

Proposal For a Major Utility Investment Banking Subsidiary

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Major utilities have internal strengths that could be used to create and operate an investment banking subsidiary. Such a source of financing could yield positive benefits for the utility and the area that it serves. The potential characteristics and impact of such a financing subsidiary are presented in the article.

The world of development finance is an innovative, fast changing environment. Small and medium-sized companies seeking to expand or relocate must be cognizant of the myriad of financing sources available to them and the rules and regulations surrounding these programs. Unfortunately, the majority of small and medium-sized companies consistently have a problem securing the financing necessary to implement their expansion or relocation plans with an acceptable return on their investment.

As the state and federal governments continue to come under pressure by the electorate to reduce monetary expenditures, funding for innovative, public supported financing programs to assist business have also been reduced. This coupled with the fact that most bank lending policies have been extremely conservative due to the recent savings and loan crisis has created a severe capital shortage for most small and medium-sized companies.

With all of this in mind, it is important that utility holding companies that have made a long term commitment to developing their subsidiary's service territory consider developing an investment banking subsidiary that would provide either debt or equity capital to small and medium sized companies looking to locate facilities in that utility's service territory.

This type of investment banking service would be unique within the utility industry, in that while most utility companies have a basic understanding of government related financing mechanisms (i.e. "gap financing") they are unable to provide an "Investment Banking" type of consulting service or make direct loans to their prospects. This type of service would provide a utility with

a distinct competitive advantage over its competition. The implementation of this program would also further enhance the utility company's reputation as a full service economic development organization.

The vast majority of Fortune 50 utility companies have tremendous in-house expertise in the financing of capital projects through both debt and equity investment vehicles. The utilities' finance, accounting and economic development departments create a strong nucleus for the creation of an investment banking subsidiary that has the ability to provide access to debt financing, lease financing, venture capital, and access to direct loan programs to be created and administered by the investment banking subsidiary.

LEGAL STATUS

The creation of an investment banking subsidiary is predicated upon the sponsoring utility company having an approved non-regulated holding company already in place. This type of organizational structure is necessary to remove the burden of public regulation from the newly formed financial entity. Creation of this subsidiary without a holding company would subject the investment banking subsidiary to regulatory control by that state's commerce or public service commission. This regulatory control would force the new entity into having its investment decisions publicly reviewed and subject to approval based on the benefit to the utility's rate payer. This type of regulatory review is unacceptable to a company that must make quick decisions in an industry that is highly competitive and market driven.

Organization

The proposed investment banking subsidiary could be organized as follows, The Board of Directors would be made up of seven professionals with a diverse background of expertise. Of the seven board members, four would also be members of the Board of Directors of the sponsoring utility company. The remaining three seats would be appointed by the holding company board and will act as "outside" directors. The Board of Directors would be responsible for setting and monitoring the investment policy for the subsidiary.

The President and chief executive officer would report to the board of directors and would be the sponsoring utility company's chief financial officer. The president would be responsible for the implementation of the investment strategy as directed by the board of directors.

Chief legal counsel would report to the President and be the same as the sponsoring utility's chief legal counsel. Legal counsel would be responsible for overseeing all legal documentation prepared for a prospect and limiting the subsidiary's liability for damages.

The Vice President of Finance would report to the President and would be the sponsoring utility's treasurer. The Vice President of Finance would be responsible for the creation and execution of all debt and equity financing for the prospect.

The Vice President of Accounting would report to the President and would be the sponsoring utility's director of accounting. This Vice President would be responsible for all accounting functions, payments, loan workouts and other administrative functions.

The Vice President of Marketing would report to the President and would be the sponsoring utility's Director of Economic Development. This Vice President's responsibilities are the marketing of the subsidiary's programs to prospective and existing industry.

Each officer will be responsible for the staffing and organizational structure of his/her department.

MISSION

The mission of this newly created subsidiary would be to structure and acquire financing for small, medium and potentially high growth start-up companies that locate in its sister company's service territory, thereby creating employment opportunities and sales opportunities for its sister company.

FINANCING

To achieve this goal, the newly created subsidiary, as described above, would be capitalized by a significant cash injection from the holding company. This initial capitalization would provide for program funding and working capital costs for the first two years. At the end of that time, the subsidiary would survive and grow through receipt of interest income, dividends, stock appreciation, commissions and fees charged in the investment banking process. Additional equity funds may be acquired through the holding company if return on investment meets or exceeds other holding company investment options of similar risk.

EXAMPLES

With the organizational structure, mission and funding for this new organization in place the investment banking subsidiary will have the capability to effect positively the economic growth and well-being of its sister company's service territory.

Hypothetical Project Criteria

Assume a project with the following characteristics:

- Projected cost of land and building: \$2,000,000.
- Projected cost of machinery and equipment: \$4,500,000.
- Projected working capital for the first 18 months: \$3,000,000.
- Two hundred full time permanent positions to be created within the first 18 months.
- 2,500 kw peak demand.
- 1,646,000 kwh per month.
- Three shifts per day, seven days a week.

Package 1

Financing package has the following characteristics:

- Tax exempt bond with a viable interest rate of 7.3% with a term of 20 years and an option to call in 10 years for the entire bond issue of \$8,900,000.
- Community Development Assistance Program Loan of \$400,000 at 5% for 20 years.
- Build Illinois Small Business Development Loan of \$200,000 at 5% for 20 years.

Total blended interest rate for this financing proposal is 7.14%.

Package 2

A second financing package has these characteristics:

- Commercial bank loan for land and building of \$1,400,000. for 15 years at 12%.
- Commercial bank line of credit for working capital of \$3,000,000. This figure would be tied to receivables on a monthly basis. Average annual interest rate of 13%.
- Capital lease for the machinery and equipment of \$4,500,000. to be tied to an AA letter of credit from a major U.S. bank. Average annual interest rate of 14%.
- Community Development Assistance Program Loan of \$200,000 at 5% for 15 years.

Blended interest rate for this financing proposal is 10.64%.

As can be seen, there are various ways to finance a potential project; these are only two put into a simplistic format. The actual recommendation from the subsidiary would take into consideration potential tax liabilities and credits for the proposed packages as well as impacts on cash flow and the prospect's desired rate of return on its capital investment. The previous two financing packages all provide a combination of financing programs to try and achieve a blended interest rate that is below the prime rate. Additionally, they are structured to provide long term fixed rate financing for the majority of the debt when applicable.

POSSIBLE ROLES OF INVESTMENT BANKING SUBSIDIARY

Each of these financing packages also lends itself to assistance from the investment banking subsidiary.

The investment banking subsidiary of the utility holding company could provide the following services for package #1. Legal staff would research and qualify this bond issue as tax exempt. All legal documents from the inducement resolution to the bond indenture would be developed by the legal staff of the subsidiary. The subsidiary may purchase all or part of the bond issue, depending upon the needs of the prospect and the current status of the subsidiary's investment portfolio. The subsidiary would apply for and lobby on behalf of the prospect for state financial assistance.

On financing package #2, the utility financial subsidiary could participate in the following. The subsidiary would arrange a

commercial bank loan and line of credit on behalf of the prospect through its extensive contacts in the United State, Europe and the Pacific Rim. The subsidiary may decide to offer the prospect a capital lease on its own or arrange for one through its contacts in that field or offer a lease guarantee for a specific price. The subsidiary would apply for and lobby on behalf of the prospect for state financial assistance.

COST EFFECTIVENESS OF AN INVESTMENT BANKING SUBSIDIARY

The two previous scenarios are simple representations of the power and influence a subsidiary of this type might yield. However, one of the most important factors a utility must consider when establishing an investment banking subsidiary is determining cost effectiveness. To properly evaluate cost effectiveness, it is necessary to make assumptions regarding anticipated investment activity. Identification of projects that may involve investment funds, and specifics such as capital investment to be made, number of jobs to be created, anticipated revenues, and profit margins must be estimated. To best determine the expected scope of potential projects, past projects reported in a utility's new industries and expansions reports for the most recent two years were referenced. During that two-year period, a total of 139 new and expanding industries were reported. Of these, 75 were eliminated from further consideration because the project either failed to meet the program's guidelines or else the project was determined to be too large (loan ceiling amount would probably not impact project). Totals and averages were calculated at random for 25 of the remaining 64 projects.

For purposes of further evaluation, the following averages (approximate) will be used:

- Capital Investment — \$1,646,000
 - New Jobs — 56
 - Average Retail Cost Per Kwh — .0540
 - Average Profit Per Kwh — .0390
 - Annual Electric Revenue — \$2,817,445
 - Annual Electric Profit — \$2,034,825
 - Annual Investment Profit — \$1,646,000
- At a \$100 Million initial funding level some results would be:
- Average Investment Amount: \$823,000
 - Job Creation: Average project size

\$1,646,000 creating a minimum of 10 new jobs. Average project will create 56 new jobs.

First Year Loan Activity:

Steps:	Number of Contacts:
Initial Marketing	160
Full Application	35
Loans Approved	25

Kw Profit and Usage: Assume average electric power consumption of 2,087,000 Kwh per year per project and a profit margin of \$.0390 per Kwh.

Loan Amortization: Interest rate calculated at one point below prime rate (8%), using an average 15-year amortization period.

Fee Structure: Closing Costs-Direct Billing

Default Rate: Assume: Default rate on year end cumulative loan balance:

Year 1:	0%
Year 2:	1%
Year 3:	2%
Year 4:	2%

Internal Cost of Capital: 6%

The preceding cost/benefit analyses were calculated excluding all applicable administrative expenses. The figures reflect direct investment activity only. It was estimated that program administration would require approximately \$400,000 per year. One hundred percent of which will be absorbed by fees charged on investments to companies.

The annual return at the \$100 Million initial funding level would be:

Average annual return per project.

- Kwh generated from each project — 2,087,000
 - Profit per Kwh \$0.0390
 - Electric profit per project — (2,087,000 x .0390) - \$81,393
 - Average loan amount — \$823,000
 - Profit per loan — \$65,840
- Total return over five year period

a. Profit of sale of power — \$10,174,125

b. Total net revenue — \$24,148,841

c. Calculated return based on power sales (10,174,125 + 100,000,000) - 10.1%

d. Calculated return based on total net revenue (24,148,841 + 100,000,000) - 24.1%

It is important to note that the aforementioned figures and rates of return are expressed in current dollars. Devaluation due to inflation (or other factors) is not considered in the calculations. In all likelihood, devaluation will probably be greater than 0% but less than 10% annually. Since most figures through this analysis are not adjusted, calculations will be generally expressed in terms of current dollars.

To this point, the subsidiary's benefit has been determined strictly in terms of an investment and expressed as a direct "return on investment." This aspect of investment banking for economic development is only one of the several benefits that will result. In addition to each project yielding approximately \$147,773 profit each year, it is important that revenues are generated that will not only cover variable costs (such as fuel), but also help offset the utility's fixed costs. Total annual revenue (including profit) for the 1989-1990 test cases was approximately 5.40¢/Kwh. This translates to a total annual revenue figure of approximately \$112,697 per project.

Revenues and profits resulting from increased gas sales are also not considered. Since electric and gas service territories may not coincide and project locations will fluctuate, it would be difficult to estimate projected revenues from gas sales.

Another important benefit that will result from this subsidiary will be new employment opportunities. In addition to the number of "direct" new jobs that will result, 3.2 support jobs are expected to be created from each new manufacturing job (according to the Illinois State Chamber of Commerce). The total number of new jobs,

both direct and indirect, are significant and truly benefit the utility's service territory.

New employment serves as a stimulant to the state and local economies. As evidenced by the new support jobs that are anticipated, the positive impact of this program will carry over into other areas of the economy. Increased commercial development, housing starts, and taxes are but a few of the indirect benefits that will result.

SUMMARY

The development of an investment banking subsidiary in a Fortune 50 utility is a difficult, moderately risky venture. However, the potential return on investment both from an economic development and finance perspective are tremendous.

As the recession of the 90's continues to burden the state and federal governments, capital for small, medium and emerging companies continues to shrink. Hence, the economic well-being of a Fortune 50 utility's service territory may become jeopardized.

The investment banking subsidiary outlined in this article is yet another tool utility companies could use to ensure the long term economic health of their service territory while at the same time earning an excellent return on investment for their shareholders.

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