Suggested solutions to the Rubis case study

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1/ Carry out a financial analysis of Rubis. 4 points

Rubis is a company that is experiencing strong growth, +11.6% in sales between 2011 and 2014, a large amount of which is the result of the numerous external growth operations (see appendix 3) and the rest of which is attributable to an increased presence in emerging countries which generates a volumes effect. Given its activities, Rubis is subject to price effects (dollar / euro exchange rate, oil price), the effects of which it is difficult to distinguish on the 2014 financial statements.

This growth is well managed, since the operating margin has been maintained at 6% of sales. This is an excellent performance given the increasingly larger share accounted for by the energy division whose margins are structurally lower than those of the terminal division which is much more capital intensive than the energy division.

Unsurprisingly, Rubis' policy of strong internal growth (see appendix 3) goes hand in hand with investments that are far higher than depreciation and amortisation (in a ratio of 2 to 1). Its external growth policy has led to acquisitions that are on average as large as investments in internal growth.

Working capital, which only accounts for 5 to 7% of capital employed, is healthy at 10 days of sales with fluctuations possibly due to acquisitions (impacting on the balance sheet on 31 December at 100% but the income statement only pro rata since their date of acquisition).

Operating cash flow is growing steadily which is a sign of the success of the growth strategy implemented. Free cash flows are negative at around €300m over the period as a result of this growth strategy. Half of this amount is made up for by capital increases (most of which result from the reinvestment of dividends in shares offered to shareholders) and by debt which is growing in absolute value, but is not at all worrying because EBITDA is growing just as fast. Which results in a stable ratio of net financial banking debt / EBITDA at around 1.5, well below the maximum of 3.5 set out in the loan agreements and at a level which does not raise any concerns about Rubis ability to repay its debts.

We note that Rubis keeps a large amount of cash permanently on the asset side of its balance sheet (€410m in 2014) which gives it a lot of flexibility and the possibility of seizing opportunities.

Notwithstanding heavy investments in internal and external growth, Rubis maintains ROCE that is on average two points higher than its cost of capital (7% vs 5%, see question 3), which is a sign of its ability to create value. Its return on equity is higher (around 9%) thanks to a moderate leverage effect.

A financial analysis of Rubis shows the success of a well thought out industrial strategy that is consistently implemented and a financial situation that is quite satisfactory and that provides Rubis with the resources to meet its ambitions.

2/ Given the characteristics of Rubis' bank loans (see appendix 5) and its financial situation, do you think that the value of Rubis debt is significantly different from that of the amount of debt recorded on the balance sheet? Why? 0.5 point

As Rubis' net debt is well below the thresholds in its covenants (1.3 vs 3.5), and its net debt / EBITDA ratio is moderate, there is no reason why the group's solvency should be doubted.

Accordingly, the value of its debt should not be very different from the amounts on the balance sheet.

Moreover, since most of its long-term debt is recent (€250m in 2013 and €512m in 2014) it is likely that the interest rate is in line with market interest rates. As short-term debt is renewed on a regular basis, it is not likely to conceal differences with its market value.

3/ Calculate the cost of equity and the cost of capital for Rubis at the close of 2014, knowing that the risk-free interest rate is 0.3%, the market risk premium is 7.7% and the beta coefficient of Rubis shares is 0.70. You can assume a corporation tax rate of 25%. The figures in appendix 1 and 5 should enable you to estimate the cost of net bank and financial debt. 1.5 points

Rubis' cost of equity = risk-free interest rate + beta x market risk premium = 0.3% + 0.7 x 7.7 = 5.7%

Rubis net cost of debt = 2014 financial expense x (1 – corporation tax rate) / net debt at close of 2014 = 11 076 x (1 – 25%) / 307 219 = 2.7 %.

Value of Rubis equity at close 2014 = 1 837 107
Value of Rubis' net debt at close 2014 = 307 219

Which is a net debt-equity weighting of 86% - 14%.

Cost of capital = 86% x 5.7% + 14% x 2.7% = 5.3%

4/ Carry out a market analysis of Rubis. 2 points

The Rubis share price has risen steadily since 2005, by 11.6% on average, which, combined with dividend yield of around 4%, results in a return of around 15% per year for its shareholders. This rate, which is way higher than the cost of equity (5.7%), is explained by the constant improvement in Rubis performance, which is delivering book returns which are superior to the required rate of return. The current price-to-book ratio (1.36) shows that investors are expecting that this situation, with Rubis creating value, will continue in the future.

The share price performance shows relatively low volatility: for example, between the highest price in 2007 and the lowest price in 2009 (financial crisis), the Rubis share price only lost 33% compared with 58% for the CAC 40 index, which confirms its beta of 0.7.

Over the period being reviewed, Rubis is both a growth stock with an increase in its EPS of 9% per year and a P/E ratio of over 15, and also, which is not very common, a stock delivering high dividend yield (4% per year) due to a dividend payout rate of around 2/3 of its earnings.

5/ What do you think of the profiles of the two divisions of Rubis in terms of growth, returns and risk? 1.5 point

The Energy division is in a strong growth phase, sustained by acquisitions, which have enabled it to multiply its sales by 14 in 9 years, its EBIT by 6.6 with growth of only 135% of its capital employed. Its pre-tax ROCE increased sharply, rising from 5.4% to 15.3% over the period, which is an excellent level. It has thus become the flagship division of the group, accounting for 2/3 of EBIT. This is an activity with low margins that is not very capital intensive (turnover on 2014 sales of 3.2), one accompanying the other.

The Terminal division, which in 2005 accounted for half of the group's EBIT and which used to post excellent returns (18% before tax), has not managed to maintain its performances over the period. Its earnings have fallen to a third lower than those of the Energy division while it was making more than three times that at the start of the period. The turning point was in 2013 where heavy investments (capital employed rose from €285m to €505m) have not (yet) had an impact on EBIT. It is an activity with high margins (necessary in order to remunerate the heavy investments required properly) and very capital intensive (turnover on 2014 sales of 0.6).

It might be thought that the Terminal activity is the less risky of the two, because storing on the part of third parties seems to be less risky than distributing products, it's almost a rent. But this impression is not really backed up by the figures provided.

6/ Without doing any calculations, what was, in your opinion, the consequence in terms of risk and growth of Rubis' geographic expansion over recent years? 1 point

Rubis has gradually extended its activity into emerging countries (Caribbean and Africa) resulting in greater growth but also more risks that are specific to these countries.

7/ What do you think of the methods for remunerating Rubis' managers presented in appendix 6? What financial theory do they illustrate? 1 point

The variable part of management remuneration depends on the performance of the Rubis share price and half of it must be reinvested in shares that are blocked for 3 years. The managers interests are thus aligned with those of the shareholders because they will only receive variable remuneration if the share price rises. The reinvestment in Rubis shares for 3 years is intended to avoid management behaviour that would result in the share price rising only over the short term in order to obtain higher variable remuneration, before falling again.

Accordingly, this aligns management's interests with those of shareholders, in accordance with the principles of agency theory.

8/On the basis of what you know about Rubis' strategy, what is, in your opinion, the main aim of its financial director in terms of financing policy? How is Rubis' practice of allowing shareholders who so wish, to opt for a dividend paid in shares, an illustration of this aim? 1.5 point

Flexibility, given the intensive policy of external growth implemented by the group. However, external growth opportunities arise at times that do not fall within the group's control. Accordingly, this means permanently having potential reserves available in order to take advantage of opportunities that may suddenly come up. Which is why, for example, the group has a net debt / EBITDA ratio far below (less than 2) the maximum set out in the loan agreements (3.5), leaving a capacity for additional debt that at the end of 2014 worked out to 3.5 - 1.3 = 2.2 times EBITDA of €233m, or around €500m.

Paying the dividend in shares for shareholders who so wish amounts to reducing the cash leaks and thus increasing the resources available to Rubis.

9/ On 23 March 2015, Rubis announced the acquisition of ERES, a group active in storage in Nigeria, Senegal and Togo in the storage, transportation and distribution of bitumen at a price of around €530m. ERES had no net bank and financial debt and had recorded sales in 2014 of €500m and an EBITDA of €64m. Calculate ERES 2014 EBITDA multiple resulting from this acquisition and compare it with that of Rubis on the basis of a share price of €60. Who can explain the differences between these two figures?

1 point

ERES' EV/ EBITDA multiple = 530 / 64 = 8.3 x

At €60 per share, the market capitalisation of Rubis is 38 860 x 60 = €2 330m and the value of its capital employed is 2 330 + 307 = €2 637m, which gives an EBITDA multiple of 2 637 / 233 = 11.

This difference is probably explained by a higher level of risk for the ERES activities compared with Rubis' current activities. Nigeria has never been known to be a haven of peace – corruption, political instability, secession of the south, Boko Haram.

10/ Explain why this acquisition could probably have been entirely financed by a new debt. You could calculate the ratio of pro forma net banking and financial debt / 2014 EBITDA, as if the acquisition was completed on 1 January 2014 and financed entirely by a new debt.

1 point

If this acquisition had been financed by debt, Rubis' debt (€307m) would have increased by that of ERES (zero) and the acquisition price (€530m), or a total debt of €837m. The group's EBITDA would have increased by that of ERES, i.e. 233 + 64 = €297m. Which results in a ratio of net financial and banking debt / EBITDA of 837 / 297 = 2.8, lower than the maximum authorised by the bank loans, of 3.5.

11/ Now explain why Rubis, despite interest rates on bank loans being at an historic low, decided to finance this acquisition partly through a capital increase of €150m with preferential subscription rights and the rest in shares?

0.5 point

The Debt / EBITDA ratio from the previous question was quite acceptable in view of the undertakings given by Rubis in terms of its bank loans, but does not leave much room for manoeuvre: 3.5 – 2.8 = 0.7 point of an EBITDA of €297m = €208m. Moreover, this ratio was much higher than the historic high reached by Rubis over recent years.

By carrying out a capital increase of €150m, when the Rubis share price was at an historic high, so in very good financial conditions for its existing shareholders, Rubis limited its debt / EBITDA ratio to (837 – 150) / 297 = 2.3. Which meant residual room for manoeuvre of 3.5 - 2.3 = 1.2 point of EBITDA, i.e. 1.2 x 297 = €356m.

12/ When its share was trading at €60, Rubis announced an issue price of new shares of €46 with 1 new share for 12 existing shares held. Show how on the first day of the capital increase, the share price will fall by €1.08. Why is the existing shareholder not down by €1.08? Why is the new shareholder, who can subscribe shares at €46, not getting a good bargain?

1.5 point

The value of the preferential subscription right is (60 - 46) / (1 +12) = €1.08. The first say of the capital increase, the subscription right is detached from the share and traded separately, and accordingly, the value of the share will fall by the value of the subscription right, i.e. €1.08.

The shareholder does not lose out because instead of having a share that is worth €60, he/she has a share that is worth €58.92 and a subscription right that is worth €1.08. Making a total of €60. Accordingly, he/she has not become poorer.

New shareholders can only subscribe a new share at €46 if they simultaneously acquire 12 subscription rights, making a total investment of 12 x €1.08 + €46 = €58.92 (rounded off), i.e. the new price of the Rubis share after detachment of the preferential subscription right. So this is neither a good nor a bad deal for new shareholders. They are simply buying the Rubis share at its price.

13/ What is the percentage after this capital increase of a shareholder who previously held 1% of the share capital and for whom this operation resulted in no net entry or exit of cash? By

how much was he/she diluted? 1 point

Dilution of a shareholder is calculated as follows = Product of capital increase / (product of capital increase + market capitalisation before capital increase) = €150m / (€150m + €60 x 38 860m shares) = 6%. A shareholder who held 1% before the capital increase will thus hold 1% x (1 – 6%) = 0.94% after this capital increase.

14/ What should the impact of this acquisition be on the Rubis group's cost of capital? Why? No calculation is required, just the trend. 1 point

This acquisition should push up Rubis' cost of capital because it increases the share of its assets in more risky emerging countries (Nigeria) than the average of its existing assets.

15/ What should the impact of the financing of this acquisition be on the Rubis group's cost of capital? Why? No calculation is required, just the trend. 1 point

The method of financing this acquisition will have no impact on Rubis' cost of capital because the cost of capital only depends on the risk of the market of the assets and not on their financing method.