

WATERED STOCK AND GOODWILL

Capitalization on Basis of Estimated Earnings— Bonus Stock

(Continued.)

Briefly stated, the method of arriving at the capitalization of a concern upon the basis of the future estimated earnings of the undertaking is the arriving at the capital stock of the new concern, not upon the basis of an equivalent total fair value of the assets acquired, but upon the basis of a calculation as to the amount of capital stock upon which a dividend could be paid at a certain rate, the total dividend being equal to the estimated annual net profits to be earned in future years.

Mr. D. Kerr, C.A., Montreal, in his address, gives this instance: A concern has been earning, say, \$300,000 per annum. A new corporation acquires this concern, and estimates that under the new arrangements future earnings, when the contemplated plans are matured, will be \$500,000 per annum. If the promoters of this new concern used as a basis for capitalization purposes a rate of 5 per cent., the capital stock of the new company will be fixed at \$10,000,000, because 5 per cent. on \$10,000,000 equals \$500,000, the estimated future net earnings.

Will Equal that Dividend.

Observe that the capitalization is not fixed at \$10,000,000, because there will be real assets representing this value, but merely because, upon a 5 per cent. basis, estimated future profits of \$500,000 will equal a dividend upon \$10,000,000 capital stock.

If the promoters estimated upon a basis of 10 per cent., then the capital stock would be \$5,000,000 instead of \$10,000,000, because 10 per cent. on \$5,000,000 equals \$500,000, the estimated profits.

Observe that these profits are not the profits that have actually been earned in the past, but are the profits which it is estimated will accrue in the future and based upon the past earnings, together with estimated economies to be effected, increased output, decreased cost of production, etc. It is also well to remember that usually these problematical and frequently too rosy anticipations do not materialize until some considerable period afterwards, if at all.

This method of capitalization upon the basis of estimated earnings affords a very convenient method of placing upon the goodwill of a concern as high a book value as may be desired.

Often the assets acquired, excluding goodwill, are paid for by the issue of bonds or preferred stock, or both, or the proceeds of these, and the common stock issued represents the book value of the goodwill acquired.

Different Views of Goodwill Values.

In valuing the goodwill or other intangible assets of companies, it is interesting to know that there is a greater difference in valuations than is found in the valuation of physical assets. Naturally, one must allow for differences of opinion in estimating values. When, however, the difference is 100 per cent., 200 per cent., 500 per cent. or more, there is need for more thought than ordinarily is demanded. Yet there are, rightly or wrongly, these differences in valuations of goodwill, etc.

Test of Fair Value.

As previously stated, a fair valuation of goodwill is, as a rule, three to seven times the annual net profits.

If one were told that the consideration payable for the goodwill of a concern was equal to ten, twenty, thirty or forty times the average annual earnings of the past, he would be very careful to inquire into the conditions, as such cases would certainly be most exceptional.

If the goodwill of any concern be paid for in hard cash, how often would one hear of such purchases being equal to ten, twenty, thirty or forty times the average annual earnings?

The test of fair capitalization would appear to be that the par value of any capital stock issued in exchange for assets acquired would equal the same amount if hard cash had been paid.

It is also interesting to note that when the total consideration for the assets and goodwill of a concern has been paid in hard cash, the amount paid for goodwill is usually

fair and reasonable. The inflation of the book value of the goodwill acquired takes place practically always when the consideration is paid for, wholly or partly, in stock or other securities of the purchasing company.

In order to fully comprehend the question of watered stock and capitalization, it is necessary to understand how "bonus stock" is given with the purchase of other securities. In this connection there is a great deal of misconception.

The uninitiated have an idea that corporations give to the public this so-called bonus stock.

In order to explain the bonus stock arrangements it might be well to assume a transaction.

A group of financiers obtain options, or purchase agreements, covering the assets and business of another concern. They form a new corporation, which agrees to assume the responsibilities of these financiers under the agreements and in consideration of thus assigning the agreements to the new corporation, the latter in addition issues to them as consideration, say, the whole of the common stock of the new corporation; in addition, the new corporation decides upon a certain bond issue, and the financiers agree to take this bond issue at a certain figure, say, 90 per cent.

Sell for Any Price.

The financiers are now in possession of the bonds and the common stock of the new corporation. They decide to sell these bonds to the public at 92 per cent., giving with each bond a bonus in common stock equal to 50 per cent. of the par value of the bonds. Strictly speaking, however, the public really buy bonds plus common stock for 92 per cent. of the par value of the bonds purchased by them. The stock is termed "bonus stock."

Let the position be stated in another way. The financiers have acquired certain bonds and stocks. As owners of these, they may sell them at any price they may decide, just the same as can anyone owning other securities or assets.

From this illustration it will be observed that, it is not the new corporation which gives this bonus stock, because the corporation has issued this common stock to these financiers for consideration, even though the consideration may not be of value equivalent to the total par value of the stock thus issued.

(To be Continued.)

CANADIAN PACIFIC AND GERMAN HOLDINGS

A correspondent writes, (says a Canadian Associated Press cable message), to the London Morning Post on the sale of Canadian securities in enemy names: "The secretary of the Canadian Pacific has stated that shares of the company in New York and Montreal registers are beyond the sphere of our public trustees' activities, but he added that in obedience to Royal proclamation the company has stopped transfer of shares to enemy names and payment of dividends thereon. That is well so far as it goes, but is it enough? The restrictions imposed are for the duration of the war only. Property in these enemy shares ought to be stopped by some public authority.

"What is happening is the Germans are sending these Canadian Pacific Railway shares to New York by submarine and selling them there at a discount sufficient to recoup purchasers for non-payment of dividends during the war. The government ought to induce the Dominion government to declare that such sales will not be recognized at all. The neglect to take this step has been a gross oversight on the part of our government, which might long ago have come to an arrangement with the Dominion government if they were big and alert and in earnest for the attachment of enemy shares and non-recognition of transfers. Fortunately, it is not even yet too late to take action, because the bulk of enemy holdings are still unsold."

How institutional bond buyers are purchasing government bonds is exemplified in the following list of various government securities purchased by the Sun Life Assurance Company of Canada since the outbreak of the war, totalling over \$9,000,000: Dominion of Canada, \$2,573,666.66; government of Great Britain, \$2,205,766.66; Anglo-French governments, \$3,000,000; French government, \$901,179; Russian government, \$500,000; government of Newfoundland, \$50,000. This does not include the company's subscription of \$5,500,000 to the last Canadian war loan.