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Board Focus on M&A

A Closer Look at Utilities and Energy Trends for 2008

Steady Deal Flow Anticipated for Utilities and Energy

High energy prices and strong cash flow, along with continued interest from foreign buyers due to a weakened dollar, have helped create a favorable deal environment.

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What is your general outlook regarding energy deals in the coming year?

Jim Dillavou: I think activity will remain strong in the energy industry. Of course, all M&A transactions require leverage, and energy deals aren't immune to the current issues in the credit markets, which may put a damper on some activity. But for the most part, we continue to see a high level of interest and several buyers looking at and working on deals.

Steven J. Agresta: I agree. I'm most familiar with the utility sector, and I think the last year has shown that private deals not only can get done, but can get by state regulators. There have been a number of things in place to stimulate an uptick in utility deals for several years, but the failure of a couple of private deals a few years ago put a chill on the sector. Now that we've had two or three successful deals, I expect to see more going forward.

The biggest deals in the last year were TXU, Duquesne, and NorthWestern going private. Before that, there had been failures in Portland, Oregon, and in Arizona, which the private equity world learned from, particularly how to deal more effectively with state regulators. Thus, the next round of deals was approved. So I think, along with the other reasons stated, we'll see more transactions and consolidation.

William Hardie: As far as power generation assets, we'll continue to see a fair amount of transaction activity. The capital market support for that sector has recovered from the disruptions of the summer of 2007, and people are relatively comfortable continuing to invest in the sector, so we should see some movement of assets there. Aggregators are achieving cost synergies by building out their portfolios. We expect to see those aggregators continue to take advantage of some of the regulated businesses that will extend their generation portfolios, as well as others on the financial ownership side who, having been involved on a three-, four-, five-year time horizon, are looking to liquidate their investments. On the oil and gas side, the commodity price environment is very helpful to the M&A business. The ability to buy assets at prices south of where the commodities are trading creates opportunity, and we expect to see that trend continue as well.

Given that oil surged toward $100 a barrel earlier this year and natural gas prices rose, how do high commodity prices affect deal activity, types of transactions, and the volume of M&A transactions in various subsectors?

Agresta: I think the answer is subsector specific. There are subsectors, such as utilities, where high oil and gas prices won't have much effect except to the extent that oil prices would affect the overall economy. There are certainly other subsectors that are more directly tied to energy commodity prices where it would have a big effect on stock valuations, and therefore on currencies available for transactions.

Dillavou: I agree. If you look specifically at volume, the deals get more expensive in much of the industry. But pricing factors have also opened up the whole area of alternative energy. So between that and some of the related legislation, there is a lot of interest in those types of transactions. However, there's a limit to how many alternative energy assets are available in the United States, and some look more like start-up deals. I think high prices have certainly contributed to a strong overall environment in the energy industry, which has helped create a favorable environment for transactions and interest in the industry.

Hardie: The high commodity price environment will certainly impact the E&P sector. As I mentioned, the ability to buy assets at prices lower than what commodities are trading for creates a good dynamic for deal activity. This also bodes well for the oil field service sector, as people become comfortable that there will be a renewed effort at extracting reserves through secondary and tertiary recovery methods, which means the service companies should remain busy, thus M&A activity in the oil field services sector should be relatively robust as well. Then with respect to the commodity price impact on the generation sector, obviously high gas prices mean coal-fired and other dark-spread generating businesses will continue to do very well, which means their values will go up, and as a result, there will be M&A interest in those assets. That should also have an effect on people's interest in pursuing renewables. High commodity prices, from a political perspective, always get Washington interested in renewables, whether they be biofuels or wind or things of that nature, because of their effect on consumers and voters. So there should be some activity in the renewables area as well.

What are some key drivers of M&A for utilities and energy companies?

Agresta: I'll take a shot at utilities, but first, a bit of background. Due to local monopolies, the utility industry never was allowed to figure out what its optimal scale was until about the mid-1990s when there was a wave of consolidations, and even those consolidations didn't get to the point where optimal scale became obvious to the players. Then there was a pullback from those consolidations due to the California energy crisis. So we've got this industry that historically was split up on the investor side into about 100 monopolies of various sizes trying to figure out what the optimal size is, both from a cost point of view and a regulatory risk point of view. On top of that, we now have a situation where the dollar is weak so there's a big incentive for non-U.S. companies to come in and buy. As I mentioned earlier, there also appears to be a trend of state regulators being cooperative. So I think all those things are likely to produce the higher deal rate we've discussed.

Dillavou: Part of what has allowed both private equity and foreign buyers to become active is legislation that's been in place for several years creating the Public Utility Holding Company Act (PUHCA), which has made it easier to get those deals done. While I think it's been shown that deals can happen, getting approval from state regulators still will not be easy. It will most likely require a specific situation, and potential buyers will have to pick those transactions carefully to find the right environment. But there is also a real prospect for consolidation in the industry and good reasons for it to happen. There's a need for substantial investment in new plants, particularly as we see increasing pressure to shelve older, more polluting plants, and investment in the infrastructure around transmission and distribution. So those factors should lead to a continued move toward consolidation. I don't think there will be a high level of activity, but rather, steady deal flow that will grow over time.

Hardie: With respect to the regulated utilities, obviously the most significant driver in their ability to pursue acquisitions is the regulatory environment in which they operate. Most states these days are still interested in reducing the cost of power, and continue to evaluate or implement the separation among generation, transmission, and distribution because they believe doing so will drive economies for the benefit of the consumer. So we haven't seen a lot of active utility buyers in the generation space, although there have been exceptions where there are assets that are particularly well positioned geographically for a certain utility, and an asset will come on the market that will serve its load needs quickly and easily at a value that is attractive relative to the alternative of building a new power plant or what can be achieved from the market. The utility buyer, in competition with the merchant buyer, is always at a disadvantage from a regulatory approval perspective, although utility buyers are at an advantage from a cost-of-capital perspective. So sellers must weigh all that when determining who the right buyer is. With respect to merchant energy companies, I think they will continue to be the buyers of choice and certainly the most successful buyers. Interest rates are likely to decrease during 2008 as a result of macroeconomic forces, which reduces merchant energy buyers' cost of capital and means they can be more aggressive in pursuing assets to build out their portfolios. As I mentioned earlier, portfolio buyers are looking to add to their portfolios in geographic regions where they have assets to drive cost synergies, and we expect that trend to continue.

Agresta: I'll add as a footnote that my non-U.S. clients have shown up ready to shop but are completely unaware of the importance of state regulation in the United States. That issue has required them to climb a steep learning curve, and it is an impediment. They'll show up saying, "Well, PUHCA's gone, so we can do a deal, right?" And the answer is, "Well, maybe you can do a deal. Let's figure out which states you might be able to work with."

Dillavou: On the nonregulated side, we've discussed what prices have done and how that's created interest, but there are several other factors worth considering. Companies in the industry have had strong cash flows. They now have the cash they need to invest and are ready to spend it, so there's a strong level of interest among strategic buyers as well as from the outside, which I'd say is probably the strongest level of interest from private equity that we've seen. A number of industry-specific funds have continued to raise

significant amounts of capital that is now available for investment, and even though some parts of the economy haven't looked that good, the energy industry is probably less at risk if the United States were to enter into a recession. Therefore I think we will continue to see a lot of activity taking place and a lot of interest in assets that come to market.

Agresta: With regard to the regulated side for non-U.S. buyers, U.S. asset prices look really cheap, and that's a big attraction.

Dillavou: We've also had the evolution of the master limited partnerships in the United States, which are tax-advantage vehicles that have garnered a lot of interest. They have ready access to cheap capital, so they continue to buy assets and shop heavily. They are truly in growth mode.

As you know, one of last year's largest deals was Kohlberg Kravis Roberts' $31 billion purchase of TXU. Do you anticipate that private equity dollars will continue to play a large role in 2008?

Agresta: There are a lot of attractions in the utility sector for private equity, including the fact that the prospect of carbon regulation is going to be a big upside. It's difficult to crank that into valuations right now because we don't know what the carbon regulations are going to look like. That creates an opportunity to pick up assets that are not fully valued at this point. So my guess is the answer's going to be yes, there will be more private equity activity.

Dillavou: As I touched on previously, I do think there will be increased private equity involvement in the industry as a whole. When we talk about the KKR transaction as being utility-specific, there's certainly a level of interest. We don't really know how quickly that's going to pick up and how soon private equity will really be active and able to make those kinds of investments successfully. But certainly in the unregulated power subsector and throughout the rest of the energy industry we will see continued activity and a high level of interest. The large private equity players will continue to look at these kinds of deals and may be more focused on energy than they have been in the past, given the market conditions. And again, we have energy-specific private equity funds that are also actively looking.

Hardie: My instinct tells me equity players generally see the process KKR went through in its acquisition of TXU as being relatively difficult, and as a consequence, it's probably not high on the radar screen for most private equity buyers. The regulatory environment and the politics KKR had to put up with in that deal will continue to serve as a barrier to private equity being a real active participant in the utilities space. That said, if there are attractive assets or attractive utility businesses at values that make sense, then you would expect people to weigh the transactional friction of a utility deal against the potential returns, and there may be a situation where those returns will still make sense.

Agresta: I would suspect that the credit issues will have more of an effect on the giant deals than on the midsize deals. So it's unclear to me whether we'll see another $30 billion TXU kind of deal in the next few months.

Has the number of foreign buyers increased or is it anticipated to increase in the next few years? How about the reverse—are U.S. buyers interested in foreign markets?

Hardie: I am a firm believer that both macro as well as industry-specific trends that exist will continue to attract foreign buyers. A weak dollar as well as the opportunity to invest in infrastructure assets here in the United States are two very positive dynamics that will draw the interest of foreign buyers. On the regulated side, we'll probably see some resistance to foreign buyers of regulated assets, but an opportunity will always exist for merchant generation to be attractive to foreign buyers without the political hurdles associated with a regulated asset.

Dillavou: I'd certainly agree with Steven's earlier comments about U.S. assets being relatively cheap. That, of course, may make international assets more expensive, although much of the energy market is a global market.

Certainly given the nature of the market, there are a number of U.S. buyers that will be looking at international projects because of their global reach, particularly in the service and exploration businesses where we will see a fair amount of international activity going offshore. We also have a kind of dichotomy. While there are some countries prone to geopolitical risk–making them less favorable for investment, there also are a number of economies that have become much more stable, thus providing new opportunities. So I think we will see increased activity from U.S. buyers as they look to expand into these regions.

Could you give some specific examples?

Dillavou: Throughout parts of Asia and South America we've seen economies strengthen, and even in places like Mexico the economy has become much more stable, so it's a better investment climate for buyers as they consider going international. Then there are other economies, such as Venezuela's, that investors are avoiding, as the geopolitical environment has not been suitable for M&A.

Agresta: I certainly agree with Jim that currency valuation is only one factor; a big factor, but only one factor. It will attract certain kinds of buyers to the United States because our currency is relatively cheap, and it will inhibit others from going abroad, but it won't inhibit everyone because there are lots of other strategic reasons to place investments overseas in areas that are not shut down by expensive exchange rates.

Could you describe the relative valuations within the major energy subsectors?

Dillavou: First of all, if we are talking utilities, because they're regulated operations, we've said the activity level is not going to be that high, so I would expect those valuations to remain fairly steady. And because regulated operations have a steady return, any drop in interest rates will have a positive impact on valuation. With respect to the E&P business, where we have high prices, we should continue to see a strong market, but I don't think prices will be that high or out of line in relation to the underlying commodity prices. Most buyers are not taking the view that prices will escalate significantly. In fact, they're discounting current levels when looking at valuations. Throughout the rest of the sector, particularly in the midstream areas and in the service sectors, business has been strong and valuations should hold up well. Again, the overall environment in the credit market will be a limiting factor in looking at valuations. Buyers will have to physically pay for acquisitions with more equity.

Agresta: It seems to me there's a potential for a shift in relative valuations once the United States has carbon regulation. It's almost certain we will have carbon regulation, but what's not certain is whether it will be effective and, therefore, whether it will change valuations across the sector. But I think that's a big question mark sitting out there that we'll begin to understand the answer to in two to three years, though it will probably take another three to five years after that to see the full answer.

Hardie: Generally speaking, we've seen generation asset values trend higher over the last 12 to 18 months, and with the interest rate environment that's likely to exist over the next six to 12 months, I would expect that trend to continue. The commodity markets, to a large measure, control where people see oil and gas businesses trading, and thus where those M&A deals will get done. So I think that's really a function of where commodities move, and my guess is as good as anybody's. We've seen a lot of weakness in the valuations on ethanol businesses, as there has been a glut of those companies recently. I think that's a temporary thing. That market will sort itself out, find equilibrium, and then, because of the political environment, I expect continued upward movement once some stability in the market is achieved. The same is true for the rest of the renewables. They've continued to have strong valuations, aside from the ethanol businesses suffering recently, because of the overbuilding that's taking place.

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