



SMALL IS BEAUTIFUL

WHY BUYING SMALL UTILITIES
YIELDS BIG RETURNS

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As more utilities overhaul their business models, utility executives and energy-investors should consider this new truism for the utility business: thinking small can produce big results. Small utilities can offer attractive growth opportunities for large utilities and infrastructure funds scouting for future earnings growth.

Utilities face limits on how much and how quickly they can grow their rate bases. New products and services typically do not contribute enough to move the needle. So it's no wonder that almost 8,000 utilities worldwide worth \$1 trillion have been acquired during the past five years. (See Exhibit 1.)

Utilities can pursue megamergers. But recent history suggests that the regulatory approval process bogs down these deals and strips away value. As a result, more companies, such as Algonquin Power & Utilities, Gaz Metro and SteelRiver Infrastructure Partners, are pursuing smaller utility acquisitions.

The market for small utility acquisitions is actually quite big. There are about 175 investor-owned electric and gas utilities in the United States that have net property, plant and equipment (considered a proxy for rate base) values of less than \$500 million. In addition, there are more than 3,000 municipally and government-owned utilities. Together, these smaller utilities have net property, plant and equipment worth more than \$45 billion.

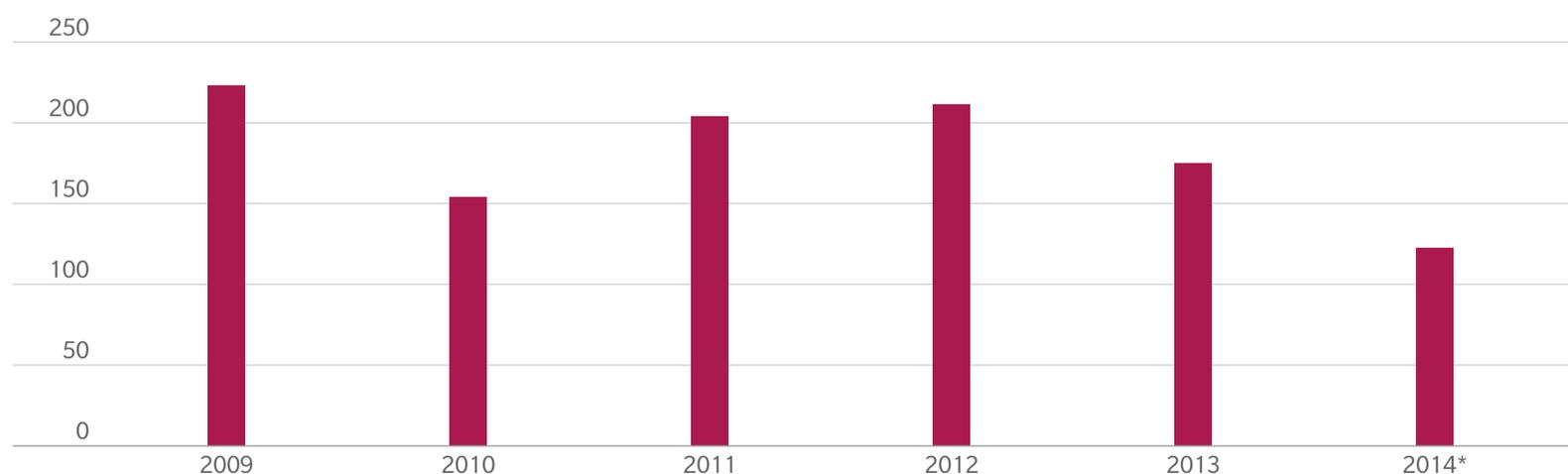
BEING PREPARED

There are many reasons why smaller utilities present opportunities to unlock value. First, small utilities often do not receive much management focus or investment. Some are smaller parts of bigger energy companies that are focused on higher growth or return businesses, such as natural gas and oil pipelines or exploration and production. Others represent fractions of their parent companies' utility holdings. As a result, growth in net property, plant and equipment

EXHIBIT 1: UTILITIES ACQUIRED IN THE PAST FIVE YEARS

DEAL VALUE

US\$ BILLION



Source: Dealogic, Oliver Wyman analysis.

*As of October 17, 2014.

is below average for half of smaller utilities, but for only one-quarter of larger utilities.

Small utilities often offer greater opportunities to improve the local customer experience and state regulatory relations. Regulators and politicians crave local relations and local jobs created by new offices and call centers. Instead, many larger utilities have focused on functional consolidation and standardization.

In addition, many smaller utilities distribute natural gas. With sustained lower gas prices expected in North America, gas utilities offer substantial upside for fuel conversion and gas system expansion.

Investors considering acquiring a utility need to be prepared to pay market multiples that reflect the company's enterprise value as a percentage of its net property, plant and equipment or as a multiple of earnings. However, 85 percent of smaller utilities are sold for slightly below the market multiple. By contrast, only 33 percent of larger utility acquisitions or mergers are conducted at a slight discount to the market.

Finally, there are fewer management issues to address. As opposed to big mergers which often fall apart after senior teams meet and fail to reach agreement, smaller acquisitions

involve far fewer issues. Many can be win-win asset purchase transactions that offer career growth or cash-out opportunities for senior managers.

THINK SMALL

Some argue that smaller transactions are not worth the effort. Bigger transactions may create greater value sooner, while smaller deals often require a similar level of resources such as management time, advisory and due diligence costs. However, a fresh, focused and disciplined approach to acquiring a small utility can be cost effective. Furthermore, utility roll-up opportunities exist in every region of the United States. Over time, a robust strategy of many smaller utility acquisitions, coupled with first-class acquisition integration efforts, can yield value equal to – if not greater than – one big deal.

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