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Due Diligence in Acquiring Generation Assets What Valuation Is Sometimes Overlooked?

Summary

In years past, generation assets were seldom sold, and few due diligence reviews were made. In today's competitive environment, however, sales of generation assets have become increasingly common, and the conduct of due diligence reviews has increased considerably. This *Management Insight* summarizes the key elements of the due diligence review process and highlights one area of it that is often under-emphasized.

Why Due Diligence?

A due diligence review serves a number of important purposes, but fundamentally is conducted to identify and characterize issues associated with the proposed sale and transition that may be material to the shareholders. These issues are often related to determining and/or verifying important assumptions that are central to the financial evaluation of the proposed acquisition.

As such, they often concentrate on validating the plant's material condition, valuing assets, and confirming the numerical assumptions of the financial model used in the analysis, including such items shown in Table 1.

For large coal plants and for nuclear plants in particular, a review of the decommissioning plan and the adequacy of the plant's decommissioning fund(s) is also critical.

Table 1:
**Illustrative areas addressed in a
Due Diligence Review (partial list)**

- Market Valuation
- Asset Valuation (Property, Plant, and Equipment)
- Plant Operations and Maintenance
- Plant Support (e.g. Engineering, etc.)
- Fuels
- Human Resources and Labor Relations
- Finance, Accounting, and Information Technology
- Legal and Risk Management
- Environmental and Regulatory

What is Often Overlooked?

While areas of review such as those in the Table are important, they sometimes tend to be mechanically implemented. When this occurs, they fail to provide important insight into how the new owner can add value to the acquisition apart from possible economies of scale, financing advantages, etc.

In other words, what is the value proposition brought forth by management in the merger? Such value propositions can be made if a Management and Culture Review of the acquisition is also conducted as an integral part of

the due diligence process (rather than being “buried” in the financial and functional reviews). Equally important, such an analysis can markedly facilitate the organizational transition from the previous owner to the new, and possibly hasten the realization of the projected benefits for the new owner.

What Should Be Done?

All too often, the acquiring company assumes that it will simply replace the top management of the acquired organization, and hence all management difficulties will simply go away. Nothing could be further from the truth. History is replete with examples of acquisitions that did not work out as expected because anticipated synergies did not materialize, implementation took much longer than planned, the new management style conflicted with the existing culture, labor relations were not conducive to change, or the organizational values of the acquiring and acquired organizations were not compatible. In some cases, the differing management styles and cultures were never successfully integrated, and the newly acquired assets were once again spun off. In many more cases, however, the new acquisitions simply languished, never quite fulfilling their expected benefits.

One way to avoid such outcomes, or to at least minimize its effects, is to conduct a thorough Management and Culture Review as part of the due diligence review. Such an evaluation need not be overly intrusive, and can easily be incorporated into the overall review, either separately or made an explicit part of the review of overall operations and/or human resources. Many of the data sources needed to conduct the review will be collected in any event, and include such documents as manpower staffing studies, organization charts, results of previous re-engineering efforts, process improvement reviews, business plans, succession plans, external reviews, union complaints, safety performance, salary comparisons, separation

policies, etc. Together with focused interviews throughout the acquired organization and a few in the acquiring organization, an accurate evaluation of the potential match between the two organizations can be made, and a plan for eventual integration can be hastened.

What Are the Keys to Success?

The key to success in such Management and Culture Reviews, however, hinges on three important elements: **objectivity**, **process**, and **strategic focus**. **Objectivity** includes the ability to remain unbiased and uninfluenced by management’s haste to “make the deal.” It is better in the long-run to obtain an accurate perspective of the acquired organization’s management/cultural strengths and weaknesses early on, than it is to try to fix unforeseen shortcomings later. It is also important to avoid parochialism in such reviews. Hence, experience in evaluating differing management styles across a variety of organizations can be of significant value.

Process applies to the Review itself and includes the ability to quickly identify documents, materials, and personnel as needed sources of relevant information. It also requires data collection, review, and analysis to be accomplished efficiently, with professionalism, and with due concern for the acquiring organization’s personnel. Experience in conducting similar studies of a sensitive nature which could have impact on the future of personnel at various levels is thus desirable.

Finally, it is critically important to maintain a **strategic focus** on the acquisition, and not become mired in financial or operational details alone. A strategic perspective allows the Management and Culture Review (and the due diligence review itself) to concentrate on those elements that are critical to the acquiring organization. This helps ensure that management decisions are made and optimized instead of simply plugging numbers

into a financial model. The model is, after all, only one part of the overall due diligence process.