OCTOBER 2020

ADVFN International Financial Awards WINNER 2020 Best Advisory CFD Services

ATLANTIC CAPITAL MARKETS

ROLLS ROYCE, Buy, Sell or Avoid?

01872 229 000
www.atlanticmarkets.co.uk

History

Rolls Royce is a British brand synonymous with quality and British engineering, it has come a long way since its beginnings when the firm was established by Henry Royce back in 1884 which began by manufacture dynamos and electric cranes. Charles Rolls established a separate business with Henry Royce in 1904 largely due to the fact Royce had developed a range of cars which Rolls wanted to sell. A corporate owner was incorporated in 1906 with the name Rolls-Royce Limited.

Rolls Royce is no stranger to financial strains, in 1971 the firm entered into voluntary liquidation because it was unable to meet its financial obligations, its business and assets were bought by the government using a company created for the purpose named Rolls-Royce limited. Rolls-Royce Motors was then separated out in 1973.

Rolls-Royce plc returned to the stock market in 1987. In 2003 ownership of Rolls-Royce plc was passed to Rolls-Royce Group plc, which was incorporated in March 2003, which issued its own new shares for payment to the previous shareholders. Rolls-Royce Group plc passed ownership in May 2011 to Rolls-Royce Holdings plc. Rolls-Royce plc remains the principal trading company. Rolls-Royce Holdings plc, like its immediate predecessor, is merely a holding company.

On the first day of trading back in May 1987 the share price opened at 128.5p and subsequently moved beyond 200p before that year's stock market crash sent the price back to 112p.

In December 2013 the shares peaked at 1,275p, they were half that level by 2016 after Rolls slumped to a record loss of £4.6 billion and made its first dividend cut in 24 years. The firm then restructured in 2018 which saw the loss of 4,500 jobs.

1980's

The 1980s saw the introduction of a policy to offer an engine fitment on a much wider range of civil aircraft types, with the company's engines now powering 17 different airliners compared to General Electric's 14 and Pratt & Whitney's 10. The civil engines business represents the company's main area of growth: between 2010 and 2018, Rolls-Royce invested £11 billion in facilities and R&D and launched six new civil engines including the Trent XWB and the Pearl 15 for the business aviation market.

Restructuring and pre Covid concerns

In February 2017 Rolls-Royce posted its largest ever pre-tax loss of £4.6 billion; This included a £4.4 billion write down on financial hedges that the company uses to try to protect itself against currency fluctuations. There was also a £671 million penalty to settle bribery and corruption charges with the Serious Fraud Office (SFO), the US Department of Justice, and Brazilian authorities.

On 14 June 2018 the company announced a restructuring of the business to create three simpler decentralised units (civil aerospace, defence and power systems), to rationalise back office functions and to remove middle management functions. The cost savings should amount to £400 million per year by 2020, with an up-front restructuring cost of £500 million.

In August 2018 Rolls-Royce announced it was taking a charge of £554 million to cover faults with some Trent 1000 engines on Boeing 787 Dreamliner's. Rather than going thousands of hours between inspections, the faults with turbine blades mean the engines currently require inspection every 300 hours of flight. In the same announcement Rolls-Royce said it would spend £450m fixing faults on the Trent 1000 in 2018, £450m in 2019 and £350m in 2020, with the work complete by 2022.

Key Ratio's

	31.12.15(£m)	31.12.16(£m)	31.12.17(£m)	31.12.18(£m)	31.12.19(£m)
PE Ratio	127.49	-	3.69	-	-
PEG	5.65	-	-	-	-
Earnings per Share Growth	22.55%	-	-	-	-
Dividend Cover	-	-	-	-	-
Revenue Per Share	746.33p	814.09p	889.15p	846.10p	871.17p
Pre-Tax Profit per Share	3.26p	-258.73p	259.87p	-158.74p	-52.26p
Operating Margin	10.19%	-0.49%	11.98%	-7.41%	-5.76%
Return on Capital Employed	16.50%	-1.08%	26.27%	-17.59%	-32.42%
Dividend Yield	-	-	-	-	-
Dividend per Share Growth	-	-	-	-	-
Net Asset Value per Share (exc. Intangibles)	20.07p	-175.01p	-48.68p	-	-
Net Gearing	2.51%	31.47%	8.68%	29.05%	-36.79%

Chart

2020 and Covid Impact

it comes as no surprise that Rolls Royce have now revealed plans to shore up the business with a £2bn cash raise. The fundraising is required to shore up the balance sheet after the Covid-19 crisis impacting the overall aviation sector. Shares recently dropped to a 17-year low and, to make matters worse, the company has scrapped its final dividend for the first time since flotation in 1987. Existing shareholders now face seeing their holdings diluted by almost 77% if they do not participate in a rights issue that will increase the number of shares on the register by 333%. Taking up the right issue at the heavily discounted price will at least ensure that those shareholders protect their original investment, which they will want to do if they believe that Rolls has the potential to make a recovery from the current crisis. The fundraising is due to complete on 11 November.

Overall Rescue Package

The rights issue form part of a total £5 billion of additional liquidity the company is seeking to raise. In addition to the £2 billion cash raise, the company is also looking to raise £1 billion from a bond issue. It also disclosed it has commitments for a new two-year term loan facility of £1 billion, plus support from UK Export Finance for a £1 billion extension to the 80% guarantee on an existing £2 billion five-year loan. The new £1 billion loan facility depends on the rights issue being completed and the cancellation of the company's so far undrawn £1.9 billion credit facility. The company itself remains hopeful that some of the actions already taken, including plans for a major restructuring programme costing 9,000 jobs, can return it to a positive cash flow position during the second half of next year before achieving strong cash generation in 2022.

What are the details of the Rolls rights issue?

In order to raise the £2 billion, Rolls Royce is issuing 6.4 billion new shares. This will give shareholders the right to buy 10 new shares for every 3 shares already owned, at a price of 32p per new share. The move will increase the total number of Rolls shares in existence by 333%, from 1.93 billion to 8.37 billion. With so many new shares in circulation, shareholders will see their holding diluted by 77% if they don't take up their rights.

On the 1st of October, when the rights issue was announced shares were trading at 130p, meaning that pricing the new shares at just 32p represented a 75% discount. But in reality, the discount is 41% based on the theoretical ex-rights price of 55p, which is the level when factoring in the impact of the new shares. The size of dilution will be influenced by the number of rights issue shares acquired during the cash call. The biggest risk for the firm at this point is if the existing share price falls below the price the new ones are being offered at, we did see this back in the financial crisis with some of the banks such as Royal Bank of Scotland.

Clearly there is no reason to subscribe if you can buy the shares cheaper in the market.

So, what are the options for existing shareholders?

Subscribe for the new shares.

This option does mean investing fresh money into the business, not something everyone will be keen on, but a move that existing shareholders could be forced into to avoid the dilution effect on their overall position.

For example, if you have 3000 existing shares, you have the right to buy 10,000 new shares at 32p. By buying all your rights for a total price of £3200, you now have 13,000 shares and own the same percentage of the company as you did before the rights issue.

Sell some of the shares so you can the buy rest with the proceeds.
The number of shares you are able to buy will depend on what price people are willing to pay for the rights you are selling. But you will end up owning a smaller percentage of the total shares than you did before the rights issue.

Sell all the rights.

The price achieved will depend on the price that people are willing to pay for those rights. Using the same example as above, you will still have 3000 shares, but this will be a much smaller percentage of the company than before.

Do nothing and let your rights lapse. By doing so you will be diluting your stake in the company, including your entitlement to future dividend payments. If you do this, your rights will be offered for sale to other investors and you will be sent any proceeds by the company's share registrar (minus expenses).

Nothing can happen until there's been a general meeting of shareholders to approve the fundraising plan. This will be held on Tuesday, 27 October at 11am. To vote, participants must be on the Rolls-Royce share register by the previous Friday. The deadline if you are selling rights is 5 November, with the closing date for those taking up the rights or not selling being 11 November. The result of the rights issue will be known by 8am on 12 November, when dealings in the new ordinary shares will also get underway. Share certificates will be issued and accounts credited no later than 25 November.

Considerations

A recent share price above 200p presents a favourable City backdrop for the rights issue. Even though the 200p was fleeting with current swings, those looking at the shares with fresh eyes and money are likely to find the opportunity to buy further shares in the rights issue at a heavily discounted level too much to resist. This has been shown recently with one of the company's major shareholders, Los Angeles-based Capital Group Companies upping its stake from 5% to near 9%.

For existing shareholders who can buy their rights in full in order to avoid being diluted, there are plenty of arguments in favour of getting involved.

Analyst Commentary

With such a choppy and changing back drop few analysts have been willing to commit, however analysts at Berenberg believe the shares are worth 250p, and at Morgan Stanley the analysts feel the measures adequately address questions around the financial position with them pointing to liquidity of £7 billion by the end of 2021.

Other factors

The long-term impact of the Covid-19 restrictions is the biggest variable and unknown measure in the overall situation. The introduction of effective Covid-19 testing regimes at major airports has the potential to provide relief to the aviation sector and in turn translate to the flying hours that Rolls is so dependent upon. The more hours the engines fly the quicker they are due for the next servicing round. It's also worth noting that there's much more to Rolls than just aero engines, with the defence and power systems arm underpinned by stable, longer-term contracts. The company has also started to focus on sustainable power putting the firm in a strong position during the world's transition towards a net-zero carbon economy.

Potential Take over?

There's also the outside possibility of takeover interest. BAE Systems is one potential bidder that has been loosely mentioned and Rolls Royce would also be a rather fitting target for acquisition specialist Melrose. However, the UK government still holds a "golden share" in Rolls which could well put any potential take over bids to the back burner.

There is also no guarantee that the fund raising is going to be sufficient. The firm's own downside scenario" highlighted in August's interim results shows that if we have a sustained second wave of Covid-19 then the firm would need to draw down £1.9 Billion.

Summary.

Undoubtedly the big swings will certainly put it on the radar for the high impact traders, equally the extreme lows will also appeal to the bargain hunters, that all being said these factors are due to such an uncertain backdrop.

The fortunes for the near future of Rolls Royce are largely out of their hands and will be linked to the recovery we see from the current pandemic. The firm has taken all possible measures available at this point relating to raising cash and trying to shore up their position but it is also worth remembering Rolls Royce were in trouble ahead of this and the current issues have only been amplified by the pandemic. There are a couple of key considerations for investors to mull, how long will the pandemic continue, does the share price now reflect the business as it stands? Are you willing to forgo the near-term dividend with a longer-term view?

If you answer yes, then it could be worth tucking some away for the long term. However, it may be necessary to hold these for the very long term as the outlook for the next few years is not that strong. This is due to the fact that Rolls Royce is yet another major UK based brand that is living on old glory. Such as BT, BP, Lloyds. These names were safe as houses 20-30 years ago, but not so much anymore. They have all failed to keep pace with the global marketplace, and Rolls Royce, like BP, is left selling a 20th century based product, oil, in the 21st century, leaving a serious risk that without a major pivot by Rolls Royce in the long term it could yet end up like Eastman Kodak, a major player in an ever decreasing market.

For the traders, caution needs to be taken. It is a stock that is swinging dramatically daily offering the potential for big rewards, of course this goes hand in hand with the opportunity for big risk. The sector is also under the cosh, however non so much as Rolls Royce. The current swings highlight the markets uncertainty around the stock and the news flows continue to impact in the near term.

About Atlantic Capital Markets

We are a multi-Asset brokers offering clients the ability to buy the shares either in a traditional fashion with standard shares or taking advantage of leverage and purchase via a CFD.

Call us on 01872 229 000.