

OUTLINE OF NOVEMBER 6TH LECTURE

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RULES FOR APPRAISAL OF COMMON STOCKS FOR INVESTMENT PURPOSES

1. Appraised Value is determined by (a) estimating the Earning Power, (b) applying thereto a suitable multiplier, and (c) adjusting, if necessary, for asset value.
2. Earning Power should ordinarily represent an estimate of average earnings for the next five years.
3. Earning Power should ordinarily be derived from actual earnings over some period in the past. Where trend has been neutral, the period should be five to seven years. Where definite trend is shown, actual earnings for last year of reasonably normal general business may be taken, if it seems desirable.
4. In deriving Earning Power, the past earnings may be adjusted for known or highly probable developments -- e.g., changes in capitalization, properties, tax rates. Changes of a qualitative nature -- e.g., in competitive conditions, products, management -- should be reflected in the multiplier.
5. The multiplier should reflect prospective changes in earnings. A multiplier of 12 is suitable for stocks with neutral prospects. Increases or decreases from this figure must depend on the judgment and preferences of the appraiser. However, in all but the most exceptional cases the maximum multiplier should be 20 and the minimum should be 4.
6. If tangible asset value is less than earning power value (earning power X multiplier), the latter should be reduced by 25% of the deficiency to give the final Appraised Value. (Do not increase for excess tangible value except as under 7).
7. If Net Current Asset Value exceeds earning power value, the latter should be increased by 50% of the excess to give the final Appraised Value.
8. Where extraordinary conditions prevail -- e.g., war profits or war restrictions, a temporary royalty or rental situation -- the amount of the total <sup>probable</sup> gain or loss per share due to such conditions should be estimated, and added to or subtracted from the appraised value as determined without considering the abnormal conditions.
9. Where the capitalization structure is highly speculative -- i.e., the total of senior securities is disproportionately large -- then the value of the entire enterprise should first be determined as if it had common stock only. This value should be apportioned between the senior securities and the common stock on a basis which recognizes the going-concern value of the senior claims. (Note difference between this treatment and a valuation based on dissolution rights of the senior securities). If an adjustment is needed for extraordinary conditions, referred to in (8), this should be made in the total enterprise value, not on a per-share-of-common basis.
10. The more speculative the position of the common stock -- for whatever reason -- the less practical dependence can be accorded to the Appraised Value found.