Case Study – Carron Energy

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BACKGROUND

It is 1999 and AES, a large American utility company, is acquiring power generation assets in the UK including Drax, the largest coal fired power station in Europe for which they pay £1.9 billion, and other smaller facilities such as Uskmouth near Newport in South Wales. A high proportion of the cost of these acquisitions is funded by debt, provided primarily by a syndicate of European banks.

Uskmouth is a 240 acre site and its coal fired power station had been de-commissioned by National Power in 1995. AES had a strategy to totally refurbish the existing 363MW generating facility, providing it with a 25 year life extension and ensuring compliance with the latest emission standards. Significant elements of the plant were completely replaced and, most notably, a flue gas desulphurisation system was fitted. In all, £120 million is believed to have been spent on the project, largely funded by way of non-recourse bank debt. The plans of AES also involved the future construction of a much larger gas fired power station on the site and National Grid, at a cost probably in excess of £30 million, built a 1,250 MW grid connection facility on the site to cater for this potential expansion.

Whilst the plant was brought back into service in early 2001, things had already gone seriously wrong. Significant engineering problems led to delays and issues of operational reliability. The electricity industry was in turmoil with several high profile collapses (Enron, TXU) and deregulation had led to unsustainably low electricity prices. Uskmouth's failures to meet its forward contracts for supply were proving costly and, in March 2002, receivers were appointed. Following the collapse of a major customer, Drax was also in trouble and, with the withdrawal of AES, the assets were left in the hands of the project bankers.

The Receiver decided to cease operations, most of the work force was laid off and the Uskmouth facility was placed into a care and maintenance state. The inability to demonstrate adequate performance only compounded the difficulties in selling the asset in an industry then plagued by structural problems, evidenced by the fact that the receivership lasted more than two years.

By early 2004, what Uskmouth had was disillusioned stakeholders with an unproven but well invested asset. What it did not have was the funding, confidence, management and other resources to turn it into a performing business. It was, as is called at Rutland, a stranded asset.

THE INVESTMENT RATIONALE

Rutland are a private equity house specialising in the acquisition of distressed or otherwise challenging situations. No private equity firm had ever made an acquisition of a power station in the UK. In early 2004, Rutland began working with a talented management team who had the skills and experience to organise a fix of the operational problems at Uskmouth. The rationale was simple - forward electricity prices were rising, the inadequate state of UK power generation was coming into focus and it was apparent that the asset could be acquired at a small fraction of the recent refurbishment cost.

The opportunity to add value lay primarily in three areas:
(i) to achieve a return to reliable and efficient service of the existing coal-fired facility including the introduction of new management, licenses and systems infrastructure;

(ii) to exploit the potential for a new build combined cycle gas turbine power station on the site, stopping short of the build itself; and

(iii) to transfer the asset into a cleaner corporate structure but which would retain the benefit of the significant tax allowances.

THE ACQUISITION

Rutland were familiar with the buying process from receivers which can be very different from conventional sale processes. Price was not the only issue – minimal conditionality and recognition that warranties would not be available were important factors in getting the deal done.

Due diligence also had to be different. Without any meaningful trading history, financial due diligence was necessarily focussed on the key assumptions underlying the projections. In the case of Uskmouth this came down to the forward prices of electricity relative to coal, the useful operating life of the asset, its reliability and its flexibility. Even with expert advice, it would have been impossible to acquire an asset such as this without assuming some risk on the time and cost required to get the facility fully operational. This had to be balanced with the potential rewards from the project.

With the above in mind, Rutland first approached the Receiver in March 2004 and, by June, had secured the acquisition of the asset. Rutland invested £23 million of equity into Uskmouth. This, together with around £10 million of bank overdrafts and credit from suppliers and service providers was enough to acquire the asset, complete the re-commissioning and fund the initial requirement for working capital and pre-trading losses. The nature of the opportunity and circumstances of the acquisition made it unfeasible even to consider bank acquisition loan finance at this stage.

THE RESCUE

Immediately following the acquisition, a full management and administrative team were recruited and financial and operational systems were established. Whilst, at first sight this might appear a daunting task, it had the advantage that the team and the systems could be picked afresh without the problems encountered in many turnaround situations of inheriting existing underperformers.

Early appointment of an independent operating and maintenance contractor for the power station was key. This was followed immediately by the further overhaul and re-commissioning of the facility for which Rutland made the necessary funds available. All necessary licenses had to be obtained, credit terms were achieved with key suppliers to minimise equity funding and trading relationships were established with electricity exchanges and other customers. Important to all these relationships was the positive reaction stemming from Rutland's evident support and drive for the full recovery of the business.

The first power was sent into the grid in September 2004 and, a little more than a year on from acquisition, an operating business had been firmly established, paving the way for the introduction of £35 million bank lending facilities in October 2005. Not only was this an important independent vote of confidence in the re-commissioned facility, these new funds provided the collateral for Uskmouth to enter into forward power sales contracts, effectively underpinning a base level of profitability for the next three years.

With the up-turn that had by now occurred in the UK energy markets, the complete return to service of the facility and the encouraging prospects for further electricity generation development on site which had been progressed in parallel, interest in Uskmouth was soon increased. This led to a sale of the asset in early 2006.

SUMMARY

In common with its investments elsewhere, Rutland demonstrated that specific sector experience is not such an important ingredient in acquiring a project such as this. Uskmouth was an abandoned asset with significant recovery prospects. Its difficulties stemmed from a highly leveraged funding structure for what was a challenging project made worse by a turmoil in its market environment. The turnaround was about commercial common sense, discipline, drive and assistance to the day-to-day management. Rutland sold Uskmouth for £125 million and made over four times its investment in 20 months, generating an internal rate of return of 150 percent. ■

Mike Harris is a partner at Rutland Partners where he has been working with the team there for seventeen years. For further information on Rutland and its deals, visit www.rutlandpartners.com