



What is it Worth? What is the Business?

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The international power business has shifted its focus. In the early 1990s, it was all new generation or greenfield plants and the independent power producer (IPP) was the business model. This model did not move well from the developed countries where it originated to the developing world. The absence of credit-worthy buyers, significant country or foreign exchange risks and the lack of an adequate commercial and legal infrastructure all conspired to produce a costly and time-consuming process of high risks and low profits. It also delayed the need for market reforms in many countries and encouraged the continuation of inefficient, state-run monopolies.

As these problems became apparent, many countries, notably in Latin America, opted for withdrawing the state from the electric power business and introduced more competitive, market-oriented solutions. At the same time, the international companies were seeking new means of managing risks and discovering alternative investment opportunities. It was soon realised that country risk was the big risk (the Asian financial crisis helped here) and the only way this risk could be managed effectively was to develop a cross-country portfolio of investments. This made size important and the big players, the new global power companies, have become larger and larger, while industry concentration has grown rapidly; today, the top 20 companies have over half the market.

In addition, it became obvious that the real profits are in distribution, not generation.¹ Global excess production capacity, more knowledgeable clients and intense competition have driven down prices and profitability in new plants. In any case, in most countries, the major inefficiencies – and hence profit

opportunities – were not in the generation but in the distribution business. The maintenance of some degree of monopoly power, the opportunity to deal directly with the customers and the immediate flow of cash provided the investors with a potentially more manageable and profitable investment environment – as well as the opportunity to better control future capacity expansions. The new model for the state is privatisation and competition; for the investors, the purchase of existing assets.

As can be expected, the shift in business paradigms is producing its own set of problems and opportunities. Countries engaged in the process of selling off their electric power assets are finding it a challenging and difficult political process. The global power companies bidding for these assets, in turn, are struggling to define the nature of their new business and how to manage risks and ensure profitability.

This paper addresses some of the issues and problems arising from this shift in the business paradigm and, based on the author's experience, how to develop successful strategies that will lower risks and increase profit opportunities.² The focus is on the investor, rather than the country.

Evaluating the Assets

Political necessity forces countries to put a 'minimum' value on the assets for sale. Prestigious international accounting firms are hired to determine the value of the assets and, by obtaining at least this value, politicians protect themselves from accusations of giving away the national treasures. With a few exceptions, the assets always sell for more than what the accountants say they are worth.

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1. *A few years ago, when the author drew attention to this point, ("Beyond Project Finance", The Electricity Journal, Seattle, June 1995), reaction was a combination of "real men build power plants", "we can't collect from the widows and orphans" and "we're not speculators – we don't churn assets". It is remarkable how quickly this view has changed.*
2. *This experience has been generalised; most companies are reluctant to publish their mistakes and regard their successful experiences as valuable commercial property. A good consultant is discreet.*

The reality, as every good real estate salesman knows, is that an asset is worth what the buyer is willing to pay – not the value put on it by the seller. The fact that there are usually significant differences in purchase offers is indicative of the wide range of opinions as to the value of any particular asset. The accounting firms are providing political coverage and their initial evaluations, usually based on incomplete and dubious data, ought to be regarded with proper scepticism.³

There is no substitute for each potential buyer estimating the value of the asset to their company's portfolio. The announced value is merely one piece of information. This is an obvious and accepted procedure. The problems occur because of how it is done. Companies hire consulting firms similar to the one preparing the government estimate and, using similar procedures, they come up with similar estimates. The more risk averse the potential purchaser, the closer the bid to the minimum – and the greater the chance of losing.

the time. The objective is to make capital gains while minimising your risk exposure

2. Remember, these assets were originally purchased and developed by a state enterprise. Seldom will this result in an optimum combination of assets. Restructuring these assets can produce significant improvements in the cash flow that have little to do with the price and quantity of electric power sold. All state power companies, for example, own excess real estate. State enterprises find it difficult to sell an asset once it is acquired. Land purchased many years ago and now prime urban real estate is still used to store poles and transformers, to house employees and to maintain the social obligations that go with public ownership. State enterprises also hold excessive inventories. When the budget is available, you buy. In several recent purchases, the sale of these 'excess' assets has recouped a significant part of the original purchase price.

The key to a successful bid is an evaluation of the asset under the proposed new ownership. The change in the rules requires new activities and new ways of doing business.

Some Lessons

1. You are buying assets, not a power company. This is just one potential investment in your portfolio. The big decisions are about when to add to or subtract from the portfolio. If you think it will improve your risk profile or that your firm has the resources that will add value, you buy. If it fails to perform, or it is worth more to someone else, you sell. The decision to purchase and the value you place on the asset must be in terms of what it does to your portfolio and the value it adds to your shareholders' equity. Producing or distributing electric power is a means, not an end. You are not making a decision forever; you do not have to own 100% and you do not have to hold it all of
3. You are buying a business opportunity. Selling or distributing electric power is only one part of this business opportunity. In most developing countries, for example, few enterprises have as extensive a consumer database as the local power company. The power company knows where people live (no small feat in confused urban areas of today), they know who pays their bills and, on the basis of power consumption, have a good proxy for income earned. If you are in the credit card business this is valuable information. In most of these countries there are few restrictions on sharing this type of information and profitable alliances have been formed between banks and the local utility. Other examples of expanded business opportunities include cable TV, undertaking

3. *These evaluations can create problems for both the seller and the buyer. The seller has a number that may or may not be realistic and he is stuck with it – renegotiating the number can have a high political cost. It also invites the buyers to 'negotiate' the number rather than evaluate the asset. For buyers, an official minimum price can create problems in the boardroom; how can management offer more than the appraised value determined by a well-known consulting firm.*

billing and collections for other services, selling surge protection devices, etc.

The successful and growing international companies have learned these lessons. They send businessmen and women, rather than just accountants and power engineers, to evaluate assets. Traditional utilities find it a struggle and it is not easy for them to move outside the box they have created for themselves. They are usually the ones complaining about the excessive prices paid by some of the high flyers.

Operating the Assets

The minimum price evaluations usually reflect the value of the asset as it is presently being used, that is, the practices of an inefficient state enterprise. The key to a successful bid is an evaluation of the

providing information and in listening to the complaints of their customers. Carefully developed public relations campaigns explaining the problems and what you are doing to improve the service will go along way in overcoming public hostility, tolerance of illegal connections and poor payment records. Establishing and monitoring a complaints system can be critical in ensuring continued government and public support.

2. Your commercial and industrial customers are your keys to profitability. In most developing countries 70% to 80% of the quantity of power purchased is by these customers. All too often, a potential purchaser underbids on the assumption that it will be difficult to cut off supply for non-payment on the part of the 'widows and orphans'. The reality in most systems is that, as long as you collected what is due from the business clients,

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asset under the proposed new ownership. The change in the rules requires new activities and new ways of doing business. Identifying and evaluating the impact of these potential changes, as well as the usual package of restrictions that will be imposed, is a fine art requiring both imagination and a willingness to take risks. The industry leaders are taking a broader view of business opportunities than the more conservative utilities. Here are some of the more successful operating strategies that can enhance value-added.

1. Treat the purchasers of your services as customers. State monopolies have beneficiaries, private enterprises have customers. A poor record of bill collection, for example, usually has something to do with how easy it is for the customer to pay the bill. Inaccurate accounts, limited collection points, difficult hours, long lines and unsympathetic employees are easy and cheap to correct and can significantly improve the customer's willingness to pay and your cash flow. Public enterprises are notoriously poor in

you could forget about the 'widows and orphans'. These larger clients also offer the best opportunities for mutually beneficial business deals. Most distribution systems suffer from inadequate capacity and strategically placed co-generation facilities can greatly improve reliability. A partnership with some of the industrial consumers to invest in these facilities can improve profits. These clients are also most likely to be interested in improved reliability and would be willing to pay the necessary premiums to achieve it.

3. Identify the bottlenecks. The poor state of many distribution systems is often the result of years of neglect. Improvements in the cash flow can be obtained by relatively minor investments. Metering is a typical example of investments of this type. One company, for example, achieved a 20% increase in its cash flow by purchasing and installing new meters on the premises of customers waiting for meters or with broken meters. The former state enterprise never

seemed to have enough money in its budget for a bulk purchase of meters. Minor investments in transmission or transformers can expand and improve the system quickly and at relatively low costs.

The value of the asset to your company depends on making a realistic estimate of the profits from making changes in operations and management that would be possible under the new ownership structure. Many companies limit themselves to identifying cost cutting opportunities. This is only one aspect of a successful strategy; identifying new investments and business opportunities is probably the more important part.

Labour and Management

State enterprises and, as is being discovered in the US, private monopolies all have excess labour and management. Most potential buyers regard the ability to downsize and restructure the labour force as a critical factor in improving the efficiency and profitability of an enterprise and thus its value. In some cases, such as Brazil, redundant labour is dealt with up front and paid off as part of the privatisation process. In other countries, such as India, with a strong commitment to maintaining low labour productivity, removing redundant labour is a major obstacle in the sale of assets. In general, the labour issues are handled badly by both buyers and sellers, leaving a legacy of mistrust that will return to haunt the new owners. This does not have to be the case and, with careful planning at the beginning of the process, better use of existing labour and management can enhance the value of a company.

1. The electric power business is capital intensive and labour costs are not always that important. One company, for example, that purchased a small hydro plant found itself with 700 employees. Given the very low wages of these employees, the wage bill had a minimal impact on the overall profitability of the plant. The labour was a fixed cost and any productive employment found for it, either in the plant or in other uses, added to profitability. If labour is a fixed cost – and usually poorly paid – then it is important to find ways of profitably using it.

Most former state enterprises, for example, will have a backlog of maintenance that can usefully employ some of this labour provided it is complemented with relatively small inputs of management and capital. Establishing more customer service offices open for longer hours, for example, can draw on this ‘excess’ pool of labour. In any case, this is a growth industry and an expanding market can accommodate many of the sins of the past. Problems arise because the new owners have in mind a labour-capital mix that reflects their experience in capital-rich countries rather than the labour-intensive mix found in most developing countries.⁴

2. The existing labour force and management knows a lot about the company you have bought or are about to buy. If you want to know where the hidden assets, potential liabilities and inefficiencies are, they are the people to talk to. They are usually anxious to please their new boss. Their behaviour and practice at this time will be a result of the existing incentive structure rather than by any lack of intelligence on their part. They, more than anyone, are aware of some of the absurdities of their present situation. Utilising this intelligence is not always easy; barriers of language and custom can be substantial. This is where a local partner or consulting firm can provide the more informal contacts that will provide the information required to develop a better understanding of how to evaluate and operate your new asset.

Conclusion

The above observations touch on a few of the more general points that need to be considered when evaluating a potential purchase. Each potential purchase is a unique opportunity that, with a little imagination and out-of-the-box thinking, provides the buyer with a better grasp of the value of the asset and successful strategies for its profitable employment. The key is to regard this addition to the portfolio as a business opportunity that goes well beyond simply buying and selling electric power. The successful companies have realised this and are paying good prices because they have a better understanding of the real value of the asset. ■

4. *The water distribution business provides some interesting experiences that could be applied to electricity. Water taps and collections are managed by petty retailers under a franchise arrangement. This is done on an informal basis (Jakarta) in electricity where those with access, sometimes legal and sometimes not, retail supplies to their neighbours. The utility sees little of this income. Creating a legal business structure for these retailers could help resolve some of the employment and illegal connection problems as well as providing new revenues to the company.*