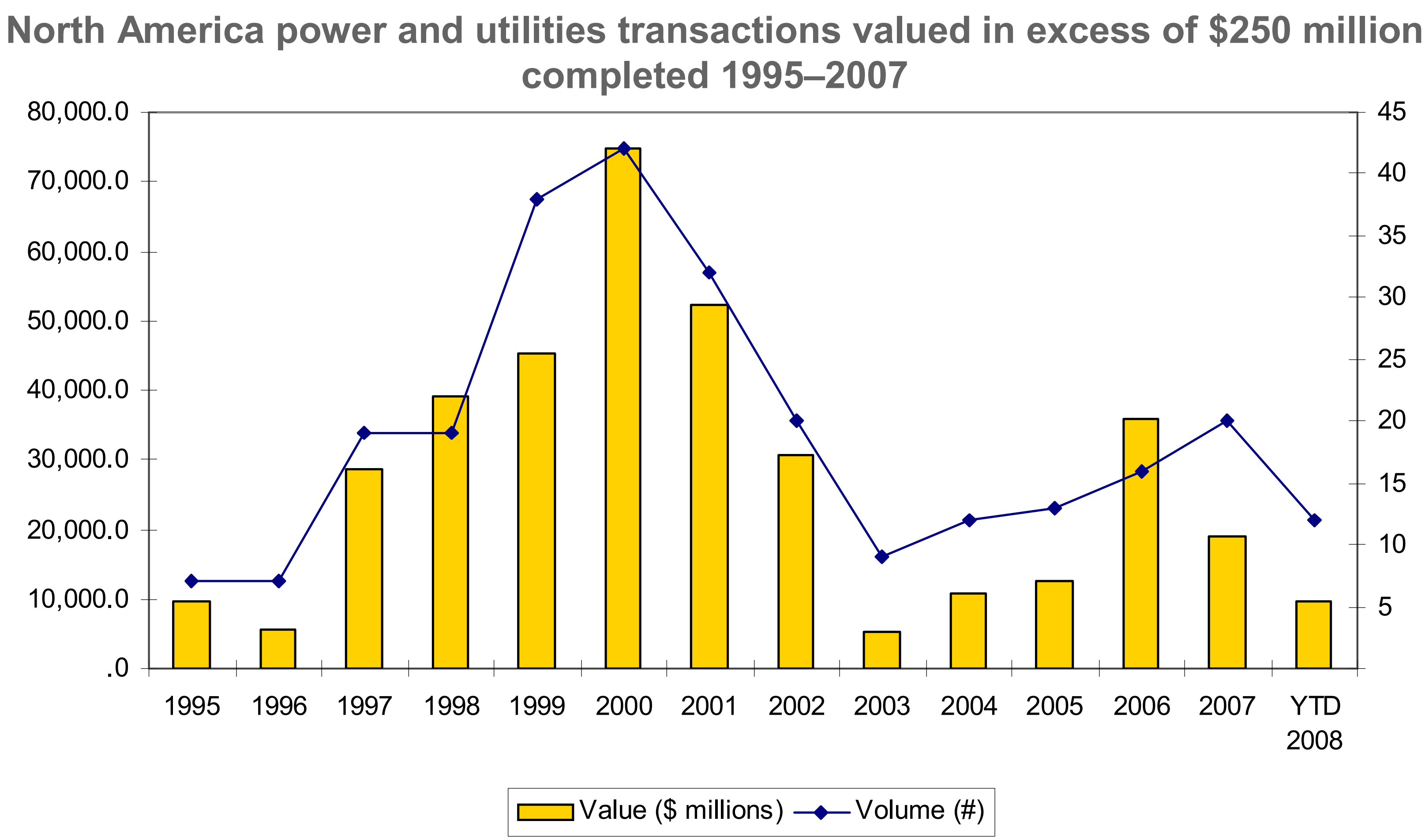
# Competitive Implications of Private Equity Investment in the Electricity Sector

March 3, 2009

# M&A trends




Source: CBK analysis of data from Securities Data Corp., accessed November 2008.


Ernst & Young
Quality In Everything We Do

# What is Private Equity

- Private Equity is a generic term that encompasses distinct strategies in the market for private equity:
  - Venture Capital– acquiring controlling stakes in early stage companies, (eg, Nth Power)
  - Leverage Buy-out– acquiring controlling stakes in mature companies utilizing large percent of debt, (e.g., KKR, Blackstone)
  - Infrastructure Funds– acquiring controlling stakes in essential backbone services to the community, (i.e., utilities, roads, ports), (e.g. Macquarie, Babcock & Brown)
- Leverage Buyout and Infrastructure Funds are key owners in the Power & Utility Industry:
  - KKR acquisition of TXU
  - Lindsey Goldberg's acquisition of Sempra Energy, (LDC)
  - Macquarie's acquisition of Puget Sound
  - Madison Dearborn's acquisition of Astoria Power Generation
  - These purpose of these funds is to earn returns greater than what the public debt, equity and real estate markets can generate over the long term

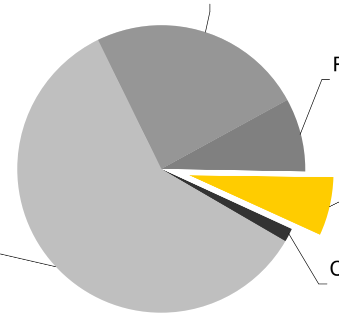
# Where does the money come from?

## PE considerations

- Institutional Investors, such as pension funds are the largest source of capital for PE and Infrastructure Funds.
- These institutional investors utilize PE funds to attain part of their asset diversification strategy which is to balance high risk, high return investments with lower return, lower risk investments
- While Institutional Investors seek investments in bonds, real estate and cash equivalents to diversify their risk of loss, these investors generally are seeking PE funds to earn returns greater than public equity when they allocate capital to PE
- In the power & utilities sectors, (merchant) power stations, fast-growing utilities and alternative energies have attracted a significant amount of interest from PE

## Pension fund considerations – Calpers

**Sample investment portfolio of pension fund**




*Sources: Calpers, Dow Jones*

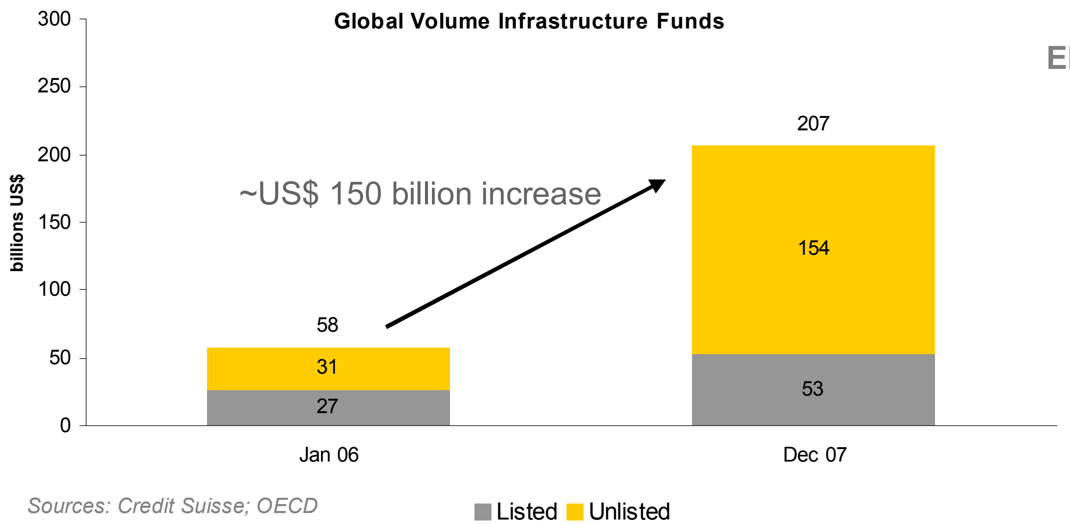
## Sources of capital for PE

| Sources of capital for PE | |
|---|---|
| **Pensions** | **40%** |
| Corporates | 17% |
| Individuals | 17% |
| Funds of funds | 14% |
| Foundations | 8% |
| SWFs et al | 4% |

# Why is this industry appealing for infrastructure funds?

## Infrastructure fund considerations

- Institutional Investors, such as pension funds are the largest source of capital for PE and Infrastructure Funds.
- These institutional investors utilize infrastructure funds to attain part of their asset diversification strategy which is to balance high risk, high return investments with lower risk investments, and lower, more annual yield-like returns over a long period of time
- While Institutional Investors seek investments in bonds, real estate and cash equivalents to diversify their risk of loss, these investors generally are seeking infrastructure funds to earn returns that are more steady and predictable than public equity when they allocate capital to infrastructure funds
- In the power & utilities sectors, electricity and natural gas transmission assets, regulated distribution utilities, water and wastewater utilities and alternative energies with predictable cash flows have attracted a significant amount of interest from infrastructure funds




*Sources: Credit Suisse; OECD*

### Electricity infrastructure: A burgeoning asset class

| **Infrastructure investment requirements (trillion US$2000; 2003-2030 globally)** | |
|---|---|
| Generation | 4.6 |
| Transmission | 1.5 |
| Distribution | 3.6 |
| ***Total*** | ***9.8*** |

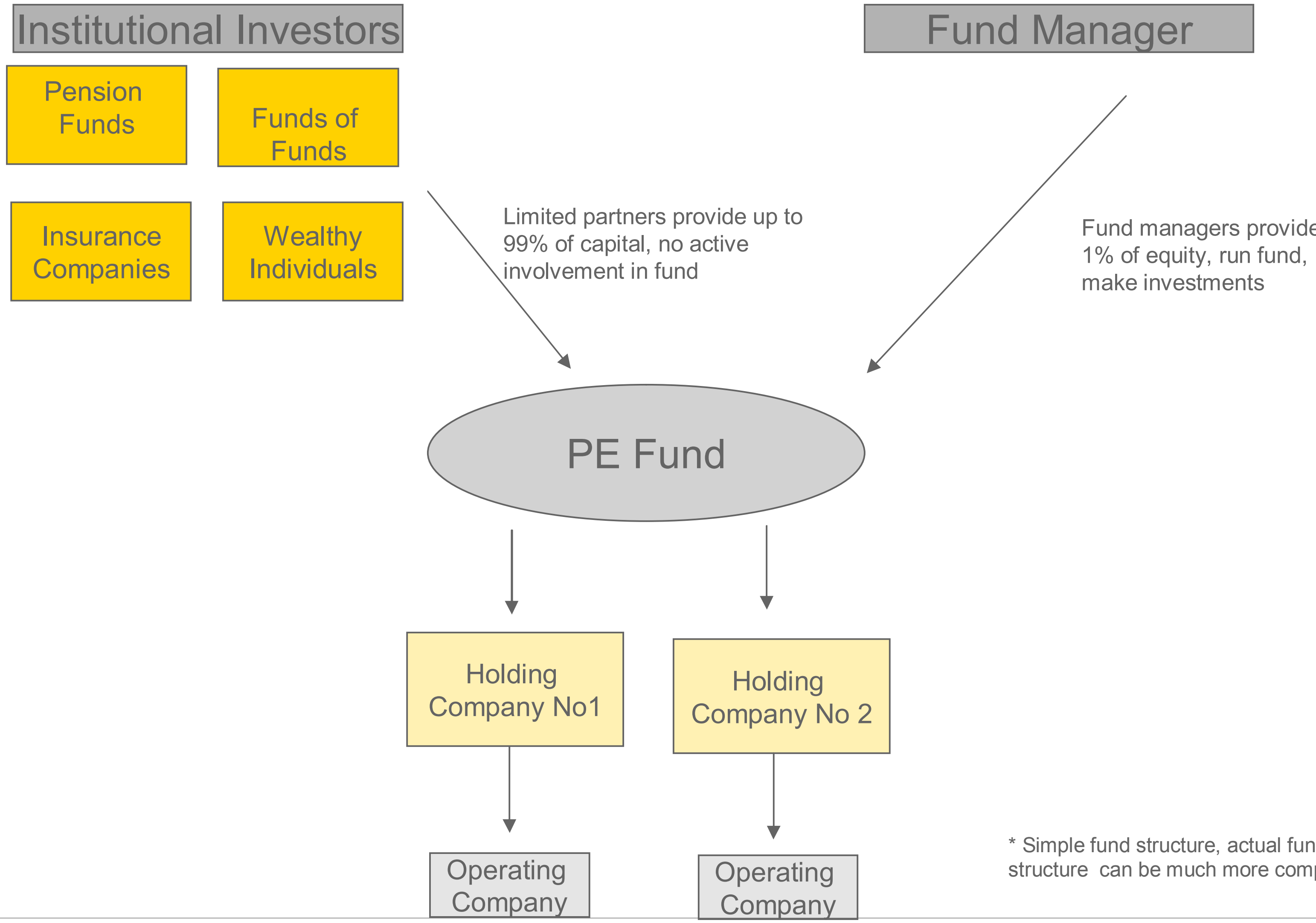


Ernst & Young
Quality In Everything We Do

# Some Observations

| Time horizon (years) | Hedge Funds <1 | Private Equity 5-7 | Infrastructure Funds 10-30 |
|---|---|---|---|
| **Equity IRR (%)** | High teens | Mid-high teens | Low-double digits |
| **Cash yield (%)** | N/A | N/A | >6% |
| **Risk tolerance** | Very high | High | Low |
| **Involvement in management** | **N/A** | Medium | Low |
| **Activism** | High | Low | Low |
| **Flexibility** | Very high | Medium | Low |

# What does a fund structure* look like




* Simple fund structure, actual fund structure  can be much more complex

# How PE operates

- *Acquire controlling stake in companies that are undervalued or underperforming*
- *Achieve a specified return rate over a determined period of time*

## Origination

***Buy carefully and selectively…***

Sector targets
- Origination network
- CEO/management campaigns
- Investment bank coverage
- 'Big 4' coverage
- Internal processes – measured and compensated

## Acquisition

***Start with the exit in mind…***

- Streamlined decision process
- Intense focus on:
  - Detailed due diligence
  - Advisor insights
  - Business improvements
  - Leverage and tax-structure
  - Right management

## Ownership

***Aligned incentives to performance improvement…***

Top management
- Incentives aligned to value creation
- Focused value-creation process
- Financial discipline
- Cash culture
- Constructive governance
- Exit readiness
- De-cluttering

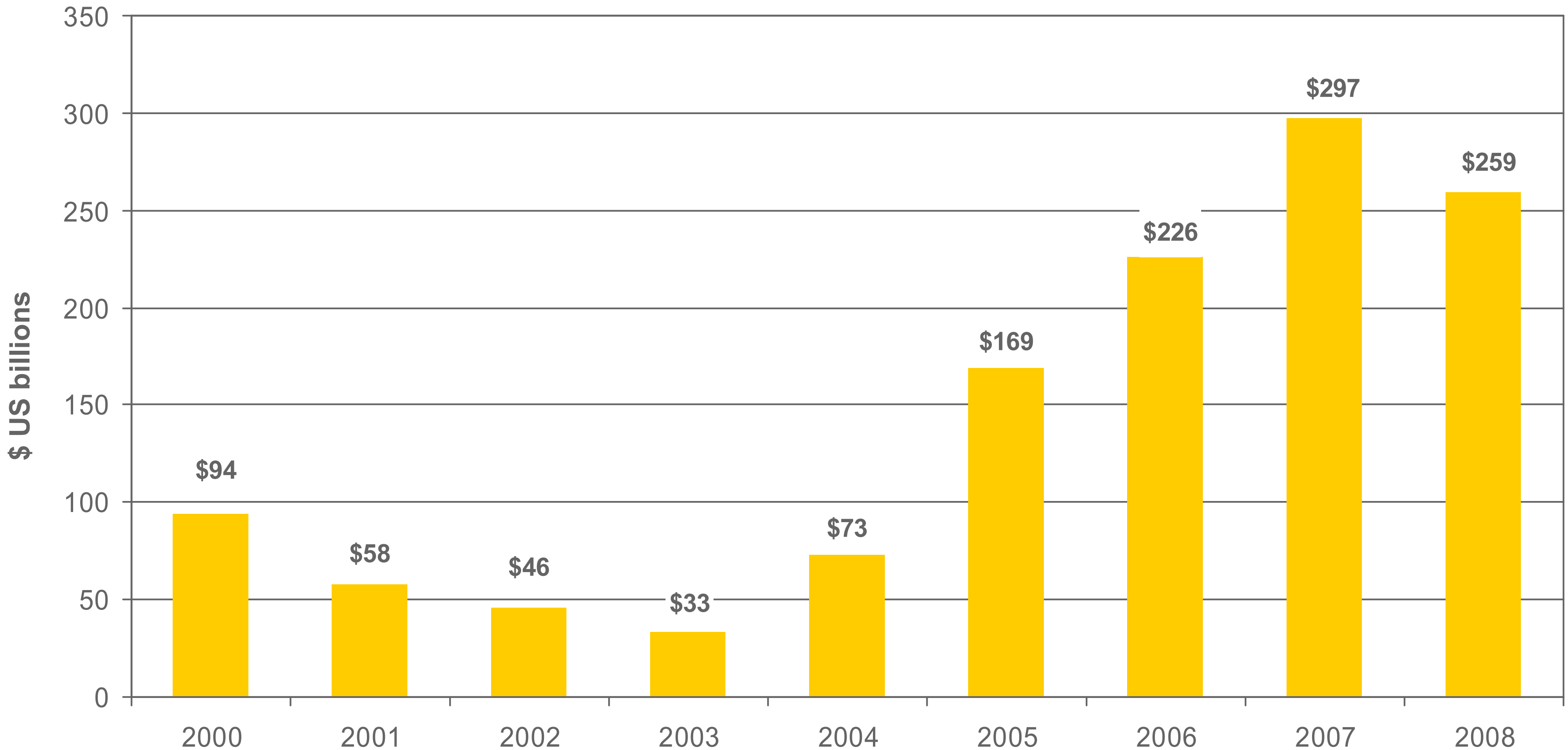
## Exit

***Plan exit carefully…***

- Extremely well-prepared for market
- Leverage advisors
- Detailed, 'clean' exit process
- Professional process
- 'Warm up' the market

# US buyout fundraising since 2000*

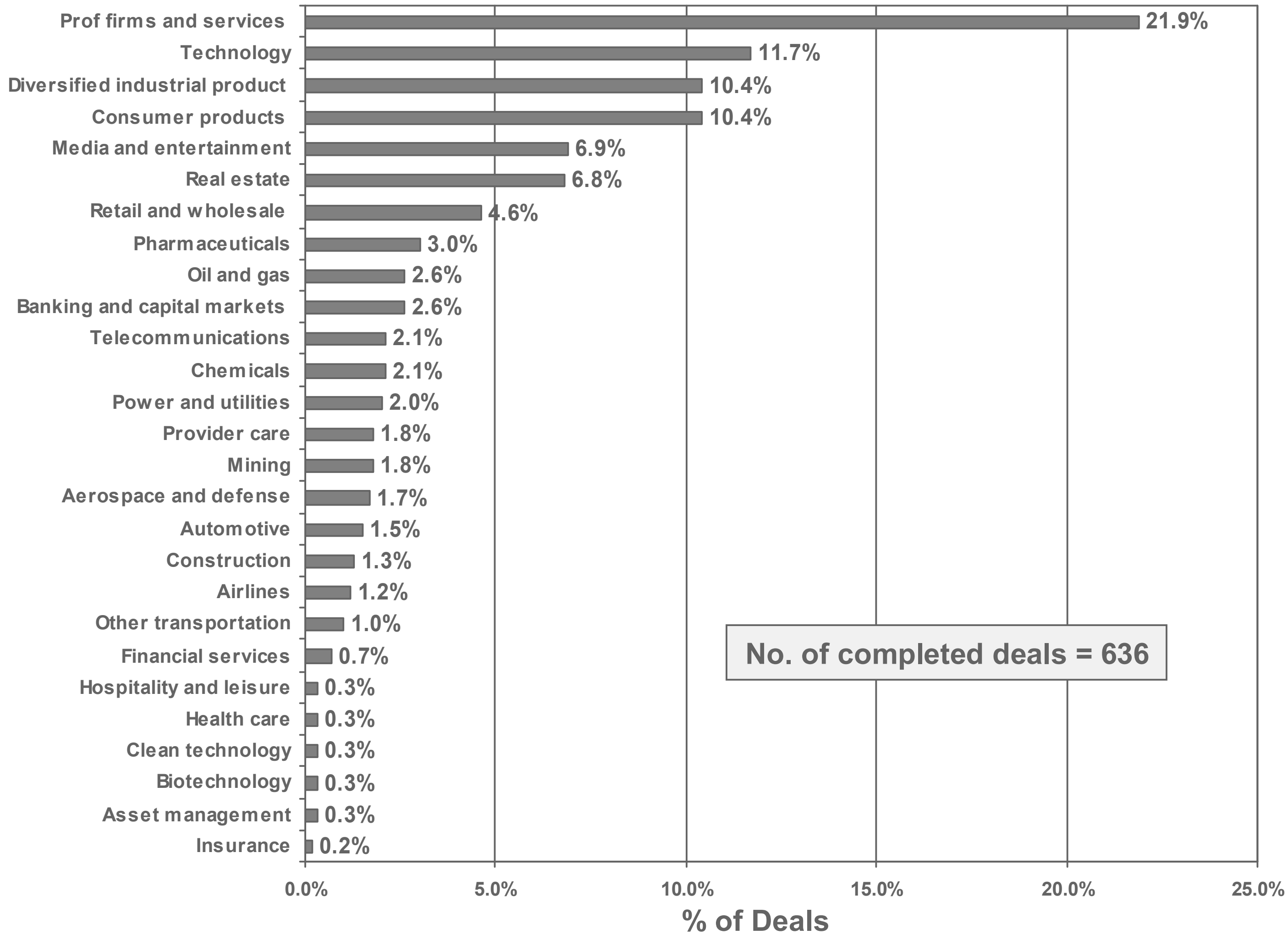
***(in billions)***




* Includes buyout and mezzanine funds.

Sources: (1) "Distressed, Mezz, Energy Remain Hot Strategies," Buyouts, 5 January 2009;

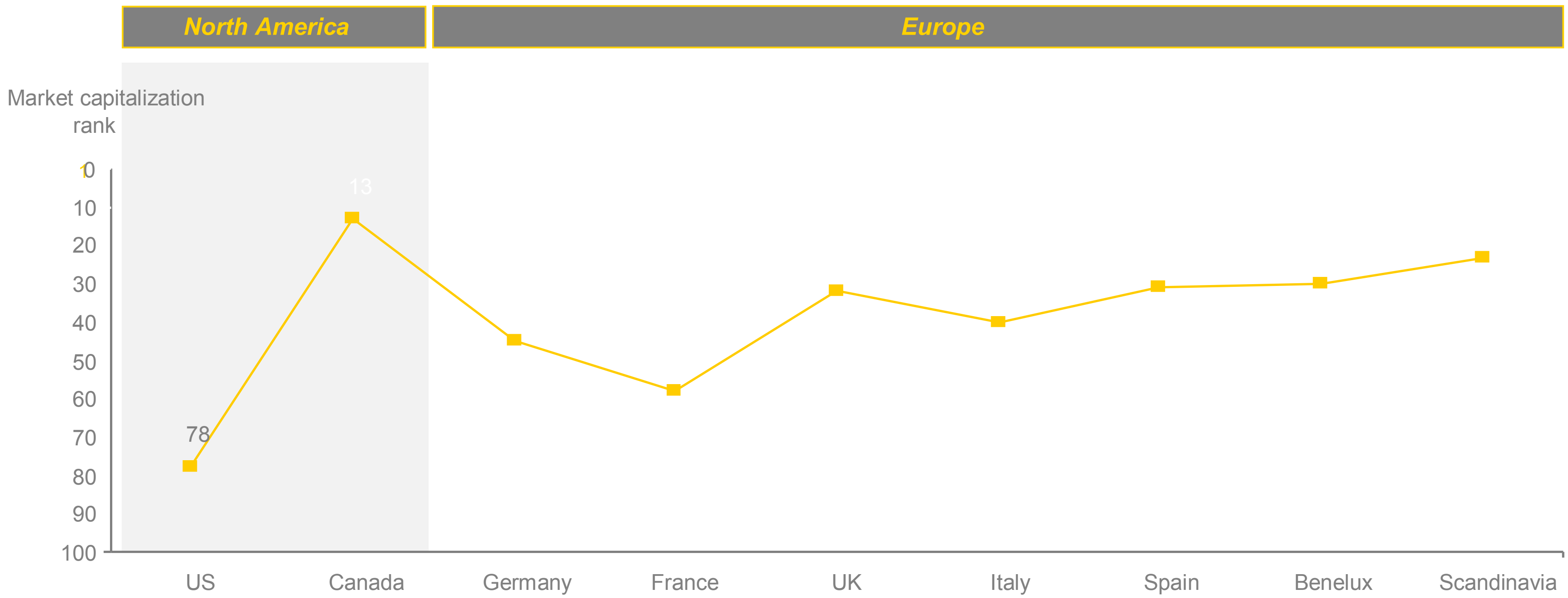
# Cumulative Q3'08 US LBO deals by industry sector




Sources: (1) "Deal Pace Hits Rock Wall In First Quarter," *Buyouts*, April 14, 2008, pg. 37; (2) "Buyout Shops Get Creative in Slow Deal Market," *Buyouts*, July 7, 2008, pg. 40; (3) "Deals Closed in Q3 2008," *Buyouts*, 6 October 2008, pg. 54 (4) EY Analysis.

# PE is active in every key market…

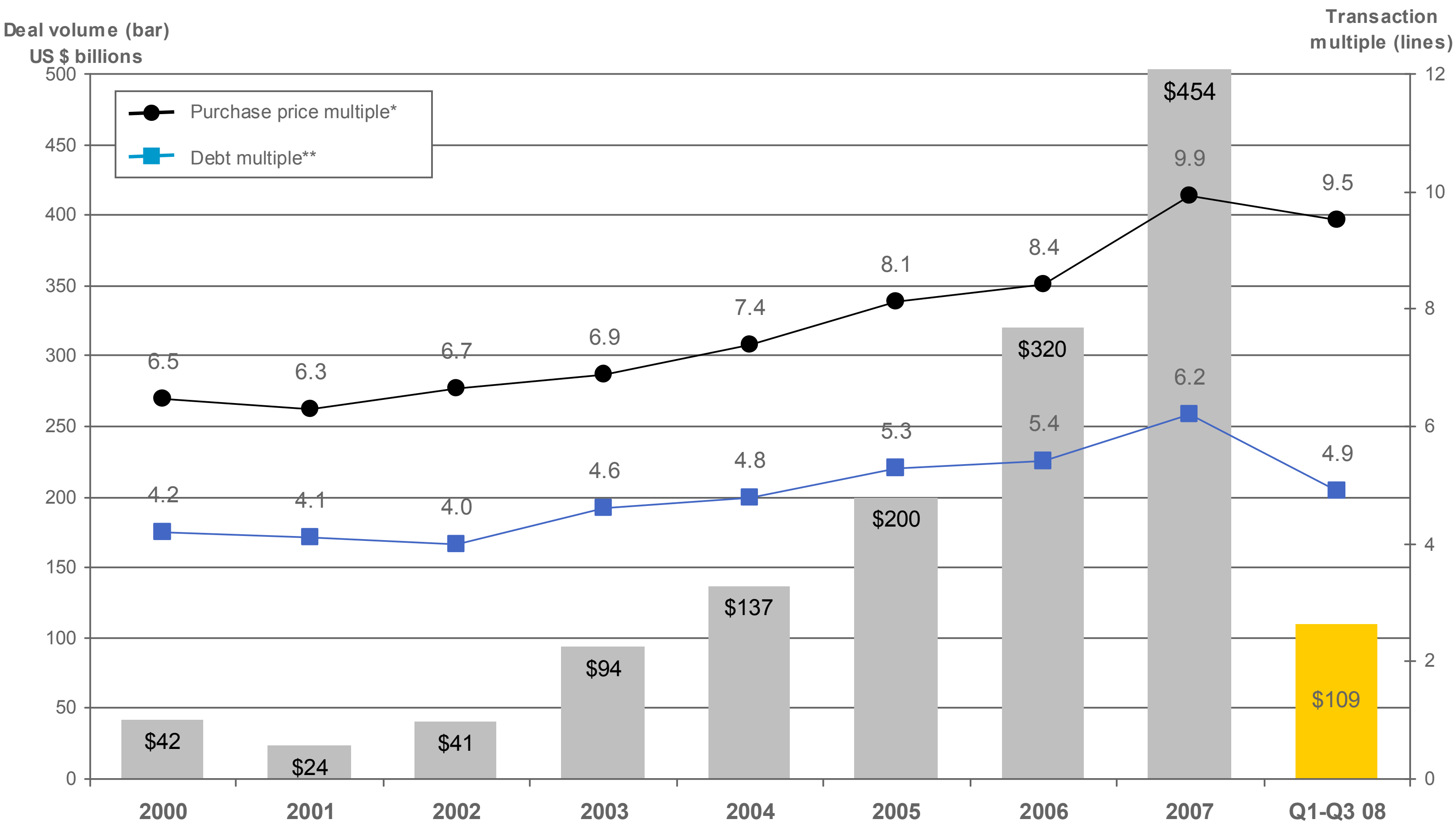
## Public stock market ranking of largest completed PE deal in 2007




| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| ▸ **Deal** | ▸ TXU Corp | ▸ BCE | ▸ ProSieben Sat.1 Media AG | ▸ Pages Jaunes Group | ▸ Alliance Boots | ▸ Seat Pagine Gialle | ▸ Amadeus Global Travel Distribution | ▸ The Nielsen Company (NL) | ▸ TDC (DK) |

*Source: Thomson Financial*

# US LBO deal volume and transaction multiples since 2000




* The purchase price multiple is calculated using the average purchase price of LBOs $500m or greater divided by adjusted EBITDA.
** The annual debt multiple is calculated using the average debt to adjusted EBITDA ratio for LBO transactions for companies with EBITDA greater than $50m.

Sources: (1) *Buyouts*, 7 June 2008,(2) *Buyouts*, 6 October 2008; (3) "M&A Stats," *Standard & Poor's*, vol. 10, no. 9, September 2008.

# PE and Infrastructure funds were able to access massive amounts of debt prior to the credit crisis

## (Sample list of transactions 2004-2008)

| Year | Acquirer | Target | Purchase Price ($ in millions) | Debt ($ in millions) | Leverage (%) | Type of Debt |
|---|---|---|---|---|---|---|
| 2004 | Blackstone, KKR, TPG, H&F | Texas GeCo | $2,900 | $2,495 | 86% | A&B Term loans; Revolver & LC (not in total) |
| 2006 | Madison Dearborn Partners | Astoria PowerGen | $1,044 | $770 | 74% | 1st & 2nd Lien; Revolver & LC (not in total) |
| 2006 | International Power (*) | Cole to Creek | $1,170 | $935 | 80% | 7-yr $735m Term B; 2nd Lien 7-yr $200m; Revolver & LC (not in total) |
| 2007 | Macquarie | Duquesne Light | $1,800 | $770 | 43% | Debt in HoldCo, break-out not available |
| 2007 | IFM | ConEd Development | $1,477 | $750 | 51% | 7-yr $425m term; planned $325m unsecured high yield |
| 2008 | KKR, TPG | TXU | $32,000 | $24,600 | 77% | Senior secured and unsecured |
| 2008 | International Power | 4 Peakers | $856 | $400 | 47% | 7-yr $400m term loan; $108m Revolver (not in total) |
| 2008 | Hastings Fund | Southwest Generation | $840 | $460 | 55% | 7-yr $460m term loan; $80m Revolver and $20m LC (not in total) |

(*) Example of Corporate Buyer using significant amount of leverage for transaction.

Source: SNL Financial, Source Media, Company websites, Power Finance & Risk

# Credit markets, beginning in the 3Q'08 suffered from catastrophic events…

- The 3rd quarter impact of the US takeovers over Fannie Mae and Freddie Mac, the bail out of AIG, the collapse of Lehman Brothers, and the FDIC intervention into WaMu shook lenders to their core, and caused massive hoarding of cash
  - Three-month Libor, the basis for many adjustable loans, shot up from 2.783% on 30 June to 4.053% on 30 September. The overnight rate, upon which much of the commercial paper market is based, was even more dramatic – on Tuesday, 16 September, overnight Libor doubled from 3.33% to 6.44% on the announcement of Lehman's collapse. It was the biggest one-day increase in its history.(1)
- High-yield bonds fared among the worst as investors scrambled for safety.
  - The spread between Treasuries and high yield bonds rose from 711 basis points at the beginning of Q3'08 to 1,000 basis points on 30 September.
  - By 16 October, spreads had increased to 1,460 bps, shattering the previous record of 1,064 set in October 2002.(2)
  - Conversely, yields on short-term Treasuries at one point in September were actually negative, as investors accepted a small loss in exchange for their unqualified safety. Three-month Treasury yields dipped from 1.736% to .910% between 30 June and 30 September.(3)
- The actions taken by the world central banks, including coordinated rate cuts and the backing of a wide range of financial assets, is beginning to have a positive effect, but the ultimate success is still undeterminable.(4)
  - The Counterparty Risk Index, a measure of credit default swap (CDS) pricing created and managed by the independent firm Credit Derivatives Research, showed the price of CDSs coming down in recent days after skyrocketing higher at the peak of the crisis.(4)
  - The index dropped 131.2 basis points the week of 13 October, from 364.4 to 233.2. In dollar terms, the cost of insuring US$10m of corporate bonds went from US$364,400/year to US$233,200/year in the course of a week.
  - While still far above its historical highs, it's an encouraging sign.(4)

Sources: (1) Bloomberg, accessed 2 October 2008; (2) *DWS High Income Fund Q3 Performance Review*, 30 September 2008; (3) "Treasury Bill Demands Some Yields Negative After Bailout of AIG, Money Market Woes," *Canadian Business*, 17 September 2008; (4) "A Thaw in the Freeze," *Barron's*, 20 October 2008.

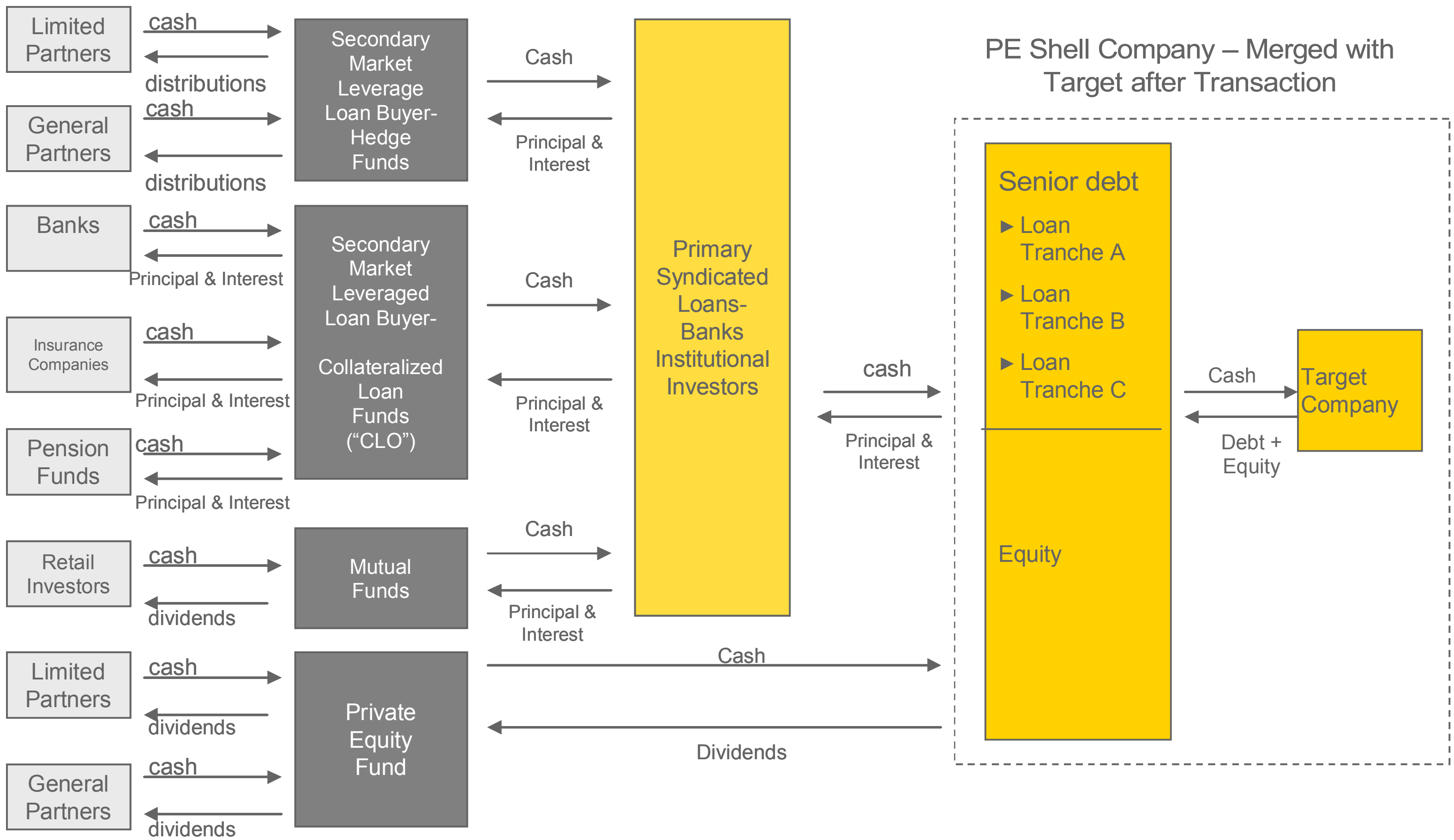
# Current market environment: State of the LBO model

- The traditional LBO model has come under extreme pressure on multiple fronts.
  - Credit, already in dwindling supply since the crunch began last fall, has become even more scarce, goading firms to execute deals with a greater equity component than ever before.
  - Economic pressures are weighing on the bottom line at portfolio companies.
  - M&A exits are difficult, and the IPO window is all but shut.
  - In spite of all this, general partners (GPs) report that valuations remain high, with sellers being slow to adjust to new market realities.
- Despite all this, Deals are getting done, albeit with less debt than before.
  - Going into 2008, the average debt multiple for large LBOs was 6.2x. Year-to-date in 2008, multiples have compressed to 4.9x, and the trend is heading still lower —looking at Q3 alone, the average was 4.6x.(1)
  - Add-on transactions have increased in significance as firms seek ways to boost the prospects of portfolio companies.(2)
  - GPs have been advising companies on ways to best weather the economic downturn. Many companies are drawing on revolving credit lines while they still can, and several are availing themselves of PIK toggle covenants negotiated prior to the credit crunch.(3)
  - Unable to finance mega deals, firms are continuing to take minority stakes.
- Through August 8th, PE firms had been involved in US$12.4b worth of minority transactions, a 58% jump from the same period last year.(4)

Sources: (1) "M&A Stats," *Standard and Poor's*, September 2008, Volume 10, No. 9; (2) "Leverage Drought Sends Deal Volume Lower," *Buyouts*, October 6, 2008; (3) "Private Equity Firms USE PIK Option to Service Their Debt," *Dow Jones Daily Bankruptcy Review*, 23 October 2008; (4) "Private Equity Firms Looking to Minority Stakes," *New York Financial Co. Blog*, 26 August 2008.

# How was the market able to absorb all that debt(*):

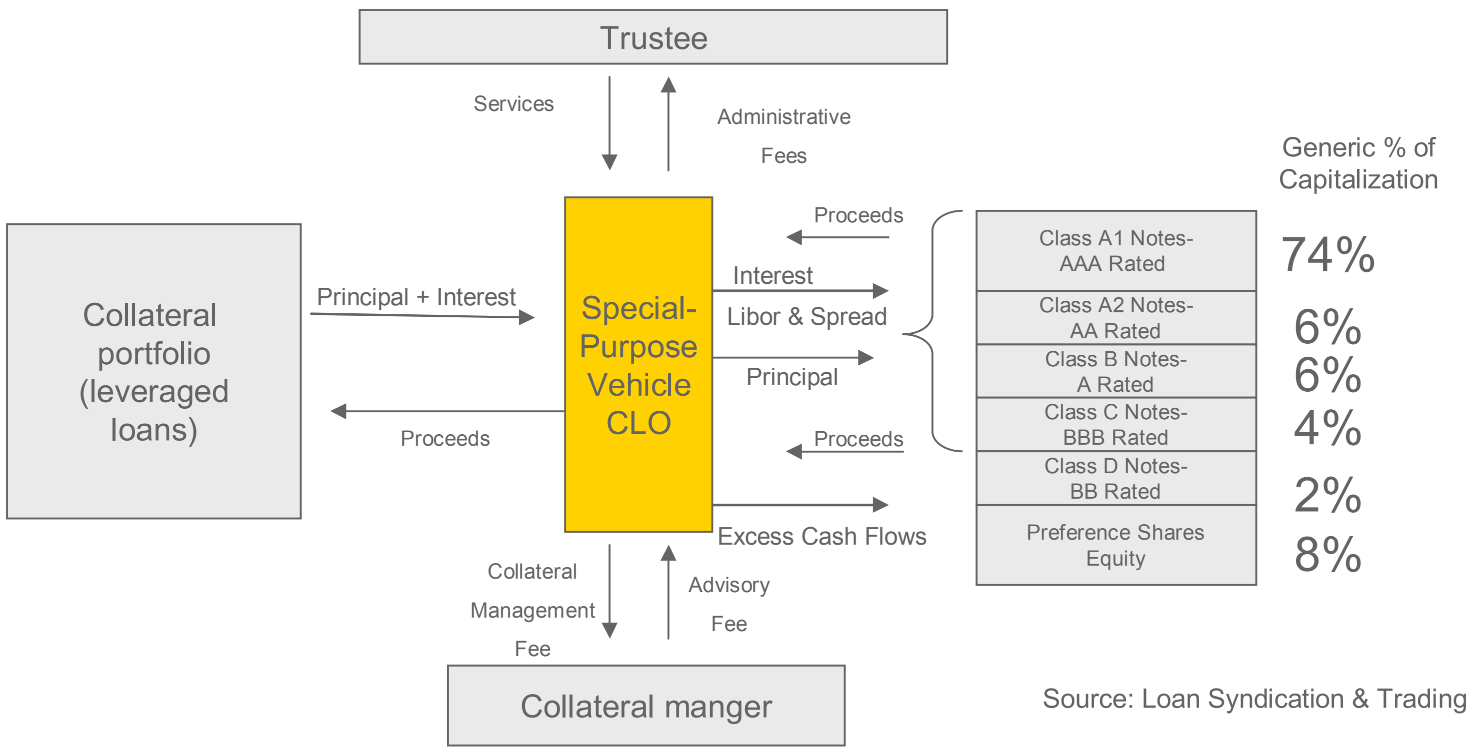
## By selling through to investors who wanted bank debt




*Hedge Funds, Mutual Funds, Insurance Companies and Banks were all eager to lend to PE and other Non- Investment Grade Buyers**

(*) This structure represents one example of the source of funds for a PE funds acquisition of a Target

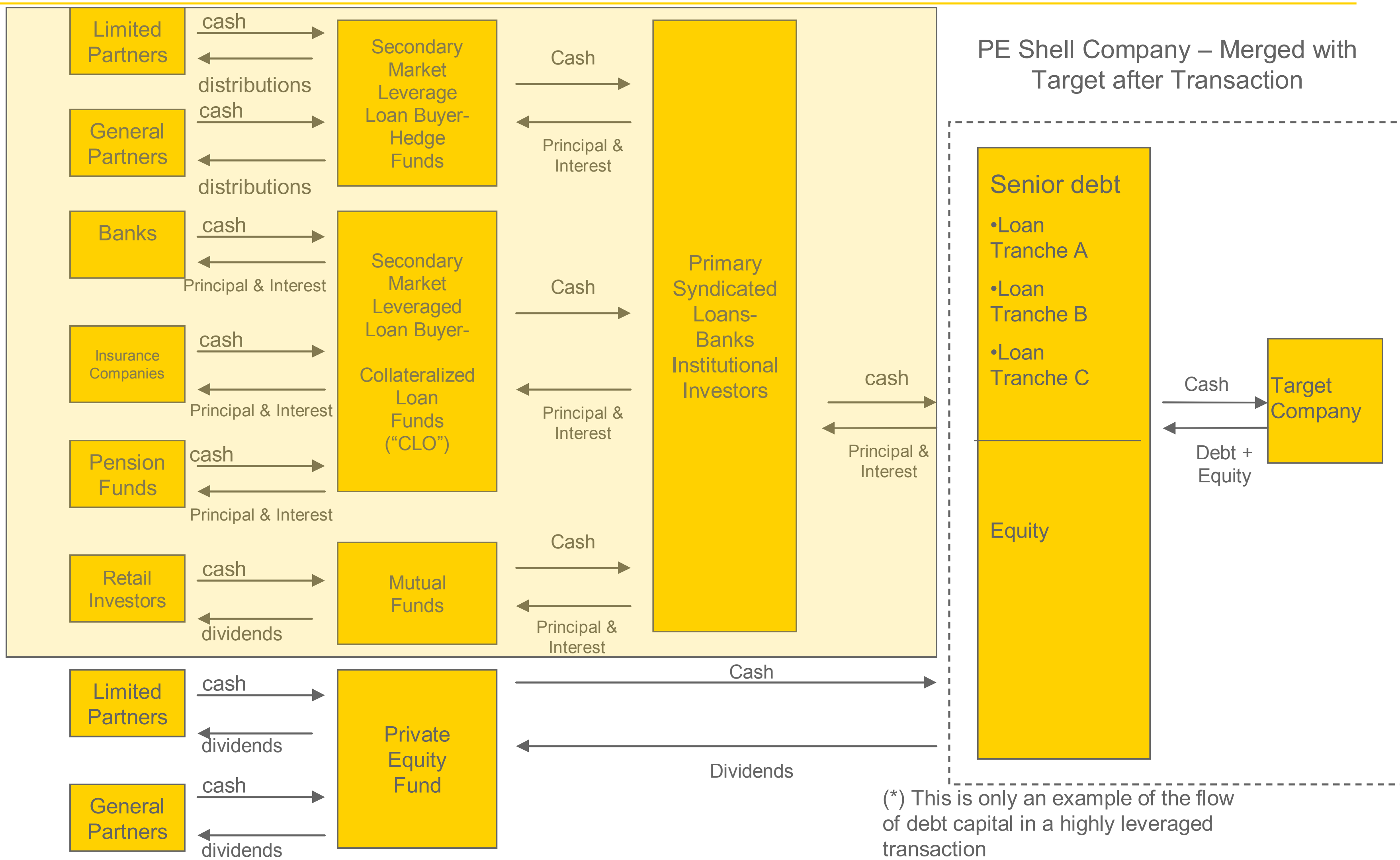
# CLO's were by far the largest acquirer of syndicated bank debt issued in M&A transactions




Source: Loan Syndication & Trading

- CLO's are a subset of the broader CDO Market, and the largest investor in leveraged loans
- Typically, CLO's include the loans of 125 to 175 issuers in 25 to 30 industry groups- designed to diversify risk
- Senior Tranche investors include:banks,insurance companies, pension funds and investors that require investment grade opportunities
- Equity shares include: hedge funds, investment banks and others willing to maximize risk/return prospects
- CLO's are an arbitrage play for the equity component, to collect the higher interest from the underlying loans, (libor + 150 or more) than what they pay to investors- (libor + 25) as an example

# Access has dried up, because these Investors have been hit by CDO losses and the fear of similar losses on CLO's(*)




(*) This is only an example of the flow of debt capital in a highly leveraged transaction



ERNST & YOUNG
Quality In Everything We Do

# The 2007 syndicated loan arranger league tables provides insight into the amount of debt raised

**2007 U.S. Lead Arranger**

| Rank | Bank Holding Company | Volume | # of deals | Market Share |
|---|---|---|---|---|
| 1 | J.P. Morgan | $449,372,593,168 | 741 | 25% |
| 2 | Bank of America | 293,393,467,960 | 833 | 17 |
| 3 | Citi | 280,455,334,471 | 356 | 16 |
| 4 | Wachovia Securities | 92,064,651,358 | 321 | 5 |
| 5 | Credit Suisse | 81,250,529,163 | 174 | 5 |
| 6 | Deutsche Bank | 71,748,433,853 | 109 | 4 |
| 7 | Goldman Sachs & Co. | 62,234,426,596 | 96 | 4 |
| 8 | Lehman Brothers | 46,235,382,679 | 77 | 3 |
| 9 | Merrill Lynch & Co. | 40,591,062,892 | 93 | 2 |
| 10 | Wells Fargo & Co. | 32,450,081,017 | 195 | 2 |
| | | **$1,449,795,963,157** | **2,995** | **58%** |

**2007 U.S. Leveraged Lead Arranger**

| Rank | Bank Holding Company | Volume | # of deals | Market Share |
|---|---|---|---|---|
| 1 | J.P. Morgan | $148,988,173,255 | 285 | 20% |
| 2 | Bank of America | 100,465,998,620 | 373 | 13 |
| 3 | Citi | 89,149,042,471 | 122 | 12 |
| 4 | Credit Suisse | 73,340,529,163 | 163 | 10 |
| 5 | Deutsche Bank | 44,868,433,853 | 82 | 6 |
| 6 | Goldman Sachs & Co. | 43,631,926,596 | 86 | 6 |
| 7 | Wachovia Securities | 36,463,695,308 | 157 | 5 |
| 8 | Merrill Lynch & Co. | 33,676,062,892 | 82 | 4 |
| 9 | Lehman Brothers | 26,905,182,679 | 68 | 4 |
| 10 | UBS AG | 20,692,403,419 | 76 | 3 |
| | | **$618,181,448,256** | **1,494** | **63%** |

Source: Reuters Loan Pricing Corporation

# Who else has Invested in the Industry

- Sovereign Wealth Funds- (e.g.,Taqa, Khazana)
- Balance Sheet of Investment Banks- (Goldman Sachs in Cogentrics and Horizon Wind before disposing of investments)
- Oil & Gas Companies—(e.g., BP in gas fired generation; Shell in renewable power)
- Pension Funds– (e.g., Ontario Teachers Pension Fund 50% interest in Intergen)
- Hedge Funds—(e.g., Pirate Capital in Mirant)