



The time is ripe. The Dow Jones utilities index grew 22 percent in the last year. It's a development that could be enhanced by higher electricity prices and new investments in transmission reliability and renewable energy technologies.

Potential suitors, however, will need to properly value the hard assets as well as whether prospects have upgraded their infrastructure to comply with environmental laws. They will also examine whether those companies have been able to revise their rate structures to comport with higher energy prices. And, finally, acquirers will be considering the intrinsic growth rates in the jurisdictions where the utilities reside.

MARKET FUNDAMENTALS

To be sure, the past still haunts the utility sector. The hustle and bustle of the 1990s spurred some utilities to overreach. An aggressive generation build-out led to a glut of power on the market. In the end, some unregulated power generators were left with underutilized assets that lost a lot of money.

Fitch Ratings still has some concerns. In the short run, it says that the economy along with eager capital markets has buoyed all segments within the capital-intensive utility industry. Low interest rates and the entrance of new equity investors have improved the group's liquidity and will help companies rebuild infrastructure and meet environmental mandates.

But those same fundamentals may produce future "fallout," says Ellen Lapson, an analyst with Fitch. Easy money not only has facilitated the number of mergers but also has prompted some enterprises to possibly pay too much for both specific assets and whole companies. Only time will tell. In recent times, Duke and Cinergy combined in a \$9 billion deal. Meantime, NRG acquired Texas Genco for \$7 billion and Berkshire Hathaway bought PacifiCorp for \$5 billion.

"Capital market conditions that are currently positive for this sector will eventually turn less accommodating," says Lapson. "Companies that form growth plans and financial

Outlook for M&A

Factors That Will Shape Future Nuptials

BY KENNETH MARKS

FOLLOWING A year in which two large announced transactions were terminated (Exelon/PSEG and FPL/Constellation), it is appropriate to reflect on the outlook for M&A activity in our sector.

On balance, we believe that M&A activity will continue at a relatively strong pace, although we believe the composition of this activity may shift temporarily, with potentially fewer large domestic corporate-to-corporate mergers and a greater number of transactions involving utility combinations with nontraditional or possibly foreign buyers or involving disaggregation transactions to create more "pure plays."

In addition, we expect further consolidation in the merchant generation area, as the benefits of scale are greater and the synergies created can typically be retained. One overriding factor supporting higher levels of M&A activity is the strength of the capital markets, including strong valuations in the equity markets and the availability and attractiveness of financing in the debt markets.

Regarding utility mergers, we believe that informed participants recognize that the factors that led to termination of the two utility transactions were relatively unique to the deals involved. Consequently, corporate

managements are continuing to evaluate and pursue potential M&A transactions, assessing the business and financial opportunity, coupled with a regulatory assessment of the ability to obtain acceptable regulatory approvals for their specific transaction. In assessing potential regulatory compacts, we believe that utilities will become more expansive in considering approaches to allocate synergies created in a transaction – including, for example, their use in funding "green" investments or other socially desirable programs.

As we gauge M&A activity going forward, there are a number of developments which will likely impact the level and characteristics of this activity.

❖ NONTRADITIONAL BUYERS.

Nontraditional buyers (including infrastructure funds, private equity firms and hedge funds) continue to grow in size and number and importantly their knowledge of the sector. Infrastructure funds, which are particularly focused on the utility sector due to its stable cash-flow generation, benefit from having a low cost of capital, limited need for leverage and long holding periods. While infrastructure-

EDITOR'S NOTE

Investment banker Kenneth Marks was the subject of an *EnergyBiz* cover story in March/April 2005. We are pleased to present his current thinking about the future of power sector mega-deals.



▲ MARKS

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.