

1,422.6
1,541.3
1,741.8
2,951.0
1,908.7
3,379.8
2,729.5
2,861.0
2,362.0

0,897.7

Case 25

British Aerospace PLC (A)

In the summer of 1991, Sir Roland Smith, chairman of the board of directors of British Aerospace (BAe), concluded that the company required £432 million in additional equity. This capital would be used to finance export sales, to continue the delivery of products already financed by customer advances, to fund ongoing restructuring and rationalization of the firm, and to rebuild the firm's equity base. In January 1991, Sir Roland had told securities analysts that he expected BAe's pretax profit for the year would total £300 million. In late August, however, there was troubling news that the recession in Britain was imposing a significantly greater strain on the company's performance and finances than had been expected. Results for the first six months ending in June 1991 showed a pretax profit of £86 million, off from £146 million in the first half of 1990. BAe's financial staff estimated that pretax profits for the year would drop to -£85 million.

In these circumstances, should BAe go to the market immediately, just as news of the first-half results were being absorbed by the financial community? Or should it wait a few months and risk a rights offering of shares under the darker cloud of the full-year results? The financial results and a sale of new shares would depress the share price from the 565-pence level prevailing in late August. If the company moved quickly, before it had to report first-half results in early September, it might exploit the high current price. Although capital market conditions were improving, BAe could not predict how soon it would be able to return to the market at August's 565-pence share price once it released first-half results. On the other hand, a rights offering of shares would require the firm to forecast near-term financial performance, which might also depress share prices. If the firm did proceed soon with a rights offering, what should its terms be? Specifically, where should BAe set the exercise price of each right, and how many rights should be issued per share of outstanding stock?

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THE COMPANY

British Aerospace was among the largest industrial firms in the United Kingdom, with 1990 sales and net income of £10.54 billion and £278 million, respectively. Its principal business sectors consisted of (1) defense systems, (2) commercial aircraft, (3) the Rover automobile group, and (4) property and construction. Exhibit 1 presents the contributions of each of these sectors to the firm's total annual sales and profits in recent years.

Defense Systems. The company was a significant competitor in the defense-systems market: It led all Western European defense contractors, and it ranked third, after McDonnell Douglas and General Dynamics, among all defense contractors in the industrialized countries. BAe's products included military airframes, missiles, ammunition, explosives, and guns. The company declared that its objective was to "consolidate its position as one of the world's leading defense contractors as the industry restructures." Given the decline of the Soviet bloc from 1989 to 1991, it appeared that the defense-systems industry would enter a period of reduced demand and major rationalization. Although the demand for defense products was dropping in August 1991, BAe's management believed that demand would recover to previous levels by the year 2000. Outside analysts were especially interested in the "Al Yamamah" defense construction program for Saudi Arabia, for which BAe was the prime contractor. This program supplied defense systems, construction services, training, and support to the Saudi government. As of August 1991, BAe's gross revenues from this program exceeded £8.3 billion. BAe's management believed that sales from the contract would amount to £2 billion per year to the year 2000.

Commercial Aircraft. BAe participated in Airbus Industrie and produced regional commercial aircraft and executive jets. Airbus was a consortium venture between BAe, Aerospatiale of France, Deutsche Airbus of Germany, and CASA of Spain. BAe designed and manufactured wings for the various Airbus models. Airbus was expected to grow and introduce new models over the next few years, which suggested that BAe would have to make significant commitments of working capital to the project.

Although demand for regional commercial aircraft was expected to grow, competition was expected to be particularly keen. Analysts believed that no manufacturers would earn a satisfactory return on capital employed in this sector; consequently, they expected the regional aircraft industry to undertake a substantial program of rationalization. BAe intended to participate in this rationalization and to introduce new models in conjunction with partners. The executive-jet segment was growing well and provided a satisfactory return on capital.

The Rover Automobile Group. BAe produced and sold automobiles under the Rover, Land Rover, MG, and Sterling marques. BAe acquired Rover in August 1988, in what most observers agreed was a distress sale. Rover had been operating unprofitably for years prior to 1988. Since the acquisition, BAe had focused on improving profitability in the Rover group. This had entailed emphasizing export sales, repositioning Rover's car products toward the upper quartile of its respective market sectors, raising prices, changing the management process and working practices, and collaborating closely with Honda in product engineering and manufacturing. BAe expected that continued product enhancement and expansion would require capital expenditures greater than £350 per year over the next

three years. Even with declining demand for automobiles in late 1990, management believed that the Rover group would be self-financing over the next three years.

Property and Construction. BAe entered this sector in 1987 when it acquired Ballast Nedham, an engineering and construction firm. In 1989, BAe also acquired Arlington, a developer of industrial parks. BAe offered three reasons for its entry into this sector: (1) the defense-systems sector required construction capability; (2) BAe's own restructuring would create surplus land and industrial facilities that BAe would want to sell or develop; and (3) complete infrastructure projects were generally viewed as an important industrial-growth segment. The recession in real estate that began in 1990 was gaining in severity, however, and depressing the financial performance of this sector of BAe's business.

PAST FINANCIAL PERFORMANCE AND ANALYSTS' EXPECTATIONS

In late 1990, securities analysts openly acknowledged the business and financial challenges facing BAe: one analyst cited BAe as "one of the last really inefficient U.K. manufacturing companies." Nevertheless, he also issued a "buy" recommendation at 526 pence per share, arguing:

There is obviously a lot wrong with British Aerospace. The company is, however, aggressively coming to terms with its difficulties through a radical programme of restructuring that will improve trading margins. The buy case rests upon defense profits stabilizing on a much reduced cost base, upon which recovery in motors, aerospace, and property can build. With growth in telecommunications and asset sales reducing debt, these could double profits on a five-year view . . . 1991 will be a particularly strong year for BAe.¹

Other analysts echoed this view. Their forecasts of financial performance for the year ending December 31, 1991, projected pretax profits at about £465 million, earnings per share at about 110 pence, and a dividend per share at 27.5 pence. These forecasts were, in part, an extrapolation of favorable historical trends in the company (see Exhibit 1). They were also founded on expectations of a robust market for automobiles, a strong recovery in property, and large exports under the Al Yamamah program.

RESULTS FOR FIRST-HALF 1991 AND FUTURE FINANCING REQUIREMENTS

Exhibit 1 presents the financial results for the first half of 1991, which Sir Roland would soon be obliged to report to investors. The figures showed that pretax income had fallen to £86 million as compared with £146 million for the same period a year earlier. Even worse, BAe analysts projected that, although the pretax income for the full year would be no greater than £150 million, it would be offset by £235 million in extraordinary restructuring

¹P. Compton, "British Aerospace—Company Report," UBS Phillips & Drew Global Research Group, December 5, 1990.

charges. Thus, Sir Roland's staff projected that pretax earnings would be *—£85 million at best*. These results would be a stunning reversal of the historical trend and of the expectations of securities analysts.

The earnings decline was due to softening of business in the commercial aircraft and property sectors of the firm's activities. The defense sector remained robust, although growth in orders under the Al Yamamah program had not yet materialized. The Rover group had been saddled with £45 million in extraordinary expenses arising from its withdrawal from the North American automobile market.

Against this backdrop, management sought to raise £432 million in new common equity. The cash position of the firm had deteriorated sharply in the first half of 1991, because of heavy capital expenditures and seasonal buildup of working capital in the Rover group; reductions in customer advances as deliveries continued under the Al Yamamah program; and extraordinary rationalization expenses. The firm's net cash balance (cash less short-term debt) had declined from £711 million outstanding at the end of 1990 to *—£120 million* by the end of the first half of 1991. BAe's financial staff believed that net cash would return to a positive balance of £100 million by the end of 1991, although this would be well below prior years' balances (see Exhibit 1).

Exhibit 2 presents the prevailing price trends for BAe shares. BAe shares had enjoyed a surge in value in February 1991, along with the rest of the stock market, upon the conclusion of the Gulf War. Since then, the share value had subsided somewhat. At a level of 565 pence, shares were trading at a multiple of 5.8 times 1990 earnings per share (compared with a market-average multiple of 13.9 times 1990 earnings per share), and at a substantial discount from the 1990 book value per share of 845 pence. One analyst argued that the book value understated the true breakup value of the firm because it ignored future cash flows from the Al Yamamah program, the intangible values in the Rover group's brand names, and potential gains in more than 6,000 acres of developable land.²

RIGHTS-OFFERING METHOD OF ISSUING COMMON STOCK

In Britain, as in the rest of the European Community,³ securities regulations required public companies to offer new shares of common stock to existing shareholders first. Shareholders retained the right (but not the obligation) to purchase shares offered to them; in other words, shareholders had "preemptive rights" over newly issued shares. The prevailing method of selling common stock was called a rights offering of shares. In a typical rights offering, existing shareholders were offered the opportunity to buy new shares

²Ibid.

³The rights offering, a preemptive offering of shares to existing shareholders, was the predominant method of share issuance outside the United States. The technique preferred in the United States was the "general cash offer," or "bought deal," where an underwriter would buy the shares from the issuing company and resell them to any interested investor. Some evidence suggested that rights offerings were less than or equally as costly as general cash offers to the issuer. Rights offerings differed from general cash offers mainly in that (1) in a rights offering, the price of the new shares was theoretically irrelevant and (2) rights offerings protected existing investors against involuntary dilution.

in proportion to their current holdings; the exercise price was fixed at some discount to prevailing market prices; and the option to buy lasted for a limited time, such as 30–50 days. The task for the shareholder was to decide whether to (1) exercise the rights, (2) sell the rights to someone else, or (3) do nothing and allow the rights to expire worthless. If the shareholder exercised the rights, his or her percentage interest in the company would remain unchanged; but if the rights were sold or allowed to expire, the shareholder's interest would be *diluted* to the extent of new shares issued.

The primary task for the issuing company was to design the rights issue to promote its success. Three elements needed to be decided:

- *Proportion of new shares to current holdings.* The right typically entitled the shareholder to purchase a specified number of new shares in proportion to the number of shares he or she currently held. For instance, a two-for-five rights issue meant that two new shares were offered for every five shares already owned.
- *The price discount.* Most rights offerings discounted the shares by 12 to 20 percent from prevailing prices. It was commonly believed that shares were discounted as an incentive to investors to buy the shares. Some analysts argued that the price at which shares were to be issued was irrelevant, because any discount affected the number of shares to be issued, which, in turn, affected the dilution of preexisting shares. Thus, discount and dilution might offset each other. Exhibit 3 illustrates the theoretical effect of a rights offering by BAe on its share price and market value of equity. The exhibit reveals that, if the shareholder failed to exercise or sell the rights, he or she would sustain a loss in value, and that loss would grow with increases in the rights ratio or the price discount, or both.
- *Underwriting.* In theory, companies had no need of an intermediary for the share issue because they would be selling shares to their own shareholders. An intermediary would, however, ensure that the company would receive the desired amount of proceeds in the issue: a firm underwriting commitment was essentially a put option that enabled the issuer to sell its shares to the underwriter in the event that its own shareholders did not exercise their rights. The typical fee for a standby commitment was 1.25 percent of the gross proceeds of the issue. Sir Roland wondered whether this would be a fair fee in BAe's case.⁴

CONCLUSION

The decisions about the timing and terms of the share rights offering seemed to depend on the financial information that the firm would soon release. How would the stock market respond to this information? Was there a way to frame the information to best advantage? Raising £432 million from existing shareholders meant a significant addition to the book value of the firm's equity and an even larger addition to its market value. Sir Roland Smith would, however, need to proceed cautiously in taking any action.

⁴The commitment would need to be outstanding for 30 to 50 days. BAe's sigma, or volatility, was .36; its beta was 1.08. Short-term British government Treasury bills were yielding 10.07 percent at the end of August 1991. BAe's dividend yield was about 5 percent. The stock price currently was 565 pence. The exercise price of the standby commitment would be the same as the exercise price of the shareholder right.

EXHIBIT 1 Historical, Projected, and Expected Financial Performance (values expressed in £ millions, except per share amounts, which are in pence, and shares outstanding, which are in millions)

	1988	1989	1990 Actual	1991 Projected	1992 Projected	First Half	
						1990 Actual	1991 Actual
Revenues							
Defense	3,000	3,800	4,423	5,500	5,000	2,055	1,918
Aircraft	978	1,525	1,560	1,950	2,300	687	910
Rover	1,179	3,430	3,785	4,000	4,000	1,863	1,863
Property	409	547	577	570	800	269	315
Other	80	100	195	155	165	-88	-120
Total	5,646	9,402	10,540	12,175	12,265	4,786	4,886
Operating profit							
Defense	315	300	486	460	420	177	273
Aircraft	-9	19	35	20	20	12	-33
Rover	52	64	55	80	120	33	-45
Property	18	58	9	20	60	9	15
Intercompany	-34	0	NA	10	11	3	5
Total	342	441	585	590	631	234	213
Interest expense	-40	-103	-138	-90	-90	-45	-100
Exceptional items	-40	-5	-71	-35	-35	-43	-27
Pretax profit	236	333	376	465	506	146	86
Tax rate (%)	34	28	26	28	28	28	31
Minority interest	0	-26	-18	-42	-45	-3	15
EPS (p)	62	83	98.2	112	123	35.6	24.7
DPS (p)	20.6	22.7	28.7	27.5	31	10.5	13.8
Net cash	215	1,142	711	600	500	576	-120
Book value/Share (p)	860	826	845	1,000	1,050	821	1,678
Shares outstanding	—	—	299.89	—	—	294.94	238.8

Sources: Company annual reports and "British Aerospace—Company Report," UBS Phillips & Drew, December 5, 1990.

except

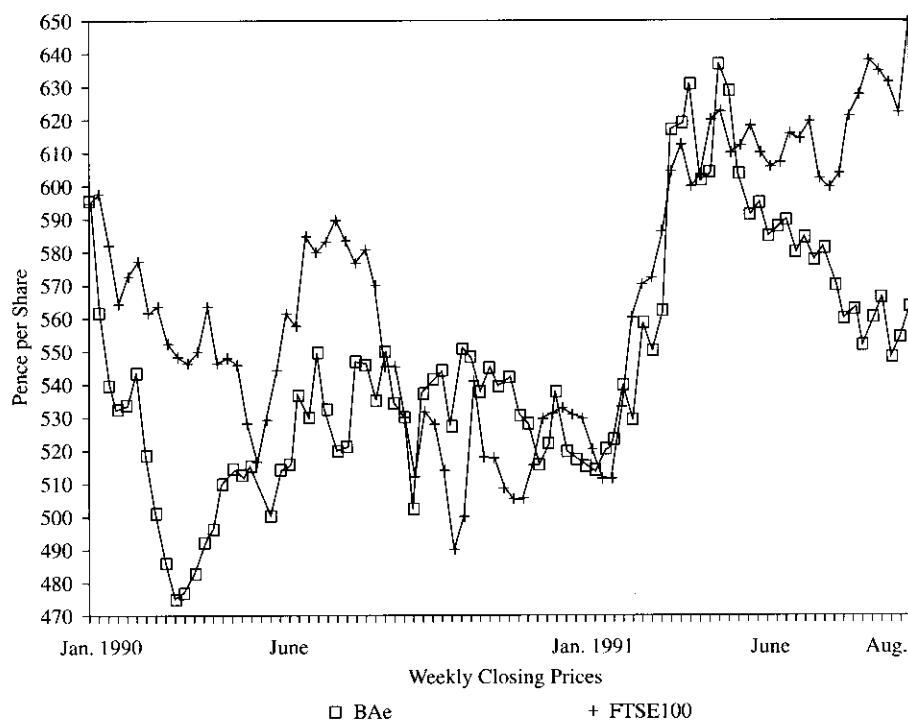
First Half
1991
Actual

1,918
910
1,863
315
-120
4,886

273
-33
-45
15
5
213
-100
-27
86
31
15
24.7
13.8
-120
1,678
238.8

EXHIBIT 2 British Aerospace Prices per Share versus London Stock Market Index (FTSE100)*

Stock Prices of British Aerospace
Compared to FTSE100 Index



*For the sake of comparison, the FTSE100 has been indexed to the British Aerospace share price at January 1, 1990.

Source of price data: Datastream, Inc.

EXHIBIT 3 Example of a Rights Offering Using Values for BAe, Summer 1991

	Scenario 1	Scenario 2	Scenario 3
Some key assumptions			
1. Rights ratio	2:5	3:5	4:5
2. Amount to be raised (£mm)	432	432	432
3. Exercise price (pence) [Line 2/Line 7]	452	302	226
Before issue			
4. Stock price before (pence)	565	565	565
5. Number of shares outstanding (mm)	238.8	238.8	238.8
6. Market value of shares (£mm)	1,349	1,349	1,349
After issue			
7. New shares added (mm) [Line 2 × Line 5]	95.52	143.28	191.04
8. Cost of new shares (£mm) [Line 2]	432	432	432
9. Total value of outst. sh. (£mm) [Line 8 + Line 6]	1,781	1,781	1,781
10. Total number of shares (mm) [Line 5 + Line 7]	334.32	382.08	429.84
Results			
11. New share price (pence) [Line 9/Line 10]	533	466	414
12. Value of a right (pence) [Line 4 - Line 11]	32	99	151
Impact of dilution if you exercise or sell the right:			
13. + Value of right (pence)	32	99	151
14. - Decline in stock price (pence)	(32)	(99)	(151)
15. = Dilution in value (pence)	0	0	0
Dilution in value if you do not exercise or sell the right:			
16. + Value of right (pence)	0	0	0
17. - Decline in stock price (pence)	(32)	(99)	(151)
18. = Dilution in value (pence)	(32)	(99)	(151)

Comment: The amount to be raised (Line 2) is assumed to remain constant across different rights offering deals. Thus, the rights ratio (Line 1) and the exercise price (Line 3) are interdependent. The *ex post* share price (Line 11) declines as more shares are issued. The value of the right (Line 12) rises as the exercise price (Line 3) declines, consistent with option pricing theory. Lines 13-15 reveal the hypothesized value neutrality of rights offerings. Lines 16-18 reveal the consequences for the unwitting.

Source: Casewriter's analysis.