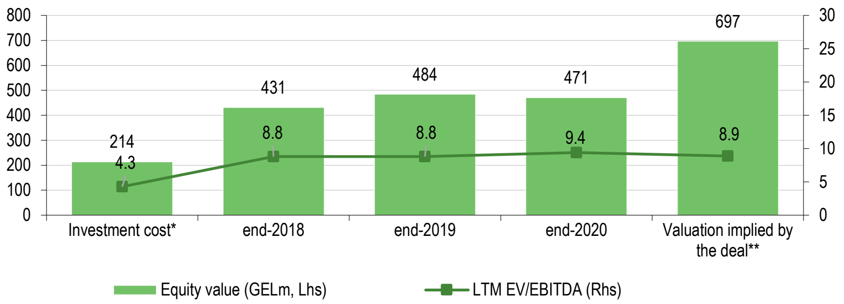
Georgia Capital

Sale of majority stake in the water utility business

Investment companies
Private Equity

On 31 December Georgia Capital (GCAP) announced it has agreed to sell an 80% stake in its water utility business (held through Georgia Global Utilities, GGU) to FCC Aqualia for a US$180m cash consideration. We estimate the deal values the business at a 13.4% uplift to its carrying value at end-September 2021 (on top of a c 13% uplift in Georgian Lari (GEL) terms that GCAP booked in Q321 vs Q221) and translates into a 2.2pp NAV accretion for GCAP (vs end-September 2021). GCAP will achieve a solid 2.7x multiple on invested capital (MOIC, of which 2.2x realised) and a 20.1% IRR in US dollar terms. GCAP will use US$95.4m of the proceeds to partially fund the redemption of GGU's US$250m green bond (with the balance provided by FCC Aqualia). GCAP will retain full ownership of the renewable energy assets (now held through GGU).

Valuation of GCAP's water utility business throughout the investment cycle



Source: Company data. Note: *both the equity value and EV/EBITDA multiple reflect the combined cost of the 25% stake acquired in 2014 and the 75% stake acquired in 2016. **EV/EBITDA multiple estimated by GCAP.

Why consider GCAP now?

Georgia's economic rebound from the 6.2% real GDP decline in 2020 has been quite remarkable, with reported 11-month growth at 10.7% and growth forecasts for 2021 ranging from 7.7% (IMF) to 10.8% (TBC Capital). Moreover, expectations for 2022 are at 5.0%+ (dependent on the extent of the rebound in tourism revenues). GCAP provides moderately geared exposure to the Georgian economy, mostly through resilient, market-leading businesses in the healthcare services, pharmacy, insurance, water utility, renewable energy and education sectors.

The analyst's view

We believe the water utility disposal marks an important milestone on the path to validating GCAP's private equity investment strategy. It shows GCAP can acquire, develop through value-accretive initiatives and profitably sell portfolio companies to a high-quality international strategic investor. The uplift to end-Q221 and end-Q321 carrying values may also suggest a prudent valuation policy. All this may help narrow the 48% discount to end-September 2021 NAV (or 52% based on the 'live' NAV) at which GCAP is trading, which is wider than its pre-COVID-19 pandemic levels of c 10–30% and the discount of UK-listed private equity (PE) peers of c 10–20% (even if the latter discrepancy is partially justified by country-specific risks).

5 January 2022

Price	**725p**
Market cap	**£341m**
NAV*	**£646m**
NAV per share*	1,398p
Discount to NAV	48.0%

*At 30 September 2021 based on a £/GEL rate of 4.2743

Yield		0.0%
Shares outstanding**		46.2m
Code/ISIN		CGEO/GB00BF4HYV08
Primary exchange		LSE Premium
AIC sector		N/A
52-week high/low	485p	725p
NAV high/low	1,398p	933p

**shares in issue less unawarded shares in management trust

Gearing at 30 September 2021

Gross gearing	40.8%
Net gearing	31.5%

Fund objective

Georgia Capital focuses on scalable private equity opportunities in Georgia. These opportunities have the potential to reach at least GEL0.5bn equity value over the next three to five years and the company can monetise investments through exits.

Bull points

- The majority of the portfolio is exposed to resilient and well-established businesses.
- Georgia is likely to continue its secular trend with 5%+ real GDP growth after 2020.
- Regular dividend income with growth potential from several portfolio companies.

Bear points

- GCAP has just started building its track record of investment realisations.
- Concentrated portfolio exposed to a frontier economy is inherently higher risk.
- Vaccination rates remain well below Western Europe (although the gap has been gradually narrowing.

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Selling to a high-quality strategic investor

On 31 December 2021, GCAP announced its fully owned subsidiary JSC Georgia Capital has agreed to sell an 80% stake in the water utility business to FCC Aqualia. The acquirer is the fourth and ninth largest water management company in terms of population served in Europe and globally, respectively (according to the latest Global Water Intelligence Ranking from March 2021), servicing close to 30 million people in 17 countries. FCC Aqualia's two major shareholders are the citizen services group FCC, active particularly in the environmental services, water and infrastructure sectors (51%) and the Australian ethical fund IFM Investors (49%). The transaction is subject to shareholder approval, with the general meeting expected in late January or early February 2022.

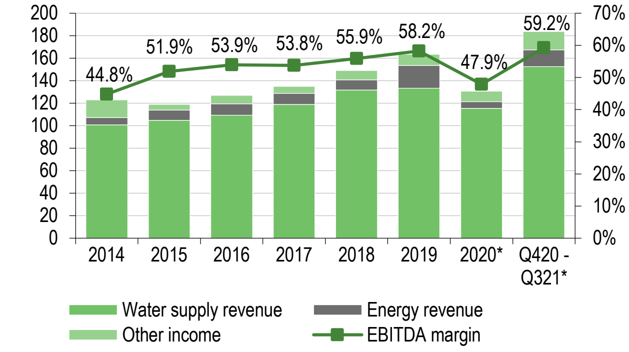
The sale will be conducted as a two-stage transaction, with FCC Aqualia initially acquiring a 65% stake in GGU, a holding company for GCAP's water utility business and the operational assets of its renewable energy business. This stake represents an 80% economic interest in the water utility business. The second stage will follow the redemption of the existing US$250m bond (planned in July 2022) issued by GGU in July 2020. This will be financed by FCC Aqualia and GCAP, with GCAP providing a US$95.4m shareholder loan to GGU. Subsequently, the renewable energy business will be spun off from GGU in September 2022, allowing GCAP to recover full ownership of GGU's renewable energy assets while FCC Aqualia will reach an 80% stake in GGU. Moreover, FCC Aqualia granted GCAP a put option on the remaining 20% stake, which is exercisable in 2025 or 2026 (at a normalised last 12 months, LTM, EV/EBITDA multiple of 8.25x). In turn, GCAP granted FCC Aqualia a corresponding six-month call option exercisable from the date of the expiry of the put option in 2026 (at a normalised LTM EV/EBITDA ratio of 8.9x, in line with the multiple at which the 80% stake is being sold as per GCAP's estimates).

The deal means that GCAP's management is delivering on its strategic priorities even ahead of the timelines initially communicated during the capital markets day (CMD) in November 2020 as GCAP's aim was to sell one of its large portfolio companies within 18–24 months after the CMD.

Successful value creation during the holding period

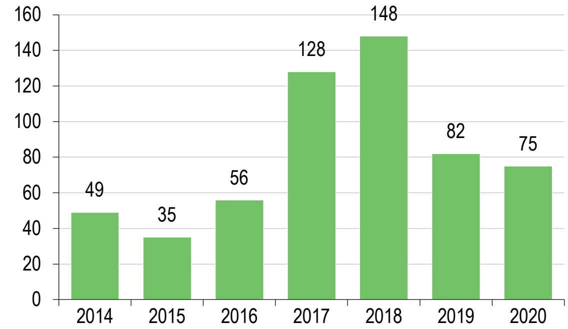
The water utility operations cover a regulated monopoly in Tbilisi and the surrounding area, providing water and wastewater services to 1.4 million residents (more than one-third of Georgia's population) and c 36,000 legal entities. Additionally, it includes the operations of hydro-power plants with an aggregate capacity of 149MW, with c 50% of the generated power used for water supply purposes and the rest being sold on the market to third parties. From the acquisition of the initial 25% stake in GGU in 2014 to end-September 2021, the business posted a revenue and EBITDA CAGR of 6.7% and 11.4%, respectively (see Exhibit 1). At the same time, its EBITDA margin improved from 44.8% in 2014 to 59.2% in the 12 months to end-September 2021 (or 60.5% if Q420 was adjusted for the new tariffs).

Exhibit 1: Water utility business's revenue (GELm) and EBITDA margin



Source: Company, Edison Investment Research; Note: *If the new water tariffs were applied retrospectively, the water utility business's total revenue in 2020 and Q420-Q321 would be GEL174m and GEL194m respectively, while its EBITDA margin would be 56.6% and 60.5% respectively.

Exhibit 2: Water utility business's CAPEX 2014–2020 (GELm)



Source: Company

Over 2017 to 2019, GGU embarked on an extensive capital expenditure agenda to develop new, and upgrade existing, water and wastewater utility infrastructure (Exhibit 2). This allowed the company to realise significant operating efficiencies, including a reduction in the consumption of self-produced electricity by c 45% or 144GWh from 2015 to 2020, freeing capacity for market sales (GGU's energy revenue grew at a 13.0% CAGR between 2014 and LTM to end-September 2021). These investments also translated into an increase in the regulatory asset base, which enhanced the earnings potential of the business amid the new 2021–2023 water tariffs that the local regulator approved in December 2020, translating into 38% higher allowed water revenues. The tariffs were set at a level that allows the business to recover unearned revenues in the last regulatory period (2018–2020), particularly from the 13% y-o-y decline in water supplies in FY20 amid the COVID-19 pandemic (mainly due to lower demand from corporate clients, because residential demand remained stable throughout the year). The new tariffs assume a return on investment of 14.98% (with reference to GGU's regulatory asset base), in line with the business's mid-term target return on invested capital of 13–15%. We also note the business may have benefitted from an increase in electricity prices following the local market deregulation in 2019.

Capital expenditures in the water utility business declined to more normalised levels in 2019 (and should reach a run-rate of GEL80–100m pa, according to the company), contributing to positive free cash flow generation. In response to COVID-19, the business pursued a cash accumulation and preservation strategy (in line with the rest of GCAP's portfolio). GGU also successfully issued a US$250m five-year green bond with a 7.75% coupon in July 2020 (of which US$155m was allocated to the water utility operations), despite the pandemic turmoil. As a result, it had a cash buffer of GEL49.8m at end-September 2021.

GCAP to achieve a 2.7x MOIC/20.1% IRR in US$ terms

FCC Aqualia will pay US$180m in cash for the 80% stake in the water utility business, implying a fair value of the entire business of US$225m. We estimate this represents a c 13.4% uplift to its last carrying value in GEL terms at end-September 2021, translating into a c 2.2% uplift to GCAP's overall NAV at end-September 2021. We also note GCAP revalued upwards the water utility business by c 13% in GEL terms in Q321 on the back of an 8.5% q-o-q increase in LTM-adjusted EBITDA, coupled with a c GEL26m reduction in net debt amid higher cash level from strong revenue generation (supported by the new water tariffs, higher consumption of corporate clients and increased electricity sales). Hence, the deal-implied value of the business represents a solid c

30% uplift in US$ terms (c 27% in GEL terms) to the end-June 2021 carrying value, which also happens to be the last available external valuation of the water utility operations prepared by Duff & Phelps. Overall, the revaluation of the business since end-June 2021 added c 5.8pp to GCAP's NAV in GEL terms, according to our calculations. It is also worth noting that the US$180m exit proceeds represent c 21% of GCAP's last reported NAV but c 39% of its current market capitalisation (given the wide discount to NAV).

The exit results in a solid 2.7x MOIC and 20.1% IRR in US dollar terms (including both realised and unrealised gains) achieved since acquisition. GCAP acquired GGU at a blended LTM EV/EBITDA multiple of 4.3x, while the exit multiple estimated by GCAP stands at 8.9x (see the chart on page one). This is despite the GEL depreciation versus the US dollar in recent years, with returns in local currency at 3.7x and 27.8%, respectively. The realised MOIC is 2.2x in US dollar terms and 3.0x in GEL terms, which includes GEL97.1m from dividends received since acquisition. The receipt of cash proceeds will have a positive effect on GCAP's leverage, with a pro-forma leverage ratio at end-September 2021 at c 19.6% (vs the actual leverage at 25.4% as per GCAP's calculations) assuming a cash settlement as if it had been at end-September 2021 and a US$95.4m shareholder loan to GGU for the financing of the redemption of the renewable energy bond (as discussed above). The allocation of the remaining balance is subject to GCAP's board review, expected to take place in Q122 and may include share buybacks, deleveraging, lending to portfolio companies and potential new private equity investments.

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