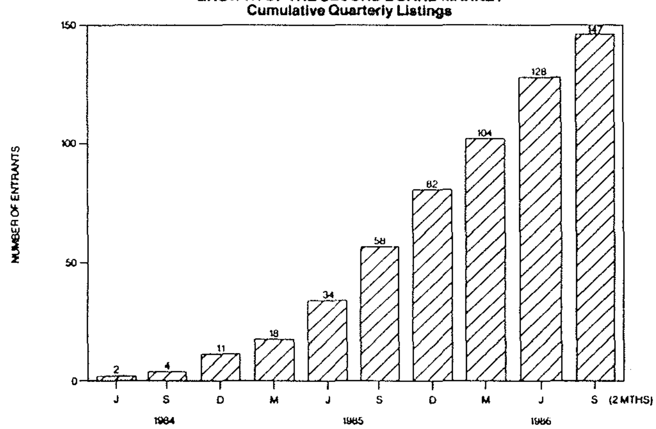
> ". . . . some of the second board listings have too much goodwill in their valuations and investors get taken for a ride."

Our detailed analysis of Second Board markets to date clearly indicates significantly above average investment performance has been achieved in what has often been described as a high risk market.

It is curious to note in these times of concern for greater disclosure and scrutiny by the Corporate Affairs Commissions that a majority of companies have listed on the Second Board without a registered prospectus yet have significantly outperformed those that were subjected to CAC scrutiny.

ASBC is currently undertaking an independent survey of the experiences of both regulators, professional

GRAPH 1
GROWTH OF THE SECOND BOARD MARKET
Cumulative Quarterly Listings



† ASBC is a specialist independent consultancy firm advising smaller companies on listing on the Stock Exchanges, and in particular the Second Board markets.

advisers and companies alike in relation to the listing process, the results of which will be submitted to the NCSC Prospectus Review Committee.

THE AUSTRALIAN SECOND BOARD EXPERIENCE

The development of the Second Board markets in Australia reflected a longstanding concern about the lack of sufficient equity finance available to small business. The well documented decline in the number of listed industrial companies in Australia during the 1970's and the early 1980's was viewed in part as evidence of a failure by the existing Stock Exchanges to cater for the financing requirements of small businesses.

The Campbell Committee, noting the decline with concern, identified a number of reasons for companies not listing. These included the possibility of loss of control through takeover, the inability of small companies to achieve the spread of ownership and the minimum capital requirements necessary for listing and the costs and complications of listing (Final Report, 1981, p 577).

Similar concerns had prompted the establishment of the Unlisted Securities Market ("USM") by the London Stock Exchange in November 1980. This enabled companies in the United Kingdom to be floated and traded without complying with the full requirements of listing. Consequently entry requirements were easier and cheaper than under a full listing.

A measure of the success of the introduction of the USM can be gauged by the rapid growth rate achieved. By November 1982, on the USM's second anniversary, there were 127 USM companies, capitalised at £674 million. However many pundits pessimistically pointed to the early dependence on oils and hi-tech stocks and predicted an end to both the pace of new entrants and the new market itself.

Three and a half years later, over 450 companies had been listed and the USM boasts a combined capitalisation of over £4.1 billion. The pace of USM entry shows no signs of slackening and the diversity of businesses attracted has resulted in a better balanced profile for the market.

While modelled on the USM, the Australian Second Board addressed the perceived problems of the Australian system. The principal features include the potential for differential voting rights (allowing the owners to maintain control), reduced shareholding spread and lower minimum capital requirements. In addition a company seeking entry does not require a profitable trading history.

THE GROWTH OF THE AUSTRALIAN SECOND BOARD

In the first twelve months that followed the opening of trading on the Perth Second Board, trading commenced in Melbourne, Adelaide and Sydney. By the first anniversary there were 34 companies listed, predominantly in Perth.

The second 12 months saw the rapid development of the Second Boards in the Eastern States and continued growth in Perth. By the second anniversary there had been 128 companies listed on the Second Boards around Australia. Throughout this period the pace of entry was consistently around two new entrants per week.

Since then that growth rate has continued unabated and by the end of August 1986, 147 companies had listed on the Second Boards. In addition, a number of applicants are being prepared now that June-end audited accounts are available.

An interesting development has been the decision by the Stock Exchanges to channel entrepreneurial investment companies through the Second Board markets. Recent examples include Battery Group, Brunckhorst Investments, Panfida, Natcorp Holdings, Corporate Development, Audant Investments and Eurolynx.

While the companies themselves are often without track records, the quality of management is outstanding covering some of the leading lights of the Australian corporate and investment world. In a parallel move, SPAL Management (led by Stephen Sedgman, one of Australia's most successful fund managers) has listed several managed investment vehicles specialising in both Australian and overseas equity markets.

The existing 147 entrants have already raised $396 million — comprising $270.8 million immediately prior to or at the time of listing and $125.2 million subsequently. The vendor interests totalled $291 million (based on the listing price).

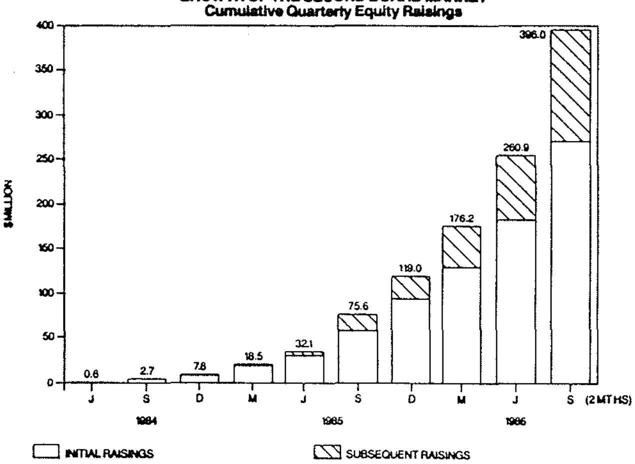
The combined capitalisation of all Second Board entrants exceeded $1 billion for the first time in August. The current capitalisation of the 147 companies of $1,170 million represents a premium of $483 million or a 70.3 per cent increase in market value.

Already nine companies (Betatene, Miniskips, Hugall & Hoile, TPS Group, MRSA, Pipercross, Finbar — formerly Lombardo Group, Access Technology and Century Holdings) have made the transition to the national Main Board. The successes of Miniskips and Hugall & Hoile have helped to focus investor attention on the Second Boards and to encourage others to follow. However the poor performance of several of the other "graduates" provides a salutary warning that a move to the Main Board is not in itself a panacea. A number of other Second Board companies have indicated their intention to transfer on the back of their next profit report.

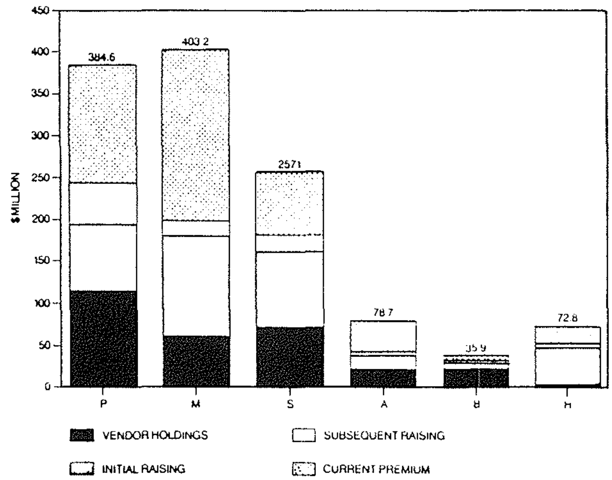
Perth continues to dominate in terms of companies listed reflecting the long head start allowed by the more conservative East Coast financial centres. However as Graph 3 shows, in terms of capitalisation, Melbourne is ahead (despite having only half as many companies) largely due to the substantial Current Premiums already achieved. The larger average size of the East Coast companies (reflected in both Initial Raisings and Vendor Holdings) is also a contributing factor.

Note also the relatively larger level of Subsequent Raisings for the Perth companies reflecting their longer public life and perhaps some initial under-capitalisation in order to facilitate listing.

GRAPH 2
GROWTH OF THE SECOND BOARD MARKET
Cumulative Quarterly Equity Raisings



GRAPH 3
PERFORMANCE BY EXCHANGE
Current Listings



STATE BREAKDOWN

The Second Board markets are separate and distinct trading boards in each state — unlike the Main Board which is a national market. However it is possible to list on more than one Second Board and of the 138 current Second Board companies, 31 are listed on more than one Board.

Table 1 : All Second Board Entrants — State Breakdown

Listings on Each Exchange

	SOLE	JOINT	TOTAL	TRANSFERRED	CURRENT
PERTH	62	12	74	(7)	67
SYDNEY	19	20	39	(1)	38
MELBOURNE	13	27	40	(2)	38
ADELAIDE	12	3	15	(1)	14
BRISBANE	8	2	10	0	10
HOBART	1	5	6	0	6

INVESTOR PERFORMANCE

Investors in the Second Board markets have generally fared well with some quite spectacular results. Of the 143 companies that have listed and traded at 31st August, 1986, almost one in three is currently trading at more than an 80 per cent premium to listing price, three-quarters are selling at or above their listing price, while one in eight is selling at a substantial discount (i.e. greater than 20 per cent discount to listing price). Two companies, Weber Drilling and Rendell Industries, were suspended although subsequent restructuring moves should see trading resume shortly.

In addition it should be remembered that some 95 per cent of all companies listed and traded on the Second Board markets have traded above the initial issue price at some stage since listing.

Of the more notable individual share price performances, no fewer than 35 companies have seen their

Table 2 : Share Performance Since Listing
All Second Board Entrants

80% + Increase	43	
40-80% Increase	14	
20-40% Increase	14	
0-20% Increase	38	109
As yet untraded		4
Fallen not more than 20%	14	
Fallen more than 20%	18	32
Suspended		2
		147

capitalisation double since listing and the best performers cover a wide range of activities.

Amongst the poorer performing stocks we find a preponderance of high-tech hopefuls that, to date, have failed to impress investors, while two other companies, Weber Drilling and Texaust Australia, provide services to the beleagured oil industry.

In commenting on the failure of some high-tech stocks, it should not be overlooked that 3 of the TOP 10 PERFORMERS are high-tech situations (Qlone, Circadian Pharmaceuticals and Sonartec). Indeed, of the 33 Second Board stocks currently categorised as high-tech, two-thirds are trading at a premium. The combined current capitalisation of $382 million represents a 130 per cent premium over the initial vendor holdings ($68.3 million) plus the $98.2 million raised from the public. This is greater than the 70.3 per cent premium recorded by *all* Second Board entrants and the 51.4 per cent premium recorded by the non high-tech Second Board entrants.

The Second Board high-tech experience is thus no different to what might be expected given the inherently greater risk-reward nature of such ventures and the relatively short time that these companies have been operating.

BREAKDOWN BY BUSINESS ACTIVITY

The composition of the Second Board has changed substantially over the last twelve months. The earlier emphasis on startup ventures and new technology companies has been replaced as the Second Board markets attract a wide range of businesses and develop a more balanced profile. This trend reflects both the continued development of the Second Board markets and the emergence of other capital markets, particularly the venture capital sector which includes the Management & Investment Companies ("MIC").

Promoters and companies seeking equity finance now have a broader range of alternatives and there is now a clearer delineation of the roles of the different capital markets. Public investors in Second Board stocks appear to have shown a lack of the necessary patience for startup ventures (with a few notable exceptions) and a healthy venture capital market has developed to fill that market niche. In turn the Second Board can provide a ready source of equity finance for more established businesses seeking to expand that may no longer qualify for venture capital funding. Similarly several of the original Second Board stocks have moved to the Main Board in order to raise larger sums of capital.

Among the established companies attracted to the Second Board are a number of service companies which tend to be too small to successfully maintain a Main Board listing and whose tangible asset backing (emphasised by traditional providers of finance) considerably understates the business's worth. The Second Board has proven an ideal compromise.

Similarly the current spate of investment companies has arisen because their lack of an established track record prevents listing on the Main Board while the low cost and speed of listing makes the Second Board a most effective fund-raising alternative. As these and other trends emerge, the Second Board can be seen to develop its own unique profile of business activity.

The analysis of business activity and relative weighting in Table 3 shows some dramatic shifts in the composition of the market as the weightings from an

Table 3 : Breakdown of Business Activity
All Second Board Entrants

SECTOR	NO. OF COMPANIES	MKT CAP $m	% OF TOTAL	WEIGHTING DEC 85
PRIMARY PRODUCTION	8	146.5	12.5	17.7
PROCESSING/METALS	6	79.1	6.8	6.7
CONSTRUCTION/ PROPERTY	10	37.0	3.2	7.8
BUILDING/INDUST'L MATS	2	1.4	0.1	0.0
ENGINEERING	22	110.0	9.4	10.8
ELECTRONICS/ ELECTRICALS	12	121.9	10.4	20.5
OFFICE EQUIPMENT	3	5.5	0.5	0.6
SERVICES	12	85.9	7.3	9.9
FINANCE & INVESTMENT	24	311.4	26.6	7.5
TOURISM & LEISURE	9	41.7	3.6	3.4
MEDIA & FILM	10	65.2	5.6	4.5
RETAIL	8	33.8	2.9	3.7
FOOD & BREWERS	6	12.7	1.1	0.8
HEALTH & HOUSEHOLD	8	78.6	6.7	5.1
MISCELLANEOUS	7	38.9	3.3	0.9
	147	$1,169.6m	100%	100%

earlier review (shown at the right hand side of the table).

The most notable features are the decline of the Electronics/Electrical sector (down from 20.5 per cent to 10.4 per cent) and the massive increase in the Finance & Investment sector (up from 7.5 per cent to 26.6 per cent). The Health & Household category (which covers some of the biotechnology companies) has shown good growth from 5.1 per cent to 6.7 per cent over a period of substantial growth in the overall market size.

PROFILE OF THE TYPICAL SECOND BOARD ENTRANT

As the Second Board markets develop and change to reflect investor interests and sentiment, the typical profile of the new entrants also changes. To see this, we have compared the Second Board listings in the first six months of 1985 with the new crop of entrants in the first six months of 1986.

Based on the comments below, we can construct a profile of the typical Second Board entrant as follows:

Typical Second Board Entrant

	First Half 1986	First Half 1985
Probable:		
Listing Place	Melbourne or Sydney	Perth
Type of Activity	Finance & Investment	Electronics/Engineering
Typical —		
amount raised	\$2-4 million	\$1 million
initial capitalisation	\$4-6 million	\$2-3 million
Method of listing	Prospectus	Information Memorandum
Range of —		
amount raised	\$0.0-\$14.2 million	\$0.1-\$6.5 million
initial capitalisation	\$0.13-\$19.9 million	\$0.3-\$9.1 million
High tech	One in seven	One in three

In the first six months of 1985, there were 23 additions to the Second Board markets including the first listings in Melbourne, Adelaide and Sydney. However, Perth remained the dominant force in the Australian Second Board marketplace and 18 (78 per cent) of the new listings were in Perth. 6 of the listings (26 per cent) were in Melbourne or Sydney. (Note there is some double counting as three companies listed on more than one exchange).

A total of \$22 million was raised from the public (average \$0.96 million) and the combined initial capitalisation was \$62.6 million (average \$2.72 million). Three out of four listings were via an Information Memorandum with only one in four listings by a prospectus offer to the public. The most common activities were Electronics (22 per cent), Engineering (17 per cent), Retail (13 per cent) and Services (13 per cent).

Investor interest in new technology was still strong at the time and not surprisingly, one in three of the new listings was a "high-tech" company. A total of \$7.8 million (35 per cent) was raised. At present 62 per cent of the entrants that have traded are at or above their listing prices.

In contrast, *in the first six months of 1986* there have been 44 additions with 20 of the listings (45 per cent) in Melbourne or Sydney, while only 17 were listed in Perth (38 per cent).

The average amount raised had doubled to \$1.86 million with the total amount raised almost quadrupling to \$82 million. The combined initial capitalisations exceeded \$160 million (average \$3.69 million), 19 of the 44 listings were via prospectuses and 2 were compliance listings.

At present 84 per cent of these entrants are trading at or above their listing price.

The most common activities were Engineering (18 per cent of entrants), Finance and Investment (16 per cent), Construction and Real Estate (11 per cent) and Food and Brewing (9 per cent). However based on amounts raised, the Finance and Investment sector accounted for \$33.2 million of the \$82 million, or 40.5 per cent. In contrast the 8 Engineering companies raised some \$10.5 million (13 per cent of the total raised) and reflecting a lack of investor enthusiasm for high-tech stocks only 7 high-tech listings occurred — less than one in six. They raised \$14.1 million (17 per cent of the total raised).

The Finance and Investment sector proved to be the highlight for investors as a number of entrepreneurs established investment vehicles on the Second Boards — including Pat Elliott (ex-Morgan Grenfell), Peter Wenzel (ex-McIntosh Hamson), Sam Gazal (ex-Winthrop Investments), Mac Brunckhorst (ex-Security Pacific) as well as leading fund manager, Stephen Sedgman and stockbroker, Andrew Kroger. Other professional investors are planning future moves onto the Second Board, including Adelaide's Bruce Rowan, while in recent months both Ron Brierley and Bruce Judge have taken strategic stakes in Second Board companies.

THE ASBC OFFICIAL SECOND BOARD INDEX

The rapid growth in the number of Second Board companies combined with the sometimes parochial nature of the markets (essentially there are six separate and distinct trading boards), has made it often difficult to gauge overall performance and the Second Board has clearly suffered from the lack of a properly constructed index.

Previously we defined performance in terms of the change in aggregate capitalisation since listing. This has a number of drawbacks not least of which is that performances over quite different time frames are being aggregated. Consequently as the number (and size) of companies increases, earlier performances are "diluted" by the latest entrant (that has not yet had the opportunity to perform) and we get a constant "averaging down" effect. The solution is to create an index series that effectively filters out the distortions that arise on each listing under our previous methodology based on aggregated capitalisation.

To this end, Australian Second Board Consultants Pty. Ltd. commissioned the Sydney Stock Exchange Research Department to compile the first national Second Board index. The index, known as "the ASBC Official Second Board Index" is a market capitalisation weighted index composed of all Second Board entrants and is updated as new companies are listed.

The ASBC Official Second Board Index is unusual in several respects. It is by far the most comprehensive index publicly available as it includes all companies in the population that have traded. It is also one of the largest indices being regularly produced covering over 140 companies at present.

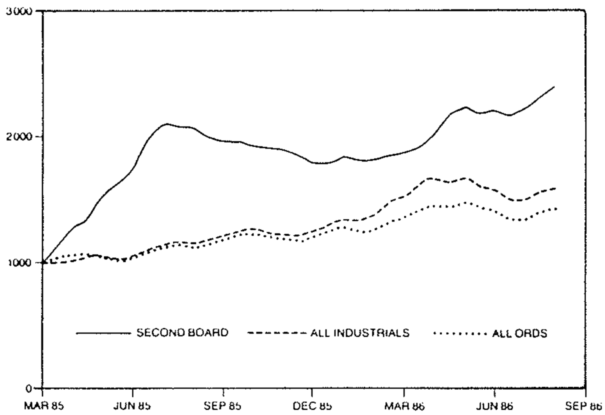
The population covered is also growing rapidly so care needs to be taken when new entrants are included. In calculating the ASBC Official Second Board Index, new entrants are first included (on the evening prior to listing) at their issue price. This captures the premium on listing that may accompany a new listing. Subsequent capital raisings are incorporated in the same way as used in preparing the AASE Indices. Unlisted securities are not included.

The ASBC Official Second Board Index has been constructed with an index base of 31st March, 1986 (base value = 1000). Prior to this date there were too few companies to provide a meaningful index series due to problems of volatility and infrequent pricing data.

The index is shown below with both the All Ordinaries and All Industrials indices adjusted to the same base value for comparative purposes.

Relative Performance	1 mth		3 mths		12 mths		17 mths	
All Industrials	+2.3%	15.09%	+13.0%	1.70%	-15.9%	60.80%	+50.9%	282.58%
All Ordinaries	+2.2%	15.15%	+11.6%	2.97%	- 8.5%	47.85%	+67.2%	245.30%

THE ASBC OFFICIAL SECOND BOARD INDEX



The most notable feature is of course the confirmation of the substantial outperformance by the Second Board markets since inception. A closer examination shows two sustained periods of outperformance (March-July 1985 and February 1986-present) with the Second Board "marking time" in the intervening period.

The first surge coincided with the strong debuts of some of the early listings such as Betatene and DTX Australia and the subsequent spillover effect into other Second Board stocks as East Coast investors moved into what remained a tight market. The subsequent investor reaction against some of the lesser high-tech hopefuls saw the market moving sideways in the second half of 1985.

During that period a number of new developments took place. The other Second Board markets established themselves with a new breed of Second Board entrants starting to emerge. The move away from high-techs and start-up ventures gained pace and the diversity that has become a characteristic of the Second Board markets became apparent. Strong performances by such new entrants as Australian

Metals Exchange and Qlone were matched by existing high fliers such as Miniskips, Hugall & Hoile and Australian Venture Capital resulting in the latest period of outperformance.

The ASBC Official Second Board Index peaked at 2418.03 on 27th August 1986 while the lowest point remains the base date 31 March 1985. As at 31 August 1986, the index stood at 2402.88, a rise of 140 per cent in seventeen months. Already in 1986, the index has risen 40.7 per cent compared to the 27.6 per cent increase in the All Industrials, and the 18.8 per cent increase in the All Ordinary.