CEGCO - THE ARABIAN ORYX

THE CEGCO ACQUISITION IN JORDAN WAS COMPLETED IN CHALLENGING TIMES. BY **ROHIT GOKHALE**, DIRECTOR, ACQUISITIONS AND PROJECT FINANCE, **ROHIT SINHA**, MANAGER, ACQUISITIONS AND PROJECT FINANCE, AND **SOUDKI ATASSI**, MANAGER, ACQUISITIONS AND PROJECT FINANCE, **ACWA POWER**.

ACWA Power International (ACWA Power), a Saudi firm specialised in developing privately financed power generation and desalinated water production plants, entered into a binding agreement with Jordan Dubai Capital (JDC) to acquire a controlling stake in Jordan's Central Electricity Generation Company (CEGCO) on June 2 2011 and subsequently after completing the conditions precedent to the transaction completed the acquisition on July 18 2011.

Prior to completion of the acquisition on July 7 2011, ACWA Power also signed a binding agreement with the IFC as per which the IFC agreed to make a minority equity investment of about US$11m alongside ACWA Power in the acquisition of the above controlling stake in CEGCO.

ACWA Power along with the IFC now owns a 65% stake in Enara Energy Investments PSC (Enara), which in turn holds 51% ownership of CEGCO. The transaction effectively values 51% of CEGCO at US$144m.

Malakoff Corporation Berhad (Malakoff), the Malaysian electricity company, and Athens-based Consolidated Contractors Company each continue to own 25% and 10% stakes in Enara, respectively, although Malakoff has made its intention to exit by selling to ACWA Power its stake well known. CEGCO itself will continue to be owned 40% by the Government of the Hashemite Kingdom of Jordan and 9% by the Social Security Corporation of Jordan in addition to the 51% ownership stake of Enara post the acquisition.

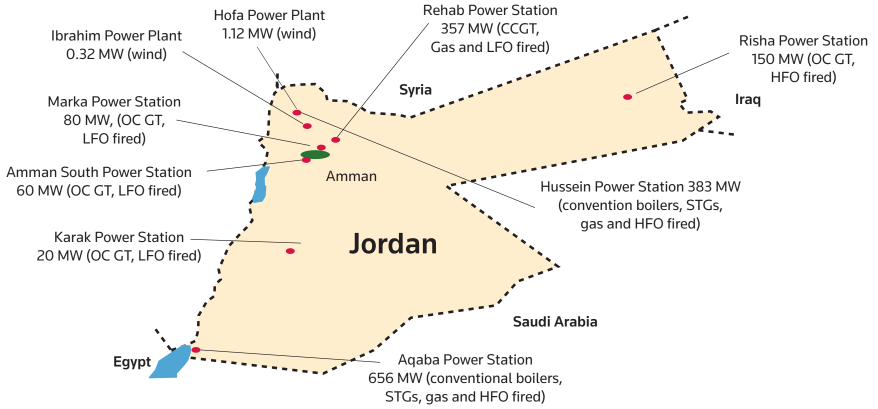
CEGCO is the largest power generator in Jordan with seven power generation sites across the country totalling circa 1,700MW of installed power capacity from a mixed portfolio by technology and fuel type meeting about 59% of the country's electricity needs.

History and development of the transaction

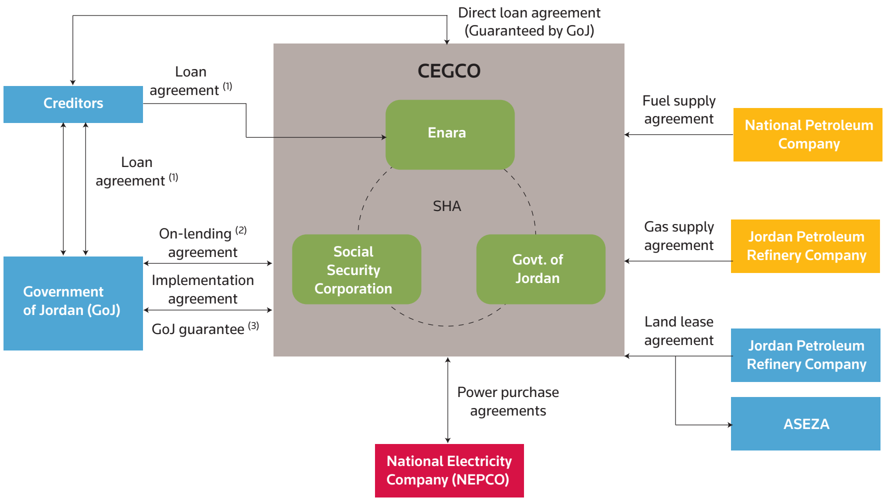
ACWA Power was focused on Jordan even before the acquisition opportunity presented itself. ACWA Power views Jordan as one of its core and strategic markets, with favourable demographics demonstrating an average growth rate in electrical energy of around 6%–7% pa over the last 10 years and a projected growth rate of about 6% over the next five years. Its population has been growing at a rate of around 2.5% pa. Although Jordan is rated sub-investment grade at BB (S&P) and Ba2 (Moody's), it offers a unique geographical location with good social infrastructure and a quality human resource base.

ACWA Power has been monitoring developments at CEGCO since it was privatised in October 2007 and acquired by JDC. CEGCO generates almost 57% of Jordan's power but with a fleet of plants that have an average age of 18 years. ACWA Power saw it as a solid platform

CEGCO SITES



3CEGCO FUNDING STRUCTURE

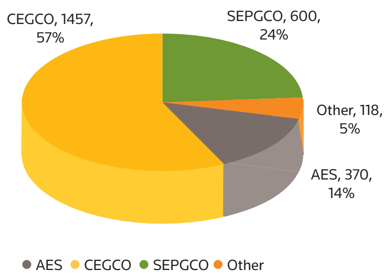


with considerable opportunity to renew and expand given that the country itself needs to double its power generation capacity within the next decade.

ACWA Power submitted its bid for the acquisition of the controlling stake in CEGCO to JDC in October 2011. It faced stiff competition to the bid from Korea Electricity Corporation (Kepco), which was also vying for the stake. After further deliberations with JDC, subsequent to the submission of the bid and on the basis of its strong and well-structured proposal, JDC began definitive discussions with ACWA Power towards December 2010 for finalising the share purchase agreement (SPA).

Negotiations were almost completed in early January 2011 and as parties were close to signing the SPA, the Arab Spring broke out in the region with Jordan unable to escape the heat. As a result, ACWA Power paused for a while to assess the evolving situation and eventually in June 2011 signed the binding SPA for acquiring the stake and completed the transaction in July 2011.

JORDANIAN POWER SUPPLY



ACWA Power undertook this landmark utility-scale acquisition with the help of Standard Chartered as its financial adviser, 5 Capitals as its environmental adviser, Chadbourne & Park as its international legal counsel, Al Sharief Zubi as its Jordanian counsel and Marsh as its insurance adviser.

The transaction was structured amidst some pressing challenges but ACWA Power with the strength of its strategic vision overcame all of these, and this made the transaction unique.

Technical challenges

CEGCO comprises a portfolio of power plants each with equipment that has been purchased from different manufacturers and over different times (the average age of the plants was around 18 years). Furthermore, the portfolio was developed first under state ownership and then privatised in 2007. It was not built up with a well defined strategy as one would expect in a government utility. The biggest challenge lay, therefore, in understanding the technical and operational characteristics of these plants.

ACWA Power's well-qualified and world class in-house technical team met this challenge by undertaking technical due diligence starting with a desk-top review of the portfolio followed by a site visit of each of the plants. Interviews were also conducted with the plant management in order to get an insight into the operations of the projects. As a part of the desk-top study historic records on maintenance and operations of each of the plants and its major equipments were evaluated.

As a result of this, ACWA Power was able to get comfortable with the operating, maintenance and technical characteristics of the portfolio and then able to project the expected performance of the plants going forward as well as laying out a strategic map for future repowerings and capacity additions at the existing plants that was crucial in defining the acquisition strategy for CEGCO.

Furthermore Jordan's demographics mean that electricity demand will continue to grow apace in the next decade. The country has not been able to meet demand growth in recent years and this presented an opportunity to ACWA Power through its acquisition of CEGCO to acquire a cornerstone portfolio in the country and use it to further add electric generation capacity through this portfolio in a cost-efficient manner.

Although others saw the portfolio of old plants as a disadvantage, ACWA Power's technical team saw a big opportunity in repowering the existing assets using their strategic locations and the infrastructure already existing at the sites in terms of auxiliary equipment as well as the electricity transmission infrastructure to deliver incremental electricity to meet the needs of Jordan in the cheapest possible manner.

If properly structured, CEGCO would be able to provide Jordan in the future with electricity supply at a price that was cheaper than what the market could provide. This would become a win win situation for both ACWA Power and Jordan in that ACWA Power would fulfil its growth ambitions of increasing the installed capacity under its control and Jordan would benefit from the cheapest possible electricity.

Environmental matters

One of the other important aspects that was thoroughly reviewed by the ACWA Power team was the environmental management at the plants to evaluate the shortcomings and risks, if any, and to develop a proper environmental plan in the future to meet ACWA Power and international standards. The normal view taken in such circumstances would have been that the environmental management being poor and lacking therefore represented a big risk. Hence normally in such circumstances either a heavy budget is allocated to correct the environmental risks or risks are attempted to be passed on through warranties on the sellers.

ACWA Power, however, took a different view and went to the heart of environmental matters that it identified as critical items during due diligence and assessed them to come out with a rectification plan. A practical plan was developed that revolved around making requisite capital allocations towards meeting environmental norms and understanding and making use of the environmental concessions granted on some of the old assets by the Government of Jordan as these old assets were to be wound down.

This work was useful later when the IFC joined ACWA Power as an equity partner and ACWA Power's assessment and the future plan in respect of the environmental and social matters was vindicated when the IFC also agreed to it and agreed it as the environmental and social management plan to be implemented at CEGCO.

Workforce matters

When ACWA Power took over the assets the total manpower at CEGCO was circa 1,100 and it was assessed that there was a surplus manpower compared with its requirement based on the existing level of operations. Previous management of CEGCO had already undertaken a manpower rationalisation exercise that concluded in October 2010 whereby about 380 employees accepted the voluntary retirement plan.

Additional retrenchment would have been required going purely by international norms. While the normal route employed in such transactions is an immediate cut in the level of the workforce to bring about cost savings, this was particularly difficult at CEGCO given the advent of the Arab Spring and its repercussions. However, ACWA Power saw an opportunity in the 1,100 strong workforce at CEGCO.

First, ACWA Power saw that the surplus workforce could be effectively deployed as ACWA Power went about increasing the installed capacity of CEGCO through repowering of the old power assets and addition of new capacity in the future. Second, ACWA Power, which is growing rapidly in the Middle East region. saw in the workforce an opportunity to add people within its family who are reasonably experienced in running a diverse fleet of machines and use them gainfully in its projects elsewhere in the region in the long run.

Political/social unrest in the region (Arab Spring)

Around February and March 2011, the so called Arab Spring broke out in the Middle East and North Africa region and the ripples it created in Jordan raised the risk profile for the transaction.

1 – The political upheaval was raising questions at a macroeconomic level as to whether it would destabilise the country politically and whether that would hamper the economic prospects of the country. Jordan's economy depends heavily on tourism and the services industry. Any political disruption would mean these industries getting affected adversely at least in the short to medium run.

2 – Due to the political upheaval in Egypt the gas pipeline that was supplying natural gas to Jordan from Egypt at a subsidised price (compared with international market prices) started getting disrupted periodically due to frequent explosions caused along the pipeline by miscreants. This was Jordan's only source of natural gas, which was the primary fuel for many of the power plants (including some in the CEGCO portfolio) in Jordan. Continued supply of natural gas was now looking uncertain.

3 – Lack of gas meant that Jordan had to import secondary fuel, ie, HFO primarily and diesel. This fuel was not subsidised and this meant the fuel bill more than quadrupled for the year as gas was only sparingly available in 2011. This put a lot of strain on Government of Jordan (GoJ) finances and in turn on NEPCO's financial position. NEPCO is the monopoly offtaker of electricity for all power generation companies in Jordan. NEPCO's payments of monthly bills for electricity delivered by CEGCO started getting delayed as a result of the strain on the GoJ finances, which was not a feature observed in the past years at CEGCO.

ACWA Power paused for a while and evaluated these events as they were unfolding while at the same time being transparent with the sellers, letting them know that they were very much behind the transaction but wanted to let the dust settle on the various political/ social events happening in the region before moving ahead.

ACWA Power sought the counsel of its political advisers and eventually assessed the situation and decided to move ahead despite the problems as it felt that the Government of Jordan was doing an excellent job of furthering the political reform process, which meant that the problems of some of the other countries would not be experienced by Jordan.

Furthermore, ACWA Power was also confident that with the support of the Arab brothers like KSA, UAE, Qatar, Kuwait etc, Jordan would be able to maintain its financial creditworthiness in the medium term.

IFC partnership

In order to mitigate some of the political risk and also secure a partner in development of future opportunities in Jordan (both for contributing equity and non-recourse debt) ACWA Power considered the partnership of IFC as being critical in its foray into CEGCO and Jordan.

With this point of view it secured the partnership of the International Finance Corporation, which is a key player in Jordan in various industries and more in the power and energy industries as it pursues its developmental goal of making capital available for long-term sustainable energy and power projects in the country in addition to other projects in the social infrastructure sector.

Currency fluctuation risks at CEGCO

One of the primary reasons for higher volatility of the earnings at CEGCO was the exposure to foreign currency payments in the form of Japanese yen, KWD and euro loans raised historically at CEGCO. CEGCO's revenues were only partly indexed to the movement between Jordanian Dinar and the US dollars. However, that did not help in hedging the exposure that CEGCO had towards yen, KWD and euros.

Although the loans in these currencies were very cheap (in terms of interest rates) they were still leading to volatility due to currency movements. The ACWA Power team assessed this and looked at various options available to hedge the foreign currency movements to US dollars (as the Jordanian Dinar is pegged to the US dollar and as part of the tariff for CEGCO is indexed to US dollars).

The most sensitive currency was the yen and it was decided that the best way forward would be to hedge the foreign currency payments by locking in forward rates between yen and US dollars over short periods of time (two to three years).

While this did not totally remove the volatility it certainly gave some level of certainty over the short time frames in predicting the earnings.

Refinancing potential

CEGCO was also relatively underleveraged (average debt service cover ratio of around 1.8x until end-2013) and this provided an opportunity to further lever the company and provide capital back to the shareholders.

ACWA Power's financing team made some reasonable assumptions around the refinancing of these assets in the due course of time.

Desalination potential

ACWA power also saw an opportunity to further develop water desalination plants, especially in Aqaba, to meet the potable water requirements of Jordan. Its presence, especially in Aqaba, would enable it to develop competitive proposals for water desalination plants and meet a crucial need for water in Jordan.

Renewable energy potential

Through its presence in the conventional power sector comprising of thermal power plants, CEGCO also provided an opportunity to ACWA Power to foray into the renewable energy sector, ie, in solar, wind and waste to energy power plants. CEGCO already has two small wind power plants at Hofa and Ibrahimiyah with useful wind data at these locations.

In the immediate future ACWA Power intends to increase the size of the wind turbines at these sites at less than market cost and provide additional cheap electricity to Jordan. CEGCO also has as its subsidiary a waste to energy power plant that is a joint venture with the Amman Municipality. Although the size of this plant is very small, ACWA Power sees a lot of potential in this sector and will be working to further increase the generation capacity through renewable energy sources.

Value of land

CEGCO also owns substantial tracts of land in areas near cities that are beyond its requirement. This surplus land would be more valuable given its nearness to cities and big populations to other industry players than to CEGCO. ACWA Power would therefore consider proposals for other developments at these sites jointly with other industry players or the sale of these surplus land tracts to other industry players.

Acquisition with a strategic view

In summary, the transaction was unique in that it was an acquisition based on a strategic vision and critical evaluation of optionalities – not just on acquiring assets on an as is where is basis. The vision was to enter into a country that needs cost efficient electricity and to meet this objective by maintaining and even increasing the existing electricity generation from the portfolio using the unique advantages of the existing platform.

The transaction was structured securing the support at the outset of a key international developmental lender like the IFC (World Bank group) and was based on thorough technical due diligence whereby a big potential for repowering and delivering cheaper electricity was identified. All of these highlights overcame the problems posed by political and social unrest and created a unique platform for ACWA Power to grow in its core target market and also meet its growth objectives in a responsible manner. ■