

Plugging into the Energy Sector

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PLUGGING INTO THE ENERGY SECTOR



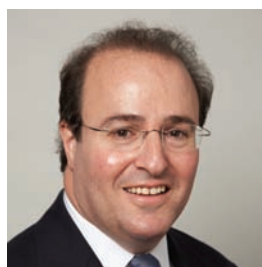
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Perhaps no other industry is undergoing the kind of sea change that is currently being seen in the energy sector. High commodity prices are impacting oil and gas, while inefficiencies in the electricity grid have opened the door for other alternatives. And, of course, the regulatory environment pressures all areas in the sector. *M&A* corralled top pros throughout the sprawling landscape to discuss the impact on dealmaking. Taking part in the conversation were Lazard Managing Director Jonathan Mir; George Henry, an MD at Lincolnshire Management; Deloitte's Jim Dillavou, who heads the firm's energy group; Neil Suslack, a co-founder of VC Braemar Energy Ventures; and Energy Spectrum's Jim Spann, a managing director at the firm (not pictured above).

Mergers & Acquisitions: *There's obviously been a lot of news out there in the energy sector. To start off, let's talk about what everyone is seeing in their respective fields.*

Mir: We cover a huge swath of the energy value chain and the answer is a little different depending on where you are looking in the space. In the traditional, publicly traded, investor-owned, utility space there is a slow, but steady consolidation trend in the country right now. But it's still hard to get deals done because the industry doesn't support very high premiums, which makes it difficult to create transactions that meaningfully exceed the stand-alone value proposition for either the buyer or seller.

The alternative energy space is an area with the most explosive growth. It is being driven by high commodity prices, and regulatory requirements that didn't exist a number of years ago. State-by-state RPS requirements in the electricity space, ethanol blending targets in the biofuel space, and then, finally, technologies that were completely nascent or didn't exist ten years ago are starting to approach commercialization. Types of transactions in alternative energy can vary widely. One type is the almost frenzied levels of merger and acquisition activity, which is evident in the wind space where large European players are willing to pay almost any price to enter the United States market. They view the U.S. as fragmented and a highly attractive regulatory regime. Very different from those that are the newer and less established companies looking for growth capital as they establish their business plans in other sectors of the market.

Dillavou: Overall, we are seeing a very strong level of activity in the energy markets, and I don't really see that slowing down at all. There is a lot of interest, but not necessarily a lot of established companies. Throughout the whole midstream space and the services sector we are also seeing lots of activity. And, of course, there is always a lot of buying and selling in E&P [exploration and production]. The large integrated companies continue to look at, and sell off, pieces of their businesses and provide opportunities from that standpoint.

Suslak: If you look back at the energy business, the amount of revenue that was reinvested back into research and development [R&D] is a very low number compared to other industries. It's about two or three percent. Even fairly mundane businesses like building products and materials were still outpacing energy investment in R&D for a very long period of time.

This has created a little bit of pent-up demand for

new technology and all of the drivers are coming together now. And part of this is historic because a lot of the energy businesses were regulated, and in some cases they were monopolies. You are starting to see companies like GE, Seamans and some of the chemical companies making acquisitions of early-stage, venture-backed businesses and we think that the trend is going to continue.

Mir: We work with a lot of companies that are attempting to bridge the gap from the pilot stage to the commercialization stage. They are looking to align themselves with large strategic players that have critical in-house capabilities. And there seems to be more openness for very large companies to spend the time and effort working with small companies than you would have seen a number of years ago.

The large entities are really starting to get beyond the not-invented-here syndrome and invest time and effort in initiatives that are very small compared to the scale of the parent organization.



Spann: The oil and gas portion of the energy industry is a depleting asset business, by definition, so that's having an effect on both polar extremes. There is significant demand for capital to replace and provide a new supply of oil and gas, while at the same time, as older fields are depleting and maturing, there is a significant amount of consolidation opportunities that aim to improve efficiencies. And the MLP's [master limited partnerships], both in the midstream space and now in the E&P space, are taking significant advantage of that opportunity.

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Jonathan Mir
Managing Director
Lazard Freres & Co.

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Roundtable

Henry: On the other end of this spectrum, we are seeing a tremendous amount of activity at the smaller services companies. Part of what's driving it is that you have a lot of entrepreneurs who have really worked hard to launch their businesses, and in the last three to five years there has been an explosion in the prices for their services as well as in the demand. Their businesses have just grown beyond where they are comfortable operating them, both from the perspective of putting in the right systems and controls and from a financial perspective.

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bullish on
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Managing Director
Lincolnshire Management

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And since they tend to be local companies, it is not uncommon for us to see a business that may have only two customers. They realize that having two customers is not a sustainable way to build a business, so they look for a partner. Our goal often is to put together something that may go from three customers to 12 customers, so they can build a sustainable platform.

Mergers & Acquisitions: *How is private equity playing in the energy sector? How much opportunity is there and how sustainable is it?*

Spann: Years ago my first boss chastised me for wanting to specialize in energy because it was going nowhere. Yet, here we are, years later, still talking about the same issue. It seems to be an industry that is constantly looking for new capital and has a steady stream of new areas of activity. You have wind power on one end and ethanol on the other, as well as gas drilling in the Rockies, which is a whole new venue, and midstream companies trying to take wellhead production to market. Pri-

vate equity has been an active player in energy for a very long period of time, and we don't see that changing anytime soon.

Suslak: On the technology side, a lot of people say to us: “What's different this time around?”

It's a fair question because a lot of the shift into alternatives is driven by the underlying commodity prices. But it's different today because there are many more drivers at work than just the commodity prices.

There is a tremendous push for new technology to deal with pollution issues; there are problems with storage, both on the fuel side and on the power side; there are also problems with the electricity grid and the way we deliver power to businesses and homes; and, overall, there is tremendous congestion on the system and a lot of inefficiency.

People want these problems solved. This is the reason this trend will keep up for awhile. There are a number of factors at work counterbalancing the fact that we have high prices and we want to wean ourselves from some of the dependency that we have on imports.

Mir: Activity has really been influenced by fundamental changes in the private equity market. They are extremely large funds, for starters. Also, in the last several years, there is the emergence of a new asset class of infrastructure funds that view energy as part of the investment landscape.

They include anything that has a monopolistic cash flow and hard asset positions like roads, bridges and tunnels. In both the traditional private equity landscape and also among particular infrastructure-oriented investors, people start to think about energy assets along a risk-reward spectrum, where a number of years ago there was just a particular return requirement imposed on an investment.

Now people are starting to look at certain assets thinking about the risks involved and are considering lower returns than you would have seen a number of years ago. Transactions around the power and utility space and interstate pipelines will be done with pretty low costs of capital, which drives a lot of activity. Those trends will probably stick around for some time.

Dillavou: Infrastructure assets probably add a more steady return, so they are not commodity sensitive.

Mir: That is certainly the case with assets that are less commodity price sensitive. Assets that are deeply commodity price sensitive end up with a different risk profile and so involve a different return requirement.

Roundtable

“With the tax advantages that [MLPs] have, they are now looking at E&P transactions.”

Jim Dillavou
Head of Energy M&A
Deloitte & Touche

Dillavou: We talked about MLPs with their low cost of capital, and those started with more infrastructure-type investments, such as gas pipelines and so on. But what we are seeing in the marketplace now is that with the tax advantages that they have, they are looking at E&P transactions. And we are starting to see several MLPs for sale, which is certainly a change and says a lot about the viewpoint of the market and investors.



Spann: And as opposed to paying four or five times cash flow for a producing property—which would have been more of the industry standard in the recent past—we are seeing the MLPs being valued at closer to eight to ten times that same cash flow. So there is no wonder that more and more of the operators are looking for ways to monetize those assets.

Mergers & Acquisitions: *What does it take to buy an energy company in terms of due diligence? I imagine there's a lot of factors that need to be taken into consideration?*

Henry: Whether it is a new technology or an established multi-billion-dollar company, each business will have completely different issues.

My firm is typically dealing with entrepreneurs who view operations first, sales second and financial controls last, in terms of importance. Out of the seven deals we have completed, none of the businesses had audited financials; they just had reviewed financials. We had to have different accounting teams go in with us to help put those together.

In one case, we actually insisted that the entrepreneur engage a Big Four accounting firm and get an audit done

before we closed. We moved along the path toward closing under the assumption that if it's a clean audit we would close, but we knew issues could arise.

Spann: In the energy industry, due diligence has some unique characteristics. We think of it in the order of management, resource base, operations, capital access and controls—in that order.

Checking out the management is such a critical issue, it ends up requiring that you tap into the relationships of the industry. You want to ask: “How does this particular team fit in?”

Then you have to bring in the technical guys to look at the resource base, whether it is a midstream project or a drilling venture. You can't touch it and feel it or see what exactly is down there. So we need the technical pros to help us get our arms around the risks involved and the variables.

Finally, the operations and capital access areas tend to require more traditional, more consistent forms of due diligence. And that's where you do a physical review on your own, as well as get the technical folks to look at those assets.

Suslak: On the venture side, we are giving them capital to reach certain milestones and the main thing we focus on is the technology. We really need to understand the issues that they are going to face on the R&D side in order to scale up to the commercial level that they need to reach.

Then, understanding the markets for the technology and the infrastructure issues is really important. So, we spend a lot of time in the markets understanding how competitive a particular technology will be. And then, of course, management, which is probably one of the biggest issues we spend time on.

Mergers & Acquisitions: *Switching gears a bit, how has the credit crunch affected energy deals?*

Henry: We closed three deals over the summer during the crunch, and they were not highly leveraged. Even though we are in the services business, if the E&P companies slow down, our business is going to also slow down.

What we have done is really try to get as much production work as we can. We look to partner with good people. We worked with Deerfield and Silver Point to get two other deals done this summer. So the market hasn't closed if you have good relationships.

Mir: We closed the TXU transaction last week [October, 10], and there is a very significant amount of debt that

needs to be syndicated. One of the more interesting trends to watch would be as spreads widen out, if there is more caution in the lending market, do the more difficult or marginal investments start to become affected. Do the venture debt markets start to become more difficult for younger or growing companies? Does the project finance market become more difficult for companies to navigate as they try to scale up and commercialize technologies?

For example, in the biofuels industry, spreads on project finance went through the roof in a period of just a few months and nearly changed construction plans for a number of companies. To add to it, commodity prices were not working to the benefit of anyone in that business. So it might be interesting to track how deals on the edges of the industry become affected, because that's where you can start to really see changes in attitude.

Henry: We have heard through some of our investment banking contacts that the strategic buyers in the services sector are getting very excited because they think that this is going to at least temper the prices private equity groups have paid.

Dillavou: There is a lot of interest from the strategic buyers and they have all had very strong cash flows, so they are looking to put that money to work and make those kinds of investments. At the same time, from the sellers' perspective, the thought that maybe this is a temporary aberration and prices could be suffering from it, may result in some reluctance to bring assets to market.

Mir: It could potentially. Over the last few years the nuclear sub-segment has been entirely dominated by financial buyers, and strategics have just been completely priced out of the market. If the debt financing market for these assets changed today you might see strategics become more competitive.

Spann: We have not had difficulty putting debt financing in place this summer or even this fall, although we do expect that as risk premiums widen, the cost of funds will climb. We think rates are about to rise, and it does raise some interesting questions relative to the values of MLPs, which tend to be trading as a bond proxy.

Mergers & Acquisitions: *What are the regulatory issues that come with investing in an energy company?*

Spann: One odious regulatory issue that we are all having to deal with is environmental regulations. Every transaction we look at we are constantly trying to de-

termine the status and the situation of the ground water and air around the physical asset and what regulations or capital requirements will be necessary to stay in business.

Mir: There has been some noise coming out of Congress about the acquisition by foreign entities of energy assets. There are some legislative initiatives to increase the teeth of the CFIUS Act. There are pending transactions in the utility market right now that may become relevant to sensitivity around the acquisitions of U.S. assets. So there is a myriad of regulatory complexities, certainly in the power and energy space that people are grappling with. This environment makes some transactions more difficult or requires a much more dedicated level of investment in terms of thinking through the issues you wouldn't have seen a number of years ago.

Dillavou: When we talk about the utility industry, in particular—and having to deal with the state regulators—it's important to have the right message and bring to the table something that's politically acceptable to help settle the deal. What's going on with environmental issues and what will happen with carbon and other types of similar environmental regulations, such as government programs for ethanol, is anyone's guess.



Suslak: It is a little bit tricky to invest based on a regulation because it can always go away, so we tend not to do that, but it's helping people get financing in their early stages.

There is, in Europe, feed-in tariffs for certain technologies. So there is a lot of money at work that makes technologies cost competitive. On the power side, there is the whole issue about reliability standards, which relates back to the grid being very disconnected. There has been some national effort to try and set standards.

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Co-Founder
Braemar Energy Ventures

Roundtable

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Managing Director
Energy Spectrum

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Henry: I think from the services perspective, we see some of our E&P customers run into environmental hurdles. It's not necessarily environmental cleanup issues, but rather just environmental stuff in particular areas that they are not going to be allowed to drill in. And there is a lot of back and forth. We are not involved in those debates, but we are very much attuned to the outcome because it can mean a lot more work, or a lot less work, from a particular customer.

Mergers & Acquisitions: *Is there an opportunity for U.S.-based private equity firms to do more deals abroad, or is it just overseas PE shops coming to the U.S. to do energy deals?*

Mir: We have seen at least two trends of note, first, a seeming increase of foreign investors focused on the U.S. power and utility industries, most recently evidenced by Iberdrola's proposal to acquire Energy East. And if one looked at the largest utilities, and power and energy companies in Europe, you could identify potential interest in the North American market.

The U.S. market is considered extremely fragmented compared to Europe. For example, in Europe the wind business has been around for a very long time and it is already a consolidated industry. This is quite different from the U.S. market, which is growing quite rapidly but is still in development.

Mergers & Acquisitions: *Why is Europe so far ahead?*



Mir: The collective force of local regulation over a number of years. Germany had a Green Party that profoundly affected their political landscape for decades. There is no such analogy in U.S. politics. And so, accordingly, Germany, has the largest base of installed solar in the world, which doesn't seem sensible, but it's how it works. It's what their politics demanded.

Spann: Gasoline and diesel in Europe also carry a carbon tax and have pricing schemes, which created all

kinds of incentives for the countries to come up with alternatives. Wind was the beneficiary of that.

Mir: It is interesting here because the states are really forcing the federal government to address national scale regulatory issues in a way that has already taken place in Europe. Right now, all of the states are developing independent standards across a broad range of energy usage requirements, almost deliberately Balkanizing the landscape.

Because at some point businesses will say this isn't sensible, the government has to create national standards. It is untenable over the long term to have multiple carbon trading regimes existing in different parts of this country. They must simply be consolidated under one national market over time.

Dillavou: Several European power companies are just looking for the right opportunity. But it's not easy to get support for a transaction involving an electric utility. The Energy East transaction is certainly a sign of it.

On the outbound side, I think we are seeing the larger entities looking at energy opportunities overseas, and we are seeing a fair amount of it. It takes a lot more to justify going international, and a lot of energy assets may be in locales that are difficult to do business in, so there is the political risk. It's not for everyone.

Suslak: On the technology side, over the next several years, you might see growing interest from Chinese and Indian companies to buy U.S. technology. China is already the strongest manufacturer of batteries and other devices, such as solar, where that low-cost manufacturing expertise can be very valuable. As those countries bulk up, they will be looking to the U.S. and Europe for acquisition opportunities. It's not occurring yet, but it's quite likely going to happen down the road.

Mir: That may surprise people. We will be surprised to see very large Indian or Chinese companies grab name-brand U.S. businesses.

Henry: We have seen numerous opportunities in Canada and several more in Mexico and chose not to go that direction. But it would sort of fit into our diversification plan.

However, if you look for the next buyer of this business, if it is a private equity group and they want to grow it and then track the ultimate buyer, it may be an international services company.

Mergers & Acquisitions: *Where you think we'll see the*

next big opportunity for investors?

Henry: Eventually what will happen is that the businesses you are working on that are now high-tech will move along the typical company lifespan and become revenue and cash flow producing entities. We've looked at a lot of ethanol-related businesses, a lot of solar businesses, but we just haven't found the right opportunity. We're certainly looking for them, though.

We're getting a lot of opportunities across our desk, although they still look a little too much like venture, but they are getting closer.

Suslak: One of the advantages we have from a technology standpoint is that these businesses can play into the project finance infrastructure market so that they can scale up to be cash-line businesses relatively quickly.

If you have a technology that makes fuel, processes coal or does some kind of refining, you can scale it off relatively quickly by eventually getting to a size at which you can then go to project finance. Then the business can be cash flowing, and from there you can approach the private equity players, who will then find it attractive.

A lot of these technologies are still on cusp, but the next step will be project financing, so you get to the scale that makes it interesting.

Spann: We keep our strategy confined to the lower middle market for midstream companies, so we tend find great opportunities in the incubators for the MLPs. We can put together transactions that are not throwing off the kind of immediate cash flow that the MLPs like to have for accretion purposes. So, whether it is acquisitions and consolidations to reduce costs or new builds, we look to put together systems that reach a significant scale and become good bite sizes for the MLPs down the road. And the companies benefit from the uplift that results from the MLP's low-cost of capital.

Mir: As new technologies approach the commercialization point, there becomes a need for growth from capital that lies somewhere between true VC and traditional private equity. These are companies that are at inflection points where they need to go from demonstration-scale technologies to commercial-scale technologies.

We see a lot of companies get a little stuck at this inflection point.

Mergers & Acquisitions: *Who do you think will pick up some of the slack?*

Suslak: Hedge funds. Project lenders are getting a little more comfortable with scale-up risk, as soon as there is at least one or two plants in the field to demonstrate the technology. So, the gap there may be smaller than it was three or four years ago in a lot of these technologies.

Mir: That's who we call when we need that sort of growth. That's where we go for inflection point companies, most of the time. In other instances we might go to a strategic partner.

Mergers & Acquisitions: *Is there anything interesting on the horizon that we should be looking out for?*

Mir: It will be interesting to watch the convergence of what people had previously defined as the alternative energy space, on the one hand, and then the power and utility space on the other hand. A lot of these small companies are extremely good at identifying clever technologies and certainly have been sophisticated in identifying the ultimate market opportunity, but you need to bridge the gap to truly commercialize. So watching the convergence and the interaction with the traditional utilities space will be quite interesting, actually. It will be a challenge for both sides.

Spann: One of the things that will surprise people is the cost of adding new production, whether it be oil and gas or anything else. It will certainly be an issue in this country and in Canada as well.

It's turning out to be much higher than it has been historically, and that is going to be creating a pretty strong underpinning for those low-cost suppliers. As a result, the cash flow and margins of some companies will be much stronger and much stouter than it might be for others.

Suslak: The growth of the alternative markets is very strong, but at the end of the day, it is going to still be a very small part of the way we are going to get our power. And so there is going to be a bigger push in incremental technologies. It will impact the ways we do things in the existing resources, such as oil, gas, coal and probably nuclear.

The way we get power today is probably going to be somewhat similar to how we will get it several years out from now. So incremental changes, in terms of how those resources are delivered to us—be it gasifying coal or trying to find new sources of gas and oil—will probably be a trend.

Dillavou: Looking at where energy prices are and the continued strength is probably key to a lot of the activity we are seeing. It's obviously an important part of being able to successfully do alternative energy projects, which has created a lot of opportunity when those kinds of things become more viable.

Mir: It would certainly seem to be something to watch as the country finds a consensus on if and how carbon regulations can work here. You are starting to see the impact of the uncertainty in integrated resource planning across the power and utility space where companies are getting their resource plans turned on their head in the middle of their planning cycles because of uncertainty around carbon pricing.

Henry: We are very bullish on natural gas for a lot of the reasons that have already been mentioned—it is clean burning, it's here and we have a lot of it domestically, so it is not a political risk. Also, some of these areas that were once thought of as being too expensive to get gas out of the ground, we've seen technology continue to improve, so it's more accessible. **MA**