23 August 2018

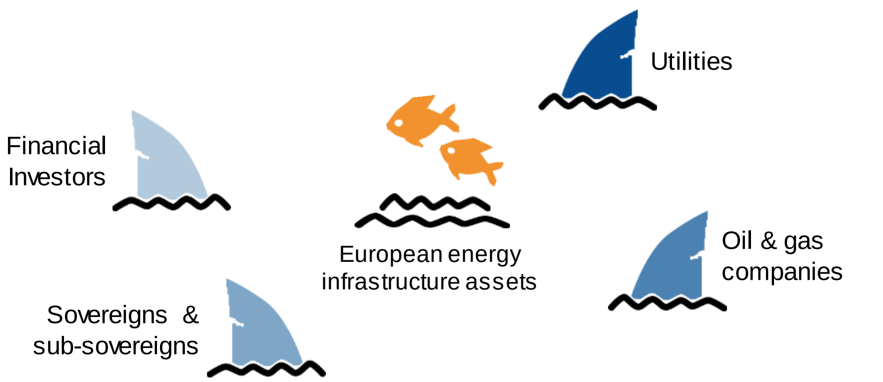
Corporates

European Utilities
More predators than prey as deal-making pushes asset prices higher

European utilities have splurged on acquisitions after years of retrenchment. More than USD 50bn in deals are likely in 2018. Yet growing competition for assets from a wider circle of investors may be storing up trouble as valuations rise. Utilities can ill afford to stay out of the game for risk of losing market share despite a natural reluctance to overpay for assets and embark on mergers.

The risk appetite of European utilities has grown after several years of i) cleaning up portfolios of generation assets ii) improving balance sheets and iii) cost cutting. The renewed interest of the utilities' executives in growth amid growing political pressures coincides with still low interest rates, ensuring that energy infrastructure assets and their promise of stable long-term cash flows are increasingly in demand from a wider selection of other investors: Sovereigns and sub-sovereigns, financial investors and increasingly oil & gas companies. Financial investors in particular are steadily increasing their exposure, having participated in more than a third of recent executed deals.

Figure 1: European energy infrastructure circled by different stakeholder groups



Source: Scope illustration

The danger is that if utilities do not take up M&A opportunities, fearing that deals might stretch their balance sheets as valuations rise, they risk giving up market share to industry outsiders which could in turn undermine their long-term growth prospects and credit quality. A complicating factor for potential buyers and sellers is growing government sensitivity about the strategic importance of energy infrastructure in Europe.

Deal making in Europe this year illustrates the fast-changing landscape:

- In Germany, state-owned development bank KfW acquired one of two 20% stakes up for sale in electricity transmission company 50Hertz on the instruction of the government in Berlin after the investment had elicited the interest of State Grid Corp. of China. Belgian grid operator Elia acquired the other tranche.
- State-linked Chinese investors are competing for other European infrastructure assets: China Three Gorges launched an unsolicited EUR 9bn takeover bid for EDP and China Southern Power Grid is buying 25% of Luxemburg grid operator Encevo.
- Germany's E.ON, which finalised the sale of a 47% stake in Uniper, against its management wishes, to Finland's Fortum, also agreed a complex EUR 20bn asset deal with RWE, refocusing their respective businesses on regulated grids and electricity generation through the break-up of Innogy.
- Oil & gas corporates are testing the waters in electricity with French oil major Total acquiring independent power producer Direct Énergie for EUR 1.4bn and Spain's Repsol acquiring Viesgo's low-emission assets and retail business for EUR 750m.

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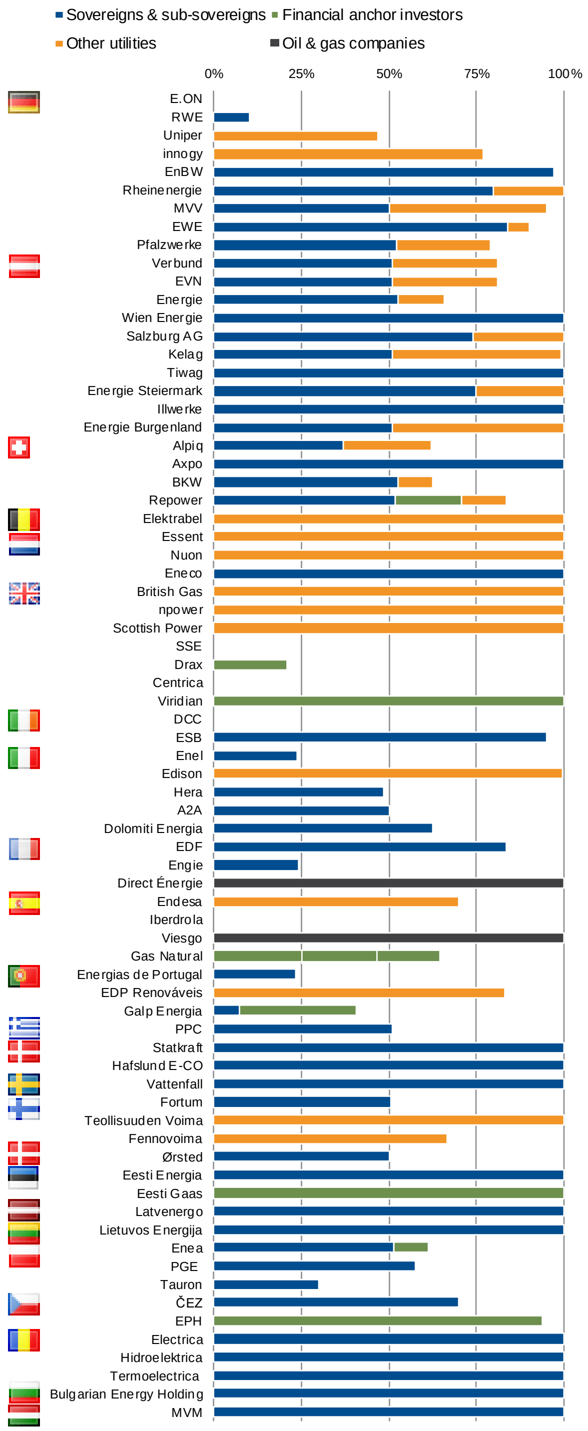
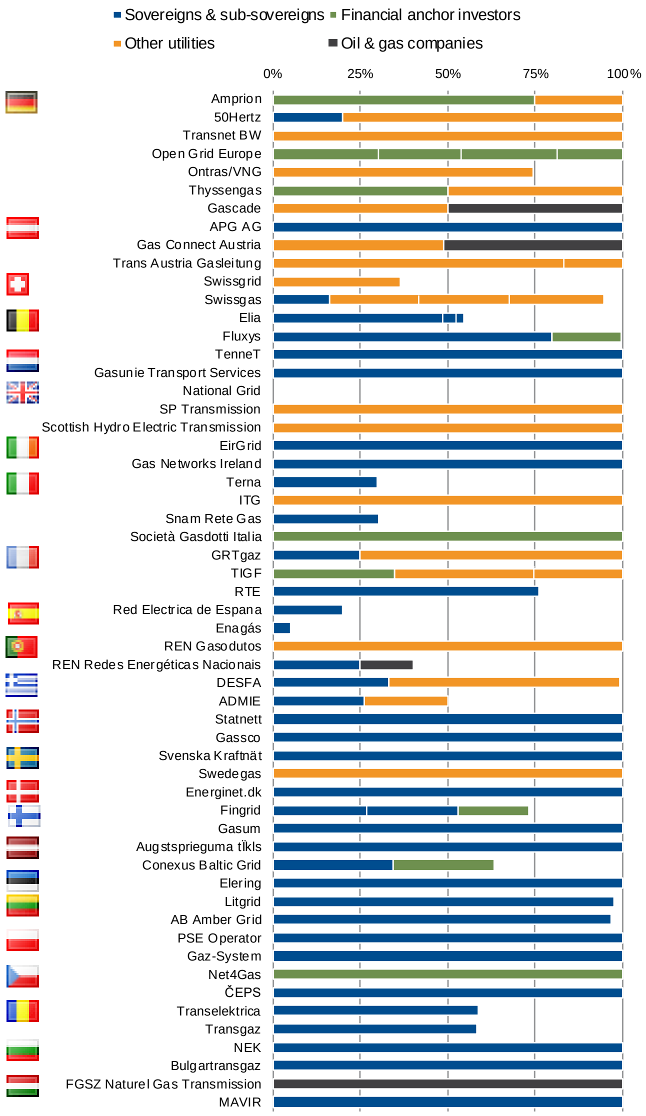
Increasingly diverse stakeholder group for major European utilities[1]

Figure 2: Major European integrated gas and/or electricity companies and power generators: Major shareholders



Source: Latest company information, Scope

Figure 3: Major European gas and electricity TSOs (transmission system operators): Major shareholders



Source: Latest company information, Scope

[1] In case a major shareholder, i.e. other utility or holding company, is a government-related entity, Scope classifies that shareholder as owned by a sovereign or sub-sovereign; in cases where the utility is jointly owned by two or more entities, all anchor shareholders are displayed; a blank field indicates a large free float of the company's shares and no significant shareholder.

Increasingly crowded waters for utilities investing in Europe

Different stakeholder groups with different interest for European utilities assets

The range of deals in the utilities sector in Europe illustrates the powerful new groups of stakeholders with an interest in energy infrastructure assets in the region:

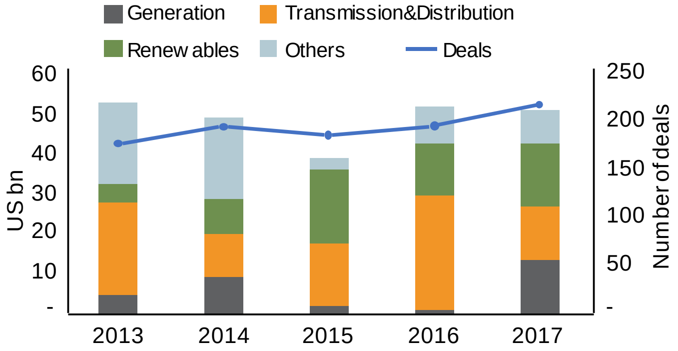
- **Financial investors** such as private equity, infrastructure funds and insurers are in search of satisfactory returns after an unusually long period of ultra-low interest rates, while benefiting sometimes from easier funding than corporates.
- **Sovereigns and sub-sovereigns** (governments, federal states, municipalities) can face political pressure to reverse privatisations, reinforce their public-sector mandates, or undertake politically motivated deals as protectionist pressures grow. Moreover, state-owned companies, particularly from China but also the Middle East, are increasingly eyeing European infrastructure assets.
- **Oil & gas companies** are joining the hunt for utility assets. Scope believes that those players are looking for increasing diversification and 'forward integration', particularly in light of volatile oil & gas pricing, hence their search for assets which could provide a buffer from potential volatility in the core business or broaden their access to retail rather than industrial customers. These companies are also laying long-term plans for what might replace their core business if and when hydrocarbons start playing a significantly less important role in economic activity.
- The incumbent **utilities** are jostling for position as foreign competitors from outside Europe look to expand their geographic footprint in the region.

Scope regards this increasingly diverse stakeholder circle as a feature of infrastructure investing in Europe, with energy assets joining others such a water utilities and airports, which sets it apart from other sectors.

Intensified battle for assets displayed by rising valuations and accelerated transaction volumes

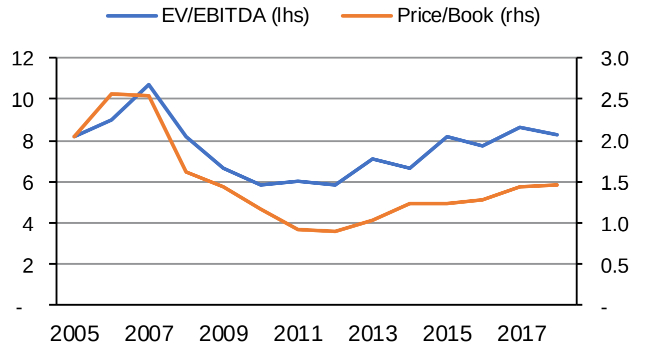
Given the intensifying battle over compelling assets, prices are rising, visible in increased stock market valuation multiples for listed utilities, up at new highs, particularly for regulated utilities. Utilities stocks (EURO STOXX Utilities) have risen on average by 25% in the past five years based on enterprise value/EBITDA multiples (see Figure 5). Hence, the price premium which needs to be paid on these industry multiples for acquiring follows that pattern, particularly when different stakeholders will be fighting over the acquisition target. Reflecting the landmark transactions in 2018, e.g. Fortum-Uniper, CVC/Grupo Alba-Gas Natural Fenosa, Allianz-Elenia; Elia/KfW-50Hertz, and potential transactions such as China Three Gorges bid for EDP, deal volumes are likely to surpass the USD 50bn mark in 2018 (see Figure 4).

Figure 4: Power transactions in Europe - Deal value and volume, by segment



Source: EY analysis based on Mergermarket data, Scope

Figure 5: EURO STOXX Utilities: Average valuation multiples



Source: Bloomberg, Scope

M&A and credit risk: The danger is more medium than short term

Higher transaction prices as a function of higher sector valuation and higher price premiums

For (sub)sovereigns and financial investors, increased transaction multiples as a function of the increased sector valuation—plus a price premium which reflects the stiffened competition among potential bidders—are little threat to their credit quality. The integration of a utility is less likely to affect the overall cash flow generation of the investor. They also usually benefit from better financing conditions than conventional corporates. In contrast, elevated transaction multiples might raise issues for the credit quality of corporates such as utilities and oil & gas companies if paid multiples prove to have been too high and cash flow from the acquired ventures turns out to be weaker than expected.

High transaction multiples not a problem as long as credit is cheap …

From Scope's perspective, overpaying is not necessarily a huge problem as long as money remains cheap. Scope believes that many European utilities are back on the acquisition trail precisely because they have more financial headroom after years of paying down debt and reducing costs as they grappled with the financial crisis, poor power prices, and abrupt regulatory changes in Europe.

… but may result in rating pressure if refinancing happens in less benign market conditions

However, there might be a sting in the tail of such accelerated M&A activity when it comes to refinancing deals in the future in potentially less favourable conditions.

Financial investors are driving up valuations

Financial investors primarily looking for robust, regulated infrastructure

The increasing role of financial investors such as infrastructure funds, insurers or pension funds in the European utilities sector is following a similar pattern in other infrastructure segments such as airports and water utilities. Financial investors— e.g. Macquarie, Allianz, Singaporean sovereign fund GIC, Swiss Life—which are under pressure to deploy investors' money, have been enticed by the assumed robust cash flows generated particularly by regulated energy utilities.

Financial investors responsible for 1/3 of deals and more than 2/3 of transaction volume

Scope observes that these investors are broadening the range of energy assets in which they are interested, venturing beyond projects, such as wind farms and solar parks, to do landmark deals involving the acquisition of significant stakes of more than 20% in some utilities or even joint control with other investors. According to A.T.Kearney and data from Dealogic, the share of financial investors has grown significantly over the last few years, having reached more than 1/3 based on the number of transactions and more than 2/3 based on the deal values.

The trend is helping push up valuations, as financial investors typically benefit from easier credit terms than corporates, particularly for regulated infrastructure assets.

Figure 6: Financial investors taking a rising share of total deals as measured by deal value

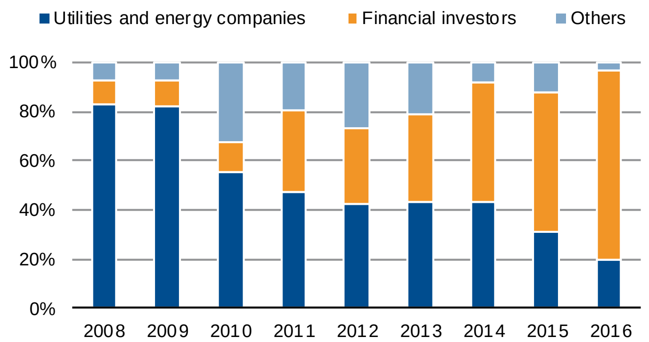
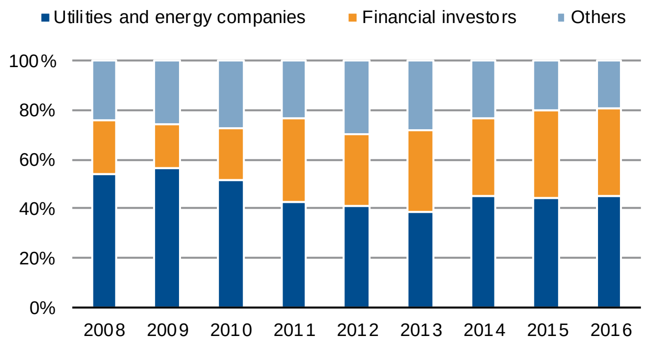


Figure 7: Financial investors taking a rising share of total deals as measured by number of deals



Source: Dealogic database; A.T.Kearney analysis in A.T.Kearney 'Mergers and Acquisitions in Utilities 2017, Scope

Figure 8: Selected landmark deals of financial investors in European utilities

Investor	Target	Year	Acquired stake
CVC Capital Partners and Grupo Alba	Spanish Gas Natural Fenosa	2018	20%
Consortium of Allianz, Macquarie Infrastructure and Real Assets and The State Pension Fund Valtion Eläkerahasto	Finnish DSO Elenia Group	2018	100%
Consortium of Allianz and Canada Pension Plan Investment Board	Distribution Business of Spanish Gas Natural Fenosa	2017	20%
Consortium of Abu Dhabi Investment Council, J.P. Morgan Asset Management and Swiss Life Asset Management	Portuguese Naturgas Energía Distribución	2017	100%
US-American infrastructure fund Global Infrastructure Partners	Spanish Gas Natural Fenosa	2018	20%
Consortium of Macquarie Infrastructure and Real Assets and Swiss Life Asset Management	Italian gas TSO Societa Gasdotti	2016	100%
Consortium led by Macquarie Infrastructure	British National Grid Gas Distribution Ltd	2016	61%
Dutch infrastructure fund DIF	German gas TSO Thyssengas	2016	50%
Singaporean sovereign fund GIC	French gas TSO TGIF	2013	35%
Consortium of Allianz and Borealis Novus Parent B.V.	Czech gas TSO Net4Gas	2013	100%
Consortium of Macquarie European Infrastructure Fund 4, Infinity Investments, British Columbia Investment Management Corporation and MEAG	German gas TSO Open Grid Europe	2012	100%
Consortium under the lead of Commerz Real AG	German electricity TSO Amprion	2011	74%

Source: Scope

Sovereigns and sub-sovereigns caught between privatisation and reverse privatisation strategies

Different degree of sector privatisation across Europe

Historically, many utilities have been so-called government-related entities given their role in providing public services. As can be seen in Figures 2 and 3, many national or regional government are still the controlling shareholders in European utilities, particularly for critical infrastructure e.g. operators of nuclear power plants or services which fulfil a public mandate such as transmission and distribution, notably in Central and Eastern Europe but also in the Nordic countries. Some countries such as Austria, Denmark and Norway require state control over critical utilities by law.

Trade-off between public-sector mandate and the need for privatisation

Sovereigns and sub-sovereigns caught between competing pressures to pressure to privatise and consolidate control over energy infrastructure. Selling energy assets is a good way to raise cash and reduce public debt and state spending. Prominent examples include Portugal and Greece but also France which is planning to reduce stakes in incumbent energy companies EDF, Engie and RTE. On the other hand, living up to the demands of public-sector mandates, which private-sector companies have sometimes struggled to do, and wariness about strategic assets falling into foreign hands are arguments for avoiding or reversing privatisations.

Protectionism and political pressure as a new forces for M&A in the utilities landscape

Scope sees a growing bias towards reverse privatisation, with protectionism is a new driving force.

- Public pressure for improved performance from some utilities in conjunction with the looming risk of underinvestment, particularly grid operators or water utilities, which led to the reverse privatisation of German municipal utilities, e.g. in Berlin, Cottbus, Leipzig, Bochum, Hamburg.

- Growing interest of foreign sovereign wealth funds and state-owned companies, from China but also from the Middle East, in European assets, including utilities. Prominent recent examples include Chinese State Grid Corp. and China Three Gorges.
- The related tendency towards protectionism against the growing influence of these non-European investors. Recent examples include interference by the German government in the bidding for 50Hertz, or action by Poland in 2016 when the ruling Law and Justice party put assets owned by French utilities EDF and Engie on a list of firms deemed important for energy security to block their potential sale.

Coming back to valuation, such reverse privatisation helps push up sector multiples, given the sovereigns' and sub-sovereigns' different rationale than achieving the best pricing which are justified by anticipated cash flow recognition.

Chinese companies stand out as increasingly acquisitive in Europe

Chinese ventures eyeing European infrastructure assets

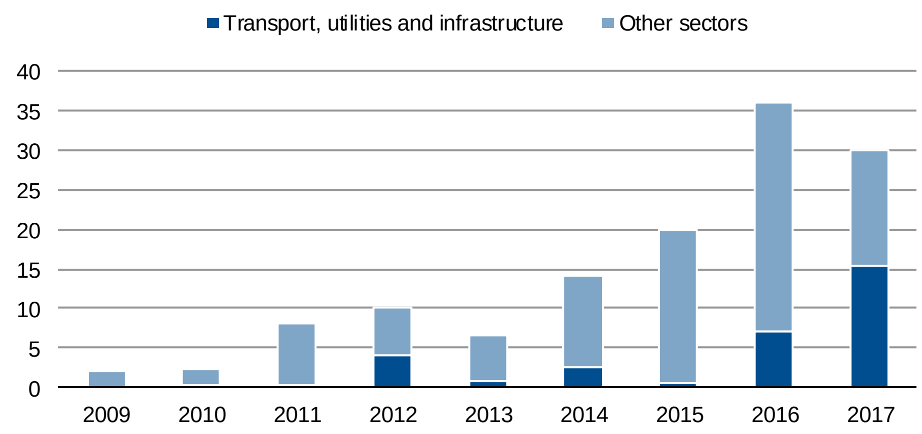
Chinese state-linked and other companies have long been eager to invest in Europe, but in recent months, the energy sector has been in their M&A focus.

- Chinese State Grid Corp. has acquired stakes in Greek ADMIE, Italian Terna and Portuguese Redes Energéticas Nacionais, but was thwarted in trying to buy 20% of Germany's 50Hertz.
- China Three Gorges acquired 29% of Portuguese EDP in 2012 and has now bid for the shares it doesn't already own. The Chinese company made a landmark deal by acquiring 80% of German offshore park Meerwind in 2016.
- Most recently, Chinese state-owned company China Southern Power Grid bought into Luxembourg's grid operator Encevo.

Infrastructure already makes up half of Chinese direct investments

Fast-growing Chinese investment in European utilities and other infrastructure assets (see the chart below) is such that it made up around half of Total Chinese foreign direct investment in the EU in 2017. So this new competition from overseas is likely to increase takeover price premiums.

Figure 9: Strong growth of Chinese foreign direct investment in the EU (in EUR m)



Source: Rhodium Group in 'EU-CHINA FDI: Working towards reciprocity in investment relations', Scope

Figure 10: Selected landmark deals of (sub)sovereigns in European utilities as the acquirer

Investor	Target	Year	Acquired stake
City of Oslo	Norwegian utility Hafslund to be merged with E-CO Energi Holding AS under a new holding company owned by the City of Olso by 100%	2018	46%
German KfW	German TSO 50Hertz	2018	20%
Chinese state-owned company China Southern Power Grid	Luxembourgish Encevo	2018	25%
Chinese State Grid Company	Greek electricity TSO ADMIE	2017	24%
City of Hamburg	German DSO Stromnetz Hamburg GmbH	2016	100%
Chinese holding company Beijing Enterprises	German company EEW Energy from Waste	2016	100%
Azerbaidschanean SOCAR	Greek gas TSO DESFA	2016	66% (but deal failed)
City of Cottbus	German municipal utilities Stadtwerke Cottbus	2015	75%
Land of Berlin	Berliner Wasserbetriebe	2013	
Consortium of 400 municipalities	German gas and electricity DSO E.ON Thüringer Energie Aktiengesellschaft (ETE)	2013	82%
Chinese State Grid Company	Italian CDP RETI which holds a 29.85% stake in Terna S.p.A. - Rete Elettrica Nazionale and a 30% stake in Snam	2014	35%
Chinese State Grid Company	Portuguese TSO Redes Energéticas Nacionais	2012	25%

Source: Scope

Oil & gas companies seek diversification and long-term business protection

Oil & gas companies are increasingly diversifying their product portfolios

Scope believes that these companies will become more and more active investors, increasingly willing to “test the waters” in electricity. Oil & gas companies are positioning themselves as more diversified energy companies, creating more competition for established utilities, even though process is likely to be slow.

As energy consumption shifts further from coal and oil towards natural gas and renewables, the asset portfolios of oil majors are following suit. A related trend is greater electrification in many economic sectors, notably in transportation (“e-mobility”) which remains a leading consumer of oil products.

Venturing into electricity production is a way for the oil & gas companies to secure their business models for the very long term, not least with the additional pressure from some investors for them to hold “greener” asset portfolios. The goal for some companies is to create a presence across entire electricity value chain, and start building it up based on their existing expertise.

Gaining exposure to electricity may help offset volatile oil and gas prices

Oil & gas firms are also looking for increasing diversification (geographies and products) and ‘forward integration’, particularly in light of volatile oil & gas prices, thereby looking for assets which could buffer potential volatility from the core business to some extent or which would broaden the outreach to the residential market and businesses.

While some oil & gas companies such as Italy's ENI but also Russia's Gazprom and OMV of Austria have a long track record in electricity and gas (ENI is heavily involved in power generation, Gazprom holds stakes in several grid operators, OMV is involved in both power generation and gas transmission), others European incumbents such as TOTAL, Royal Dutch Shell and Equinor (former Statoil) are only now entering the arena.

Figure 11: Selected landmark deals of oil & gas companies as the acquirer

Investor	Target	Year	Acquired stake
French TOTAL	French Renewable Energy IPP Direct Energie	2018	73%
Dutch Royal Dutch Shell via its British subsidiary Shell Petroleum Company	British gas & electricity supplier First Utility	2018	100%
Spanish Repsol	Power generation assets and retail business of Spanish Viesgo	2018	100%
French TOTAL	2 gas-fired power plants in France	2018	100%
French TOTAL	French Renewable Energy IPP EREN Renewable Energy SA	2017	23%
Russian Gazprom	Latvian gas TSO Conexus Baltic Grid	2017	34%
British BP	UK based solar developer Lightsource	2017	43%
Oman Oil company	Portuguese TSO Redes Energéticas Nacionais	2012	15%

Source: Scope

Intra-sector M&A: Utilities may have to work harder to protect market share

Dilemma for European utilities

From Scope's perspective, European utilities are caught in a dilemma. Any company naturally looks at competitors when it comes to seeking growth through acquisition, but such an intuitive strategy may prove more demanding for European utilities when competition for assets has become more fierce. The most recent break-up plan of Innogy was likely formed by E.ON and RWE in order to avoid a potentially hostile takeover bid for Innogy.

From contraction to expansion mode

Deleveraging, asset rotation and downsizing was the name of the game for most European utilities over the past eight years. Adverse market conditions, with weak commodity/wholesale prices, growth in renewable capacity and de-carbonisation policies drove executives to restructure portfolios if not whole business models.

With the asset-stripping phase now over, European utilities are confronted with rising asset prices as they contemplate bulking up their businesses again.

Risk of overpaying

The catch? Executives have to balance natural reluctance to overpay for assets or undertake mergers—like the failed tie-up between Spain's Gas Natural and Portugal's EDP—with the risk of losing market share to new entrant. Lost market share might be to the detriment of their credit quality in the long term, either in itself or because that then forces management into M&A deals at a later date in more unfavourable circumstances. It is a difficult trade-off between "staying in the game" and accepting prices which might not pay off in the medium term.

Figure 12: Selected landmark deals of intra-sector M&A

Investor	Target	Year	Acquired stake
German RWE and E.ON	Innogy	2018	Full breakup intended
Finnish Fortum	German power and gas company Uniper	2018	47%
Consortium between Italian Snam, Spanish Enagas and Belgian Fluxys	Greek gas TSO DESFA	2018	66%
Belgian Elia	German electricity TSO 50Hertz	2018 2010	20% 60%
Spanish Gas Natural and Portuguese EDP wanted to merge		2017	Deal failed
Russian Rosatom	Finnish nuclear power plant operator Fennovoima	2016 (deal delayed over safety clearence)	34%
Consortium between Spanish Enagás and Belgian Fluxys	Swedish gas TSO Swedegas	2015	50% each
Consortium between Gingko Tree and EDF Invest and Dutch Pension Fund PGGM	Spanish gas DSO Madrileña Red de Gas	2015	
Dutch Tennet	German electricity TSO assets of E.ON	2009	100%

Source: Scope

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