

- The Price / Earnings Ratio (PE Ratio) is the price of the stock divided by the EPS. Therefore the PE Ratio = $\$50 / \$2.50 = 20$ times.
- The PE Ratio represents the number of years the company will have to make the same amount of profits in order to equal the current share price. The higher the PE Ratio, the higher the stock is rated by investors.

Takeoverco inc wants to buy a smaller company called Targetco inc. In order to do this it needs to raise \$100million. To raise the \$100million Takeoverco will issue 2.5 million shares at a discounted price of \$40.00 per share. (*Rights issues are usually made at a discount to current value, however we have simplified and exaggerated the numbers here for illustration purposes only*).

There are now 12.5 million shares outstanding in Takeoverco. You still have 1,000 shares (assuming you don't take up your pre-emption rights). The newly merged company posts results of \$30million in profits. Let's assume that the PE Ratio is still the same at 20 times. This means that the overall company value (Market Capitalisation) is now $\$30\text{million} * 20 = \600million .

- So now the share price of Takeoverco is $\$600\text{million} / 12.5 \text{ million} = \48.00
- The current value of you holding is now $\$48.00 * 1,000 = \$48,000$. This is 4% below your entry price of \$50.00.
- The percentage ownership stake you have in the company is now $1,000 / 12,500,000 = 0.008\%$, which is 25% less than you had before.

This isn't great news so far! Your percentage ownership in the company has reduced, as has the value of your shares even though the company's market value has increased. So, let's look at Earnings per Share:

Post merger Earnings are \$30million and we divide this by the number of new shares outstanding (12.5 million).

$$\text{EPS} = \$30\text{million} / 12.5 \text{ million} = \$2.40$$

When you originally bought the shares you bought them with an EPS of \$2.50. Even though the company is now making more profits overall, the company has actually decreased Shareholder Value, because in making that extra \$5million profit, it has diluted existing shareholders by a greater degree and therefore EPS has declined.

The next few paragraphs outline the full implications of a rights issue. If you want to skip it, proceed to the heading below entitled "Key financial terms".

=====

We didn't include the fact that in a rights issue the stockholder would either be able to pay for new shares at the discounted rate of \$40.00 per share or would have received a payment instead.

Even if you did take up your rights, this would have been the scenario:

You owned 0.01% of the company's shares, thereby entitling you to rights over 0.01% of the new shares.

$$0.01\% * 2,500,000 = 250.$$

You can buy 250 new shares at \$40.00, so you would spend another \$10,000 on top of the original \$50,000.

Your average cost of entry is now: $\$60,000 / 1,250 = \48.00 .

Your shares are worth \$48.00 each now. So you have made no loss, although the EPS is lower. Remember they are worth \$48.00 because the company value in the market is \$600million and there are 12.5 million shares post merger.

If you'd taken cash instead of taking up your rights then provided that the share price on the share issue date is greater than the issue price (\$40.00), then you'd receive a cash payment. The cash payment is based on the following calculation:

$(\text{Issue date share price} - \text{Issue Price}) * (\text{number of shares you own at the record date})$

So, if the share price on the issue date is at or below \$40.00 then you'll receive no payment at all and you'd suffer from the dilution effect as outlined above.

Let's assume the markets have been a little unsteady and the share price has fallen to, say only \$42.00 on the issue date, then you would receive the following:

- **Calculation to evaluate the Ex-rights price**

Remember, this is a 1 for 4 rights issue

$$\frac{(\text{issue date share price} * \text{No. of shares you already own}) + (\text{issue price} * \text{No of new shares})}{\text{Combined no. of shares}} = \text{Ex rights price of share}$$
$$\frac{(\$42.00 * 4) + (\$40.00 * 1)}{5} = \$41.60$$

- **Calculation to evaluate the value per right that you own**

$$\$42.00 - \$41.60 = \$0.40$$

- **Calculation to evaluate the expected payment for not taking up your rights in the rights issue**

$$\$0.40 * 1,000 (\text{shares you owned originally}) = \$400.$$

So if you didn't take up your rights and the share price on issue date was \$42.00, then you would receive a cheque for \$400. Hardly enough to compensate for the loss in shareholder value you are suffering in the above scenario where the share price has fallen.

The above example **is a little extreme and** is included to demonstrate the significance of Earnings per Share, as opposed to straight earnings. You must be aware of how companies can raise their money for acquisitions, so that you can fairly assess whether they are going to enhance shareholder value. When assessing the growth of a company you must look at the growth in **EPS**.

Key financial terms

Term	Description and definition	Comments & significance
Balance Sheet	The statement of the company's assets and liabilities at a given 'snapshot' in time. It is prepared with the Income Statement and Cash Flow Statement.	This is the part of the company's quarterly, half yearly and annual results that shows you the company's health in terms of assets and liabilities. The company may have increased profits, but has it achieved this by increasing its financial leverage (i.e. more borrowings) and are these borrowings at a healthy level?
Cash Flow	This is net earnings before depreciation, amortization and non-cash charges. Cash Flow is calculated by adding depreciation to net earnings and subtracting preference share dividends. Cash Flow is one of the ultimate ways of determining the health of a company.	<p>A profitable company can still go bust. Why? Because it isn't generating enough cash. Young companies often have negative cash flows. Just look at a selection of Internet companies for examples. Many of these companies aren't even profitable and will never be, let alone their ability to generate cash.</p> <p>Remember that a company needs CASH to pay its bills. If it cannot pay its bills it will go bust. Cash Flow is an extremely important figure, but as with all of these figures, don't just look at it in isolation. You need to check it with some of the other figures. For example, a new start-up with negative cash flow may look very unhealthy on the face of it. But you might find that it has millions tucked away in cash and cash equivalents. Many of the Internet start-ups have survived in this way up to now, even in spite of their weak business models. It was only a matter of time for many of them!</p>