Lantau Pique

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In this edition

In the course of advising on various issues that affect the value of power stations, both new and existing, there have been moments when it seems cool heads leave the building and mindless zombies take their places. Zombies intent on finding a way to get a deal done and paying no heed to details like whether the deal is value accretive.

In this issue of Lantau Pique we take a lighthearted look at five “archetypes of failure”, taken from real life, but naturally disguised to protect the guilty.

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Five Archetypes of Failure

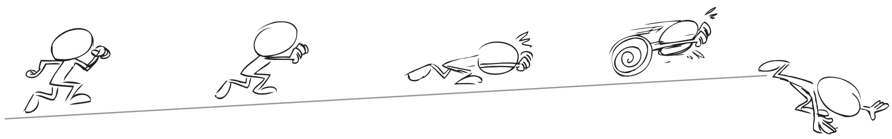
King Canute and the Tides

“We will dispatch this plant better than the current owner does.”

A flexible peaking plant was being sold. Review of market prices versus historical dispatch data revealed that the plant was occasionally missing opportunities where the market price exceeded its dispatch cost, resulting in money left on the table.

Without research or further consideration, the deal team decided their traders would be able to capture 5% more of the missing value than had ever been captured before. When asked why, the response was simply that their team was smarter. (Perhaps they planned to hire a young, bright Omniscient Being—never mind that such a Being would probably command something more than normal wages).

The problem here is not that the assumption is right or wrong. It’s possible the new team would do better—the lack of information meant we were not in a position to judge either way. Rather, the problem this exemplifies is the optimistic buried assumption that raises the odds of buyer’s regret. Justification for key value assumptions must always be very explicit and deal teams must have the discipline to subject these assumptions to open debate throughout the due diligence process.



Desperately seeking value

“This valuation seems too low. Change advisors.”

It is profoundly discouraging – perhaps even frustrating and infuriating – to spend enormous amounts of time, energy and resources on a deal, only to come to the dawning realization that it’s a dog. Organizations cope with this disappointment in different ways. In one case, the investor hired a new set of advisors who provided an alternative model that miraculously produced higher values. As the result confirmed the “wisdom” of expectations, no further due diligence was needed. Why were the results so miraculous? Because once the deal was signed and the dust had settled, nagging second thoughts prompted an after the fact audit which revealed a flaw in the alternative model that resulted in a material upward bias.

Alas, the deal was already signed.

At different times and to varying degrees, all human beings fall prey to favoring our gut at the expense of the results of objective analysis. Sometimes we’re right. But then again, sometimes we’re not.

The rare but truly successful organization has the self awareness required to avoid reverting to animal gut instinct, no matter the financial or emotional pressure. As a result, these organizations are able to make decisions that are consistently and genuinely better. And that is how, over time, you build a successful sustainable, long-term focused business.

Otherwise, it’s just Vegas, baby.

How Hard Can It Be?

"Sorry we didn't get back to you two months ago, we have been busy deciding what to do. The bid is due in a week. Can you start right away?"

Advisors are sometimes asked to make clocks run backwards. And while we can occasionally do that, you take a larger risk whenever you cannot give your advisory team enough time or resources. To assume your advisors can always pull off the miracle of the loaves and the fishes is to gamble with your own money. As with all things, what you get out depends on what you put in.

The harsh reality is that prudent power sector investment decisions require well-resourced processes; careful preparation; attention to detail; timely, insightful analysis and access to a wide range of skills and expertise. These take time and involve costs.

Preparation is important for all parties. Taking some time to think through how you would like to use your advisors will enable you to extract much more value from them.

Technocrats

"What are you assuming for the heat rate in year 10"

Sometimes arguments are so focused on heat rates and degradation rates that much larger (but less specific) risks are given almost no attention at all. Other times simple things like the difference between LHV and HHV get confused. People become obsessive about precision at the expense of accuracy. Guiding a team so as to be receptive to the former but maintain sufficient focus on the latter means that you don't want to create an environment in which an otherwise good team is fearful of acknowledging and fixing material errors. You have to be aware that your valuation estimate could change materially, right up to the last minute. Stuff happens. The important thing is to fix it and go forward.

Time must also be available to consider a third set of issues, typically far more important – and difficult – to value. How does the team evaluate the risks associated with market shifts in fuels, technologies, growth rates, regulation or policy? In many instances such risks cannot be easily managed, but directly impact value. Ambiguity and uncertainty, however, can make the results seem less scientific and robust. Clear, structured, scenario-based thinking is required.

And yet these three types of issues tend not to receive attention and resources that are appropriately proportional to their materiality. For example we're pretty sure no power investor has ever gone bankrupt or exited a market or sold an asset at a material loss as a result of having spent too little time focused on heat rate degradation. But we do know of many who built portfolios with highly concentrated exposure to regulatory risk or adopted unrealistic assumptions about fuel or demand growth or competitor behavior – topics that were "too difficult" to spend precious time debating.

In an earlier Lantau Pique, we argued that the choice of market modeling platform can either enslave you to detail that matters little to value or free you to focus on factors and scenarios that greatly affect value. It is not that detail is unimportant. But if you have limited time and resources, you have to choose what matters most.

Lemmings

Everyone can't win in Viet Nam and Indonesia at the same time. Just because China is big doesn't make it universally commercially attractive. Singapore is well managed, but that also tends to increase the number of players who wish to compete there. And yet, if we had a dollar for every investor who insists on fishing in the same ponds as everyone else, we'd stop writing these Piques and move to our own tropical island.

Elsewhere, in markets where relatively fewer international investors have been paying attention, a recent tendering process saw limited participation, with a result that was almost certainly less than fully competitive. Another transaction took place under a dark cloud of policy uncertainty regarding environmental and other regulatory risks. The winning bid was such that winner most likely didn't expect to win.

Heed the gospel according to Warren Buffet: a transaction is not attractive because of the condition of the asset, but rather because of the possibility you might acquire it at the right price – one that is significantly less than fair value.

Opportunities to do so exist throughout the region, if you're willing to look. Korea needs base load power. The Western Australian capacity payment has been the bee's knees. At five years and counting, and well over 70% privatized, the Philippine WESM has developed well beyond the skeptic's initial views, and looks increasingly robust and attractive. Malaysia faces a triple whammy of expiring PPAs, depleting gas and rising tariffs. Other countries will find it increasingly difficult to maintain unsubsidized electricity tariffs, and the probable resulting malcontent could easily strengthen calls for open tenders and contestable opportunities.

Many of these market opportunities have been on the sideline for the past decade. We wonder who will be best prepared for them should they emerge as expected.