# The Business Case For Co-op Acquisitions

IOUs considering co-op acquisitions are finding fertile territory for growth.

By Kevin T. Williams

When utility executives consider the options for growing their business within a "back-to-basics" framework, naturally they consider acquiring other utilities. However, the relatively high price/earnings ratios of most investor-owned utilities (IOUs) today means bargains can be hard to find. Also, with PUCs disallowing the recovery of acquisition premiums, and mergers of equals facing daunting "social issues," IOU mergers don't look as attractive as they once did. Thus, many companies are beginning to consider prospects that lie outside the typical utility-merger model to bridge the "growth gap" between Wall Street expectations and the "back to basics" model that the Street has imposed (*see, for example, "A Starvation Diet for Utility Earnings Growth," Public Utilities Fortnightly, June 2004, p. 18*).

In the course of this analysis, the idea of acquiring electric cooperatives inevitably arises. In the past, conventional wisdom held that such acquisitions were either impossible or not worth the trouble. This "wisdom," however, is ill-founded. Cooperatives can be and have been acquired, and upon examining the fundamentals, utility executives usually sit up and take notice. In fact, at this moment some IOUs are scrutinizing the territory of electric cooperatives with acquisitions in mind.

The reasons are obvious. In short, co-op assets fit into Wall Street's notions of a "back-to-basics" utility business. Co-ops also offer opportunities for significant cost savings and synergies, mainly through rationalized business processes and customer aggregation. And co-op territories are growing faster than IOU territories—in some cases dramatically faster (*see Figure 1, "Co-op vs. Industry Growth Rates," p. 49*).

At the same time, however, barriers to co-op acquisition are fairly obvious, too. Namely, co-op directors distrust IOUs and generally rebuff merger inquiries. Co-ops don't have publicly traded stock that IOUs simply can buy. Their financial advantages—vis-à-vis tax-exempt status and government-subsidized loans—are lost in the transition to private ownership.

And finally, most co-ops are small and their territories tend to have low customer densities.

All of these barriers are real, and represent negative factors in the cost-benefit calculus. However, in many cases, the pros can outweigh the cons, and IOUs that analyze co-op acquisition candidates are finding fertile territory for growing their core utility business.

## Making the Case

Acquiring an electric cooperative differs in some important ways from acquiring an IOU. These differences arise from the ownership structure of an electric co-op. Namely, an electric co-op is literally owned by its members—the co-op's customers. This stake, however, cannot be sold or traded (absent an acquisition or demutualization); it is "trapped" as long as the co-op retains its traditional ownership structure.

Customer/members accumulate their stake in the co-op by contributing a portion of their monthly service bill toward the co-op's "patronage capital." This contribution is involuntary; it is built into the invoice and is not itemized. (While most co-ops refund a portion of long-standing members' cumulative patronage capital contributions each year, individual members usually contribute more in patronage capital than they receive in refunds.) An IOU acquiring a co-op, therefore, typically makes a lump-sum payment equal to each member's accrued stake (with a national median of about $1,400 per member) and retires the co-op's outstanding debt.

The logistics of such a buyout include the need to convince a majority of co-op members to support the transaction and accept the acquirer as their new electric utility. This is accomplished by appealing directly to members through various channels of communication, including direct mail and placements in local media.

The offer to co-op members can include various inducements—the most obvious being a lump-sum cash payment for involuntary patronage capital contributions. This is money that members generally would not otherwise receive, except over a period of years after they leave the co-op territory (because patronage capital refunds continue but contributions cease), or upon their death, depending on the policies of the given co-op.

Furthermore, since members are turning their share of the co-op over to an investor-owned company, acquisition by an IOU will relieve them of the risks of owning a utility operation and absorbing losses due to bad investments or mismanagement. Co-op customers typically absorb losses through increased rates, while IOU customers are protected from such risks.

Other incentives can include better rates (and rate stability), a broader range of services, and more advanced customer-service capabilities—contrasted with the limited capabilities of some co-ops, which actually forward after-hours customer calls to the local sheriff's office or funeral home.

## Valuation Factors

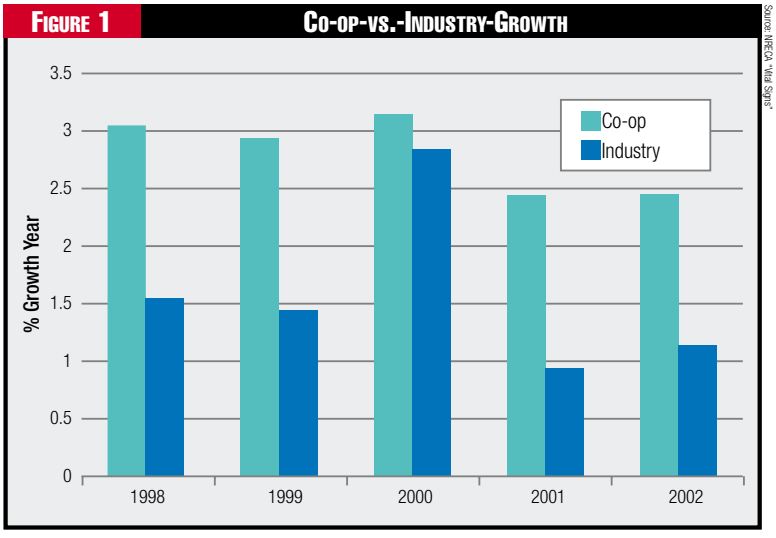
Identifying the best prospects for acquisition can be a tricky endeavor. While each case presents its own valuation and cost-benefit factors, analyzing groups of co-ops yields insight into a potential acquisition business case.

Co-op acquisitions present numerous opportunities for savings and synergies. Some of the most compelling drivers involve the strategic benefits of acquiring a fast-growing, base-load-heavy customer territory. These opportunities bring an attractive load profile to the IOU's customer portfolio, supporting capital expenditures and ultimately rate cases before state utility commissions.

Such benefits can be difficult to quantify, but other benefits can be more easily measured for the purposes of a business-case analysis. The primary benefits are cost savings at the co-op resulting from reductions in general and administrative (G&A) expenses.

G&A savings are captured by eliminating duplicative functions and improving efficiencies. Namely, an IOU that acquires a co-op will integrate the smaller utility's general management, governance, operations, rates, billing, customer service, marketing, human resources, and other functions into its own, much larger organizational systems. Because virtually every cooperative has its own general manager, operations manager, board of directors, billing system, etc., an

**FIGURE 1** **CO-OP-VS.-INDUSTRY-GROWTH**




SOURCE: NRECA, "A&A Survey"

acquirer can realize significant G&A savings by integrating these functions into its own larger organization, and applying its more-rigorous processes to ensure customers are served as efficiently as possible.

In many cases, a co-op's G&A functions can be integrated into an IOU's systems with very little incremental increase in overhead. For the purpose of a generalized business case, a savings benchmark of 60 percent savings is appropriate. In many cases, however, savings will be much greater. Additionally, O&M savings can safely be pegged at 10 percent (greater savings might be achievable in many cases, but co-ops' generally low customer density per mile of line creates a limiting factor that justifies a conservative benchmark).

Because more duplication is eliminated, cost savings will be greater when absorbing multiple, small co-ops than one larger one with the same number of customers. For example, savings from eliminating fixed costs will be greater when absorbing five co-ops with 10,000 members each than they will be when absorbing a single co-op with 50,000 members. This implies that the best candidates are groups of small, geographically contiguous (or nearly so) co-ops. However, because acquisition efforts themselves entail certain fixed costs per co-op, acquiring multiple small co-ops is somewhat more expensive than acquiring fewer, larger co-ops, in terms of all-in costs per customer.

Of course, some costs will increase following an acquisition. Namely, the "margins" (co-op parlance for profits) of the former co-op will become taxable income, and the co-op's subsidized debt provided by the U.S. government's Rural Utilities Service (RUS) will (as a practical matter) need to be refinanced. Such refinancing, however, might be accomplished at a discount as provided by applicable federal laws and regulations, depending on a variety of factors. Whether such debt is replaced by equity or market-rate debt depends on the financial goals and capabilities of the acquirer.

## Post-Acquisition Performance

Using the benchmarks outlined above, the following business-case analysis was prepared for a utility company (WireCo) in the southwestern United States. The purpose of this analysis was to evaluate the feasibility of acquiring cooperatives within a reasonable distance of the utility's territory. The results showed that nearly all (more than 80 percent) of the co-ops in the study population were likely to be feasible acquisition candidates, based on conservative assumptions. This analysis did not identify or prioritize specific candidates; such is being undertaken as part of a second phase of data collection, screening, and prioritization of acquisition candidates based on strategic and commercial considerations.

Co-ops in the sample were drawn from RUS borrowers in the year 2002, within a 400-mile radius of WireCo's territory. Co-ops' financial data are available from the RUS, pursuant to Freedom of Information Act request, but data for non-RUS borrowers is somewhat more difficult to obtain. For this business case, non-RUS borrowers were excluded, but they typically represent more successful cooperatives, based on the fact that they have been able to retire their government-subsidized debt and replace it with market-rate debt. How their exclusion affects the business case is not entirely clear. On the one hand, co-ops that are more successful might represent more attractive acquisition targets than those with poorer cost structures. On the other hand, weaker co-ops might be easier to acquire, and might provide stronger savings opportunities.

At any rate, the study sample consisted of RUS-borrowers representing the minimum, median and maximum values for seven criteria:

- Number of customers
- Total revenue
- Equity per customer
- O&M costs per customer
- G&A costs per customer
- Profits

| Positive Factors |
| --- |
| G&A expenses reduced by 60 percent |
| O&M expenses reduced by 10 percent |
| Sales expenses (typically small) reduced by 100 percent |
| **Negative Factors** |
| Rates reduced by 2 percent |
| RUS debt replaced with 7 percent debt (conservative in today's market; refinancing at a discount was not modeled) |
| Income tax imposed on all profits at the maximum marginal rate of 39 percent (note: accelerated depreciation not modeled) |
| Acquisition cost "grossed up" by 10 percent to conservatively cover fixed and variable acquisition expenses. |

Given these assumptions, co-ops in the WireCo sample were analyzed to yield pro-forma calculations of the acquisition feasibility of each. These calculations were intentionally conservative, and did not consider strategic advantages, indirect synergies, or load growth and diversity factors that would yield additional economic benefits in future years.

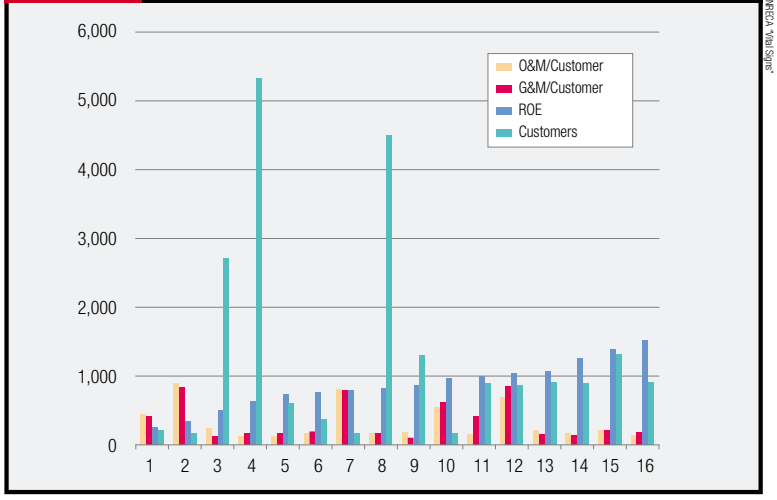
The calculations revealed that profit margins would increase by roughly one-third to about 10.5 percent of revenue on average, compared with about 7.6 percent before the acquisition.

Additionally, the resulting pre-tax return-on-equity (ROE) figures for acquired co-ops (at their current leverage) ranged from about 2.5 percent to a high of over 15 percent, with a simple average of about 8.7 percent and a median of about 8.4

percent. Given WireCo's feasibility threshold of 6 percent pre-tax ROE, more than 80 percent of the co-ops in the study population represented theoretically feasible acquisition prospects.

This business case quantified pre-tax return on equity (ROE)—a common valuation benchmark, and the one that WireCo requested. Of course, co-op profits that were previously tax-exempt will become taxable upon acquisition. Quantifying these tax impacts is an imprecise exercise, because the tax rate imposed will vary based on the consolidated income of the acquirer and the acquired co-op, as well as the tax strategies the acquirer employs. Indeed, such a calculation is largely irrelevant, given the focus on pre-tax ROE. Nevertheless, some general after-tax estimates can be offered.

**FIGURE 2** **NO-CLEAR-CORRELATIONS: COST VS. ROE POTENTIAL**




Source: WireCo's "Value Stories"

Using the most conservative approach (a 39 percent marginal tax rate on all post-consolidation profits of the acquired co-op, without regard to accelerated depreciation or any other favorable tax treatment), the result is about a 120 basis-point reduction from pre-acquisition profit margins. To be more precise, the average co-op in the study, with 7.6 percent pre-tax profit margins before the acquisition, would conservatively have around 6.4 percent profit margins after-tax, after the acquisition (versus around 10.5 percent post-acquisition, pre-tax profit margins). This estimate includes the maximum marginal cost of post-acquisition taxes, along with the other post-acquisition savings and costs considered in the study.

A final factor worth noting is the study's treatment of capital credits refunds from generation and transmission (G&T) cooperatives. Just as distribution co-ops earmark a portion of their customers' bills for patronage capital, G&T co-ops collect patronage capital from their wholesale customers, and refund it over time. This study assumes that acquired co-ops' wholesale power contracts with their G&Ts will remain intact, and thus patronage capital costs and credits are included in their post-acquisition financials. But even if the wholesale contracts do not survive the change in ownership, the new owner will be entitled to continue collecting the former co-op's G&T capital credit on an annual basis—at least until the acquired co-op's credit balance is exhausted.

For the 10 co-ops in the sample population that collect G&T capital credits, the study characterized those credits as income. An acquirer might treat them as income or conversion of a capital asset into cash (the latter having no affect on income) depending on its own objectives and practices. Even if, however, G&T capital credits are not treated as income, more than 60 percent of candidates in the population still met the 6 percent ROE threshold.

## Moving Ahead

After conducting such a macro-scale feasibility analysis, the next step involves screening and prioritizing individual acquisition candidates. Given the wide range of factors affecting the attractiveness of co-op acquisition prospects, any gross screening methodology can inadvertently eliminate compelling candidates; the best ROE in the WireCo study, for example, was yielded by a co-op with about 9,000 customers. Further—and contrary to conventional wisdom—there are no clear correlations between ROE and such factors as O&M costs per customer, G&A costs per customer, or the total number of customers of the candidate co-op (*see Figure 2, "No Clear Correlations: Cost vs. ROE Potential*).

Given this fact, IOUs considering co-op acquisitions should not assume that a co-op of a given size or cost structure must represent the most attractive candidate. Screening and prioritization must be conducted carefully to identify acquisition candidates.

Indeed, all the conventional wisdom regarding co-op acquisitions should be considered suspect until proven otherwise. Although some efforts are currently under way, no IOU in recent years has made a serious and well-planned attempt to acquire an electric cooperative. The first one to do so might transform the way IOUs view their neighboring co-ops, and launch a significant trend toward co-op acquisitions. F

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