

Additional Case Studies

Chapter 9

Raising Finance in a Market downturn

Written and researched by Dr Haider Ali

Following the stock market downturn of 2002 a number of small and new firms on the London stock market found it difficult to raise equity finance. Traditionally they would have raised funds through a rights offer to new and existing shareholders. But with stock investors becoming more risk averse, raising sufficient funds would be difficult.

In addition for very small firms there was the added problem that raising relatively small sums of capital was also quite expensive if it involved going to large numbers of shareholders, placings of stock with institutional shareholders could be undertaken but depended on there being the appetite on the part of small numbers of institutions to take part in the share offerings. Raising larger sums also had challenges because this would mean heavy levels of dilution for existing shareholders and make them less likely to take part in future fundraisings.

One of these companies was Osmetech plc, a UK-based developer of electronic odour sensors ('e-noses') for use in the healthcare industry. Osmetech's multi-sensor array based gas sensing technology screens patient samples and tests for the presence of infection-causing bacteria. Although listed on the stock exchange, Osmetech was small by any standards, in the year ended 2001 it had had sales of £56,000 and in 2001, its assets were worth just over £3million.

At that point in time the company was still in the development stage for its products. In November of that year the company had received FDA approval for its Urinary Tract Infection screening device – a first for the e-nose industry. The company had also undertaken successful pre-clinical trials for the company's Bacterial Vaginosis (BV) Microbial Analyser at Johns Hopkins Hospital, Baltimore, achieving faster and more objective results than the existing 'gold standard' diagnostic test. Finally clinical trials had commenced for the BV

sensor product at three leading UK and US hospitals. Data from these trials would support second submission for FDA approval expected at the end of April 2002.

However, despite this progress on the business front the company's balance sheet looked very poor indeed. The company's net current assets were just over £2m and since the loss in the six month period to October 2001 was £2.5m, this suggested that the company would run out of funds in the following six month period. This would be well before it could bring any products to market.

Given the funding gap, Osmetech, like a number of other small companies, went to a finance house. In Osmetech's case, the arrangement was as follows. In September, the Company secured an equity credit line of £5,000,000 with GEM Global Yield Fund Limited, a US based private investment group. The facility was available for a two-year period during which Osmetech would control the timing and the maximum amount of each draw down. The Company was not obliged to draw down on the funds on offer, but Osmetech claimed it provided important flexibility and cost-effective access to funding outside traditional equity markets. (Source: Osmetech PLC Interim Results 2002).

As Osmetech pointed out, the advantage of having a drawdown facility with GEM was that the funds could be used as and when they were needed. If the company's cash position improved and funding was not required this could turn out to be a relatively low cost means of arranging finance. However, there was a catch associated with relying on GEM for financing. The cost to the company would be met by not only the company itself but also existing shareholders, because GEM would be paid in terms of warrants that could be exercised at particular share prices. The terms of the warrants could mean that if the company asking for GEM finance made recourse to that finance when the share price was relatively low, the levels of dilution for existing shareholders would be a great deal higher than if the GEM funds had been used when the share price was much higher.

The following analysis was undertaken on a public bulletin board (by the author of this case) for another company (a games software company called SCi Entertainment), which had also relied on financing by GEM at around the same time:

At a time when the SEG shareprice is £1, SEG want GEM to subscribe for, say, £1million, then GEM will get 1,111,000 new shares and they will also get warrants

for a further 222,000 shares. The total number of shares they will get is 1,333,000 and this represents 6% of the enlarged share capital.

Now if I understand things correctly, if the share price at the time of the drawdown is not £1, but it is £3 then GEM only get 370,000 shares for their million quid and 74,000 shares worth of warrants. As a result they only have 2% of the enlarged share capital.

If my understanding is correct how well we do with SEG shares depends on how well the share price is doing at the time the company needs the draw down.

If the share price stays at current levels or even falls, and the company needs the money from the draw down, we are clobbered.

Here's a nightmare scenario.

Let's imagine the company needs the whole £5 million and at the time of the draw down the share price is £1, the company will issue an extra 6.6 million shares.

Now according to Hemscott at the moment the company has 19.579 million shares in issue. For the financial year 2002 brokers' consensus eps is 7p and the forward p/e ratio (based on the current share price of 78p is 11.5).

Let's imagine that the above drawdown takes place, what happens to the above figures? The new eps becomes about 5p and the prospective p/e becomes 15. To put it another way, in order to maintain the 11.5 p/e ratio the share price would have to fall to about 57p.