# WHY OWN IT?

## SEPARATING OWNERSHIP FROM OPERATIONS WITH CAPITAL LIGHT

Stern Stewart & Co.

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## SEPARATING OWNERSHIP FROM OPERATIONS WITH CAPITAL LIGHT

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## Management Summary

The low interest rates and excess liquidity in the market have reached unprecedented levels. Institutional investors are desperately searching for alternative investments. At the same time, several industries face a significant need for investment but operate at a relatively high cost of capital. A considerable spread has emerged between the return expectations of institutional investors and the cost of capital of these companies. Against this background, many companies are beginning to question the necessity of asset ownership in their portfolios: „Am I the best owner in the market? Is ownership one of my strategic core competencies? Is it necessary for my business model at all?" Capital Light strategies enable companies to free up capital and exploit this spread. They can strategically reinvest the released capital and apply their core competencies to a larger asset portfolio – without having to finance more ownership. The four principles for realizing a Capital Light strategy are:

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1. Obtain clarity on the best ownership throughout the life cycle: What investments are best suited for a partial sale or participation model? In what phases of the life cycle can ownership be transferred? How strong is the investor appetite? 2. Do not leave the liabilities side of the balance sheet to the banks: Which standardized transaction and participation models are suitable? 3. Optimize the capital and risk positions in the Capital Light business model: How does the service model work after the partial sale? How are the risk transfer and the long-term capacity utilization concept structured? 4. Abandon traditional ways of thinking: Does the business still think in terms of ownership and the protection of vested interests? And is the finance function limited to traditional M&A? How can old habits be done away with and a tangible paradigm shift initiated?

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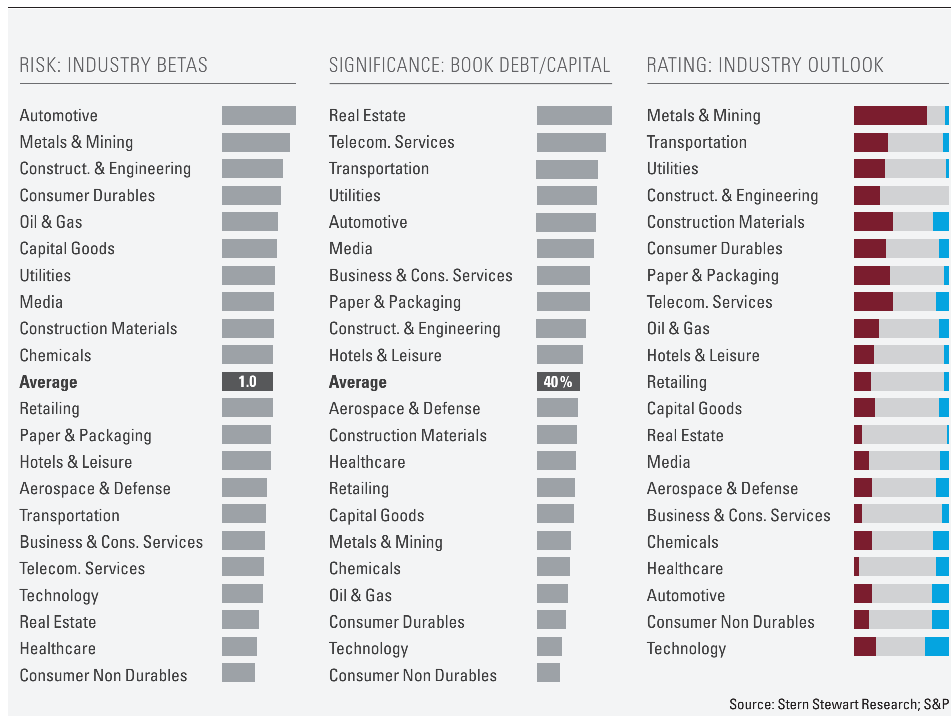
# What companies is Capital Light relevant for?

The right combination of financial and strategic factors is one prerequisite. From a financial point of view, the company's capital costs play a key role, as institutional investors can finance ownership at better terms. A Capital Light strategy is particularly attractive for industries with high sector risks, negative rating outlooks or high average debt ratios. These industries include, for example, automotive, oil & gas, consumer goods, metals & mining, utilities and construction.




Source: Stern Stewart Research; S&P

What is more, many companies are already subject to strict rating restrictions, limiting further borrowing despite the attractive current interest rates.

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In addition to the financial prerequisites, the company should also meet the strategic requirements for Capital Light – ownership must not be one of its strategic core competencies. Furthermore, the investments have to meet certain investment criteria if they are to come into question for institutional investors. Beneficial here are a long-term capacity utilization concept, stable and predictable cash flows and protection against commodity risks. The actual composition of the investment criteria depends on the type of investor in question: pension funds, insurance companies, banks, private equity or strategic investors all have vastly different risk-return profiles and holding periods for their investments.

## Principle 1: Obtain clarity on the best ownership throughout the life cycle!

The first step is to examine the company's asset portfolio. The objective here is to select assets that are suitable for further scrutiny in Capital Light models. The assets are prioritized in two ways: internally in a strategic portfolio analysis throughout the life cycle, and externally based on investor preferences.

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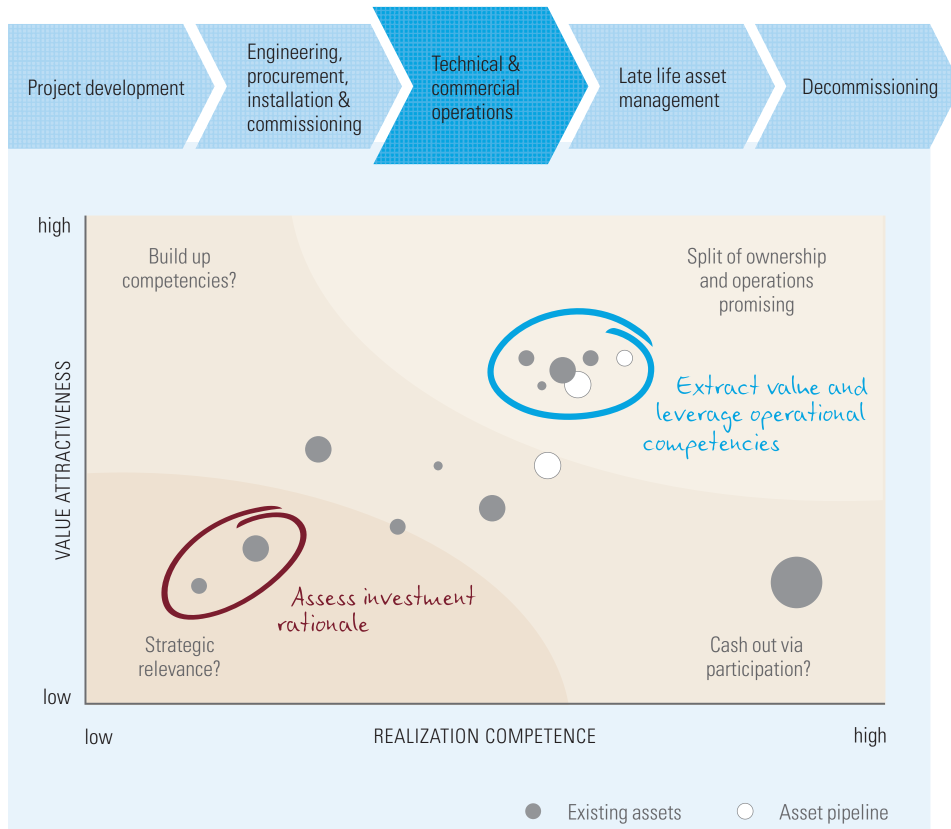


*EXAMPLE:*
*OIL & GAS E&P COUNTRY PORTFOLIO*

In the strategic portfolio analysis, the value attractiveness of the assets in their respective market segments is defined. Market size and growth, competitive intensity, profitability and market risk are the main value drivers here. The realization competence is based on the relative competitive position, the specific know-how, the synergy potential with other company divisions and the existing management resources.

The analysis should not concentrate solely on operational assets, but also consider the asset pipeline throughout all stages of the life cycle: from development, to manufacturing and production, through to the ultimate dismantling of the plant. In each stage there is the potential to generate attractive returns under different participation structures. Analysis along the whole life cycle is important, in view of the varying investor appetites. A good example of this is onshore wind parks.

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While private equity investors avoid engaging in approval risks in the development phase of a new wind park, for example, they are willing to provide financing from the construction phase (EPC) onwards. However, they prefer to exit during the operational phase, where the generated returns are usually below their minimum return requirements. In contrast, pension funds or insurance companies invest before the operational phase of the plant due to their investment criteria, and they demand protection against commodity and other operational risks.

*EXAMPLE: WIND ONSHORE*

PE INVESTS | INSURANCE INVESTS

| | | DEVELOPMENT | | EPC | OPERATIONS | | | LATE-LIFE / DECOM. | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Type | Investor | Political & regulatory risk | Approval risk | Construction risk | Political & regulatory risk | Operational risk | Commodity risk | Political & regulatory risk | Residual value risk | Environmental risk |
| Pension Fund | … | | | | | | | | | |
| Insurance | … | | | | | | | | | |
| Bank | … | | | | | | | Tbd. | | |
| | … | | | | | | | | | Tbd. |
| | … | | | | | | | | | |
| Private Equity | … | | | | | | | | | |
| | … | | | | | | | | | |
| Strategic Investor | … | | | | | | | | | |
| … | … | … | … | … | … | … | … | … | … | … |

Risk mitigation via fixed-price PPAs or EEG legislation

PE DIVESTS | INSURANCE DIVESTS

Analysis of the investor appetite exposes the differing risk-return requirements. There can also be differences in terms of asset class, investment horizon, geographic focus or investment volume. Analyzing past transactions in the industry also provides valuable insights here.

The first Principle of the Capital Light strategy can already contain surprises for some of the parties involved. For example, a detailed analysis of the assets can mean that some end up on the long list for disposal that had previously always been part of the company's core activities, because a systematic focus on the strategic core competencies meant they had to be put up for sale.



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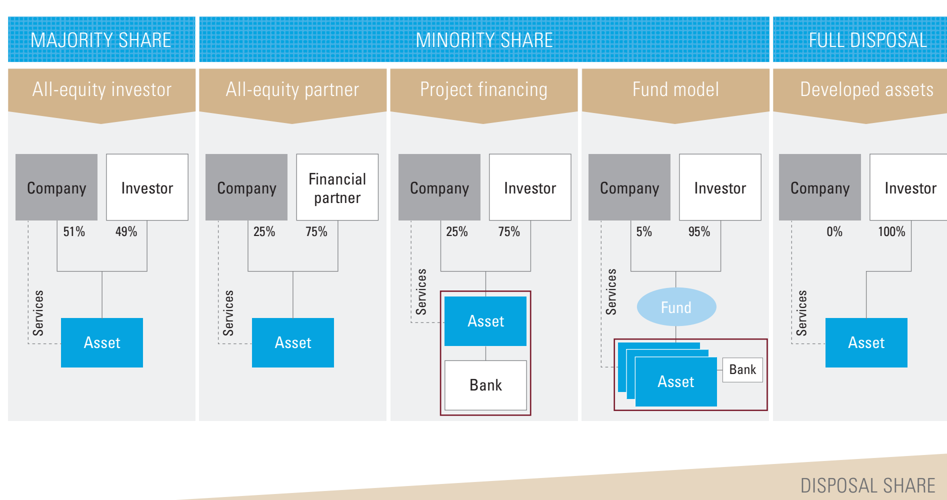
## Principle 2: Do not leave the liabilities side of the balance sheet to the banks!

While the company divisions, as the asset owners, identify the assets that are suitable for Capital Light, the finance function has to find ways to structure the participations. The objective is to precisely align the financing structure with the Capital Light business model and the return expectations of investors – and not to fulfill the desires of the company's banks. The expected returns in the context of equity, mezzanine and/or debt capital determine how the financing is structured.
With the Capital Light option, there are three types of structures that come into question: majority and minority stakes (with or without asset pooling) and a total sale.

*CAPITAL-LIGHT-TYPES OF STRUCTURES*




### 1. Sale of a minority share of up to 49 % to an investor

This can be a financial or strategic investor preferably contributing equity – due to the consolidation of debt at company level.

### 2. Sale of a majority share (e.g. 74.9 %) to a financial or strategic investor

This option enables additional off-balance-sheet borrowing at SPV level via project financing by external banks. If the holding company is subject to strict borrowing or rating restrictions, the consolidation criteria of rating agencies have to be taken into account. In the case of numerous fragmented assets, a sale can be made to a fund structure (e.g. 95%) with a large number of investors.

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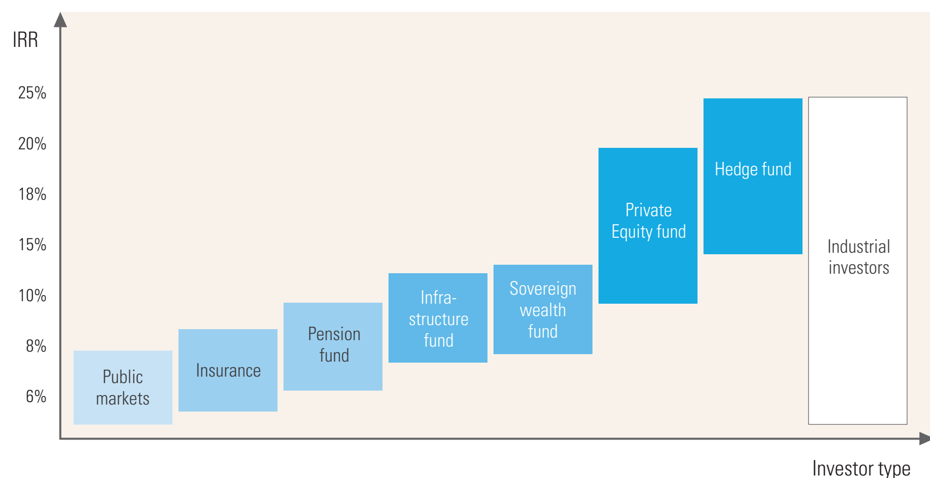
A management company is responsible for technical, commercial and administrative decisions here. With this structure type, many fragmented assets can be pooled and assets under development can be added subsequently to the fund without additional transaction costs. What is more, certain institutional investors are not allowed to directly acquire company shares, but they can buy minority shares in structured funds.

## 3. Full disposal of selected assets to strategic investors

In this scenario, a service model may still remain an option. Strategic investors are more common here.

It is important to have standardized structures prepared! They facilitate the responsiveness of the management, support internal discussions and enable negotiations with investors with a clear concept and objectives. It is important that the transaction models take the varying life-cycle phases of the asset classes and the earnings expectations of the investors into account.

*RETURNS EXPECTATIONS BY INVESTOR TYPE*





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## Principle 3: Optimize the cost of capital and risk position in the Capital Light business model!

The business model in the new participation structure comprises the service relationships and the risk transfer between the company and the investor group in each phase of the life cycle. The focus is on the service relationships, in which the company's strategic core competencies in terms of relative competitive position, know-how, synergy potential and resources can be leveraged. The following service relationships can be established throughout the life cycle (examples from plant construction/ project business):

- Development phase: „Developer role" – sale of final developed projects to strategic investors, ...
- Engineering, Procurement and Construction phase: Technical management, project management, ...
- Operational phase: Asset management, technical operation, commercial operation, structuring or origination of long-term capacity agreements, ...
- End of the life cycle: Late-life asset management, decommissioning services, ...

The goal here is not just to continue already existing service relationships in a new ownership structure, but to leverage the strategic competencies across a much larger asset portfolio. A Capital Light strategy creates the required room to maneuver, as capital freed up by a transaction can be reinvested. This means the company can apply its expertise to a larger asset portfolio than in the status quo with capital restrictions.

Alongside the service relationships, the risk transfer between the lender and the borrower has to be determined. The structure is largely dependent on the investor type. For risk-averse investors such as insurance companies and pension funds, most of the business risk has to be mitigated. For investors willing to take more risk, a selective mitigation of risks can be undertaken, depending on the individual needs.

The risk transfer has to be adjusted to suit the demands of the rating agencies if rating restrictions apply. In particular in cases of high off-balance debt levels within the Capital Light structure, a lack of „real" risk transfer to investors can lead to rating agencies consolidating the debt back to the holding company. For this reason, it is essential to carefully examine the risk transfer and the rating restrictions of the agencies.

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## Principle 4:
## Abandon traditional ways of thinking!

The implementation of the Capital Light options is presumably the most critical step. This process is an acid test of the ability of the various functions and divisions to cooperate. Both the concept and its marketing have to be borne on several shoulders. These include specialists from the divisions for the specific asset and its operation, as well as financing experts from the corporate headquarter. At this stage, the following functions can become roadblocks:

**BUSINESS:**
Thinking in terms of ownership or the protection of vested interests. In the past, the capital base was a yardstick for measuring the importance within the company group, and the future allocation of capital.

**M&A:**
Being restricted to traditional M&A business in the form of one-off sale and purchase transactions with strategic investors. Here, the leveraging of strategic core competencies is missing, as is the exploitation of return spreads and access to institutional investors. Instead, Capital Light is an iterative process – freed up capital is reinvested and the process is repeated.

**STRATEGY:**
Capital Light is considered as a one-off project and not as a lasting component of the strategy process. Strict concentration on strategic core competencies demands strong support from the strategy function.

**CONTROLLING AND PARTICIPATION MANAGEMENT:**
Existing investment guidelines often set the wrong standards for evaluating Capital Light options. The new financing structure can also stand in contradiction to the current group guidelines. Here, the actual financial value added has to be made transparent applying the right sense of proportion.

**HUMAN RESOURCES:**
Fear of staff cuts in the event of asset sales. And this although Capital Light is designed to apply the existing management resources to a larger asset portfolio. Reducing ownership does not mean reducing human capital. Indeed, in modern participation models, the opposite is the case.

In these kinds of conflict areas, the top management is an indispensable protagonist – internally as a driving force of the realization, and externally as the leading sales representative!


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Stern Stewart & Co. is an independent strategy consulting boutique. Our consulting focus is on the key management issues. This includes strategy and corporate finance, as well as organization and performance management. We see the company's management as a strategic investor in the business and support them to increase the value of their company.

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