A Top Secret Spin-Off

The largest IPO north of the border in two years was rolled out under a veil of secrecy, but could it power up investors' portfolios?

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There was some interesting news out of Canada this week, as EPCOR Utilities, a huge power producer, recently decided to spin off its power-generating assets in a highly secretive deal. How secretive? Capital Power--the new entity--already began trading on June 26 on a conditional basis, with virtually no mention from any of the standard business news sources we monitor. The deal was approved in a top-secret Edmonton city council meeting back in April, and according to the Edmonton Journal, represents the largest privatization of city assets in Edmonton's history, as well as the largest IPO to come out of Canada in two years. By the way, there wasn't one public hearing on the matter, which has caused some consternation among various interested parties, including former Alberta Securities Commission chairman Bill Pidruchney and a group of taxpayers. So what's the deal with this spin-off? Morningstar senior equity analyst Travis Miller brings us up to speed:

"Capital Power, a spin-off from Edmonton, Alberta-based EPCOR Utilities, is one of Canada's largest independent power producers with 3,300 megawatts of electricity generation capacity and investments in additional power generation facilities throughout North America. Power generation is a volatile, commodity-driven business that has gone through boom and bust cycles in the last decade. As power demand and commodity prices rose steeply between 2005 and 2008, independent power producers profited handsomely. However, we think this industry might be headed for tougher times in 2009 and 2010 as demand sags and commodity prices plummet. The bulk of Capital Power's power plant fleet uses low-cost fuel sources such as coal, hydro and wind. These should remain economic to operate even in lower demand environments, but margins likely will compress as long as natural gas prices--which generally determine power prices--remain at multi-year lows. Capital Power has tried to mitigate some of this volatility at its largest plants by signing long-term, variable-price sales agreements with the Albertan government that are designed to protect margins and returns on capital. But even these contracts could expose Capital Power to volatile fuel costs, demand fluctuations and re-signing risk.

"EPCOR plans to retain a 72% interest in Capital Power following the IPO but intends to divest its stake in the long run. The IPO was priced to yield $500 million in proceeds for EPCOR, or $23 per share. It has traded below that offer price in conditional trading on the Toronto Stock Exchange since June 26. Legal challenges and regulatory proceedings pushed the IPO completion date to July 9. Based on a net asset valuation methodology that we use for most independent power producers, our initial take is that shares should be worth about $30. The bulk of that value is imbedded in its Genesee coal plant in Alberta.

"Capital Power is one of the smallest publicly traded independent power producers in North America, leaving investors heavily exposed to specific operating issues and commodity markets in Alberta. Positive developments could include a significant increase in electricity demand in the region, especially at energy-related industrial sites, and a sharp increase in the price of natural gas. Negative developments could include sustained stagnant power demand, rising coal costs and environmental restrictions that would make running its premier coal plants more costly.

"We think its new-construction growth plans to expand its renewable energy and low-carbon power generation portfolio could create significant shareholder value in the right commodity market conditions. We think investing in larger peers such as TransAlta TAC, Mirant MIR, RRI Energy RRI and Dynegy DYN could be better ways for investors to gain exposure to North American independent power producers. We also are concerned that EPCOR's initial majority ownership and special voting rights could lead to a conflict of interest with minority shareholders. An agreement with the City of Edmonton requires Capital Power to keep its headquarters in the city and retain at least 350 employees for 25 years after the IPO, adding to operating expenses."