



# Capital management

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# Western Power is a capital intensive business




Generators make electricity at power plants.

The network grid is made up of transmission and distribution assets.


The network enables electricity to flow from generators to consumers.

Retailers issue accounts to collect revenue for the whole supply chain.


### Capital management - context

What? 

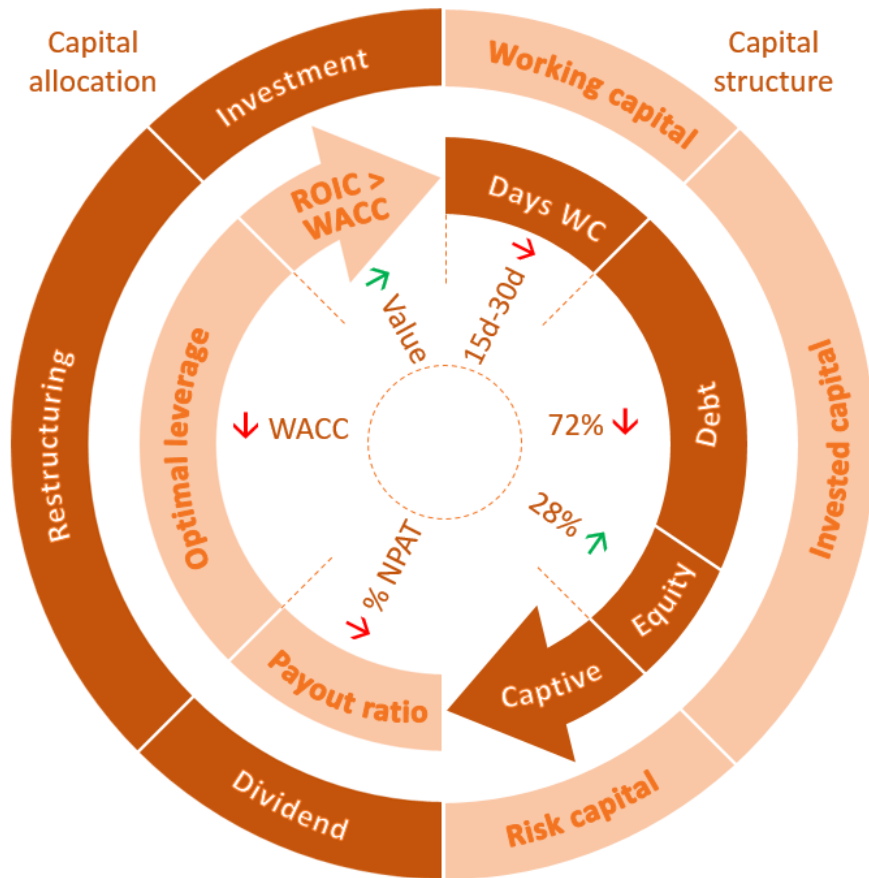
Optimal capital structure; disciplined and efficient capital allocation

Why? 

Maximise long term enterprise value

How? 

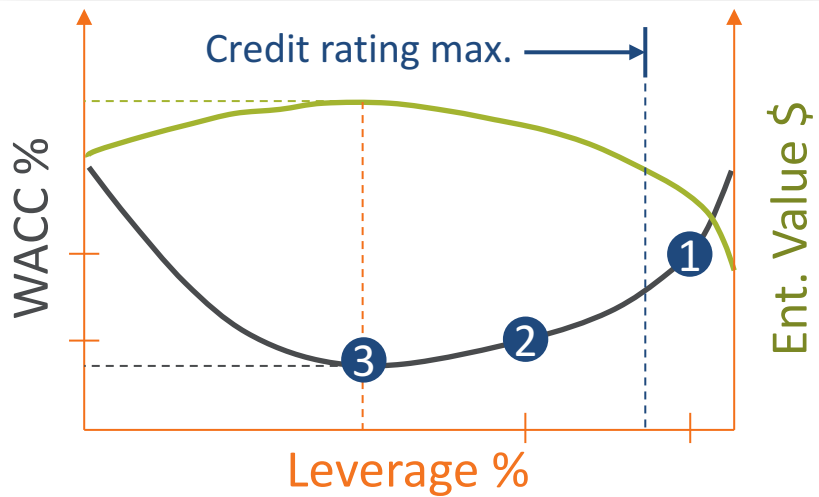
Top-down Board approval to get traction on changing company culture



Optimise leverage ( $D/(D+E)$ ):

- cost of capital ↓
- LT enterprise value ↑
- ensure capex adds value ( $ROIC > WACC$ )

## Theory vs. pragmatism



**Theory** optimise mix of  $D/(D+E)$ :

- min. cost of capital ↓
- max. LT enterprise value ↑

**Pragmatism** max. reward 4 effort:

- ① → ② steep = WACC ↓↓
- ② → ③ flat = WACC ↓

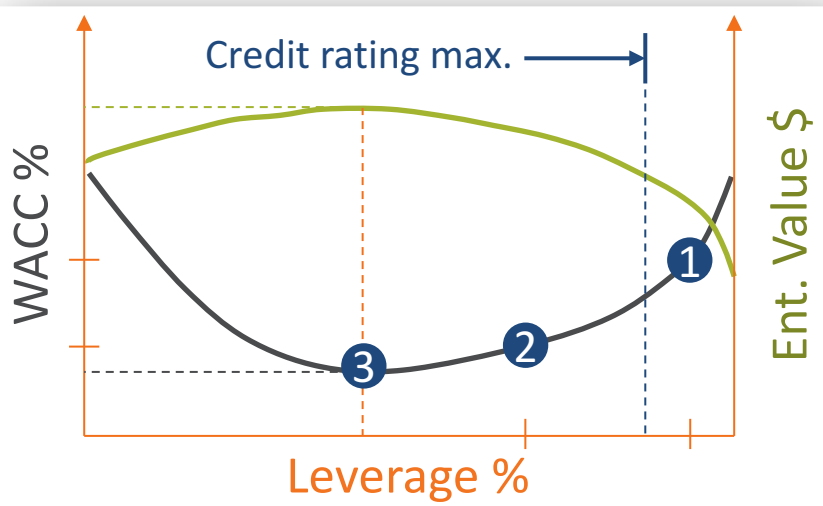
Low

Equity cost > low  
cost debt / shield

High

Debt & equity  
costs increase

## Science vs. art



$$EV = \sum \text{Discounted}(EP)$$

$$EP = NOPAT - TCE \times WACC$$

As  $D/(D+E)$  increases:

- Credit rating weakens  $r_d$   $\uparrow$  **A**
- Share claim weakens  $r_e$   $\uparrow$  **B**

$$WACC = r_d(1-t) \frac{D}{D+E} + r_e \frac{E}{D+E}$$



$$\beta_L = \beta_U [1 + (1-t)(D/E)]$$

$$r_e = r_f + (r_M - r_f) \beta_L$$

## Credit rating impact – capital structure

### Easier to 'move the needle'

#### Financial policy:

- balancing creditor and shareholder interests
- dividend policy
- develop a track record sooner by starting earlier

### Harder to 'move the needle'

#### Leverage and coverage metrics:

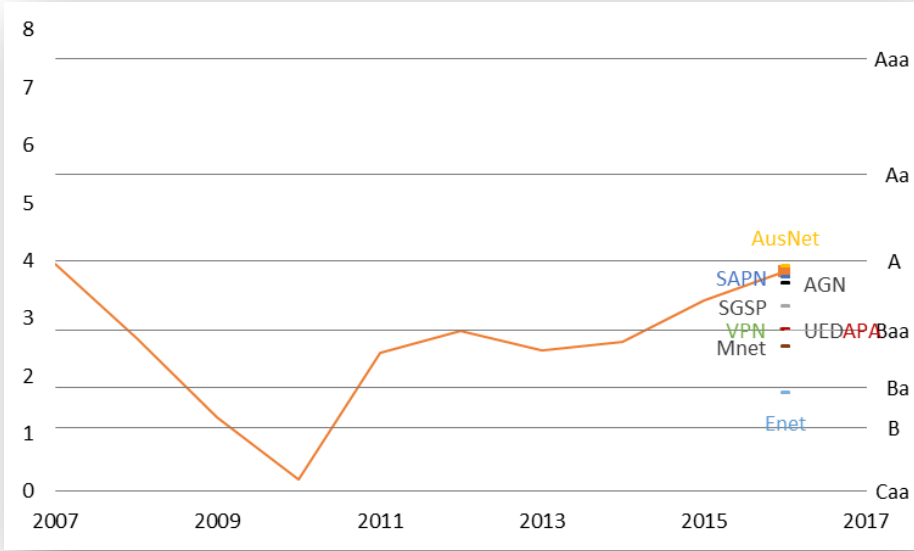
- FFO interest coverage
- FFO / Debt
- RCF / Debt
- leverage

#### Analysis:

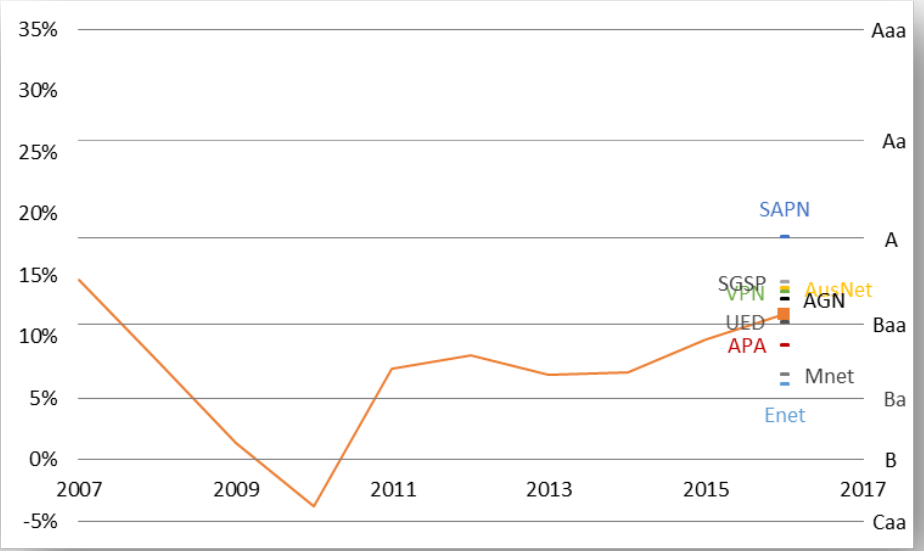
- time series (trend improve)
- cross-section (peer compare)

# Credit rating impact – benchmarking metrics

## FFO interest coverage

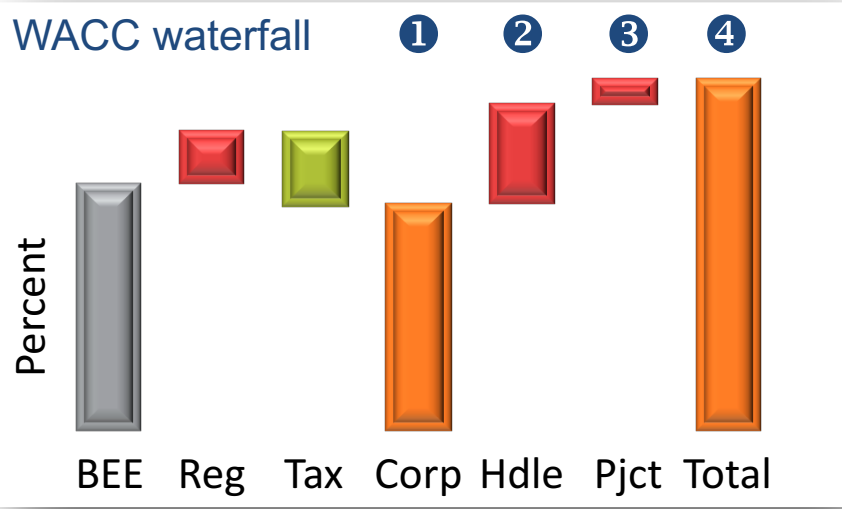


## FFO / Debt





### Capital allocation value-add



Economic profit also equals:

$$EP = (ROIC - WACC) \times TCE$$

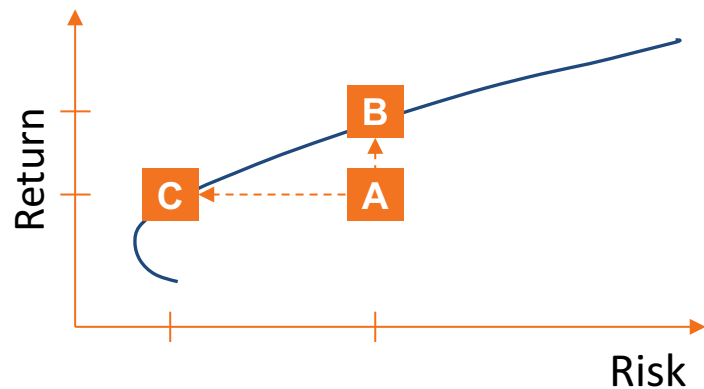


$$EV = \sum Discounted(EP)$$

Hurdle rates:

- 2 same risk as company
- 3 project / biz unit risk
- 4 too high: risky invest. bias
- 4 too low: over invest. bias

## Capital allocation efficiency



Economic profit also equals:

$$EP = (ROIC - WACC) \times TCE$$

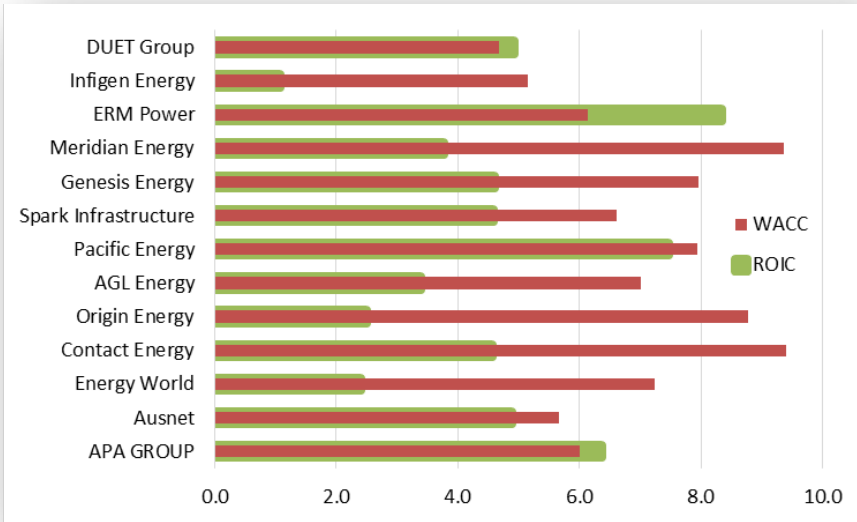
$$EV = \sum \text{Discounted}(EP)$$

Efficiency requires return to be commensurate with risk:

- **A** is inefficient
- **B** same risk, more return
- **C** less risk, same return

## Credit rating impact – benchmarking capital allocation

### Av. Historical ROIC & WACC



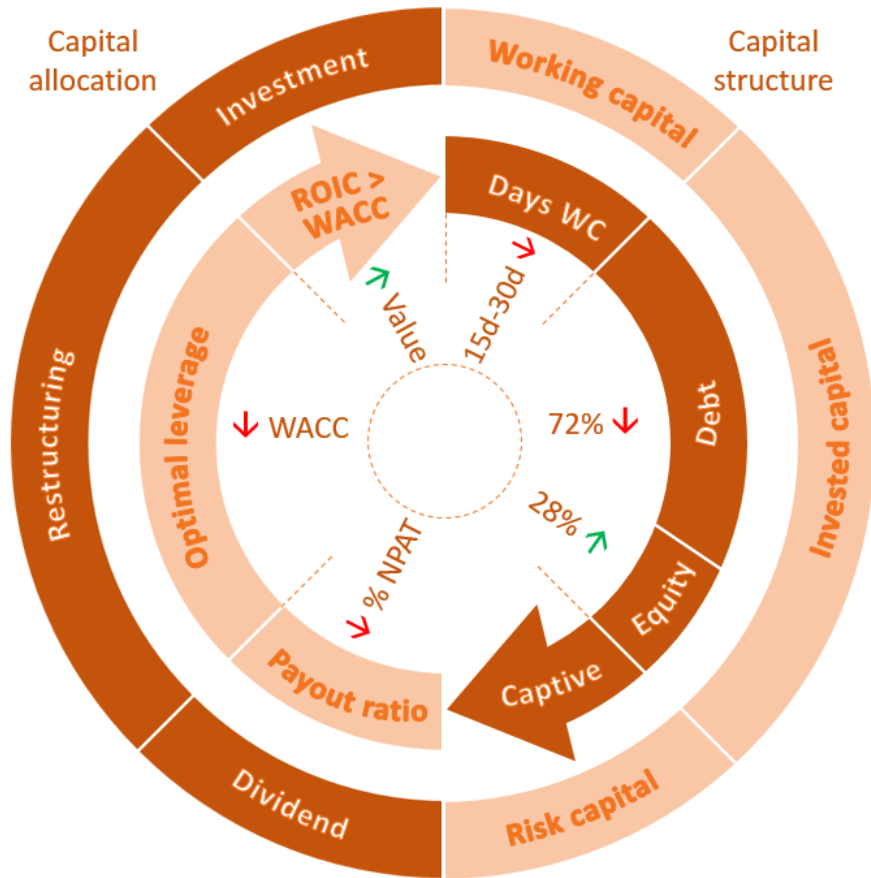
### Capex program:

- size & scope
- complexity
- management's ability to deliver (governance)

$$EP = (ROIC - WACC) \times TCE$$

$$EV = \sum Discounted(EP)$$

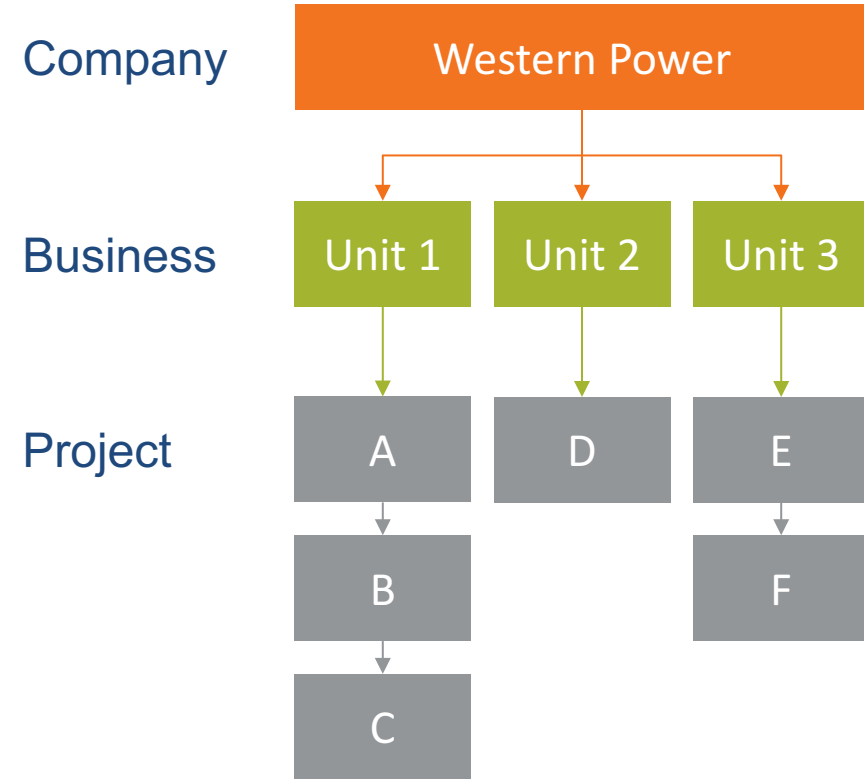
# Conclusion



Optimise leverage (D/(D+E)):

- cost of capital ↓
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# Conclusion



Leverage the accounting system:

$$EP = NOPAT - TCE \times WACC$$

$$EP = (ROIC - WACC) \times TCE$$

$$EV = \sum Discounted(EP)$$

WACC waterfall

