Générale de Santé Case Study
Suggested answers

Introduction

1/ Carry out a rapid financial analysis of Générale de Santé

- The company is experiencing strong growth (sales up 12.6% a year on average).
- Benefiting from its operational leverage, it is improving its margins from year to year. Accordingly, the operating margin has risen from 5.3% to 6.4% in two years.
- Working capital (WC) is negative (and thus represents a source of funds) but is tending to reduce in absolute value. This change in WC (difficult to explain based on information in the case study) will thus have to be financed (a total of around €50m to finance in 3 years).
- Growth in activity means that major investments are necessary. Except for 2003 (the year during which Générale de Santé sold its retirement homes activity), flows from operations are insufficient for covering the companies heavy capital expenditures.
- The company is relatively indebted (net debt / EBITDA higher than 3x).
- In order to finance its investments, the company will have to increase its debt levels substantially over the period (+€160m)
- Nevertheless, thanks to improvements in margins and the growth of the business, the net debt / EBITDA ratio remains stable
- Equity has increased as the company has only paid out a small part of its earnings in dividends
- The level of ROCE is average, but growing significantly thanks to the improvement in margins. Accordingly, ROCE rose from 5.7% in 2003 to 6.8% in 2005. 2005 ROCE is higher than the cost of capital (which is necessarily lower than the rate of return required by shareholders which is 4%+4.19%*0.67=6.81%)
- Générale de Santé is using the leverage effect (6.4% of leverage effect in 2005, which is a doubling of ROCE!). The company is carrying a relatively high amount of debt and has a ROCE that is substantially higher than the cost of debt after tax. The leverage effect increases over time, given the increase in leverage and in ROCE.

2/ Carry out a market analysis of Générale de Santé

Market performances follow financial performances, with the share price almost tripling in 3 years.

The dividend per share is up slightly in absolute value (+€0.05 per year). Given the strong growth of net earnings (and of net earnings per share given that the number of shares has remained identical), the dividend rate has fallen sharply (from 60% in 2003 to 33% in 2005) and at the end of the period, it is in line with what is expected for a company experiencing growth. The return is low (1.2%) which is logical given the strong expectations of growth.
2005 P/E ratio of 27.5x is high, which is logical given the strong growth of the business and the low operating risk (as shown by the low beta, 0.67)

The rate of return required by shareholders (6.81%, see previous question) is lower than ROCE. Générale de Santé is creating value for its shareholders. This can be confirmed by noting that the Price to Book Ratio is 3.7x.

3/ Calculate the EBITDA multiple (on the basis of 2005 accounting figures and of the last market capitalisation)

Value of capital employed = 1034 + 575 = 1609

Value of capital employed / EBITDA = 1609 / 179 = 9.0

Investment analysis

4/ Do you think it would be best for Générale de Santé to invest in its sector, or to diversify, as suggested by the analyst in order to reduce the company's risk

Investors do not reward a group for diversification (since they are able to diversify their own portfolios). They only value external growth operations that bring about synergies. Having said that, if management's aim is to reduce the company's risk, then diversification is an appropriate response.

5/ Given an enterprise value of €430m, what is the EBIT multiple paid by Générale de Santé for Hexagone?

Value of capital employed = 430

Value of capital employed / EBIT = 430 / 29.4 = 14.6x

6/ How much should annual synergies be for the acquisition to be paid for on the basis of the same multiple as Générale de Santé?

In order to have the same multiple (i.e., 9.0), annual synergies in terms of contribution to EBITDA would have to be

430 / 9.0 – 41 = €6.83m

Analysis of the share issue

7/ The funds raised by the share issue will be used to pay back the temporary credit line put in place to acquire Hexagone. Under what conditions will the share issue dilute EPS? Compute the EPS dilution assuming that the credit line costs 3% before tax? Do you think that this is the correct way of reasoning here?

The capital increase is dilutive if 1/P/E ratio > after tax interest rate

here we have
1/P/E Ratio = 1/ 27.5 = 3.64%
After tax interest rate = 3%*(1-35%) = 1.95%

So the share issue will dilute EPS.

Calculation of dilution:
EPS before = €1.05
Pro forma net earnings = 41 + 3% * 65% * 300 = €46.85m
Proforma EPS = 46.85 / (39.0+14.6)= €0.87
Dilution = 0.87 / 1.05 – 1 = -17%

This is not the correct way of reasoning as the proceeds of the share issue will end up being used to invest in Hexagone which has very good returns (net earnings of €18.6m for an investment of €430m, or an immediate return on investment of 4.33% after tax, which is higher than the P/E ratio).

Moreover, and even though the proceeds of the share issue will be used to pay off debt, the resulting dilution of EPS will be set off to a lesser degree in terms of the risk on the share, given the decrease in debt.

8/ What is the theoretical value of the preferential subscription right? What should the stock price be once the subscription right has been given to shareholders? Value of right = (26.5 – 20.5) / (1+ 8/3) = €1.64

Theoretical stock price post coupon detachment = 26.5 – 1.64 = 24.86 (which is a mechanical drop of 6% on the stock price)

What is the dilution of control for those shareholders who exercise their subscription rights? What is the dilution of control for those shareholders who sell all of their subscription rights? What is the dilution for a shareholder who could not cash in or cash out anything in this transaction (using the cash from the disposal of some rights to exercise the remaining rights)?

For shareholders who exercise their subscription rights: no dilution in the true sense of the word.[1]

For shareholders who do not exercise their rights and who sell them: dilution = 14.6m / (14.6m + 39.0m) = 27%

For those who do not cash out: dilution = €300m / (€1 034m + €300m) = 22%

I have 1,000 shares. I get 1,000 rights (worth €1,640) and I sell 824 for €1,352, then I'm left with 176 which enable me to subscribe 176/8*3=66 new shares for €1,353.

Accordingly, my share in the capital falls from 1,000 / 39,000,000 = 0.00256% to 1,066 / 53,653,000 = 0.00199%, or a dilution of 22%

10/ What do you think of the decision by Efibanca and DR Ligresti to subscribe the share issue?

[1] Reduction of a shareholder's rights so that the share issue does not result in any cash in or cash out.

This is a positive signal. The two main shareholders, represented on the Board of Directors, are subscribing the share issue, which means that they do not think that the share is overvalued.

NB: the signal is even more positive because of the fact that Dr Ligresti is a private person (not an entity) and it is likely that he will have to borrow in order to be able to take part in the operation. Additionally, he is also sacrificing his potential to diversity his portfolio.

11/ What signal is sent out by this share issue?

Generally, a share issue sends out a negative signal. However, there are two factors that attenuate (even completely cancel out) this negative signal:

- the main shareholders are taking part in the operation
- the share issue is being used for a specific investment (acquisition of Hexagone), which will create value if the potential synergies put forward by management are to be relied on.

Conclusion

12/ What will the impact of the operation as a whole (acquisition and share issue) be on

Firstly, the operating risk shouldn't change as the acquisition is being made in exactly the same sector at that of Générale de Santé.

Additionally, as the analyst notes, after the acquisition and share issue, the group will be financed in the same proportions of debt and equity as before the operations (1/3 – 2/3). So the financial risk doesn't change.

- **the cost of equity**

No impact (unchanged financial and operating risk)

- **the cost of debt**

No impact (unchanged financial and operating risk)

- **the weighted average cost of capital**

No impact (unchanged operating risk)