

THREE OUTLOOKS ON UNDERWRITING

Dear NASD Members:

The Corporate Financing and Direct Participation Program activity of NASD members increased dramatically in 1980. Corporate debt and equity filings were \$27.6 billion, two-and-a-half times their dollar value in 1979. In this total, first-time-to-market issues had an aggregate dollar value of \$1.4 billion, nearly triple the amount in 1979. Better than half the capital raised by first-time-to-market issues was for technology companies, and the bulk of the remainder for oil & gas enterprises. As for direct participation program and REIT filings, they totaled \$6.6 billion in 1980, and were 80% greater than in 1979.

These developments make it appropriate to bring you this Special Issue of the *NASD Newsletter*, with articles on (1) Problems in the Technology Issue Boom, (2) Future Prospects for Financing Small Oil & Gas Companies, and (3) Evaluating DPPs in a Small Firm.

Your comments on these articles would be appreciated, as would your suggestions for future special articles in the *NASD Newsletter*.

Sincerely,



L. C. Petersen
Chairman



Gordon S. Macklin
President

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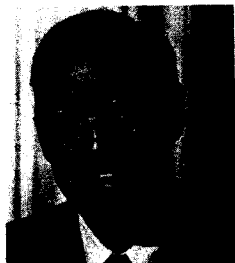
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PROBLEMS IN THE TECHNOLOGY ISSUE BOOM

by William R. Hambrecht



William R. Hambrecht is General Partner in Hambrecht & Quist of San Francisco, and was a co-founder of his firm in 1968. He has been a Governor of the NASD, Vice Chairman-Finance of the Association and Chairman of the Joint Industry/Government Committee on Small Business Financing.

The "Incredible Recovery"

During the mid-1970s, and indeed until 1978, it was popular to quote statistics that showed that public financing for companies with net worth of under \$5 million had dropped from a high of \$1,458,000,000 in 1969 to a low of \$13,100,000 in 1974, and had only recovered to \$82,600,000 in 1977. It is amazing to see what has happened in the initial public offering market since.

In 1978, there were forty-six new issues totalling \$250,000,000. In 1979, there were eighty-one new issues amounting to \$506,000,000. Finally, during 1980, two-hundred and thirty-seven companies went public for the first time, raising a total of \$1,399,000,000.

We have had an incredible recovery where, in three short years, public offering volume numbers are now setting new records.

It has not been across the board, however. Most of the activity has been concentrated in energy and technology-related companies. For example, our firm specializes in technology, and we managed or co-managed fourteen initial public offerings totaling \$317,700,000 during 1980. We obviously did not do all of the deals, so I would venture a guess that more than half of the volume of \$1.4 billion was in technology issues.

Why in the Technology World?

Why has this happened, particularly in such a concentrated fashion? There is no question that there has been a market improvement but the Dow Jones is still around 1000. For the past six years, although there has been a sizeable recovery from the disastrous markets of 1973 and 1974, price/earnings ratios for the market as a whole have been relatively reasonable. If you exclude the energy-related stocks and technology stocks from the overall market, it is still hard to say that we have been enjoying an uninterrupted classical bull market.

In our technology world, and I think this also holds true for the energy sector, we have enjoyed an almost uninterrupted, incredibly strong fundamental growth. While a good part of the American economy has labored with the persistent, difficult problems of inflation and productivity, the technology group of approximately 70 emerging companies that we follow has had

an earnings-per-share growth of 32.5% compounded annually since 1974. While this was happening, however, the markets of 1973 and 1974 brought almost all the superior growth companies back to 10 to 12 times earnings and, with the exception of several short rallies, the market for technology stocks remained in the 10 to 12 times earnings range until April of 1980. So, even though there was no basic change in the market's willingness to capitalize these earnings at a higher P/E ratio, the investors who were brave enough to participate in this market during the past six years had been earning over 30% a year, compounded annually, until the Spring of 1980.

The April 1980 Take-off

To understand what has happened since April 1980, I think you have to accept the very basic assumption that investors, both private and institutional, for the most part, do not anticipate. Rather, they react to performance.

We hold a conference every year to which we invite a large number of professional investors to hear presentations from fifty to sixty technology companies. At our conference in April, 1980, you could almost smell what was coming. Our attendance, for example, went over 900, over ten times the number that attended the 1972 conference. It was my impression that many, if not most, professional investors really had not participated in this market and were dying to jump in. They had become increasingly aware that their competitors who had invested in technology were showing superior results and the pressures were building on the non-players to get in or risk losing their money to managers who were performing. The only thing holding them back was a fear that the recession and the 20% prime rate would cause a serious break in the earnings trend. This did not happen, however, and, despite some slowdowns from the high cost of money, most of the technology group weathered last spring's recession pretty well and a virtual stampede to get aboard resulted. Prices virtually doubled and our list now shows an annualized price appreciation of better than 40% compounded annually for the past six years.

Perhaps more important, however, was the incredible amount of money that came rushing in. For example, in 1980, we managed or co-managed over 30 offerings totaling \$556,700,000.

The Problem of Quality

What does this mean today? Everything of course looks very rosy and, even though the market has dropped back somewhat, it is hard to imagine this incredible flood of money being turned off by anything other than very strong reversals in the earnings trends of these favorite growth companies. So, what does this do to the role of the broker/dealer and the problems he must face in underwriting an issue?

First of all, I think it brings back the age-old problem of quality in selecting the companies that truly do have a future and have investment appeal to the public at large. During the past six years, the market has been largely dominated by the professional institutional investors. I think the institutional market, during the past decade, has become quite sophisticated in its ability to identify high quality, young growth companies. Most of the institutions have good, experienced technology analysts who are survivors of the wild and woolly markets of the late 1960s, and it is difficult for me to imagine that they are going to get totally carried away with a speculative bull market.

However, clearly, speculative fever has been building and is now starting to draw the classical retail interest into the underwriting business. It is reasonably cautious so far, but there is no question that it is back. I think this means that many companies will come to market that will not necessarily have the all-out support of the professional market. Therefore, there will be a terrible temptation to do issues that might not qualify for the professional investors' interests. Yet, because of individual investors' interest in the underwriting market *per se*, a lot of lower-quality deals will get done.

Testing for Quality

What can be done about this? It is difficult to say. The investment banking and brokerage industry in the U.S. is basically a transactional business. People get paid on the basis of how many offerings they do and, so, the more and bigger offerings that are available, the more that will be done.

How do you assure yourself that a company truly does possess this elusive quality image? First, I think an underwriting firm should have some in-depth knowledge of the industry that the company serves. It has been my experience that quality companies are usually very easily identified by talking with their peer group and, if any underwriting firm does not have this capability within its firm, I think it makes a lot of sense to use consultants to give it an idea where their corporate clients rank within their own industry.

Secondly, of course, a prospectus writing session can be very valuable in bringing out a company's strategy, its competitive problems and its financial results. I find, however, that it is somewhat difficult to really uncover serious problems that are not obvious. Once you have committed the energies of the accountants, the lawyers and the investment bankers to completing a financing project, no one really wants to hear some bad news that will call off the deal. The dynamics of a group committed to completing a deal tend to lead people into reasonably optimistic conclusions on almost any difficult problem.

Early Association with Companies

In our firm, we try to get associated with these companies well before the time comes to go public. We

do this through investments from our venture capital funds and subsequent Board relationships with these companies. I know it is controversial for investment bankers to be on Boards of companies that they are going to underwrite but we have found, over the past thirteen years, that the major mistakes that we have made in selection of the companies that we have underwritten have come about when we had no investment or Board history with the company. There is a tremendous discipline involved with monthly statements, with periodic meetings where you get a real picture of how management thinks and acts under pressure, and it is really difficult to get the same type of working relationship from a quick two- or three-week intensive session with a group of people whose job is to make something happen.

Finally, I think we have all been very fortunate for the past five or six years in that the economic cycles of the late 1960s and 1973 and 1974 helped us greatly, by eliminating many of the promotional and poorly-conceived firms that might otherwise have come to the public market. Most of the companies which went public in recent years were the survivors of these very difficult business cycles, and managements have tended to be prudent and very realistic. I sense that a new start-up cycle is beginning and my guess is that the next three to five years will see many companies coming to the public market with very short operating histories. This does not necessarily mean that they will be bad investments, but it greatly raises the odds against the performance of the past six years.

The Pricing Problem

Beyond the quality questions, however, this market is making pricing an increasingly difficult and important factor in the offering. When you really get down to it, the price of an issue is really the most critical decision that the investment banker and the company must make.

For five years, we have had the incredible luxury of underwriting companies growing at 30% a year at 10 to 12 times earnings. But the numbers are starting to change. For example, the average price/earnings ratio of the six companies we underwrote in 1978 was 12.5 times the estimated earnings per share at the time of the offering. In 1979, the six issues were priced at an average price/earnings ratio of 13.7 times that same estimated earnings per share at the time of the offering. The issues that we wrote in 1980, with the exclusion of two that really did not have earnings, averaged 15.9 times estimated earnings. There were several that were actually priced at around 25 times estimated earnings for the current year. I can only assume that price/earnings ratios will continue to climb, as the last three or four issues that we did were based on a price/earnings ratio of 18 to 20 times. The 26 companies that have gone public in the last three years through our firm now sell at 21.1 times estimated earnings for 1981. So, clearly, our initial pricings will move up to reflect these improvements in price/earnings ratios.

Premiums: Two Reasons for Them

Pricing is not done in a vacuum. Our statistical summary which we send out every month is really an outgrowth of the pricing sheet I use to negotiate the price of an initial offering. Essentially, you compare the company going public to the price/earnings ratios of those companies in the public market that are considered similar. It is amazing how efficient the market is, and the appropriate price/earnings ratio used to be reasonably obvious. We used to argue for a small discount, the theory being that a new name in the marketplace would clearly not have the same valuation as companies which had earned the loyalty of their investors. For the past year, however, we have actually seen the emergence of a premium rather than a discount from the obvious price/earnings ratio. It is hard to explain logically, but my guess is that a new issue allows a professional investor to add the name to his portfolio without apologizing for not having bought it before. There is a great value in the world of money management for looking smart and identifying a company at its earliest possible moment.

A second factor adding to this premium has been the emergence of individual investor interest, or the so-called retail heat. We saw it building up during the end of 1979; it faded when the market fell back in 1980; but reappeared again the summer and fall of 1980. It was an almost blind, unquestioning appetite for companies that the public perceived to be hot, and this made the pricing question even more difficult to answer.

The Genentech Offering

The biggest problem we had during the past year, clearly, was the pricing of the Genentech offering. First, it was very difficult to compare it to anything, because Genentech was indeed the first genetic engineering company of any substance to enter the marketplace. Secondly, even if there were companies to compare it to, there were no earnings to speak of and it was impossible to price the issue on any price/earnings ratio.

When we first looked at the Genentech pricing question, we took the price that sophisticated, intelligent buyers had been willing to pay as sort of a starting point. I have always used a rough rule of thumb that, if you can price an issue to the public at about twice what smart, sophisticated investors will pay for a locked-up, non-marketable position, you will usually come out pretty well in the long run, if the company performs. The Lubrizol Corporation had paid \$10 per share about a year and a half prior to the public offering and, after talking with several other industrial partners and venture capitalists, it was our guess that a price of \$15-\$20 in a private transaction would not be out of line. We then filed the offering at an indicated initial public offering range of between \$25-\$35 per share.

The initial reaction appeared to show an overwhelming demand for shares. But it is not always easy to read the real demand, it gets magnified very quickly by institutions that place multiple orders with many dif-

ferent firms, and syndicate departments are not particularly noted for their candor in disclosing where their orders are from. So, the real trick in measuring demand is to try and find what the truly committed buyers, those who truly want to own the stock for the long term, are willing to pay in the aftermarket, because this is the level where a stock will usually settle once the initial speculative fever cools.

In our opinion, we thought we saw true demand building in the high 30s and low 40s. So, we felt \$35 would still be the appropriate price. We had heard rumors of \$50, or possibly \$60, in the initial trading and we were expecting some real fireworks. Actually, the stock traded as high as \$88 per share on the first day, and I just could hardly believe how some of the more experienced money managers reacted to the issue.

I will never forget a phone call early in the morning of the first day of trading from a money manager in New York who called up and, in a breathless tone, stated that he thought this was the most exciting, spectacular issue he had ever heard of or seen. Then he asked me, "Tell me, what do you really think it's worth?" I paused a moment and I said, "Last night I thought it was worth \$35." There was sort of a silence at the end of the phone, and I never did know whether he bought or sold. However, over the succeeding six weeks, the stock indeed did settle down, as the wild speculative interest dissipated.

Afterthoughts on Genentech

Well, what could we have done about this? Should we have increased the price? We told the company that the stock could be marketed at a higher level but it felt it did not want to issue it at a price higher than it could defend sometime in the future. The company did not want to take advantage of a short-term hot market and really had the desire to build long-term relationships with the equity market.

The alternative, of course, is to increase the size of the deal. But this is a difficult thing to do when it is very, very clear that the company does not need the money. As a matter of fact, during the past year, when we had so-called hot deals, we increased the size of virtually every deal to the limit that our companies could reasonably expect to use the cash over the next few years. Genentech was committed to spend \$18 million for a new plant and all of its equipment, and over \$17 million was added to the existing cash balance of over \$8 million; so the company now has \$25 million in cash for reserve working capital needs. Since it will not be in production of commercial products during the next several years, this extra cash is really a reserve to allow it to move more aggressively in product development. However, the philosophy of Genentech (and this is what I think makes Genentech unique among the research and development companies) is a very strong business orientation. Despite the fact that the company was still in its research phase, the company was operating profitably. It did this by sharing the research risk with com-

mercial partners who knew the marketplace for the future product, and it feels very strongly that this discipline is necessary to keep its focus and keep the credibility that the company has developed. To raise a sizeable amount of money beyond Genentech's most aggressive estimate of cash needs seemed to us to be a very poor and irresponsible idea.

Maintaining Responsible Markets

If pricing, then, is going to be an increasingly difficult question, what can be done to cool this market off somewhat and keep people from creating the crazy, wild markets that we had in the late 1960's, which inevitably led to the disastrous markets of the 1970's?

I think the description of the business in the prospectus, as an investment document, is becoming more and more an accepted process. Many prospectuses truly do allow the sophisticated investor an opportunity to really understand what the company does. However, there are two basic factors that are left out that allow public enthusiasm to get carried away.

First of all, there is still no clear description of the pricing assumptions of an issue. The pricing paragraph in prospectuses is now largely a boiler-plate dissertation on certain factors that the underwriter has considered. It still does not get specific. It does not say, for example, which companies your company has been compared to and, even more important, what estimate of earnings and what price/earnings ratio have been used to arrive at the price. I am as much to blame as anyone because I must admit we have yet to put an estimate into an initial public offering registration statement. We talk about it every time, we discuss the Safe Harbor Rule that the

SEC recently put forth and yet, in the final analysis, the lawyers and the company all seem to conclude that they would rather not do it.

I think it will take strong SEC pressure to demand more and more of the pricing assumptions, to get people to accept putting estimates into a public offering. I think this can only help us in the long run because, whether we like to admit it or not, virtually every issue is priced on the basis of an estimate and an estimate in print, by definition, will be a much more thoughtful and realistic number than the type of numbers that gets bandied about during the marketing phase of a new issue.

Second, my favorite number is the total market value that a price of an issue creates in the marketplace, particularly when compared to the amount of cash invested. This should be looked at very soberly.

I do want to re-emphasize that the so-called hot underwriting market is still very narrow and the good, sound small company that is not technology- or energy-related still has problems getting to the equity market. I think we are headed into a very difficult period where we all will have to deal with the problems of a speculative market, and yet still find ways to allow legitimate small business to finance in the equity market. I hope ways will be found to somehow keep wild abuses from developing, because we would all hate to see the inevitable reaction that created the disastrous markets of the recent past. We now have a very decent and viable new issue market for at least some companies, and I hope it will broaden to include the many smaller legitimate companies that need and want public ownership.

(The foregoing article is adapted from an address which the author gave to the Securities Regulation Conference in San Diego.)

FUTURE PROSPECTS FOR FINANCING SMALL OIL AND GAS COMPANIES

by Michael D. Riggs



Michael D. Riggs is Senior Vice President and Director of Corporate Finance of Schneider, Bernet & Hickman, Inc. in Dallas, and a Director of the firm. Before entering the securities industry, he was an executive of professional services and manufacturing companies.

Investors accept the risks of common stock ownership for one basic reason: they expect their investment to increase in value. Therefore, the future prospect for public financings of small oil and gas companies is immediately related to the investing public's perception of the current values and near-term prospects for this group.

As this article is being written, these stocks are out of favor. Most small oil and gas companies' stock prices are down 30%-50% from the highs achieved in 1980. We are in the midst of a well-publicized oil glut. Rumors of the imminent break-up of OPEC, followed by oil prices of \$20/barrel, are rampant.

The Small Oils are Undervalued

While future prospects for public financings are certainly affected by investors' judgments regarding near-term prospects for an industry group, these judgments may not be correct. Over the long term, the key factor is what is actually happening in the business. If the companies continue to make money and grow, investors will eventually begin to return to the group.

In my judgement, and that of the majority of my colleagues at Schneider, Bernet & Hickman, the small oils are tremendously undervalued in today's market, and investors are going to realize that before many more months pass.

We can claim some measure of expertise in the area. Last year we managed or co-managed offerings in excess of \$60 million, all for energy-related companies. This year we have completed three public offerings for approximately \$20 million, and we expect to have the total for the year exceed \$100 million.

Our basic orientation is toward the energy sector, and we expect this sector to remain strong in the future. However, because of our concentration in energy stocks, we continually ask ourselves, "Could our judgment be wrong? Is the rest of the investment community aware of something that we are missing?"

I have often made the statement that anyone who has been in the investment banking business for five years, and doesn't have humility yet, will have it soon. So I don't think we are engaging in self-deception, even though the market is telling us that we are wrong.

Four Reasons Why We Are Bullish

Our bullish views are based on several key factors:

1. **Oil Prices.** Because oil is a commodity, price is perhaps the most critical item determining the health of the industry. There are three basic scenarios for oil pricing. Under Scenario A, increased real prices, there is little question that bullishness in the oil stocks is well deserved and that they will probably increase in price over the next few years. Scenario B would hold that prices remain relatively stable over the next few years. If this happens and the oil companies can keep their prices in line, good, sound, profitable growth lies ahead. Activity is high at today's levels and profitability is satisfactory by nearly all measures. Scenario C calls for a decrease in pricing over a long-term basis and this seems to be the area that the market is focusing on at the current time. Under this scenario, the conventional logic is that the price of oil goes down, many wells become marginal producers, rigs get stacked, reserves decrease in value, and there is no question that a further decline in stock prices is inevitable.

However, under this worst-case scenario, we think that the market is missing a very key factor — the effects of the so called Windfall Profit Tax (which we like to call "The Capital Confiscation Tax"). *This excise tax actually has a buffering effect on the profits of oil and gas companies in times of decreasing prices.* In round numbers, the government takes approximately 70% of the price of oil above roughly \$18 per barrel; the tax has absolutely no relation to profitability. Therefore, 70% of a decrease in prices and a consequent potential decrease in profits for the oil companies would be absorbed by the government, through decreased taxes in the case of the independent oil companies. In the case of the major companies, the buffering effect is probably closer to 85%.

2. **Government Policies.** We do not think that it is in the national interest of the United States Government to see oil prices decrease. The strategic dependence on foreign crude has been documented many times in other journals and the implications are frightening.

The government has taken three basic actions to reduce this dependence on foreign crude. The first is to encourage conservation. The second is to stimulate increased production, and the third is to develop alternative fuel sources. If oil prices go down, all three of these efforts will be immediately and adversely affected.

Finally, it is in the government's interest to see oil prices remain where they are, or even to increase, because of the tremendous tax revenues generated by the Windfall Profit Tax. For a ballpark estimate, we figure that approximately \$50 billion was collected by the government through the excise tax last year. If this amount were to be decreased significantly, which would happen if prices go down, the impact on a balanced budget and personal income tax cuts — both key aims of the Reagan administration — would be significant.

3. **Industry Status.** Because we are so active in the energy sector, our corporate finance and research people are in the field on a continual basis, talking to the managements of companies, their suppliers and customers. Uniformly, our experience indicates that business is good in the oil patch. In a normal cycle, the first evidence of a downturn in the oil and gas business is a drop-off in seismic exploration, followed by a softening of drilling rig rates. We have not seen this happening. Stock prices may have fallen dramatically, but business in the oil and gas sector remains strong.

In its February 16th issue, the "Oil & Gas Journal" reported plans for the U.S. oil industry to spend a record of \$74,778,000,000 during 1981, with exploration and production accounting for roughly two-thirds of the total budget. The industry apparently does not foresee pricing problems developing, or it would be cutting back its capital budgets rather than increasing them.

4. **Company Analysis.** In addition to the "macro" considerations previously discussed, we spend a great deal of time evaluating the individual companies which we represent as investment bankers. Our first consideration is our analysis of management capability. We check the "team" in terms of its track record, ability to run a large, growing company and credibility in the financial community. We tend to favor owner-managed companies as opposed to professional managers.

(a) *Reserve Values and Operating Cash Flow*

Once we have completed our subjective analysis of management, including our decision as to whether these are people we want to sponsor in the marketplace, we move into the more objective areas.

The analytical concepts we have relied on in evaluating oil and gas companies over the past 10 years are principally concerned with determining changing reserve values and the level of operating cash flow to be derived from a company's reserves. When a company can add to reserves at low cost, significant increases in values and operating cash flow can occur in a relatively short period of time. The oil and gas industry is unique in that a single successful exploratory well, leading to further development, can dramatically change the value of a company's assets, given the dynamic exploration/development environment that exists today. We do not analyze independent oil and gas companies on the basis of balance sheet cost accounting and traditional income statement evaluation.

(b) *Escalating Oil & Gas Prices*

For internal purposes, we escalate domestic oil prices annually to the extent permitted by government regulations, to a maximum price of \$60/bbl. This price is hypothetically reached by about 1985, and is then held constant, given our conservative escalation factor of 10% per year.

We escalate natural gas prices by 12% per year, where appropriate, to a maximum price of \$8/mcf. Under the Natural Gas Policy Act of 1978, prices are

permitted to increase at a rate slightly greater than the rate of inflation. We believe our assumptions are conservative in the light of President Reagan's decontrol philosophy. Section 103 natural gas, now selling at around \$2.75/mcf, is substantially below crude on a BTU equivalent basis, and deep decontrolled natural gas is, in some cases, selling for in excess of \$8/mcf.

Estimated future net revenues (similar to our concept of operating cash flow) are discounted at 12% to arrive at the present value of the company's reserves. In our valuations we also apply a risk factor to discounted future net revenues — a practice traditionally used in calculating the fair market value of reserves.

Proved developed and proved undeveloped reserves are assigned risks-of-recovery factors (95% and 90% respectively) of the discounted future net revenue estimated to be recovered from the sale of oil and gas produced from reserves. For the "probable" category, we assign a risk-of-recovery factor of 50% of the discounted future net revenue estimated to be recovered from the sale of oil and gas produced from reserves.

(c) *The Valuation of Reserves*

In analyzing our client companies, we try to go beyond the obvious. With success ratios improving for wildcat wells and exploration/development drilling occurring at a record rate, it has become imperative to place a subjective value on newly discovered reserves, as well as continually to update existing reserve values, in order to be up-to-date on a company's value and to make prudent investment decisions. For example, the discounted present value of a new proved developed barrel in mid-1980 was about \$12. We believe the value today is around \$20/bbl. New onshore natural gas today, based on our calculations, is typically worth around \$1.50/mcf vs. \$1.10/mcf a year ago. We believe decontrolled deep natural gas has a discounted present value today of around \$3.50/mcf, versus \$2.50 a year ago.

The dynamics of exploration success today can lead to some material differences between a company's stock market value and the estimate of appraised value based on the last (usually out of date) reserve report. Where a discovery has been made by a company we are bringing public, we attempt to reflect the incremental value, if material, by categorizing the incremental reserves as "probable" and factoring that value into the overall appraised value estimate. We believe this "probable" category could be a significant part of a company's value in the promising years ahead.

(d) *Precious Acreage*

Additionally, we take into consideration a company's gross undeveloped acreage. The net undeveloped acreage position is attributable to the net working interest. The exploration cycle begins with acreage and, in the case of an aggressive, exploration-oriented company, acreage could be more valuable than existing reserves. We value undeveloped acreage at as near to the market value as we can determine. (The book value, the cost, of undeveloped acreage is in most cases unrealis-

tically low.) We look for companies with acreage interests in multiple-pay geological trends, especially in areas where deep, long life, decontrolled natural gas reserves exist. We believe it is important that a company have interests in several geological basins in order to trade off risk and be exposed to a diverse number of prospects, and we look for the ability of a company internally to generate and promote its own prospects.

(e) *The Umbilical Cord: Cash Flow Growth*

We are also very concerned with a company's operating cash flow. The ability of a company to finance a growing exploration and development budget, purchase acreage and reserves, reduce debt, pay dividends, etc. is determined by the growth in operating cash flow (net income, plus depreciation, depletion and amortization plus deferred income taxes, plus dry hole costs if successful efforts accounting is involved).

We pay particular attention to the operating cash flow growth: this is the umbilical cord between present reserves and future viability. A growing cash flow accompanied by reserve growth should give a company access to adequate capital. Earnings, we feel, are of secondary importance in the short run, given the unique nature of the extractive business and the vagaries of present accounting standards.

Under present accounting standards relating to treatment of exploration charges, a company can actually increase earnings by stopping exploration — the lifeblood of a company. Conversely, a company with an aggressive and successful exploration program (if on successful efforts accounting) can be penalized by the standards and may show little or no earnings. The level of

operating cash flow, however, is not changed. Most companies we follow tend to sell around ten times 1981 estimated operating cash flow and spend around one-and-a-half times their cash flow on exploration and development. The more successful and exposed a company is to exploration prospects, the higher the multiple of operating cash flow typically is.

SUMMARY

Typically, the more successful independent oil and gas companies we follow on a research basis historically tend to sell at a 20-25% discount from our estimated appraised value and around ten times our operating cash flow estimate; have incremental finding costs of around \$0.33 for each dollar of future net revenue; have drilling exposure for each dollar invested of around \$0.20 and are spending an amount on exploration and development to give the company a chance of replacing production by a factor of two times.

In today's market, the incremental finding costs and drilling exposure dollars are on target. Yet companies are selling at a discount of nearly 40% of our appraised value estimates and approximately seven times our operating cash flow estimates.

If our analysis is correct, small oil and gas companies are undervalued, but still have major needs for external capital. This means that companies are motivated to sell stock at a time when the risk/reward ratio for investors is favorable. In such an environment, the prospects for public offerings for small oil and gas companies are, in our opinion, extremely bright.

EVALUATING DPPs IN A SMALL FIRM



by Mason T. New

Mason T. New is Chairman of the NASD's Direct Participation Programs Committee and a Governor of the Association. He is Managing Partner of Branch, Cabell & Company in Richmond.

Financial Planning Services and DPPs

We began four years ago to develop a financial planning capability to serve Branch Cabell's 1,500 clients, and we formally established our Financial Planning Department in early 1980. As a regional, retail-oriented firm, we believe that offering financial planning services can give us a better knowledge of our clients' needs and broaden our relationships with them. One of the significant results of our Financial Planning Department, after fifteen months of operations, has been to discover a strong growth of client interest in and need for tax-related limited partnership investments. Hence, we are actively expanding our limited partnership product line.

The Product Committee

To meet the opportunities our clients are presenting and to discharge faithfully our responsibilities to them, we have established a Product Committee which selects the financial planning products offered by our firm. The Committee is composed of the Managing Partner, the Manager of the Financial Planning Department, the Manager of our Real Estate Investment Department, the Partner in charge of Marketing and the Partner in charge of Compliance. In the present economic climate, the products which the Committee evaluates are primarily oil & gas programs, and also some real estate partnerships. In addition, the Committee conducts a continuing review of our entire product line.

Due Diligence on Public Oil & Gas Offerings

The first step in our evaluation of a DPP is an analysis of its economic and investment merits. If an offering is a good deal, our firm is not likely to need a "due diligence" defense later on.

In public oil & gas deals, before everything else, we examine the sponsor's track record very carefully. As a matter of fact, we select most of our products from among the exploration programs sponsored by one major independent drilling company, whose record we know well. Nevertheless, depending on the nature of each new program we consider, we will generally talk to the following people directly involved:

- The President of the sponsor, to learn about the background of the deal, its organization and the objectives of the proposed partnership;

- The drilling prospect manager;
- The internal accountant;
- The department manager of the lease acquisition section;
- Bankers who can give us credit checks;
- Major drilling partners.

After satisfying ourselves with this evaluation, we may proceed with the following:

- Questioning the head of the Tax Shelter Department of other broker/dealers who have participated in the sponsor's prior deals;
- Checking with independent consultants who have placed the sponsor's prior deals with their clients;
- Getting further research from independent oil and gas reporting services and from trade journals; and
- Naturally, we have the registration statement, selling agreement and other documents pertaining to the deal examined by our accountants and attorneys.

We have found that if we conscientiously make an investment analysis of this sort, we are likely to select for our clients oil & gas programs that work financially as expected, or very near to what is expected.

Due Diligence on Private Oil & Gas Offerings

Where another brokerage firm is the lead underwriter, we obviously read the prospectus carefully and in most cases, have it evaluated by our counsel and our accountant. We also examine the structure of the deal. We ask for and review an independent analysis of the deal, if one has been made. We review the due diligence done by the lead underwriter, and we generally expect that he will have a due diligence package available for our study.

In cases where the underwriter is an affiliate of the sponsor, we utilize a more intensive procedure. In addition to reviewing the disclosure documents and the structure of the offering, we generally interview the principals and their associates; we review their prior offerings, both public and private; we check the sponsor's industry references and where possible develop some references of our own; and we talk to other broker/dealers who have participated in prior deals, to determine what due diligence they may have performed that could be helpful.

Due Diligence on Private Oil & Gas Offerings

Before our firm will involve itself in a private oil & gas offering, we go through all the steps we take on public deals. Then, most importantly, we have our counsel review the offering to determine whether it really is in compliance with the exemption from registration which is being claimed. We are keenly aware that, if we are sued, we have the burden of demonstrating that the deal qualified for an exemption.

We participate in private oil & gas and real estate offerings only where we believe we fully understand the

investment merits and risks involved in the offering, and where we believe such risks will be acceptable to our clients. In this regard, we have virtually eliminated multiple write-off private direct participation programs from our product line. Invariably, at least one of three things is wrong with them: (1) their investment merits are insufficient, (2) their structure is inappropriate and the exemption claimed for them is shaky, and (3) the tax consequences being asserted are questionable.

Real Estate: The Importance of a Good Deal

In addition to oil & gas programs, real estate partnerships are now necessary products for most broker/dealers. Clients generally understand real estate and the potential hedge against inflation which it offers. When one couples this appreciation potential with the possible tax advantages which are inherent in commercial properties and in certain residential properties, client demand is almost inevitable.

Our first major participation in a public, tax-sheltered income, commercial property partnership came about in the early 1970s. We were totally sold on the partnership — conceptually, anyway — by one of the most effective real estate wholesalers we have ever met.

Before participating in the partnership, we submitted the prospectus to our legal counsel and accountants for scrutiny. Counsel's reaction was positive and our accounting firm concluded that the accounting procedures used were acceptable and adequate.

Then we were ready for an on-site visit and for personal meetings with the principals. Several of us journeyed to the general partner's headquarters and spent a few days meeting and questioning the President, the marketing people, the officer in charge of internal accounting, the officer in charge of property acquisition, and the officer in charge of property management. One of our analysts spent many hours poring over the figures of other properties acquired and managed by this group. We made independent checks on credit ratings and individual reputations, including talking to several banks who had had dealings with the organization.

The reactions were very positive on all accounts, and we approved the product and began our marketing effort. The wholesaler (or sponsor representative) made educational presentations to our Registered Representatives in each of our offices. We organized client seminars to explain the benefits of investing in commercial real estate and specifically in this offering. The net result was that we sold approximately 10% of the total deal and were excited not only by the marketing success but by our clients' broad acceptance of a real estate product.

Eight years later, we are still waiting to get out of this deal. We are also still waiting to receive that tax-sheltered income which was promised. We got the tax shelter but not the income.

What went wrong? Everyone likes to believe that economic conditions caused the disappointing perfor-

mance of the partnership, and undoubtedly this was a contributing factor. Mainly, however, it is our opinion that the sponsoring group's overwhelming desire to meet its projections, including front-end shelters, and to get the money working quickly, caused pay-up for properties, which in turn has caused hard times for the investors. The general partner had impressive credentials, but this was its first major public partnership.

Since then we have participated in public offerings sponsored by well-established general partners with proven track records of consistency in performing at or near projections. In our opinion there is no substitute for a record of accomplishment on the part of the sponsor.

Real Estate: An Intra-State Deal

We have also organized and sponsored one intra-state offering of a real estate development deal. We reasoned that the response of our client base to real estate as an investment would be even greater if the investment were local and they could "kick the dirt," so to speak. The deal took approximately one year to put together. We are pleased about this project's prospects but we hope that any subsequent offerings we decide to sponsor will be more profitable. An investment of a year's time in an offering of this sort is economical, from the firm's point of view, only if there are follow-up partnerships that can be distributed after the first deal is completed, or if the firm can be offered profit participation in some manner. As it stands, this first offering has only been an education for us; the second and third deals, if they come, should, however, be more profitable.

Conclusion

Between the lessons we have learned from past experience and the rigorous procedures which our Product Committee has developed, we believe we are now capable of expanding our DDP product line through a judicious selection process.

In expanding our DPP product line, we must, of course, continue to emphasize investor suitability by matching the product to the analyzed needs of our clients. Our Financial Planning Department is taking great pains to know our clients' financial situation thoroughly, to be sure that they can take the risks, stand the illiquidity and utilize the tax advantages of the offerings. Before acceptance of an order, we require that our Registered Representatives go over the subscription agreements with special care before their clients sign.

This stress on suitability is the capstone of the DDP evaluation process. Determining that a specific product meets the needs of a client, and that the client can truly accept the risk, should enhance the reputation and profitability of the firm.

(The foregoing article is adapted from an address to the Mid-Atlantic Securities Conference.)

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