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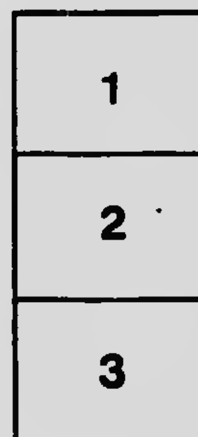

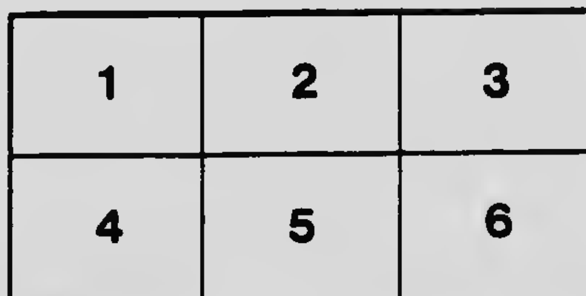

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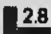
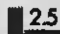
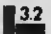
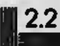
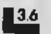
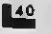
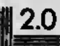

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Course in Banking

Corporation Finance

LESSON V.—(*Continued*).

In contrast is the rather crude prospectus of the other company. It is unattractive in shape, is printed on cheaper paper without decoration or cuts, not even on its brilliant red cover. The material is poorly arranged and badly written, giving the reader the impression that it is decidedly the work of an amateur, and at once discouraging any further investigation into the securities of the company, which may really be of a thoroughly sound nature.

Although there are some investment prospectuses, issued for the purpose of interesting capable, well-balanced investors, yet they are few, as the securities intended for investors,—that is, for the class who are satisfied with a comparatively small dividend, but who demand security above all else,—are usually sold through investment houses or underwriting syndicates as outlined above. The investor buys after making a judgment of value based on the demonstrated earning power of the property. The speculator buys a prospect; he purchases an interest in uncertainties and hopes to gain a profit by taking advantage of price fluctuations, or, as in the case of the mining companies and oil-well securities, by "the productivity of Mother Earth." It is the prospectuses issued to speculators that we must consider.

The prospectus is an argument. It argues that others have made fortunes in similar enterprises and enjoy ease and luxury and the best the world can afford. Why should not the reader be equally as fortunate? He is not asked to gamble but merely to investigate an industrial opportunity and act as his judgment directs. "If you cannot reason and analyze a proposition for yourself, you can't hope to acquire your share of the world's wealth." (Prospectus of Canada Sunset Oil Company). His imagination is first appealed to. He is shown the future business in active being. He sees the mine yielding forth its richness in tons of glittering ore; he sees the well pouring out streams of valuable oil; he sees the desert rejoicing and blossoming like the rose, and silver foxes being fruitful, and multiplying and replenishing the earth in the most extravagant fashion.

The strong points of the business are emphasized, the weak features minimized. Often the strikingly attractive statements are made prominent by bold-face, or other heavy type, and much is made of them, but remarks as to the more doubtful and risky features, if included at all, are tucked away in as obscure a place as possible. For example, a recent Motion Picture prospectus has the following in prominent black type. "The business is a cash business. Every class in the land con-

tributes. This applies most strongly to the working classes, as this particular form of amusement is the only thing outside of the necessities of life on which practically all of those comprising the masses regularly spend a portion of their earnings." (United Motion Picture Theatres, Ltd.).

The prospectus writer makes sweeping general statements for which neither he nor any other definite person can be held responsible. Such phrases as "competent judges have reported," or "after expert examination we believe," or "witnesses who have seen the property are convinced," are very common. "According to a very conservative estimate" is made to do duty on many occasions, and such expressions as "in considering the merits of this company the intending investor will at once perceive the value, etc." frequently introduce new and additional reasons why the stock should be purchased.

The following are quoted from three Canadian prospectuses issued during 1913-14:

"On an island in the north-east corner of Canada live a people who have realized the fondest dreams of Jason; business men, farmers, and fishermen who have put the Midas touch to pelt production.

"Here you will find a man whose credit some years ago was not "good" for a month's supply of flour, now worth an assured million dollars. Clerks working 60 hours for $10 a week, who have made $40,000 and over, inside four years. Three sisters sending home their savings, and getting an average return of $15,000 a year.

"A company owned mostly by workingmen paying 900 per cent. dividend. A common tabby cat, valued at 25 cents mothering $25,000 worth of Island black foxes—there—I've let the secret out.

"This almost fabulous wealth-making truth that is stranger than fiction—is the reward of Prince Edward Island fur farmers for the successful domestication of black or silver foxes."

This from a Calgary oil company's prospectus:

"To-morrow, that magic day, may dawn for scores of people who were otherwise doomed to a lifetime of labor and privation, and find that the Calgary Oil Company has placed them in a position of absolute independence, with the gracious goddess of fortune as their patron for all the happy years to come."

Or foxes again—

"Join in this unadulterated rock bottom business proposition, where all investors share alike; join in a deal that is mutual co-operation, friendly. Every feature of it open as the day and permeated by the sunshine of human kindness and sincerity."

Many prospectuses are accompanied by strongly worded testimonials from "experts" or "professors," by newspaper comments or government reports. Note, for example, an expert opinion on a prospective oil district.

"...... The geological formation of the oil-bearing strata and extensive surface indications of petroleum seem to indicate the certainty of there being productive resources of oil below. Sand stone and shale of a bituminous character seem to be the general surface indications of petroleum. There are apparently three anticlinal ridges extending through this range which the oil belts seem to follow.... .. Judging from the croppings, the west side of the Salinas Valley contains a vast oil reservoir. I have formed this conclusion on account of the immense depth and thickness of the oil-bearing sands and also the immense beds of bituminous shale." (Trust Finance, p. 131).

The following extract taken from the report of United States Consul Wesley Frost, is quoted in the prospectus of a Prince Edward Island fox company:

"A phenomenal expansion is taking place in the black fox industry on Prince Edward Island. Although a report on this subject was published in the Daily Consular and Trade Report for March 17, 1911, the developments since that time have been so rapid and so important that an entirely fresh treatment is called for. The remarkable success of Prince Edward Island keepers in handling and rearing the capricious royal black and silver fox became generally known and verified only so recently as the year 1910 or thereabouts; and the fact that the skins of these quasi-domesticated animals have come to command the highest prices on the London market, not infrequently fetching from $1,500 to $3,000, partly on the basis of an already accepted reputation, came to light about the same time.

"A recent sale of $30,000 for a two year old pair has just been rumored very credibly, but with an accompanying guarantee. One of the pioneer ranch men states that he refused $500,000 for his establishment, coupled with a salary offer for a term of years for his own services to operate it. It is currently believed that the London concern has itself attempted to secure, and perhaps has secured, an interest in certain ranches, but this is not substantiated."

If the speculator asks for conclusive evidence that the new enterprise will prosper and pay huge dividends, he is pointed to the records of flourishing enterprises in the same industry, which at the outset, had no better prospects of success. In the case of mining and oil propositions it is the order of all prospectuses to speak of the adjoining properties and work in a few names like "Crown Reserve," "Nipissing" and "Hudson Bay" and then add—"There is nothing to indicate any

cause why this property should not be just as good." In the fox industry the same plan is adopted. The prospectus of the International Company contains a table of twenty-one companies with dividends paid, and draws the readers' attention to the fact that the average dividend is 170 3/7 per cent. Another prospectus declares that "The Smith Silver Black Fox Company, Limited, paid a dividend of 40 per cent. this year," and another that "the dividends paid by most of the Prince Edward Island ranches in 1913 have been from 40 per cent. to several hundred per cent."

Provided the officers and directors of the new company are prominent men in business or finance, the prospectus never forgets to draw attention to this. Contracts, options, and the services of experienced, capable managers, etc., are made much of, though in the case of the more risky enterprises the prospectus merely mentions the officers and remarks in general terms on their high financial standing and wide influence as far-sighted and successful business men.

Finally the whole argument is summed up in a reference of a few exceptional cases. "Bell Telephone was given away for board-bills, yet has paid over $36,000,000 in dividends. Calumet and Hecla went begging not so many years ago; its total dividends to date are over $60,000,000.. It would take a day to numerate the instances where properties, rich and great to-day, were offered for a song. The people who did buy them are rich now, and why? Not because they were "lucky" but because they investigated promptly, judged the merit of the proposition, and acted while there was time......buying them when they did, they got all the way from 50 per cent. a year, up to 500 per cent. because they had both the judgment to recognize the worth of the opportunity and the courage to seize it." (Trust Finance, p. 135). Or note the following from a recent fox company prospectus:—

"A book-keeper in the employ of the Mr. Fred L. Rogers, the Governor's son, of Alberton, invested $300 three years ago and is now worth $45,000 directly from this source.

"Mr. Frank Hall, clerk at Holman's, Limited, received $25,-000 from an investment of $500 made in this business three years ago.

"The Rosemount Live Stock Co., Limited, of Alberton, P.W. Turner, treasurer, has paid a dividend of 1000 per cent. this year.

"Seven clerks and managers in Summerside pooled $500 each in 1910 and purchased a pair of silver foxes for $3,500. The seller, feeling that he had driven a splendid bargain, cared for the pair for a year. The first litter consisted of seven pups. The seven owners have received $36,000 cash dividends

since, and the pair bought for $3,500, could be sold for $35,000 to-day."

The ideal prospectus is well written and attractively printed, observing all rules that apply to other selling literature. The significant facts are interestingly and skilfully presented. The expressions are simple and untechnical, designed to instruct the reader, not to confuse him. There is some persuasion but points of advantage are not excessively exaggerated and difficulties glossed over or entirely omitted. History and facts play a more important part than supposition and prophecy, and an appeal is made to the reader's reason, not to his cupidity and imagination. In Canada the prospectus has been used so much for speculative and swindling schemes, that an enterprise issuing a brilliant prospectus is now regarded with a good deal of suspicion; and prospectus-writing has come to be looked upon as a more or less dishonest way of raising capital. With exceptions, the soundness of a proposition is generally supposed to vary inversely as the size and attractiveness of its prospectus.

The persons deceived are the ones least deserving misfortune. A minister has saved a few hundred dollars, a teacher has collected a small amount during many monotonous years; a widow has inherited a small sum or received it from her husband's insurance; a workman has a little laid by for a rainy day; a farmer has managed to scrape together $1000 or so. In a savings bank or the post office the accumulations draw only a small rate of interest, 3 per cent. To them the prospectus is the promise of new life. They are to exchange their savings and hard monotonous life for a fortune and ease and luxury. They forget the risk. They forget that they are buying even a chance, they believe they are purchasing a fortune. The situation is universally the same. The temptation is too great. The unscrupulous promoter and happy prospectus-writer get the small savings, and the widows and orphans get a few beautifully engraved stock certificates, only to have their dream finally dissipated by an appraisal of the securities by the local banker or some other capable authority.

The branch manager can perform a valuable service for his bank as well as for his customer by advising depositors on the dangers of investing in highly speculative securities. The banker should gain the confidence of depositors and encourage them to build up their balance at the bank instead of taking great risks in placing their money on what may be merely a gambler's throw. Time and time again bankers have encouraged thrift in the community and saved their clients heavy losses by

being on the alert when considerable deposits are about to be withdrawn. The banker's business is not merely to make money for his institution, but to perform social service for his community as well.

Questions for Review.

1. What are the chief methods followed in the sale of the stock?

2. What services does the financial agent perform? When is an effort made to sell stock in any particular neighborhood?

3. What are the functions of the underwriter? What are the duties of the "syndicate manager"?

4. Does the subscriber to an underwriting agreement expect to hold the stocks and bonds for which he has subscribed? What does he do with his securities?

5. What are the particular problems involved in underwriting a trust or combine?

6. What has been the general method of paying the promoters and underwriters of the United States trusts?

7. What are the particular points that are usually emphasized in the preparation of a prospectus?

8. What reliance can be placed, as a rule, in the "expert" evidence submitted in the prospectus of a speculative concern?

9. What are the usual arguments presented in the prospectus of a speculative company?

10. Explain the differences in the type of prospectus issued by (a) an industrial concern with an established connection, looking for additional capital; (b) a prospectus designed to get funds for a new mine; (c) a prospectus designed to sell the securities of a combine.

11. What are the characteristics of strictly investment prospectuses? Is it safe to assume that these characteristics are never present except when the security offered is of the highest grade?

Questions requiring Written Answers.

12. What would be the characteristics of an ideal prospectus?

13. What are the advantages and disadvantages to a corporation of selling its securities through large bond and banking houses?

14. What are the usual banking house methods of selling securities? Do such houses guarantee the safety of the securities they sell?

15. Bring up any difficulties.

LESSON VI.

The Proper Basis of Capitalization; Capital Investments in Canada.

The capital of a company consists of its total assets of all kinds, and not merely of its bankable funds. A sharp distinction should be made between the capital of a corporation and its capitalization. The "authorized capital" of a company consists of the stock it may issue under its charter; the "paid-up capital" consists of the stock that has been subscribed and fully paid for; and the capitalization includes not only the stock issued but the bonds and debentures as well.

In general, there are two methods of capitalizing corporations, both of which have been extensively followed. In the one case the capital—using the term in the sense of all the securities outstanding, including stocks and bonds—is fixed at an amount that represents the actual market value of all property holdings and the funds of working capital. In the alternative method the amount of the capital is determined by the actual earning capacity of the business. A newspaper, for example, may own property to the value of, say, $1,000,000; but because of its political power, the nature of its constituency and so forth, may be able to earn sufficient returns to pay the prevailing rate of interest on a capital of $2,000,000. By issuing stock up to the full value of the earning power of the business nothing more is taken from the public, but the earnings are distributed over a greater amount of securities. Such a procedure is called "stock-watering.' This should be clearly differentiated from "overcapitalization," which consists in burdening a corporation with stock or bonds to such an extent that interest and dividend payments cannot be met.

Capitalization at less than real value. In the case of small concerns, in which but a few are interested, the capitalization is often smaller than the value of the property owned by the company or its actual earning power. The main object in view is to reduce taxes and legal fees to a minimum. If a tax is levied on the capital stock of corporations it is more profitable to operate under a small stock capitalization, the excess value being covered by an issue of bonds or debentures.

The securities of a company thus "under-capitalized" will sell above par as the interest rate will be much above the normal rate. An example of under-capitalization is furnished by the Laurentide Paper and Power Company. The par value of its stock is $9,600,000. The market value in February, 1914, was

$18,432,000. Hence the under-capitalization of this company at that time was $8,832,000. Allowance must of course be made for the speculative nature of the stock.

Capitalization at Real Value.

This method rests upon the conviction that capitalization should correspond to money invested or to the cost of replacement. It is adopted quite generally by banks and other financial institutions, which fix their capitalization at the amount deemed necessary to carry on the business, and sell their capital stock at par. In this case the par value and market value generally correspond.

In most mercantile businesses and industrial enterprises, other than the large corporations and trusts, and those of a highly speculative and risky nature, it is usual to approximate the real value of the enterprise in the capitalization. The chief objection raised to capitalizing enterprises on this so-called "proper" basis of immediate cash or cost value, lies in the fact that the concern may pay dividends substantially above the regular rates of interest, which at once attracts attention, encourages competition and frequently arouses the opposition of the public.

Capitalization of Earning Capacity.

The rule in capitalizing corporate combinations and public utilities is to issue bonds or preferred stock to the extent of the real values, and common stock to such an amount as the estimated earning power of the corporation will provide with dividends.

In some Canadian mergers there has been a great volume of watered stock, usually attributable to the excessively optimistic estimates made by the promoters, and to their desire for large profits, for it is upon the common stock that they depend for a large part of their compensation.

The evils of stock-watering are so often the subject of attacks upon corporations that it may be worth while to consider the practice very briefly.

The charges against the practice are usually three:

(1) Prices to the public are raised because the corporation is obliged to pay dividends on this extra stock.

(2) This payment of dividends on a capital larger than the cost of duplicating the corporation's plants, invites competition and leads to unnecessary duplications of railroads, factories, etc.

(3) The public is encouraged to buy stocks for which there is no investment equivalent; and these stocks may become worthless if earnings decline or cease.

The opinion is generally abroad throughout Canada that over-capitalization is a "gigantic attempt to bind burdens upon the community" and to take from the "people contributions of their substance for those who have given them nothing in exchange." Without going into the subject at any length, it may be laid down as an established principle that every business concern fixes prices, not at that point where a high dividend can be secured on its capital stock, but rather at the point of largest returns. The consumer pays as much as he can be made to pay. Prices are fixed on the principle of securing all that the traffic will bear.

The second charge is more valid. Undoubtedly the payment of dividends on a large capitalization is an inducement to a competitor to enter field, for it shows that if he capitalizes his plant at its true value, he can pay at least reasonable dividends. But is the payment of dividends on watered stock more likely to invite competition than the payment of excessive dividends on true capitalization? The fact is, no business man will enter an industry simply because he sees a concern already established in it making big profits. That might first attract his attention; but his final action will rest upon his judgment, formed after careful consideration of the facts and the prospects of the industry.

The chief evil of over-capitalization—a problem quite distinct from stock-watering—is the unloading upon the uninstructed public of a quantity of worthless securities. This has been practised by those organizations in which there is little likelihood of ever paying dividends on the common stock and whose promoters have been primarily, not business men, but gamblers.

Capitalization of Trusts.

Because of its nature, as well as the method of its organization and entrance into being, a trust must be overcapitalized if it is to be successfully floated. It has been shown that the combination must be a going concern before investors will buy the securities. Speculators, therefore, are the original purchasers of the stock and bonds. This means that the securities are offered at a low price, and low prices mean overcapitalization.

If the promises of dividends made to the stock-holders, the existence of cumulative preferred stock, and the necessity of realizing promoters' and underwriters' profits, prevent the accumulation of a surplus reserve, and thus an increase in the value of the stock certificates, the over-capitalization will increase as the price of the securities declines. But if the enterprise is prosperous; if the money required for improvement can be taken from the business, if the interest charges and

dividends are met and the expected profits realized, the amount of the over-capitalization will tend to diminish, and the value of the securities may gradually be raised to par.

In itself, over-capitalization, within certain limits, is no evil. Indeed it has definite positive advantages. If dividends declared seem to be about the normal rate of interest it conceals the actual state of the business and hence lessens the temptation of competitors to enter the business and the danger of popular disapproval.

Moreover, the stock of a corporation may usually be sold to better advantage on a large, than on a small capitalization, provided, of course, that the higher capitalization is justified by the dividend paid. For instance, if an enterprise could pay a regular annual dividend of 6 per cent. on a capitalization of $1,000,000 its stock should sell readily at par, or $100. Suppose its capitalization be reduced to $500,000. Its regular annual dividend would now be 12 per cent., and the stock, representing the same corporate enterprise and having double its former earning power, should sell at $200. But as a matter of fact it would not sell above 180, which would represent a loss on the sale of the entire capital stock of $100,000.

A stock selling at $500 or $700 is unfitted for wide distribution and hence the demand for it is limited. The result is that such high-priced stocks are closely held by a few insiders and fluctuate widely on market rumors and small sales. It is of importance to corporations that their stocks and bonds should be widely distributed and a large capitalization, which fixes the market price about par, makes this possible.

Since every corporation wishes to sell its stock at the highest possible figure, the speculative demand should be cultivated. Now, if a stock sells at a high premium it is manifestly impossible for the average speculator to deal in more than one, two or a half dozen shares, and as it requires a large sum to handle a few shares, the profits from fluctuations are very small.

Undoubtedly there are dangers and disadvantages to the public arising from over-capitalization. When new corporations are being organized, and only those who are closely connected with the management know on what terms properties are purchased for which stock is issued, there is great opportunity for deception; but most business men are of the opinion that the value of any business depends upon its earning capacity as a going concern, and such legislation, as that which narrowly limits the capitalization of German companies, is of doubtful value. True the practice is often abused and may easily be carried so far, under exaggerated estimates of earnings, as to become alike dangerous and dishonest. Kept within certain bounds, however, it is justifiable from the standpoint

of both morals and sound finance and undoubtedly affords legitimate advantages.

A prominent writer, Thos. L. Greene, says on this subject: "It is not good financing to capitalize a company at only the value of its tangible assets, as if any sum over that value were 'water.' A manufacturer who does not on the average earn considerable more than the usual rate of interest upon the actual cost of his plant might better go out of business and invest his money in bonds and mortgages. Business men consider themselves entitled to at least 12½ per cent. upon their actual capital. If, then, assuming high earnings when forming a combination, a banking house should issue preferred and common stock in amounts each equal to the value of the plant, it would not be stock watering. The difference between cost of plant and earning capacity, whether we call it value of trade marks, patents or good will, is just as legitimate an asset of a company as is its merchandise, though harder to appraise properly."

A suggestion to avoid all evils connected with capitalization has been made by a committee of the New York Bar Association. It provides that shares of stock, representing dollars as their par values, should not be issued, but instead, capital stock, representir · proportional parts of the whole capital without any nominal money value. The profits would be divided proportionately as in the case of the part owners of a ship. Such a plan is valuable, and would apparently prove effective in the case of any great or general demand for a change.

Capital Investments in Canada.

Great Britain and the United States have furnished the greater part of the capital that has been invested in Canada, although we have drawn upon the resources of several European countries—notably France, Holland, Belgium and Germany. Most of our capital needs, however, have been met by capital from England. Sir George Paish, editor of the London "Statist," speaking in Toronto early in 1914, said that up to that date Canada had secured at least 500,000,000 pounds of British capital. He predicted that within fifteen years the amount would be increased to 1,000,000,000 pounds.

It will be impossible for many years to come to meet our capital requirements ourselves. What money is saved in this country is quickly absorbed in building houses and roads, and in breaking up new land. The thousands of immigrants who come to our shores possess little capital. They provide the labor, while the country is itself rich in land. We lack little but capital, and for the enormous sums required to meet our needs we must look to the older and richer nations, particularly to the United Kingdom and the United States.

According to figures furnished by the *Monetary Times*, Canada's public borrowings in London, during 1914, were 37,777,271 pounds. Last year our governments were the heaviest borrowers, railways and municipalities coming next. According to the same journal, "industrial companies were small borrowers compared with previous years. Canadian industrial securities, as a class, are not popular just now in England. Financial concerns were not in the market during 1914. Mortgage, land and lumber companies were not big borrowers by means of public issues. Lumber companies, as a group, have not been a success, and land companies have had a good innings and are resting." The record of Canadian loans in London during the year 1914 is a good one when it is remembered that the period was for seven months only, the war having broken out in August. The following figures give some of the details of our borrowings in London (the amounts are in pounds sterling):

Government	16,260,000
Municipal	6,469,487
Railways and steamships	10,943,800
Mining	175,000
Mortgage, land and lumber	705,329
Industrial	2,223,[illegible]55

The accompanying table shows the vast amount of capital borrowed on Canadian flotations in London from 1905 up to 1914:

Year.	Amount.
1905	£13,530,287
1906	6,427,500
1907	11,203,711
1908	29,354,721
1909	37,411,723
1910	38,453,808
1911	39,855,517
1912	32,456,603
1913	47,363,425
Total	£255,957,295

This amount is divided as follows:

Year.	Railroads.	Government.	Industrial.	Municipal.
1909	£15,359,953	£14,337,500	£ 2,832,508	£ 2,109,500
1910	8,818,000	12,000,000	3,608,847	3,079,400
1911	17,122,253	1,900,000	7,868,765	5,323,749
1912	9,002,585	5,550,000	7,354,994	5,372,049
1913	13,179,170	9,800,000	7,780,847	13,926,470
Total	£63,481,961	£43,587,500	£29,545,961	£29,811,168

Year.	Mining.	Land and Lumber.	Financial.
1909	£2,136,522	£ 474,000	£ 61,140
1910	4,452,200	4,800,100	1,695.261
1911	600,000	4,122,500	2,508,250
1912	650,000	1,704,975	2,772,000
1913	225,000	2.451,332	....
Total	£8,063,722	£13,552,907	£7,036,651

Railroad securities are very popular in Great Britain and we owe a large debt to England for our railroad facilities. Government loans, however, have been nearly as heavy, with municipal loans third. Most of Canada's railroad financing is done in London, and Great Britain furnishes also the greater share of money loaned on federal and provincial government issues, and on municipal bonds.

The comparatively small sum of English capital invested in industrials is particularly striking. The amount invested by Great Britain in this class is, according to Mr. Fred W. Field (Capital Investments in Canada), insignificant, when compared with the millions of dollars sent into the Dominion for that purpose by the United States. There has been a tendency to criticize Great Britain's seeming indifference towards Canadian industrials, but as she supplies vast amounts for other purposes, such an attitude is unjust. The fact is, Great Britain specializes in certain lines, the United States in others. Nor is the reason far to seek. It lies in the different attitudes of the English and American investor. The American is quick to recognize a good industrial proposition; he is in immediate touch with Canadian enterprise and alive to things that are happening or are about to happen. Moreover, he is undoubtedly more of a speculator and less of an investor, than the Britisher. The latter acts with more deliberation. He demands security above everything else. He moves more slowly; he seeks free, long-term options, and never rushes into an investment.

This attitude, or habit of mind in investing, is particularly noticeable in the mining industry. The American, always ready to invest money for large returns, is quick to see the opportunities that have made men rich in the United States paralleled in British Columbia and in other Canadian provinces. Hence when ore was discovered in the Kootenay, he was on hand, invested his money, and accepted big risks. Ultimately he sold out to British capital. At present American and British capital is about equally divided in mining enterprises; but in many cases the American has been the first purchaser, selling out to British buyers when the worth of the property was proven.

The United States at present has a keen appreciation of industrial opportunities in Canada. Boston and Philadelphia assisted materially in developing Canadian asbestos properties. Philadelphia capital developed the water-power and industries about Sault Ste. Marie. The Dominion Coal Company, the Dominion Iron and Steel Company, and the Shawinigan Water and Power Company were developed by Boston capital. Moreover, branch plants of American companies are located throughout Canada, but especially in Ontario. Farm implements are manufactured in ten or a dozen such branches, and automobiles in about as many, though often, in the latter case, the parts are imported and merely assembled. Frequently the American branch company seeks to interest Canadian and even English capital in the new factory. The Canadian Furnaces Company, Limited, and the Canadian Connecticut Cotton Mills, Limited, of Sherbrooke, Que., are such examples. They have offered their stocks and bonds to the Canadian investors also.

The following table is an approximate estimate of American investments in Canada up to 1914 (Monetary Times Annual, 1914):

Item	Amount
450 branch companies, with average investment of $300,000	$135,000,000
Investments in British Columbia mills and timber	70,000,000
Investments in British Columbia mines	62,000,000
Land deals in prairie provinces	40,000,000
Investments in lumber and mines, prairie provinces	10,500,000
Theatrical enterprises	3,000,000
Packing plants	6,750,000
Agricultural implement distributing houses	9,255,000
Land deals, British Columbia	60,000,000
Investments of United States life and fire insurance companies	67,831,497
Miscellaneous industrial investments	12,225,000
Purchase of city and town property	20,725,000
Investments in the maritime provinces	13,125,000
Purchase of government, municipal and corporation bonds, 1905-1913	123,742,455
Fox farm investments, Prince Edward Island	1,000,000
	$636,903,952

European countries other than Great Britain have been slow in appreciating Canada's investment possibilities, but there are signs of increasing foreign interest in the Dominion as an investment field. After Great Britain, France has supplied the most capital to Canadian enterprises. Undoubtedly the presence in Quebec of a French population has been a factor in attracting French capital, which is at present quite largely interested in Canadian railroad and industrial securi-

ties. A few years ago $7,000,000 of French capital was secured for the Banque Internationale, then being organzed. The French company, La Caisse Hypothecaire du Canada, or the Canada Mortgage Association, was organized for the purpose of investing French capital in the Dominion. It has a capitalization of $2,000,000 and power to issue bonds up to $20,000,000. It is estimated that the company will place from $20,000,000 to $25,000,000 in Canada. By purchase through London brokers a fairly large amount of Canadian securities, which has usually been credited to English investors, has in reality been taken up by French capital. Large blocks of the following are held in France: Lake of the Woods, Quebec Railway, Montreal Power, Montreal Street Railway, Toronto Street Railway, Algoma Central and Hudson Bay Railway.

The banks of France carry immense capital on which they pay only very low interest and Canada should make a determined effort to interest this capital in her enterprises. Sir Rodolphe Forget, M.P., the Montreal financier, has done a good deal to arouse French interest in Canadian projects. Canadian financiers should cater to the particular needs and desires of French capital. Furnishing information, issuing rapid redemption bonds instead of those extending over a long period, securing these by the entire property of the company and transforming American registered shares into bearer shares, are steps in the direction of securing an increased portion of French capital. But after all it is largely a matter of time and education, and perhaps the plan of encouraging French bankers and financiers to visit Canada is as practical and efficient a scheme as can be devised.

Outside rather extensive trading in Canadian Pacific, the most important fact to note in considering German investments in Canada, is the unfortunate failure of the Sovereign Bank, in which the Dresden Bank was interested to the extent of $1,000,000. Germany has always invested cautiously and the collapse of the Canadian bank undoubtedly shattered faith in the Dominion. Similar misfortune has overtaken a land company incorporated at Winnipeg a few years ago, and using the money of small German investors. Having bought areas in the western provinces at inflated prices, the company has not been able to dispose of these holdings. As a result German ventures in Canada have not been large.

Germany has shown little interest in the financing of Canadian railroads, unless purely for speculation. Canadian Pacific is listed on the Berlin Exchange, which, with Grand Trunk stocks purchased through London, is traded in to considerable extent. Federal and provincial bonds are without interest for German capital. Neither have light and power propositions appealed to German capitalists. Canada is as yet

too little known in Germany. Much educational work must be accomplished and the element of uncertainty, that has crept in, must be eliminated before the situation is likely to change much. Land companies and extensions in the beet-sugar industry may attract increasing amounts of German capital. The following table covers investments in Canada by the countries named, up to 1914:

Foreign Investments in Canada.

France	$70,750,000
Belgium	11,675,000
Germany	30,725,000
Holland	11,000,000
Russia	1,500,000
Turkey	3,000,000

Maintenance of Canada's Credit Abroad.

Foreign capital has constructed our railways; London has financed almost entirely the funded debts of the Dominion and Provinces, and of practically all our cities of first or secondary rank, and a large quantity of Canadian industrial stocks and bonds are held outside the Dominion. Canada has created a good market abroad and her securities have had a wide and favorable acceptance especially in Great Britain. Up to the present, Canadian methods have been little criticised, but in this matter of foreign borrowing it is all important that Canadians should take serious thought for the morrow, and that the enviable standard of credit already established should be maintained.

Canada, up to the outbreak of the war, had borrowed money to meet the interest upon her foreign indebtedness. The country is still borrowing funds for war purposes in England; but the United States has, temporarily at least, taken the place of the United Kingdom in financing our municipalities and our industries. Successful appeals, also, have been made both by the provincial governments and the municipalities to the people for capital in comparatively small amounts. A favorable sign of the times is the bridging of the gap between our exports and imports. In the month of December, 1914, exports actually exceeded imports. This was due to the falling off in the purchasing power of the people, on the one hand, and the cessation of borrowing in London on the other. Now that we have to depend in large part upon ourselves to pay the interest on our foreign indebtedness it is absolutely essential to increase our exports, and thus must be done largely by the sale of agricultural products.

The present lull in industrial and commercial activity has severely tested our banking system; but fortunately it has admirably stood the test. That fact will tell largely in our favor in future. The fine showing made by our banks in the crisis of 1907 resulted in a great flow of capital to Canada shortly afterwards. Fortunately no federal moratorium has been declared; and if Canadians continue to show the same fortitude and sound business judgment during the future course of the war there is no doubt that we shall receive all the capital we require in the years to come, and on fairly reasonable terms.

Questions for Review.

1. What is the proper basis of capitalization? Why have earnings been selected by most financiers as an indication of what a company may be capitalized at?

2. What is meant by "overcapitalization"? By stock-watering? Do not people, as a rule, confuse these?

3. What are the evils of overcapitalization? Of stock-watering?

4. What is the usual practice followed in capitalizing trusts?

5. What is Mr. Greene's opinion on limiting the capitalization of a company to its tangible assets?

6. What companies have invested most largely in Canada?

7. How do you account for the difference in American and English investments in Canada?

8. Analyze foreign and British investments in Canada, showing what are the main fields the investor selects.

9. Is New York likely to displace London as a field of capital investments in Canada?

10. To what extent may we look to France for capital for this country, in the future?

11. To what extent has Germany invested capital in Canada? In what forms has that country put its money?

12. What is your opinion of the wisdom of declaring moratoria in Canada? Will these expedients harm our credit abroad?

Questions requiring Written Answers.

13. In your opinion has Canada borrowed too much capital in recent years? If so, for what purposes?

14. To what extent should the chartered banks be relied upon to furnish capital to corporations? What kind of advances can they safely make? Should financial banking be permitted to commercial banks?

15. What is "stock-watering"? What are the evils of overcapitalization? (b) Why must our municipalities and corporations depend upon New York, rather than upon London, for capital, at least during the course of the war?

16. Bring up any difficulties.

LESSON VII.

The Sources of Corporate Funds: The Sale of Bonds.

It will be necessary to examine at this point, somewhat in detail, the sources of corporate funds and the nature of the bonds sold by corporations to secure capital for conductng the enterprise. Funds may be secured from the following sources:

(a) Officials, stockholders and directors of the corporation.

(b) Profits of the enterprise.

(c) Trade creditors.

(d) Banks.

(e) The investing public.

(f) The speculative public.

It is obvious that those immediately engaged in managing a corporation, or who have already invested in it, will be interested in its future success; and from this source additional capital is often obtained. Again, excess profits, that are not taken from surplus, may be put back in the business. A very large item is furnished by the third class—trade creditors. It is plain that accounts payable represent so much capital available for carrying on the enterprise. If trade creditors were to demand an immediate cash payment a good deal of extra capital would have to be secured to carry on the business. Outstanding accounts, therefore, make up no inconsiderable sum of working capital for most corporations. Of course, over against these accounts must be placed all goods sold on time payment.

Canadian banks make large loans to corporations, but they are particularly careful to keep such assets "liquid." As a rule the borrower is expected to have only one banker; but if the amount is very large, and two or more bankers are concerned, there must be a clear agreement concerning their respective shares in the credit granted. The credit is given for one year, and expires on a particular day; so that its renewal must be again arranged for. The borrower must submit the balance sheet of his company, for inspection; also a statement of profit and loss. This procedure, of course, refers to credits involving direct advances not secured by collateral or by bills of other dealers for merchandise sold. Thus, no matter how wealthy or powerful the customer may be, he must give his full confidence to the banker from whom he is getting credit. Funds may be advanced in very large amounts for preliminary operations before any manufacturing is done; as, for example, in the lumber business. Here advances may be made for forest operations before actual work in the mills is undertaken. This

might seem dangerous to the English, or even to the American, banker; but the Canadian banks have become practically "silent partners" in many industrial and commercial enterprises. The aid they have given to Canadian trade and industry is simply incalculable. The branch manager, however, must analyze and estimate the value of the items in the balance sheet, and separate the fixed from the liquid assets. The liquid capital of the borrowing firm—that is the surplus of liquid assets over the floating debts—must be great enough to discharge the loan, under usual conditions, within the year. There are exceptions to this rule, of course; but the general principle that guides Canadian bankers is that advances must be repaid within the year in which they are given.

Concerning these points Sir Edmund Walker said, in an address before the London Institute of Bankers:

"We are, fortunately, forbidden to lend on real property, although it may be taken as security for an existing debt; and long experience has taught the Canadian banker to beware of advances which rest even partially upon the plant or buildings or any of the fixed assets of the borrower. In other countries such banking may be both safe and wise, but our policy is to lend by established credits only the money necessary to produce and carry the merchandise to market. Now, if a customer deals with only one bank, pays for all materials and labor in cash, makes all payments by cheques on his bank, exhibits once a year his balance sheet and profits, and at the same time discusses at length the various features of his business for the purpose of having his credit re-established, it is not difficult to lend him very large sums with safety. In addition to the analyses of the balance sheet comparisons are made with several previous years, and as all correspondence is conducted on special forms with only one subject on each form, and everything is typewritten—the carbon copies of one side of the correspondence being filed with the originals of the other side—the banker can in a moment have before him in the correspondence and the analyzed balance sheet, practically all that he needs to know. All except the quite small credits are discussed with the boards of directors, and the system makes it possible to deal with a large number of credits at each sitting."

The December bank statement, 1914, *shows that Canadian banks had outstanding, in current loans in Canada,* $786,032,378, *notwithstanding war conditions and the resultant industrial depression. It may fairly be said that our banks have loyally supported their customers and the credit of the country during this crisis, carrying out the general policy followed in normal times. The banks pro-*

vide an enormous amount of working capital to Canadian corporations, and this source of securing funds deserves special attention and emphasis.

The investing public as a source of funds. We have already touched, in a general way, upon this source of funds. In this case capital is secured not only from individuals but from institutions. The more important classes of investors are: (a) professional and salaried people who wish to invest their savings; (b) women and minors who have inherited money; (c) estates held in trust; (d) savings institutions; (e) insurance companies. These sources are most successfully reached through bond and brokerage houses who retail securities to the investing public.

Investment and Speculation. The term "investment securities" covers that class of securities in which there is little or no risk, such as British consols, United States bonds and Dominion Government securities. If the element of risk is at all prominent in a security it cannot be called an investment. If there is strong evidence, although not conclusive, that the security will depreciate in value it is called semi-speculative. Most industrial bonds would be called semi-investment, even although the corporation is large and strong, for there is always the possibility that a change in fundamental business conditions or new and unlooked-for competition will cut down earnings and hence depreciate the security of the bonds. The same applies to high-grade preferred stock of successful railroads or of industrial companies. We may however use the term "investment securities" to cover any security the principal of which seems safe and the returns on which seem reasonably certain.

Speculative securities cover the great majority of corporate stocks, however promising they may be. The term "speculative security," however, does not necessarily imply that the stocks in question are not comparatively safe. As a matter of fact, some slight risk must be run to secure 6, 7 or 8 per cent. on investments. When great risk is run the security is called "highly speculative."

The speculative public may be roughly divided into three groups: (a) ignorant people who do not know the difference between speculation and investment and who are constantly placing their hard-earned money in oil wells, fox ranches, gold mines, etc., concerning which they know little or nothing; (b) intelligent men who buy speculative securities and who hold them for a rise, knowing full well that they are assuming risks; and (c) speculators who buy stocks and bonds "on margin." The first group is reached generally through advertise-

ments and circulars; the second and third by personal solicitation and through the stock exchange.

Reasons for borrowing. All large corporations borrow and have no intention of discharging their indebtedness. The reason therefor is well stated by Mr. Lough in his work "Corporation Finance": "Suppose a manufacturing company needs $100,000 to carry on its business and produces an average net income of $6,000. If it raises the whole $100,000 by stock issues it will pay only 6 per cent. dividends—not enough to compensate for the risks and uncertainties of the business. Now suppose that the company is dissolved and the same business is carried on under a new company which sells $50,000 of 5 per cent. bonds, gets additional and larger credits to the extent of $10,000 and borrows $5,000 from banks at an average rate of 5 per cent. Then, only $35,000 stock need be issued, the income of which, after deducting interest charges of $2,750, will be $3,250, or 9.3 per cent., a satisfactory return." Thomas L. Greene, author of "Corporation Finance," points out that a few years ago three-quarters of owned to one-quarter of borrowed funds, was regarded as about right, whereas now the proportion in the larger corporations is nearer one-quarter owned to three-quarters borrowed.

> *As all our large corporations are operating to a great extent on borrowed capital it is only fair to assume that the directors and executive officers should regard the business largely in the nature of a trust, in the management and control of which the creditors are vitally concerned. In the light of this fact no speculative enterprise should be permitted, unless it is distinctly understood when the bonds are sold that such business is to be undertaken. In other words, the directors owe a duty not only to the stockholders but to the bondholders and the general public as well.*

Distribution of credit instruments and securities. In raising funds to carry on the work of the corporation the management offers:

(a) To trade creditors, bills and notes payable.

(b) To banks, notes payable and endorsed notes receivable.

(c) To the investing public, mortgage bonds and preferred stock.

(d) To the speculative public, various grades of stock.

The amount of such offerings will depend, in each case, upon the assets and the earnings of the corporation. The corporate assets are made up as follows:

(a) Fixed investments, real estate, buildings, etc., and the securities of a holding company.

(b) Property that may be sold without impairing the business, such as raw materials, goods in process of production, and securities of other corporations over which it is not essential to exercise control.

(c) Finished products on hand.

(d) Accounts receivable.

(e) Cash.

(f) Intangible assets such as good-will, trade marks, etc.

Obligations on these assets are incurred as follows:

On group (a) mortgages and mortgage bonds obtainable up to between 60 and 75 per cent. of the value of the real estate: 50 per cent. of the buildings; 20 to 40 per cent. of machinery; 50 to 90 per cent. of securities.

On groups (b) and (c) income, profit-sharing and car-trust bonds on different terms; preferred stock in some cases and to some extent short-term notes and bank loans.

On groups (d) and (e) accounts payable and bank loans.

On group (f), and other assets, stocks are issued and surpluses built up. This classification is merely approximate, of course, and is not always followed in practice; yet corporation managers as a whole issue securities against assets as outlined above.

The creditors of all companies, especially those of railroads and stable manufacturing concerns, pay more attention, as a rule, to the income account than to the balance sheet, because it is from earnings that dividends and interest charges are paid. A splendid plant, located in the wrong place, or left stranded because of changes in general economic conditions, may become practically worthless. The earnings, therefore, are the important item to watch. These are distributed as follows: (1) Operation; (2) maintenance; (3) fixed interest charges and rentals; (4) floating interest charges; (5) betterment and surplus.

Short-time loans. We have already mentioned short-time loans, but may now analyze their nature more in detail. Thirty days is usually allowed by trade creditors, although the time may be lengthened for a sound concern. For sixty days or over the debtor usually gives a promissory note or accepts a time draft. It is not a good policy, however, to gain the reputation of a "slow payer"; neither is it advantageous to take credit if it loses heavy cash discounts. And finally, a company cannot accept trade credit with safety when by so doing it incurs obligations almost equal to its quick assets. The reader should note that the comparison is made between quick liabilities and quick assets, and not between total liabilities and total assets.

The item of bank loans has already been discussed. The third method followed by corporations in obtaining short-time loans is to issue promissory notes to the public. These notes are simple promises to pay, and contain all the features that are essential to all valid negotiable notes. These are: (a) two parties to the contract; (b) transferability; (c) a definite sum of money; (d) definite day of payment; and (e) proper signature. The corporation seal and signature should be used. Notes given by officers in their own names may be held as personal obligations. It should be observed that the notes of a corporation, sold to the public, run for a considerable period—from one to ten years, although two or three years is the average period. They are issued in denominations varying from $100 to $100,000.

These notes do not, as a rule, appeal to the investor or to the banks, being too short in duration for the one and too long for the other. They appeal to the man of large means who may temporarily find himself with idle funds in his possession. They are usually issued as a temporary expedient in anticipation of a long-time bond issue. They are intended to cover the temporary needs of a corporation while it is engaged in some form of construction work; or to tide over a period of unfavorable market conditions for long-time bonds.

These notes, although generally simple promises to pay, may also be based upon certain definite property. A corporation may issue these notes on the securities of other corporations which it holds. In this case there is little or no difference between the long-time collateral trust note and the short-time collateral trust bond.

Although this method of financing has been common in the United States for many years it was not until 1912 that it commenced to appear as an important factor in Canadian finance. Canadian provincial governments and municipalities began to secure funds in this way in that year. In 1913 the movement spread to the railways and the Grand Trunk, the Canadian Northern Railway and the Canadian Pacific Railway have all made use of the expedient. Mr. H. V. Jones, a Canadian banker residing in London has said of such issues (Monetary Times Annual):

"It is not wise to leave out of consideration the following important factor which will govern to a large extent the conditions under which the funding operations of such short loans is carried through. The London market generally becomes quickly cognizant of any plethora of securities of this description, and this knowledge tends naturally to react upon the price, not only of the securities of the government or corporation already issued and dealt in on the stock exchange, but on the price at which the new issue is about to be made. Prices

will tend to fall, and in the long run the borrower may have to bear the chagrin of discovering that all his manoeuvres to avoid a period of dear money and depreciated prices, have ended in failure and possibly in severe loss."

An example of this type of security issued by a Canadian corporation is found in the following: The Canadian Northern Railway issued in August, 1913, £1,500,000 of five per cent. five-year secured notes. The issue was over-subscribed by the investing public. The interest on these notes was made payable half-yearly. The notes were in denominations of 1,000 pounds, 500 pounds and 100 pounds and carried a coupon for a full half-year's interest due on February 12, 1914. They were secured by the deposit with Lloyd's Bank, Limited, as trustees under a deed of gift, of various securities guaranteed by provincial governments. The Company reserved the right to redeem the notes at 101 and accrued interest either as a whole or in amounts of not less than 100,000 pounds by drawings on any interest date on 60 days' previous notice.

Most of such notes have been sold bearing a comparatively high rate, between 5 and 6 per cent., in the expectation that money would be cheaper when the securities matured. Canadian bankers as a whole have not favored their issue, agreeing with London financiers that the accumulation of savings would not be great enough to take care of the refunding operations when the short-date securities should have fallen due.

Concerning short-term notes a writer in *The Financier and Bullionist*, London, says:

"There is much virtue in the redemption of securities within a moderate period and at a definite date, but, of course, short-term notes, as ordinarily understood, are on a quite different plane. This device has to be regarded as appropriate for conditions which, though not altogether abnormal, may be said to be unfavorable for the flotation of an ordinary issue. Indeed, the principal, if not the only reason, for any commercial undertaking resorting to this form of finance, is that capitalization by means of permanent obligation is impracticable or impossible. The borrower offers short-term bonds, either because he cannot get money at a profitable rate otherwise, or because he thinks that at the end of the term he would be likely to procure capital on a permanent basis at a lower rate of interest. Now, British railway companies habitually offer short-term notes to their bankers in connection with dividend payments and other obligations, but it would appear tolerably certain that any British railway company which proposed to adopt such a device to enable it to build, say, new stations, or provide other betterments to its property, would immediately find a difficulty, perhaps a *non possumus*, in the way."

From what has been said it will be clear that many experienced financiers consider that the issuing of short-date notes is a legitimate form of financing only when it is used to anticipate revenue, and not for the securing of funds for permanent works. One thing is certain—corporations should not incur too heavy a responsibility arising from such financing, for it is possible that the date of maturity may find the money market just as unfavorable, perhaps more so, as when the original loans were contracted. In concluding our treatment of this point we may give Sir Edmund Walker's views on short-date note issues. In an interview in the *Financial Post* Sir Edmund said it would take more to fund Canada's short-date notes than it would to rehabilitate the Balkan States after the devastation of the war of 1912-1913. He stated that most of these notes had been issued at a comparatively high rate in the hope that conditions would change in a short time to permit of their displacement by long-term securities bearing a lower rate of interest. Sir Edmund Walker feared that it would be some time before the market would be in a position to absorb, on a long-term basis, the huge accumulation of securities which had been placed on the market.

> *In issuing short-time notes great care should be taken to see that dependable security is given to them. On the whole their issue can be justified only to provide capital for temporary, not permanent needs. Both the British and the Canadian governments at times issue short-date securities in the shape of Treasury Bills in anticipation of future revenues. In war financing the government would be well advised to issue bonds for comparatively short periods—say ten years at the outside; otherwise the country may be called upon to pay heavy interest charges in future years when money might be secured on much more favorable terms than it can be had at the present time.*

The corporate mortgage. Long-time obligations, as has been explained, must he based upon fixed assets and in amount must correspond roughly to such assets.

We have already discussed the proper basis of capitalization. It will be recalled that there are, in general, three theories as to what determines the value of a business. Most people, at first glance, would say that the cost of the assets must determine their value. But a little reflection will show that a costly plant may not be worth what it has cost to build, if it cannot find a market for its products. And if it can handle at a profit an output up to its full capacity it may be worth much more than the original cost of construction.

The second theory is that the value of fixed assets is determined by the cost of duplicating them. It has been maintained that railroad rates, for example, should be such as to yield a fair return on the cost of duplicating railroads under present conditions. But this leaves out of account proximity to markets, density of population where the road is situated and many other important facts. Hence, most financial experts have little or no faith in the cost-of-duplication theory.

The third opinion is that the value of fixed assets is determined by their earning power. It requires no argument to prove that such is the case in ordinary business practice. An investor in buying the securities of a corporation will inquire first of all as to the value of a corporation's fixed assets, and will estimate those assets on the basis of present and future returns. It should be kept in mind that the earnings are a guide to the value of the *fixed* assets, and not to the floating assets such as raw materials, finished goods on hand and so forth. Thus it will be understood why it has been stated that the amount of investment securities that may be issued by any corporation depends both on the value of its fixed assets and the amount of its income available for interest charges. There is no contradiction involved here. The important fact to remember in connection with bond issues is that their amount is determined by the income of the corporation as a going concern.

Nature of a mortgage bond. Small corporations issue long-term bonds by placing a direct mortgage upon their property. When large sums of money are to be raised the procedure is not quite so simple It is of course impracticable to give a separate mortgage with each bond. It becomes necessary, therefore, to give the mortgage to some individual or concern which acts as trustee for the bondholders. Usually this function is performed by a trust company. In that case the mortgage indenture becomes a deed of trust. Each bond is a simple promise to pay, the phrasing being more formal than that used in a note. The bond is executed under corporate seal and contains a reference to the indenture between the mortgage company and the trustee.

Essential features of a trust deed. It has been found by experience that it is necessary to make this deed very exact and comprehensive. In the case of some railroads the trust deed itself, if bound in book form, would make a fair-sized volume. Of course the trust deed of the ordinary corporation is a much simpler affair, yet it is very carefully drawn. The rights and duties of the three parties to the agreement—the corporation, the bondholders and the trustee—are very carefully and explicitly set forth; and the property mortgaged is carefully described. The sections dealing with default of inter-

est or principal are especially important. The percentage of bondholders—usually 20 to 25 per cent.—at whose request the trustee shall take action for foreclosure and sale, is also stated. The course of action of the trustee in case of foreclosure is prescribed and the proceedings in case of receivership are also set forth.

Types of corporation bonds. Bonds may be classified with respect to:

(a) The security for their payment,
(b) Their purposes,
(c) The manner of their payment,
(d) The conditions of their redemption.

Mr. W. H. Lough in his work "Corporation Finance" has made the following classification under each of the above heads:

A. *Security of Bonds.*

1. First Mortgage.
2. Second Mortgage, Third Mortgage, etc.
3. Terminal, Divisional, Land Grant, or other Special Mortgage.
4. General Mortgage.
5. Sinking-fund.
6. Collateral Trust.
7. Car or Equipment Trust.
8. Debenture.
9. Income.
10. Participating.
11. Profit-sharing.
12. Joint.
13. Receivers' Certificates.

B. *Purposes of Bonds.*

1. Unifying.
2. Refunding.
3. Construction.
4. Purchase-Money.
5. Improvement.
6. Extension.
7. Adjustment.
8. Consolidation.

C. *Manner of Payment.*

1. Coupon.
2. Registered.
3. Registered as to principal, but dividends in coupon form.

D. *Conditions of Redemption.*

1. Gold.
2. Redeemable.
3. Serial.
4. Convertible.

First mortgage bonds are regarded as the highest type of security. It is difficult to find buyers for a junior security that is based on any claim less than a second mortgage. The result is that many corporations attempt to give their different bonds the appearance of first mortgages. Railroads issue in this way divisional and terminal first mortgage bonds. Although in many cases the security is valuable, as a rule the property on which the mortgage is based is valueless except to the corporation that owns it. A branch line or terminal railroad property could be given up by the railroad with less loss to it than would be incurred by the bondholders if they had left on their hands property that had lost connection with the railroad company.

Quite often, too, both industrial and railway companies issue nominal first mortgage bonds on the companies they control although their subsidiaries have already issued first mortgage securities. The holding company's bonds are, in reality, based only on the securities it holds, and are inferior to all the subsidiary companies' bonds. The words "unifying," "consolidation," "refunding" and so forth, used in connection with these junior securities, would seem to imply that the underlying bonds would be retired as they fall due with the proceeds of the new issue. These terms give such bonds a position in the market which is hardly justified.

Sinking fund bonds. In the case of enterprises, such as mines, which have a definite lease of life it is necessary to establish a sinking fund for the protection of bondholders. In such cases it is common to set aside a fixed amount each year; although sometimes coal and lumber companis set aside a certain proportion of the value of the product obtained. The installment or annuity method of providing a sinking fund is usually followed. In that case the company pays equal periodic installments to the bondholders or their trustees, to settle principal and interest in a certain term of years.

Where the corporation's assets are of a permanent nature the sinking fund is no longer regarded with favor. Mr. E. S. Meade in "Trust Finance," puts the case as follows:

"A sinking fund must be invested in securities. It cannot be put into betterments. In the form in which it is accumulated, a low rate of interest from the investment of these annual sums is all that can be expected. The compounding of these annual investments, it is supposed, equals the principal

of the bonds at the time of maturity, and the corporation is thereafter freed from a portion of its fixed charges. This gain, however, is in reality a loss to the stockholders. If the money which has gone into the sinking fund had been spent upon improving the property, the stockholders would eventually have received a larger dividend."

Collateral trust bonds. These bonds are a modified form of the mortgage bond. They are called "collateral trust" bonds because they are based on the securities of other companies owned by the issuing corporation. These securities are held in trust by a trustee, and bonds issued upon them. The securities so deposited may consist of bonds or stock or both. The collateral trust bond is highly regarded in the financial world, due in part to the fact that the securities upon which it is based are more readily saleable than real property. To protect the bondholders, collateral trust bonds generally include the proviso that subsidiary companies can not issue securities ahead of those deposited as collateral.

Equipment trust bonds. This type of bond is used principally by railway companies. The equipment used as security for these bonds is not owned, but merely leased, by the railway company. The lease runs for a period, usually ten years, at the end of which time the rentals paid have purchased the equipment. The manufacturers turn the equipment over to an intermediary company which leases it to the railroad. The lease is given to the trustee of the equipment trust bondholders. The railroad company pays the purchase price of the equipment in annual instalments, together with interest on the unpaid balances, to the trustee. The intermediary company is, of course, a creation of the parent organization. This type of financing has been made use of to a considerable extent by Canadian railways in the last few years.

Debenture bonds. The term "debenture" has come to mean a bond which is not secured by a lien on any specific property. It is, for all practical purposes, simply an unsecured promissory note running for a number of years. As debenture bonds are unsecured they are legally on the same footing as the general floating indebtedness of the corporation. They are much used in England, where it is recognized that earnings, after all, are the real security behind the bond. Canadian and American railways offer a variety of bonds, and thus make an appeal to many investors. English railways, on the contrary, rely almost exclusively on the debenture bond when raising funds.

Debenture bonds are issued in Canada and the United States for the following reasons: Sometimes first, second or even third mortgages have been placed, and a further issue of

junior mortgage securities would not appeal to investors. Again, in railroad reorganization junior mortgages are often replaced by debentures thus lightening the load of mortgages that has been carried. A third reason for their issue is that a conservative corporation may wish to reserve some of its resources for future mortgage issues. And lastly, if bonds are issued to be sold in Europe the debenture form is often used as it is highly regarded there.

Income bonds. The income bond partakes of the nature of both bonds and stocks. The principal sum is usually secured by a mortgage, but the interest is paid only if earned. For all practical purposes such bonds are equivalent to preferred stock, without voting power. Income bonds are usually the outcome of reorganizations, and take the place of junior mortgages. Their advantage to the corporation is obvious, as they do not impose any fixed charge on the corporation.

Other types of bonds. A "participating" bond is one that gets a fixed rate of interest and in addition a share of whatever is earned by its underlying security. "Profit-sharing" bonds give the holder principal and interest, and also a share in the increased value of the underlying assets if such arises before the retirement of the bonds. "Joint bonds" are obligations of two or more corporations which join in issuing them. A "receiver's certificate"—not properly a bond—represents money spent by the receiver of an insolvent corporation, under the authority of the court. They represent a claim on the property of the corporation superior to all other claims whatsoever.

Purposes, manner of payment, and conditions of redemption of bonds. The descriptive words applied to bonds and indicating their purposes are self-explanatory. "Unifying," "refunding," "adjustment" and "consolidation" imply that previous issues of bonds are to be retired and replaced in some way. According to the use to which the money which is derived from the sale of the bonds is put, the words "construction," "improvement," etc., are used. "Purchase-money" bonds are sold before the property on which they are based is actually bought. Usually the proceeds are turned over to a trustee, who receives a mortgage on the property as it is bought.

A registered bond can be transferred only on the books of the company. A coupon bond is payable to bearer. A gold bond requires interest and principal to be paid in gold. A convertible bond is one that may, within a definite time and at a fixed price, be converted into some type of stock. This privilege may attach to any kind of bond, mortgage, debenture, collateral trust or income. These bonds are, as a rule, semi-investment, rather than investment securities, as the object in

issuing them is to permit investors to become stock owners if the corporation proves a success and is earning large dividends.

Redeemable bonds are those which may be made redeemable at the option of the corporation, before date of maturity. Sometimes they are made redeemable by lot at attractive prices. This injects the element of speculation into them. Serial bonds—which at present appeal to Canadian municipalities—are redeemable in series extending over a term of years.

> *The banker cannot too carefully study the various types of securities which have been described above. Surplus funds are often invested in bonds and it is therefore essential that a full knowledge shall be had of the security offered as well as the rate of interest paid. While the main types of bonds have been described there are many modifications of each, the nature of which in each case can be understood only by careful analysis and scrutiny. Particular attention should be given to the nature of the trust deed under which the trustee (generally a trust company) is to carry out the terms of the bond issue. Bankers should familiarize themselves with the various bond issues placed before the public; their nature, security and price. The files of any Canadian financial journal will furnish valuable data on this subject, especially with respect to markets and prices.*

(*Continued in next Bulletin*).