

News+: What's left in UK water?

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The London Stock Exchange watched with only a dim sense of anticipation as the second hand struck five o'clock last Tuesday. In the end there was no final, dramatic bid for the UK's second-largest listed water company, Severn Trent, by the LongRiver consortium of institutional bidders that wished to take the entity into private ownership.

The trio of investors, comprising Canada's Borealis, the Kuwait Investment Authority and UK public sector pension fund Universities Superannuation Fund, stood resolute in its refusal to increase its approach of £22 (US\$34.5) per share – which equated to around £5.25 billion (US\$8.23bn) in total.

That was their third pitch, up £1.50 per share on the original move in mid-May. Each was rejected out of hand by the Severn Trent board on the grounds that it failed to take into account the potential future revenues of the regulated company as well as the growth in market capitalisation of the business since privatisation in 1991.

Efforts to revive the bid by one strategic shareholder, Pictect Asset Management, who said on Monday afternoon it would be open to an approach of £23 per share, fell on deaf ears. Shares in Severn Trent were today trading around the £17.60 mark.

Senior management of the utility, which serves more than 4.2 million homes throughout mid-west England and Wales, said that the after taking into account a pre-agreed 45.51p dividend payment the real value of the bid fell to £21.54 per share; a premium deemed unacceptable.

Bid date	Offer (£/share)	After shareholder distributions	Total value (£m)	Implied price to EBIT ratio*
14-May	20.5	20.046	4770.948	9.08
31-May	21.25	20.796	4949.448	9.42
07-Jun	22	21.546	5127.948	9.76

*Operating profit before tax and interest, as reported to Ofwat for FY ending 31 March 2012, was £515.2m

Source: London Stock Exchange filings, Ofwat

The passing of the bid deadline, set by the UK Takeover Commission, means that the suitors cannot make another bid for six months.

As predicted by industry insiders, there was no hostile takeover attempt – a suggestion abounding in some quarters of the national press. One source close to the failed deal told IJ News that LongRiver would be unwise to try such a move, rare in the core infrastructure space, as it would effectively amount to the buyers calling on shareholders to cast a vote of no confidence against management. Such a tactic would require strong powers of persuasion. But it could also sully a buyers' reputation in the sector and prejudice future transactions, the source added.

The abortive coup is further evidence that the UK's water utilities are in high demand among international institutional investors. Over the past few years a number of water companies have changed hands as investor appetite for large-scale

monopolistic assets with regulated revenues grows.

An implication of the Severn Trent stand-off is that the company was 'overpriced' by its owners. This is of course shorthand for buyers unwilling to pay what owners think they can get for highly-coveted assets. At the same time, it fuels the oft-repeated market perception that there is 'too much capital chasing too few assets'. When looking at the ratio of implied price against earnings on recent deals, most occurred within the high teens.

Recent UK Water utility acquisitions						
Date	Investor	Asset	Transaction details	Value of transaction	EBIT* £m	Implied total value to earnings ratio
Oct-11	Cheung Kong Infrastructure	Northumbrian Water	In an aggressive takeover bid CKI acquired full ownership of Northumbrian Water	£2.4 billion	320.4	7.49
Jan-12	China Investment Corporation	Thames Water	CIC bought an 8.68 per cent stake in Thames water from Santader in a surprise sale in January 2012	£500 million	643.9	8.9
May-12	Itochu Corp	Bristol Water	Itochu Corp bought 20 per cent of Capstone Infrastructure's 70 per cent stake in Bristol Water	£70 million	24.5	20.4
Jun-12	Gingko Tree, Morgan Stanley Infrastructure Partners and Infracapital	Veolia Water UK	Gingko Tree was one of the investors behind InfraCapital and Morgan Stanley Infrastructure Partners' 90 per cent acquisition of Veolia's UK water business	£1.2 billion	75.4**	17.7
Feb-13	Sumitomo Corporation	Sutton and East Surrey Water	Sumitomo Corporation bought UK water utility Sutton and East Surrey Water Group	£305 million	16	19.1
May-13	KKR	South Staffordshire and Cambridge Water	The US private equity group acquired South Staffs, which merged with Cambridge last year, from the Alinda fund for an undisclosed amount	Undisclosed	N/A***	-
Ongoing	-	Yorkshire Water	Citi Infrastructure Investors are seeking to sell 17 per cent of its 37 per cent holding and Infracapital wish to divest their entire 13 per cent stake	£1.5 billion (estimated)	319.5	15.6

*Operating profit before tax and interest, as reported to Ofwat for FY ending 31 March 2012 (latest FY with full results available)
**Consolidated for Veolia Water Central, East and Southeast (three separate entities)
***Cambridge and South Staffs filed separate accounts prior to their merger

Although no value was disclosed for KKR's acquisition of South Staffs from Alinda, a source told IJ News that it was a 'high multiple' of earnings - and perhaps the reason why the private equity firm didn't want it made public. In light of these figures, it is understandable why the Severn Trent board felt they could get a better deal for the business and its potential earnings.

However the implied total value of some companies may be distorted upwards by the transactions for smaller slices of equity. One advisor on such deals says: "Due to regulatory issues, smaller funds can buy sub-10 per cent pieces and they are often new entrants so pay prices for these slices, which implies a very high value for 100 per cent".

Despite the impending conclusion of an Ofwat price review, which leaves a large question mark hanging over profitability, an advisor to the deal tells IJ News that the regulatory cycle is not as influential to the level of demand as one might assume – despite some analysts predicting the end of the wave of 'mega-takeovers'.

Outside of Severn Trent, there are two listed water companies left in the UK and the Severn Trent episode could push up their value in the minds of board members and shareholders. Abu Dhabi Investment Authority was rumoured two months ago to be considering a bid for Pennon Group while United Utilities have reportedly hired Goldman Sachs amid speculation of a possible takeover.

Remaining listed UK water companies			
Entity	Market capitalisation	Share price	Price to earnings ratio
United Utilities	4,970.97	£7.31	17.61
Pennon Group	2,445.62	£6.53	90.56

Source: Bloomberg

Pennon's current price to earnings ratio is skewed by poor performance in the last half year that saw its profit margin, which had hovered steadily around 13 to 14 per cent over the previous two years, drop to -12 per cent. However this was caused largely by its Viridor waste outfit, whose profits fell by more a third, while its South West Water utility enjoyed a 7.5 per cent rise, and in the event of vendor interest it could imaginably be separated from the water business.

Potential sales processes are likely to see unsuccessful bidders on previous water sales processes jostling alongside the handful of private infrastructure funds in the European space with plenty of dry powder to deploy. Industry sources say given the large size of assets, more consortia of funds, sovereign wealth funds and pension funds are likely to form - as the ticket sizes are too large for any single investor. On the other hand, the Severn Trent tug-of-war could mean we have seen the top of the market in UK water utilities.

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