A VALUATION OF THE CENTRA GAS DIVISION OF MANITOBA HYDRO

BY IAN MADSEN

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EXECUTIVE SUMMARY

There are two generally accepted methods for valuing a company: its intrinsic value as a cash-generating enterprise, and its standard market value in comparison with peer companies. This study used both methods.

Using an intrinsic value method, and discounting the present Centra's projected future free cash flows, under a set of six increasingly more generous scenarios, the corporation's value could range from $321 to $396 million, and range between $918 and $1,132 million if its operations were optimized prior to sale.

Under the market-based valuation system, the constrained, current value ranges from $601 to $614 million, but if the company is optimized as discussed, the range could be between $738 and $1,667 million. The upper limits would be possible if a buyer thinks the company could expand its market and growth trajectory.

INTRODUCTION

Fifteen years ago, Centra Gas was a private, investor-owned company. But, for over a decade, it has been a division of the crown corporation, Manitoba Hydro, which is the major electic power producing and distributing corporation in the province. Despite this integrated status, Centra Gas has separately delineated assets and liabilities, and it has its own income and cash flow statements. As a result, the division can be valued separately from Manitoba Hydro using its intrinsic free cash flow-generating capacity.

Unfortunately, the debt that is attributed to Centra Gas is so high that its interest payments make its net income and its free cash flow very low in relation to its assets, revenues, and its gross income (the gas sales revenue minus the cost of the natural gas bought and resold).

THE VALUE OF CENTRA GAS

Table 1, page 8, shows that Centra's return on assets is lower than comparable companies despite having an advantage of not paying taxes because it is a crown corporation. Of course, its return would be considerably less if it paid corporation income taxes.

With its existing high debt load, considerable expense on interest, and despite its non-taxable status, the value of Centra Gas to the province would be between $321 and $396 million using a discounted free cash flow analysis.

If the corporation was optimized and then sold, it could be worth as much as $1.67 billion (see Table 2, page 9) using appropriate valuation metrics from comparable Canadian and US gas-dominated publicly-traded utilities. Over the last few years, the corporation has had slow but steady growth in both the number of customers and assets, gradually increasing its net income and cash flow.

Interestingly, the volume of gas delivered to customers has not increased significantly despite a dramatic decrease in the price of natural gas primarily resulting from the prodigious escalation of gas production in hydraulic fracturing — fracking — of the large shale formations in southwest Manitoba, southeast Saskatchewan, and the northern part of North Dakota.

At present, the corporation has considerable opportunities for increasing its income by providing gas to rural residents in Manitoba, as happened in Saskatchewan in the 1980's. Natural gas is a competing energy to hydroelectric power that could be used for heating homes in rural parts of the province, at lower prices than hydroelectric heating. Hydroelectric power, of course, is the main product of Manitoba Hydro, which is Centra's sister division. As the natural gas division is relatively small, it may not be a priority for Manitoba Hydro, especially now that new, competing power-generating decentralized fuel cell technologies are being used in a number of places including the United States. So far, unfortunately, this technology is not common in Canada because it would reduce customers' dependency on hydropower delivered by Manitoba Hydro, which, of course, would be a potential threat to the parent company.

As is common with some other Crown corporations, Centra Gas has a relatively high debt load which has been underwritten by the provincial government. The tolerance for high debt and low profitability could not be sustainable if Centra Gas was a publicly listed company. The low profitability and high debt load would make it hard to value the corporation on an "as is basis". Nevertheless, there is sufficient financial accounting information to permit using a standard discounted free cash flow analysis (DCF) to calculate an estimated value. In all the 'intrinsic value' calculations, established income and cash flow trends were used, and modest growth rates of between 2 and 4 per cent in free cash flow were projected, and an expected rate of return between 5 and 8 per cent, both ranges being typical for slow-growing, stable, mature companies.

An intrinsic value was, indeed, estimated, and is shown in Table 1. The high debt load and the substantial interest payments lead to the intrinsic value of the corporation being between $321 million and $396 million, which is undoubtedly low; perhaps overly conservative. Yet, if an acquirer bought the corporation at a price in that range, it would also assume about $482 million in debt at the end of the 2016 Fiscal Year. As such, the corporation would be valued between $803 million and $878 million.

Once Centra entered the private sector, it would need to pay corporation taxes. So, if the intrinsic value of the company was fully taxed, the estimated value would be much lower than if it remained untaxed. The value would be somewhere between $85 million and $104 million. Adding the $482 million debt would result in an estimated value of between $567 million and $586 million.

To make the corporation more salable, all the debt could be assumed by the parent company, Manitoba Hydro. Under this assumption, an intrinsic value was calculated for Centra Gas ranging from $918 million to $1,132 million.

Of course, a private sector buyer would have to pay corporate income tax, so the intrinsic value debt- and interest-expense-free, valuation would be between $520 million and $641 million.

This is not the whole range of possibilities, however. Centra is charged a "corporate allocation" expense for being managed by Manitoba Hydro. If Centra Gas became independent or owned by another company, it would no longer pay this expense. An intrinsic value estimate was calculated after removing the corporate allocation expense, again assuming debt and interest expense-free even though the corporation would be fully taxed. In this case, Centra Gas would be worth between $775 million and $956 million.

Over the last few years, Centra gradually improved its efficiency. If the corporation optimized its Earnings Before Interest Taxes and Depreciation and Amortization (EBITDA) margin of Gross Income (Revenues minus Cost of Sales) roughly in line with its recent trend, then in 2017 its fully taxed debt and interest expense-free intrinsic value would be between $782 million and $964 million. This margin could possibly be improved, thus increasing its valuation even more.

A prospective buyer may be willing to pay somewhere within this range. It is highly likely that a buyer would see the potential in making the corporation more profitable, and would likely plan to grow it in ways that have not happened as part of Manitoba Hydro — for instance by promotions to entice more customer additions, and extending its transmission and distribution network into more rural areas. To enhance the potential sale price, the provincial government could offer financial and other assistance to aid such expansion. The current low return on assets in comparison to its peers suggests that a higher value realization could be achieved, a potential that would certainly interest more buyers.

CONCLUSION

Indeed, the market-value based estimate for Centra is higher than the intrinsic value estimate, which would be between $601 and $614 million on an as-is (untaxed) basis, and could be as high as $738 - $1,667 million on an optimized profitability basis using financial metrics of similar Canadian and US gas-oriented publically-traded utility companies. A cautionary note is needed because the valuation of US companies seems to be at a premium in comparison with Canadian companies, which could affect the estimated value of Centra Gas in this calculation. However, the small sample of Canadian firms made it necessary to include US companies.

It is up to the government, taxpayers, and ratepayers in Manitoba to decide if Centra Gas is sold, and if the proceeds from the divestment would be used to reduce the burden of the capital spending plans of Manitoba Hydro, which are estimated to exceed $10 billion. This study is designed to provide estimates of the money that might be expected from the sale of Centra Gas.

TABLE 1

Intrinsic Value, Discounted Free Cash Flow Value of Centra Gas: Six Scenarios

1. Existing Debt Load & Interest Expense, Untaxed (Averages: Mean, Median) ($ M)	$	396.41	$	321.41
Range:	$	183.66	$	1,101.98
Return on Assets (2016), Centra, Gas Utility Average:		4.34%		4.55%
2. Existing Debt Load & Interest Expense, Fully Taxed (Averages: Mean, Median) ($ M)	$	104.23	$	84.51
Range:	$	48.29	$	289.76
Return on Assets (2016), Centra, Gas Utility Average:		3.1%		4.55%
3. NO Debt or Interest Expense, Untaxed (Average: Mean, Median) ($M)	$	1,131.81	$	917.68
Range:	$	524.39	$	3,146.34
Return on Assets (2016), Centra, Gas Utility Average:		7.82%		4.55%
4. NO Debt or Interest Expense, FULLY Taxed (Average: Mean, Median) ($M)	$	641.08	$	519.79
Range:	$	297.02	$	1,782.14
Return on Assets (2016), Centra, Gas Utility Average:		5.71%		4.55%
5. NO Debt, NO 'Corporate Allocation' Expense, FULLY Taxed (Average: Mean, Median) ($M)	$	955.62	$	774.83
Range:	$	442.76	$	2,656.56
Return on Assets (2016), Centra, Gas Utility Average:		7.23%		4.55%
6. Optimized EBITDA Margin, No Debt or Interest Expense, FULLY Taxed (Average: Mean, Median) ($M)	$	963.94	$	781.58
Range:	$	446.62	$	2,679.69
Return on Assets (2016), Centra, Gas Utility Average:		7.75%		4.55%

TABLE 2

Market-Value Based Valuation of Centra Gas: Six Scenarios

Average of ALL Companies: Cdn, US	Trailing P/E (Market Value to Net Income)	Forward P/E (Market Value to Est. Net Income)	Price to Sales	Price to Book	Enterprise Value/Revenue (Subtracting Debt)	Enterprise Value/EBITDA (Subtracting Debt)	Price to Operating Cash Flow	Price to Free Cash Flow	Average (Mean)
1. As Is, Untaxed	$ 470.47	$ 732.13	$ 969.63	$ 105.54	$ 1,037.15	$ 222.56	$ 1,153.79	$ 220.23	$ 613.94
2. As Is, Fully Taxed	343.44	534.45	969.63	105.54	1,037.15	222.56	991.54	34.41	529.84
3. No Debt, Untaxed	846.84	1, 229.68	969.73	943.36	1,519.15	704.56	1,634.54	770.79	1,077.32
4. No Debt, Fully Taxed	618.19	897.67	969.63	943.36	1.519.15	704.56	1,342.48	436.32	928.92
5. No Debt, No 'Corporate Allocation' Expense, Fully Taxed	1,072.67	1,110.48	969.63	943.36	1,519.15	828.89	1,553.05	731.30	1,091.07
6. No Debt, 'Corporate Allocation' Expense; Optimized Efficiency, Taxed	783.05	1,113.60	969.63	943.36	1,519.15	894.00	1,667.24	737.67	1,078.46

Market Value for All Six Scenarios, Using All Comparable Costs

	Mean	Median	Minimum	Maximum
1. As Is, Untaxed	$ 613.94	$ *601.30*	$ 105.54	$ 1,153.79
2. As Is, Fully Taxed	529.84	*438.95*	34.41	1,037.15
3. No Debt, Untaxed	1,077.32	*956.50*	704.56	1,634.54
4. No Debt, Fully Taxed	928.92	*920.51*	436.32	1,519.15
5. No Debt, 'Corporate Allocation' Expense, Fully Taxed	1,091.07	*1,021.15*	731.30	1,553.05
6. No Debt, 'Corporate Allocation' Expense; Optimized Efficiency, Taxed	1,078.46	*956.50*	737.67	1,667.24

Note: The small sample size for Canadian companies make the average of *all* companies more reasonable.

Note: The *italicized* median values are the most conservative.

APPENDIX

RATIONALE FOR DIVESTITURE OR PRIVATIZATION

While it is up to the people through their elected representatives to decide if a Crown corporation or other government agency or entity should be sold or otherwise privatized and the proceeds used for the benefit of all citizens and taxpayers, there are some established reasons to embark on such a path, some or all of which are cited for divestiture of such enterprises but may not be applicable in any single, specific case.

1. The government has no mandate to own or run a commercial enterprise. The provision of citizens' safety, security and justice is the government's primary role, and its involvement in the economy should generally not extend beyond this.
2. Regulation can usually accomplish any public policy reason for direct involvement in an industry. If regulation is not easily feasible, then a direct contract or subsidy to any affected individuals, entity or entities may be more efficient or effective and less economically disruptive or costly.
3. If a government-controlled or sponsored enterprise has a monopoly position, near-monopoly, or effective monopoly in a line or lines of business or businesses, then opportunities are lost in one or more commercial or potentially commercial sectors for entrepreneurs and investors to try to create and grow businesses to enrich and sustain themselves, employees, suppliers, and others.
4. A monopoly, near-monopoly, or effective monopoly market position by a government-owned or sponsored entity could result in far higher prices for customers, the general public, or a section of the public, than would be the case in a fully competitive marketplace for the industry involved.
5. A government-owned or -sponsored enterprise may compete directly against private sector firms, which are owned by or employ citizens, or against individual citizens, all of whom the government is supposed to serve, not disadvantage.
6. The government-owned or -sponsored enterprise may compete unfairly against its private sector rivals in that it had or has access to lower-cost government-sourced and -guaranteed capital (debt). It may have a much larger debt component in its capital versus that which would be tolerated in the private sector. Thus, it may not have to meet high standards for profit and cost control, allowing it to offer lower than true free market-based competitive pricing.
7. Government-owned firms may not need to pay provincial or federal income taxes. This can allow such firms to supply goods or services more cheaply than the private sector companies they are competing with.
8. Government-owned or -sponsored enterprises may not have any kind of profit orientation or target, may be used as public policy vehicles and may be given preference in their activities or even in their transgressions, such as labour or environmental abuses.
9. Government-owned or -sponsored enterprises, by virtue of being public sector vehicles overseen by bureaucrats and politicians, may be places where favoured individuals find employment, particularly at management levels.
10. Since profit is a secondary goal of a government-owned or -sponsored enterprise, it is difficult to evaluate the effectiveness, efficiency or productivity of the enterprise or its employees. Consequently, these employees and assets may not be very productive or effective.
11. Government-owned or -sponsored enterprises are often creations of certain time-fixed circumstances and outlive whatever use or public policy role their creators may have conceived. Often, advances in technology; the modernization of transport, telecommunication or information technology; the evolution of the economy

and available products and services and the increasing standard of living make these enterprises potentially obsolete. In the private sector, firms and individuals must adapt and evolve, or decline.

12. Government-owned or -sponsored enterprises perpetuate their possibly obsolete existences by virtue of the constituencies that build up around them: employees, managers, directors and bureaucrats, customers, suppliers and associated advocates or consultants. They can lobby to keep the enterprise going, despite dysfunction or losses. They are far more motivated to do so than are the taxpayers, whose average cost is much less per person and may be indirect, hidden or difficult to calculate.
13. Because they are not profit-oriented, government-owned or -sponsored enterprises are usually less efficient, and thus they lower the overall efficiency of the entire economy. This can make a whole nation less competitive than its global rivals are, whether nations or individual companies. The effects are worse the greater the government involvement in the economy. When taken to its most extreme, as happened in 20th-century communist nations, the countries were unable to compete against capitalist companies, despite their immense direct and indirect subsidies, government support and the lack of profit requirement.
14. Funds tied up in the capital of government-owned or -sponsored enterprises could be used to reduce government debt or lower taxes on individuals or corporations, which they could then spend or invest as they freely choose, and thus they could inject money back into the economy in more-lucrative and -constructive ways.
15. Governments, generally, have a poor record of picking winners, or creating or owning enterprises that have market-competitive profitability, or attractive returns on assets, equity, or even returns that exceed governments' own cost of debt service. If, rarely, they actually do, it generally turns out that they have been provided unusually good market, operational, regulatory, or other conditions not available to other, investor-owned firms.

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