

structures without considering the potential for a shift in the capital market environment or downturn in valuations can run into financial problems down the road.”

The trick is to be able to manage for possible future scenarios while working to achieve earnings growth. Both traditional utilities and private equity players want to own more hard energy assets that produce reliable and recurring revenues.

Traditional utilities have emerged from the credit meltdown of the early 2000 time period by reducing their debt and selling noncore assets while focusing on their intrinsic strengths. Meanwhile, private equity firms such as Goldman Sachs and First Reserve want more action because they understand these energy markets and feel as if they can maximize the returns. They are particularly interested in buying power plants.

Without a doubt, deals will get done. It appears that both lenders and utilities have learned to pace themselves while exercising the necessary due diligence. Nevertheless,

both the state regulatory commissions and the credit rating agencies are concerned about any renewed exuberance that could temporarily inflate market values. It's easy to get caught up in the all the merger hoopla.

“I think utilities have learned,” says Drew Spitzer, vice president of Harris Williams & Co., a middle-market investment banking firm Richmond, Va. “We have not seen the same dynamics that led to the bubble happening in the 1990s. Interest is now at an all-time high. But, we have seen a lot more cherry picking of assets that fit neatly into a company's overall business plan.”

After a long hibernation period, investors are putting renewed pressure on utilities to achieve greater earnings growth. Utilities are therefore seeking to expand through acquisitions — deals that could involve the purchase of specific assets or the buyout of whole companies. While the future of the super-regional utility is cloudy, other kinds of deals are on the horizon. Both consumers and investors can bank on that. ☺

fund transactions in the United States to date have involved smaller companies (Duquesne, Northwestern), given their growth, infrastructure funds will be able to acquire substantially larger targets in the future. Private equity funds and hedge funds, which are more willing to own risk than are infrastructure funds, are more attracted to entities with substantial unregulated generation. The size and number of these funds continue to increase, with many funds in excess of \$10 billion.

❖ **SHAREHOLDER ACTIVISM.** *An increasing level of shareholder activism has been experienced in the overall equity market, driven primarily by hedge funds looking to achieve increased “alpha” in a highly competitive market. This phenomenon is continuing to migrate on a selective basis to the utility sector where some shareholder activists have encouraged M&A transactions.*

❖ **FOREIGN (EUROPEAN) BUYERS.** *European utilities have tended to focus on opportunities on their continent, but with more recent consolidations in Europe further opportunities for European utilities in the region may become limited. The larger European utilities have the size and credit quality to pursue major transactions in the United States and benefit from stronger currency.*

❖ **DISAGGREGATION TRANSACTIONS.** *While disaggregation transactions can take many forms, the financial community is generally supportive of these types of transactions, as they create more focused corporate entities and purer plays for investors. Recently, Duke spun off its gas business, Dominion is presently pursuing a sale of its E&P business, and other companies are pursuing other forms of disaggregation or restructuring. Certain utilities may also consider disaggregation transactions where the unregulated generation business is separated from the regulated transmission and distribution business. Investors see potential value creation from this type of transaction, as unregulated generation can be financed much more aggressively as a separate entity and the metrics used by the financial markets to value the two businesses are different.*

❖ **ENVIRONMENTAL.** *At this point, it is not clear how the increased focus on environmental considerations will impact the level of future M&A activity. Environmental considerations, however, will be an increasingly important part of the M&A assessment process, as a company's environmental policy and the characteristics of its asset base will have significant impact on a company's attractiveness as a partner and on its underlying valuation.*

Kenneth Marks is managing director of Morgan Stanley's investment banking division.