University of Strathclyde

Department of Accounting and Finance

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Group Project: Stock Market

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1. Introduction

With the bought of AOL's internet access business by Carphone Warehouse (CW) this report describes an event which had a huge impact on the company CW share price and on the FTSE 250 Index stock as well.

The first part of the report briefly describes the Company CW and its main activities so that the reader gets a better understanding of the event and the reaction of the market. The Event and the Consequences will be described in the second part of the report. The last part of the paper tries to explain the reaction of the stock market on the event.

2. Description of Carphone Warehouse

The main activities of CW are provision of mobile communication products and services and fixed line communication services.

Since trading began in 1989, The Carphone Warehouse Group PLC has achieved a strong growth. Their activities have made them the largest independent retailer of mobile communications in Europe.

3. Event and market reaction

On October 11th CW agreed to buy Time Warner Inc.'s AOL Internet access unit in the UK for 370 million pounds. The deal gives CW around two million broadband customers and makes it third largest provider of high-speed internet in the UK. The acquisition is expected to increase current year pretax profit by about 10 million pounds, subject to completion by Dec. 31, and next year's profit by 40 million pounds. As can be seen in chart 1 the announcement of the deal had a strong impact on the CW share price.

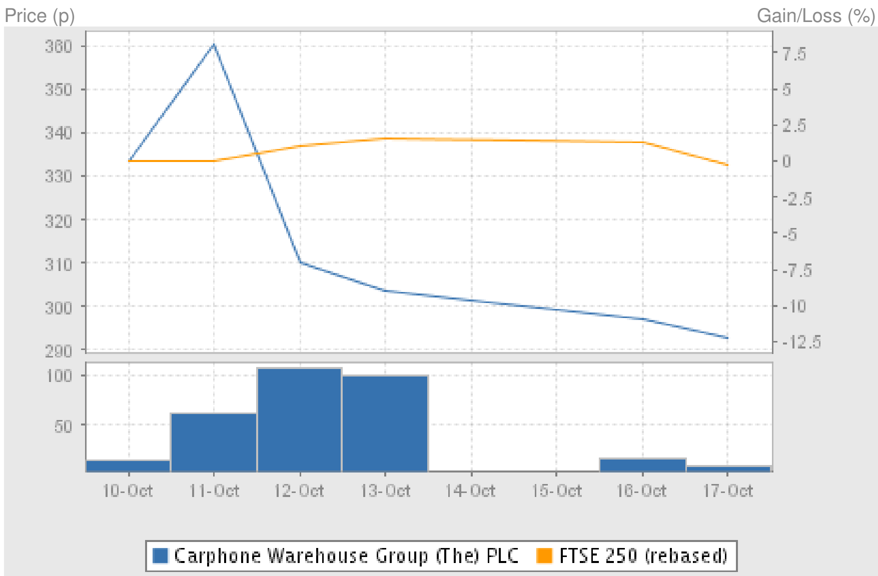

chart 1: development of CW share price compared to FTSE 250

The shares shot up over 8% on the day after the announcement had been made. Shares closed up 26.75p.

The following day shares in Carphone Warehouse plunged 13% after Vodafone Group said it would no longer sell its mobile phone contracts through the retailer's chain.

In the end of the observed Period from October 11th to October 17th the CW shares lost 12.3% while the FTSE 250 decreased by 0.2%.

4. Description and Explanation of the Market reaction in the following week

As you can see on chart 3 it can be noticed that on Wednesday, October 11th CW rose very sharply in very high volumes: more than 120m shares were traded, whereas referring to the last five years, only 7m were used to be dealt per day. So the announcement of the bought of AOL was followed by a huge investors reaction which resulted in a strong increase in the share price.

This movement shows the investors trusted in the operation and in the synergies it was likely to create, reflecting the City's approval of the deal. The deal was considered as a good investment for the development of CW. As a result the Investors heavily invested in shares of CW.

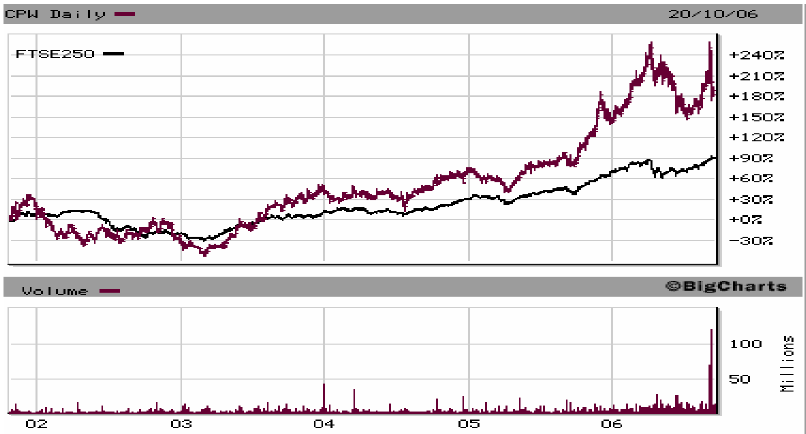

chart 2: Development of the shares of CW compared to the FTSE250/trading volume from 2002 to 2006

When the FTSE 250 opened October 11th the share dropped as much as 3.8% after the company announced higher Internet start up costs. After the announcement the share price rose by 11% helping the FTSE 250 in which the share is listed to go up by +0.93%.

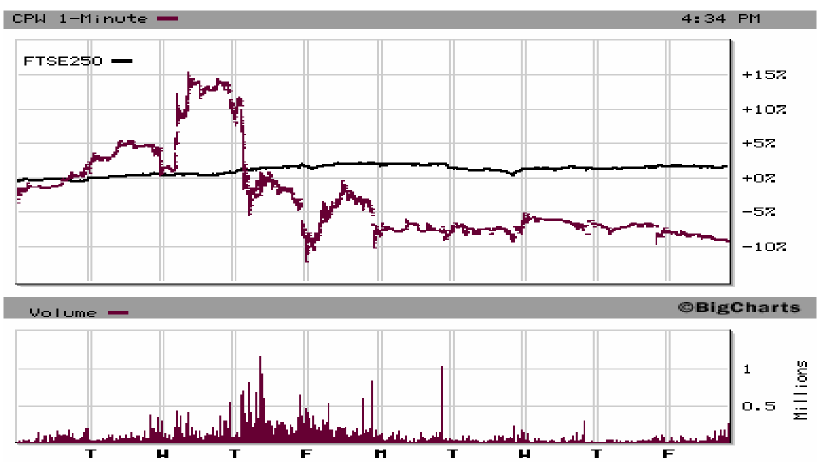

chart 3: intraday movement of CW Shares and FTSE 250 from October 10th to October 19th

We can also notice that the trading volume increased sharply the day before the results of the auction in which AOL was sold were annnounced. Thus investors were already aware of that CW was favourite in getting the award. They started buying the shares before the day of the takeover.

04/10/06: +1.44%

05/10/06: +1.10%

06/10/06: +0.39%

10/10/06: +1.17%

They bet without any certainty, but with high probability, that CW would win the bid.

Thanks to the analysis through Bollinger Bands, we can go further finding reasons of the collapse of CW the days after October 11th.

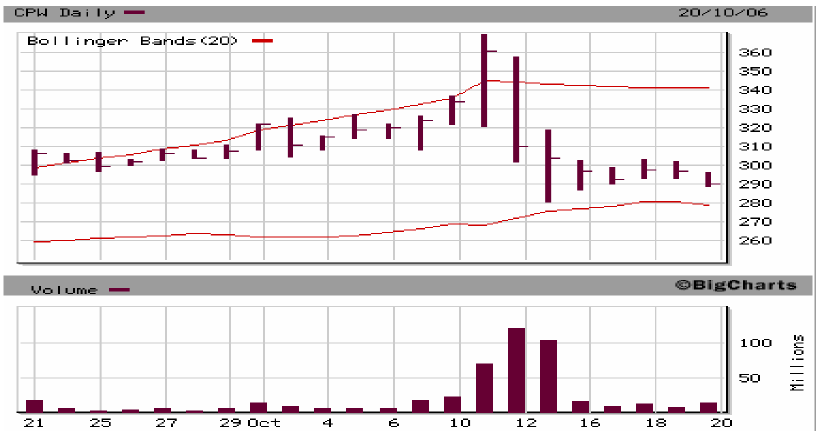

chart 4: Bollinger Bands analysis

Obviously, the main reason is the Vodafone announcement. But there are also technical reasons.

First of all as chart 4 shows that the stock was at the up limit of Bollinger bands, letting us thinking about a change in the bullish trend. Second between September 21th and October 11th the share soared by 25% (referring to Chart 5) thanks to the speculation linked to the AOL case.

We can also consider the 15% loss on Thursday as the Fibonacci retracement:

$$25\% * \frac{1}{\left[\frac{(1+\sqrt{5})}{2}\right]} = 25\% * 61.8\% = 15.45\%$$

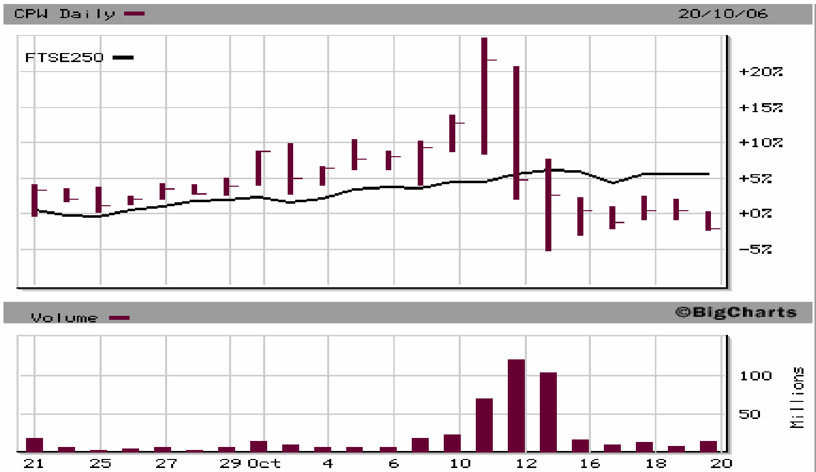

chart 5: daily movements of CW Shares and FTSE 250 from September 21st to October 19th

Another reason might be that after a 10% increase a lot of people want to take the profit they had made by selling the stock. The selling movement was exaggerated by the bad news of the loss of the Vodafone contract.

Moreover chart 2 shows us that 360p is a resistance level (already tested in Spring 06) for the CW stock.

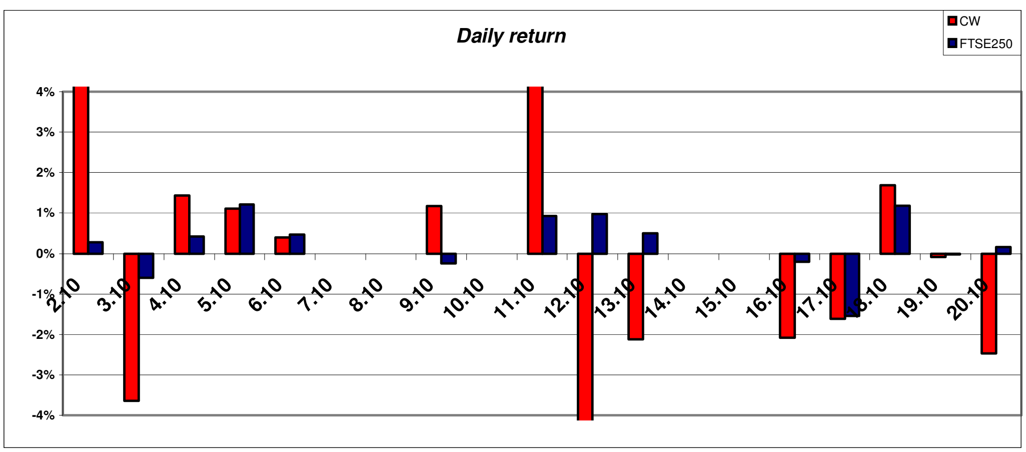

chart 6 : daily return for CW (red) and FTSE (blue) between October 9th and October 19th

Thanks to chart 6 we can notice that between October 12th and October 16th CW was strongly decorrelated with the market (CF CAPM study) in contrast to former years (chart 2) when CW shares and the FTSE 250 where strongly correlated.

Investors were worried about the Vodafone news. Their sales were causing a drop of CW stocks under the price level before the auction results (292.5p on 17/10 versus 310.5p on 03/10) were announced. This is a good example of high risk aversion and "flight to quality" movement.

The reaction of the market is quite efficient. Once events had been announced the stock market reacted immediately with big changes in trading volume and in the share price. The stock reacted very sharply, emphasizing the following behaviour of investors: as they realized a big movement on a stock, they tried taking profit of it, making the trend bigger.

Thinking on longer terms we do not believe to the creation of a "CW bubble".

We might consider the +190% increase over the past five years as a kind of "bubble" but with a P/E ratio at more than 36 the stock may appear quite risky to the investors.

Therefore this P/E difference between FTSE250 and CW might be considered as the stock "risk premium" compared to the index, explaining and pleading for the high returns of the last years.