DUET's $1.4b Energy Developments deal busts the stereotypes

PUBLISHED: 20 JUL 2015 7:23 PM | UPDATED JUL 21 2015 AT 5:30 AM

DEUT Group CEO David Bartholomew: DUET have proved a strong drawcard for both local and international investors. **Photo: Michele Mossop**

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The $1.4 billion takeover of Energy Developments by DUET Group provides the perfect opportunity to bust the stereotypes about greedy private equity funds and the market's obsession with short-term gains. Let's start with private equity.

Pacific Equity Partners has dominated the share register of low-emission energy supplier Energy Developments since it failed to gain full control in 2009. PEP launched an opportunistic cash bid at $2.50 a share for 100 per cent of the company which was rejected by the board. PEP came back with a $2.75-a-share offer that was not recommended by independent directors but won the approval of a large chunk of the register.

Investors Mutual Ltd (IML), however, shunned the offer and made it clear it would not accept the offer for its 10.16 per cent shareholding. IML portfolio manager Simon Conn said the offer undervalued the company and there was no way his firm would be bullied into accepting cash just because other shareholders were bailing out. Conn was attracted by the strong cash flows churned out by the Energy Developments business. He could see through the short-term woes caused by a poor investment in Western Australia.

He liked the management team led by Greg Pritchard. Most importantly, Conn was willing to stand up for unitholders in IML funds and put the case for PEP to run the company for all shareholders. PEP, which was recently described by Pritchard at a public function as being "a pain in the arse", started badly at Energy Developments by slashing the dividend. Conn says it took some time for him to convince the PEP brains trust that paying dividends was actually positive for the share price.

Pritchard said recently that PEP "showed up like a bunch of white knights and were very impressive … then they promptly turned hostile, which was quite confronting. But since then, the relationship has been a big success."

He went on to say: "The PEP guys are highly skilled, but on stuff like remuneration reports and risk committees, they needed a bit of training. Luckily they have learnt from the mistakes of other companies that didn't get governance right." In fairness to PEP, which is led by Tim Sims, the private equity group did not conduct an asset stripping operation at Energy Developments. It did not starve the company of capital or bleed it dry. It has to be said the independent directors of Energy Developments, led by former AGL chief executive Greg Martin, did a great job ensuring PEP's early bolshie approach was not sustained.

EXPANDING FOOTPRINT

Over the past few years the company has invested about $500 million in capital to expand is footprint and introduce innovative solutions for a range of customers. The success of that innovative approach can be seen in the range of renewable energy solutions that have been provided to Energy Development customers in order to both cut emissions and lower costs.

At a time when coal-fired power stations are losing their share of energy consumption in Australia, companies such as Energy Developments are meeting the requirements of companies in remote regions of Australia and overseas.

The long-term, take-or-pay contracts that are the bread and butter of Energy Developments and DUET have proved a strong drawcard for both local and international investors.

The decision by Conn to rebuff PEP when it tried to grab Energy Developments on the cheap has proven to have been smart. He knocked back an offer of $2.75 a share at 6.5-times earnings before interest, tax, depreciation and amortisation (EBITDA) in 2009 and is now agreeing to an offer at $8 a share at 9-times EBITDA. He issued a statement on Monday: "IML's long-term approach, and willingness to invest alongside a major private equity owner, has allowed full value to be realised for our unitholders." Conn will continue the ride and keep accessing the reliable cash flows thanks to IML's position in DUET. He says the acquisition will diversify DUET's earnings, and provide a strategic growth platform for the future.

Another aspect of the deal that deserves closer attention is the cornerstone support for DUET's $1.67 billion underwritten equity raising from the large non-profit superannuation fund, UniSuper. UniSuper has taken a big chunk of the $550 million placement of DUET securities at $2.20 a share. That cornerstone investment allowed the company to be certain it would have no difficulties getting the issue away.

A BIG ASK

Undertaking a $1.67 billion capital raising when your market cap is $3.4 billion is a big ask. That's why locking in 15 per cent sold upfront made sense.

The share issue was underwritten jointly by Macquarie and UBS. Macquarie is long-time financial adviser to DUET while UBS has been a long-term supporter of Energy Developments having handled four capital raisings in the past few years.

UniSuper's involvement is likely to be an increasingly common feature of major transactions as the country's largest super funds seek to deploy their strong cash flows in areas with long-term, reliable cash flows.

Existing shareholders of DUET will have the opportunity to pick up stock through an accelerated non-renounceable 1-for-2.69 pro-rate entitlement offer.

The newly issued DUET stapled securities are likely to be snapped up given that the $2.02 issue price represents a cash yield of 9per cent. The equity raising is expected to be completed by lunchtime on Tuesday.

It is not just the yield that ought to prove attractive to shareholders. DUET and Energy Developments have businesses which are complementary. For example, DUET is weak in Queensland where APA Group dominates. It will redress some of this imbalance with the takeover offer.

The energy infrastructure sector has been the subject of much talk about consolidation and that has usually involved mention of the ambitions of Spark Infrastructure. But it has yet to make the much talked about major acquisition.

Spark faces a choice between taking up its DUET rights or having its stake diluted. It would appear that Spark has other bigger fish to fry with its involvement in the poles and wires sale in NSW. But the certainty provided by the DUET transaction would appear to make the NSW poles and wires option look relatively risky.

The Australian Financial Review

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