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FORTIS INC. AND THE $11.8 BILLION ITC DECISION

Selena Shannon Pritchard wrote this case under the supervison of Professors Roderick E. White and W. Glenn Rowe solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In the late fall of 2015, Karl Smith, executive vice-president and chief financial officer (CFO) of Fortis Inc. (Fortis), a homegrown energy delivery company based in St John's, Newfoundland and Labrador, was preparing to meet with Fortis's leadership committee. On the agenda, was whether Fortis should make an offer to acquire ITC Holdings Corporation (ITC), the largest independent transmission utility in the United States, for US$11.8 billion.[1] If Fortis went ahead with the offer and it was accepted, this deal would be Fortis's most significant acquisition in its history and would mark the company's entry into the electricity transmission industry.[2] Smith reflected on his past 30 years with Fortis and how far the small energy company from Newfoundland and Labrador had come. The company had grown from CA$390 million in assets in 1987 to an anticipated CA$48 billion, if the ITC transaction were to proceed. The ITC deal would make Fortis one of the 14 largest public utilities by enterprise value in North America. Furthermore, the deal would increase Fortis's U.S. presence to nine states from two, in addition to the five Canadian provinces and three Caribbean countries in which the company already operated. While the potential ITC acquisition marked a big move for Fortis, Smith wondered whether this acquisition was the best decision for the company.

FORTIS'S BACKGROUND

Fortis had been founded in 1987 as a holding company for the Newfoundland Light & Power Company, which had a long history dating back to 1885 and was one of Canada's few investor-owned electricity distribution companies. After Fortis was formed, the company continued to focus on growing in electricity distribution and made its first investment, outside of the province of Newfoundland and Labrador, in Maritime Electric in Prince Edward Island, Canada. During this period, energy distribution, particularly in Canada, remained mostly publicly owned and heavily regulated. Consequently, Fortis invested in new regions when opportunities were available, in part to diversify its regulatory risk.

Starting in 1987, Fortis's chief executive officer (CEO), Angus Bruneau, spearheaded the transformation of Fortis. Bruneau was a former academic who had been the founding dean of the Faculty of Engineering and Applied Science and later the vice-president for Professional Schools and Community Services at

[1] All currency amounts are in US$ unless otherwise noted.
[2] "Fortis Inc. to Acquire ITC Holdings Corp. for US$11.3 Billion," Cision PR Newswire: News, February 9, 2016, accessed May 6, 2017, www.prnewswire.com/news-releases/fortis-inc-to-acquire-itc-holdings-corp-for-us113-billion-300217218.html.

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Memorial University of Newfoundland in St. John's. "He [Bruneau] changed what was a very traditional utility into an exciting employee-, customer-, and community-focused company which provided many of us [with] a fulfilling career," said Earl Ludlow,[3] executive vice-president, Eastern Canadian and Caribbean Operations at Fortis. When Bruneau retired in 1996, Stan Marshall was named CEO of Fortis. Karl Smith noted, "Stan was the primary architect—Angus was the visionary and Stan was the architect. Stan carried that torch for so many years."

Marshall's primary goal for Fortis was to ensure no more than 25 per cent of the company was exposed to one regulator. Regulation of the energy industry added significant pressures to companies operating within this space. Said Smith: "This is the way regulation works. You have a regulator in the province of Alberta (for example) whose obligation is to make sure that electricity customers in Alberta pay the least amount they should for electricity. That's all they care about." Accordingly, the company focused on acquisitions to diversify its regulatory risk (see Exhibit 1). In 1999, Fortis made its first international investment, in Belize, where Fortis owned a 33 per cent interest in Belize Electricity as of late 2015; and in 2000, Fortis invested in the Cayman Islands, where it owned a 60 per cent interest in Caribbean Utilities on Grand Cayman, and in the Turks and Caicos, where Fortis TCI was owned 100 per cent.

During this time, Fortis also expanded into a variety of non-electricity-related subsidiaries, including the ownership of a hotel business, a real estate business, a finance business, and a partnership with AT&T Inc. The company anticipated expanding its customer service strengths from the public utility sector into these different industries. These subsidiaries were designed to reduce the company's risk from regulatory pressures, while providing tax benefits. However, the decision was eventually made to exit these businesses and focus on energy delivery through distribution. By 2015, these non-core businesses had been sold.

In 2004, the company had made substantial investments in Western Canada, acquiring electricity distribution companies in Alberta and British Columbia from the energy company Aquila. These acquisitions were formalized into subsidiaries under the names FortisAlberta Inc. and FortisBC. In 2007, Fortis made its first investment in gas distribution with the purchase of Terasen, which was later renamed FortisBC Energy. These acquisitions were considerable for the company, and at one point FortisBC and FortisBC Energy represented 35 per cent of the company's asset base. Given Fortis's goal to ensure more diverse regulatory exposure, the executive team continued to consider new acquisition targets. During this time, Fortis attempted to acquire Central Vermont Public Service Corporation, an integrated electricity company in Vermont. The sale would have marked the company's first foray into the United States, a market with substantially more investor-owned utilities. However, the deal fell through during the review period, when the sale was reopened to additional bids. Gaz Metro, another Canadian utility company, placed a higher bid and eventually acquired Central Vermont Public Service Corporation for an additional premium.[4]

Fortis continued to target investments in the United States, recognizing the lack of viable targets in Canada. In 2012, Fortis announced its first American acquisition, the CH Energy Group Inc., the parent company of an electricity and gas distributor in the state of New York, for $1.5 billion. The 2013 acquisition of Arizona-based UNS Energy Corp., the parent company of a vertically integrated electric utility and a gas distribution utility, for $4.3 billion followed. The following year, 2014, marked the retirement of Stan Marshall. Under his leadership, Fortis's assets had grown from CA$1 billion in 1996 to

[3] Joan Sullivan, "In Memoriam: Engineer Angus Bruneau Led Multibillion-Dollar Utility," *Globe and Mail*, March 26, 2017, accessed June 18, 2017, https://www.theglobeandmail.com/report-on-business/engineer-angus-bruneau-led-multibillion-dollar-utility/article34431116/.

[4] Azam Ahmed, "Gaz Metro Bests Fortis to Buy Vermont Utility," *New York Times*, July 12, 2011, accessed July 31, 2017, https://dealbook.nytimes.com/2011/07/12/gaz-metro-bests-fortis-to-buy-vermont-utility/.

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CA$26 billion. Upon Marshall's retirement, Barry Perry, the company's vice-president of Finance and its CFO, was named CEO.

While the majority of Fortis's subsidiaries were regulated, the company also operated several non-regulated entities, including Fortis Generation, which comprised power generation facilities in British Columbia and Belize. In 2015, these non-regulated entities contributed a little less than 10 per cent of the company's earnings (see Exhibit 2).

FORTIS'S FINANCIAL SITUATION

Through its history of acquisitions, Fortis had continued to post consistent financial results. Smith expected the ITC acquisition to be completed by October of 2016. If the deal were to close on that timeline, Fortis anticipated having CA$6.838 billion in fiscal 2016 revenue (given that Fortis would have owned ITC for only two and one-half months by Fortis's fiscal year-end) up from CA$6.757 billion the year before. Fortis had historically delivered its shareholders sustained dividends, attaining a 9 per cent compound annual growth rate on dividends over the past 10 years. Over the past 43 years, Fortis had delivered an increased dividend payment to shareholders every year, among the longest records for continuous dividend payments by any public company in Canada. If the ITC acquisition was completed, Fortis anticipated its financials to include a 22 per cent increase to its adjusted earnings and a 5 per cent increase to its adjusted earnings per share (EPS) year-over-year after 2016 (see Exhibits 3 and 4).

Fortis had delivered above-normal performance for its industry. Total shareholder returns over the 10-year period from 2006 to 2016 were 8.3 per cent annually. In the same period, the S&P 500 utility sector had returned 7.4 per cent, and the TSX Utilities Index had returned 4.8 per cent.

ITC BACKGROUND

ITC, Fortis's acquisition target, had been founded in 1999, as a subsidiary of Detroit Edison and operated primarily in the U.S. Midwest. ITC had changed ownership and structures several times and by 2003 had become the first independent electricity transmission company in the United States. ITC operated across Iowa, Michigan, Minnesota, Illinois, Missouri, Kansas, and Oklahoma.[5] ITC and its subsidiaries—Michigan Electric Transmission Company, ITC Midwest, and ITC Great Plains—faced regulations and rate setting from the Federal Energy Regulation Commission (FERC). ITC was headquartered in Novi, Michigan; became publicly listed in 2005; and had assets of nearly $7.4 billion.

Prior to the deal announcement by Fortis, ITC shares had been trading at around $40 per share, and the company had a market capitalization around $10.5 billion. In 2015, ITC delivered $1,045 million in revenue, up from $1,023 million in 2014 and $941 million in 2013. ITC had also delivered year-over-year increased earnings per share, growing from $1.49 per share in 2013 to $1.57 per share in 2015. Over the past five years, ITC had also delivered above-normal results in the capital markets, delivering returns 15 per cent above the S&P 500 Index and 22 per cent above the Dow Jones U.S. Utilities Index.[6]

When asked why Fortis should acquire ITC, given it would be Fortis's first foray into the transmission industry, Smith said:

[5] CIBC Institutional Equity Research, February 9, 2016.
[6] ITC Holdings Corp., *2015 Annual Report*, accessed August 20, 2017, www.annualreports.com/HostedData/AnnualReportArchive/i/NYSE_ITC_2015.pdf.

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