Chapter 4 Large businesses

Questions

1. Explain briefly the meaning of the following terms:

   a) placing of shares
   b) FTSE All-Share index
   c) hostile takeover bid
   d) market capitalisation

2. Selkirk Systems plc has 180 000 ordinary shares in issue. The nominal value of the shares is £1 each, and the market value of one share at 1 February 20X4 is £2.85.

   The company makes a 1 for 4 rights issue on 1 February 20X4 at a price of £2.00. Your friend Jancis holds 1000 shares in the company. She can afford to take up the rights issue, but before she makes a decision, she would like you to answer the following questions:

   a) why is the company making a rights issue at all? Couldn't it just make some more shares available to sell on the stock market to anyone who wants them?
   b) why is the price of the rights issue less than the market value?
   c) if I take up the rights issue what will the overall value of my shareholding be?

3. Izzie, a friend of yours, has recently inherited some cash which she currently keeps in a bank deposit account which pays interest at 2.1% per year. She is thinking about investing part of her cash in shares, but doesn't know much at all about how the stock market works. She comes to see you with the following queries:

   a) 'a colleague at work told me he made a lot of cash out of an investment in shares on the AIM. I didn't like to seem ignorant so I didn't ask what the AIM is. Can you tell me? And am I likely to make money, like he did, if I invest in AIM shares (whatever they are)?'
   b) 'my dad said I should invest in pharmaceutical companies because people are always falling ill and there'll always be a market for pills. How could I find out more about some of the big pharmaceutical companies?'
   c) 'I don't like the idea of losing any of my money. Do you think shares are a safe investment for me?'

Required: answer Izzie's questions.

Answers

1.

a) When a company flotation takes place, it may involve a placing of shares. This is where shares are sold off to a group of buyers, usually the large financial institutions such as investment trusts and life assurance companies. The general public does not get the opportunity to buy into the new share issue.

b) The FTSE All-Share index is a stock market index that rises and falls in line with the value of all of the shares in the FTSE 350 and FTSE SmallCap groups. These two groups include many but not all of the shares listed on the London Stock Exchange; the FTSE Fledgling group of shares is not included in the All-Share index.

c) A takeover bid occurs where one company attempts to purchase a majority of another company's shares, in order to be able to control the target company's activities. A hostile takeover bid refers to a takeover bid that is rejected by the target company's directors.

d) Market capitalisation refers to the total market of a listed company calculated by multiplying the total number of ordinary shares in issue by the market value of one share.

2. Selkirk Systems plc.

a) The company could, indeed, makes more shares available to sell generally on the stock market. However, listed companies will often make a rights issue instead; it is a rather cheaper way of raising capital than via an offer for sale. Also, existing shareholders can reasonably be assumed to have a particular interest in the company, and they may well wish to support its activities by further investment. Rights issues are often very successful because of this factor. A further point is that, if rights are taken up by the shareholders they retain the same percentage of ownership as previously. This can be demonstrated by the facts in the example. Jancis currently holds 1/180th (approximately 0.56%) of the shares in the company. If she takes up the rights issue she will hold 1250 shares out of a total number of issued shares of 225 000 (180 000 shares plus the new issue of 45 000). 1250/225 000 × 100 = 0.56%, i.e. the same percentage holding as before.

b) The price of the rights issue is less than the market value simply because this makes the issue appear more attractive to shareholders and so they are more likely to make the additional investment.

c) If Jancis takes up her rights she will buy an additional 250 shares (1 for 4) at a price of £2.00 each – the value of this part of the investment is therefore 250 × £2.00 = £500.

Her existing holding, valued at market value is £2.85 × 1000 = £2850. The value of her shareholding at 1 February 20X4 (assuming the transaction takes place on that day) is thus £500 + 2850 = £3350.

3. Izzie

a) The Alternative Investment Market (AIM) deals in shares of smaller and/or newer companies than those that are eligible to obtain a full listing. The companies listed on the AIM are often (although not always) riskier investments than those listed on the main stock market. It is certainly possible to make money out of an investment on the AIM either by good luck or good judgement. However, there are no guarantees in investment. An inherently risky investment may rise or fall in value and it is not usually possible to predict with accuracy the future behaviour of any investment in shares. It may be that Izzie's colleague has simply been lucky.

c) It is quite easy to identify the names of listed companies dealing in pharmaceuticals in either the pages of the Financial Times or on the London Stock Exchange's own website. Once the companies have been identified, information (financial and other) can be found in the following places:

i) the Financial Times (share prices can be checked daily, and news items on pharmaceutical companies are likely to appear fairly often, given the importance of this sector).
ii) the Hemscott website which gives basic financial details of all UK registered listed companies
iii) the London Stock Exchange website contains a great deal of information about, for example, the historical performance of individual shares
iv) companies' own websites: these often include full-text copies of a company's most recent annual financial statements plus useful archive information

c) If Izzie is really very cautious it may be that investing in shares is not for her. Some shares are less risky than others, but there is always a risk of losing money on this kind of investment. Even if the particular company performs well, there may be a general downward movement in share prices which cuts the value of the investment. This has occurred recently in 2001, 2002 and 2003. Perhaps Izzie should consider safer forms of investment, such as long-term bank deposit accounts (which pay a higher rate of interest) or investment in government bonds or a pension scheme.