

ENERGY

M&A and financing opportunities in the CEE energy & utilities sector

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As one of the few areas that has been almost impervious to the effects of last summer's subprime crash and the subsequent credit crunch, the energy and utilities sector in Central & Eastern Europe has been a goldmine for savvy strategic investors as opportunities in mature markets dwindle. Deal value rose impressively in 2007, and as segments of the industry continue to consolidate, privatise and update their assets and infrastructure, activity is likely to continue throughout 2008. However, all deals have their challenges, and foreign investors may face additional regulatory burdens, even when operating in an EU member state. Furthermore, new and aspiring member states are under intense pressure to focus on renewable energy, which is affecting business strategies in those countries.

The current view

While the global economic downturn continues to make its presence felt, its effects seem to be negligible within the CEE energy and utilities sector. According to a PricewaterhouseCoopers report, Russia and the CIS alone saw total deal value in oil and gas rise

by 19 percent in 2007, to \$35.7bn from the \$30.1bn seen in 2006. Furthermore, average deal size stood at \$870m – over three times the average for similarly-sized regions at \$236m. It is clear that whatever the global market may be doing, the credit crunch has not dampened M&A interest across Central & Eastern Europe. Anja Dotzenrath, a principal at Booz & Company, identifies some of the key drivers behind this interest. “The opportunity to access untapped reserves of oil, gas and coal has always been attractive to investors. The same is true of consolidation and privatisation opportunities in the oil and gas sector, as demonstrated by the Austrian oil company OMV's recent attempts to buy Hungarian rivals MOL. In addition, new investment opportunities in the renewable energy sector such as the joint venture wind farm between Mitsubishi and INOS have opened up the market to further interest, as have Russian upstream oil and gas majors moving up or down their value chain,” she notes. This is set to continue in the short term as long as opportunities remain available and attractive.

Among the key areas of interest to investors

are Russia, Romania, and Hungary. Russia in particular has always been a centre of M&A activity for the CEE region, and both domestic and foreign acquirers have been active in the energy and utilities sector. However, Romania has also been home to several exciting energy projects over the last 18 months, largely driven by privatisation trends. “We have seen the ongoing privatisation project initiated by the Romanian Ministry Of Economy And Finance for the development of the Cernavoda nuclear power plant, as well as other privatisation-driven projects in thermal power stations at Braila, Doicesti, Borzesti, and Galati. The €820m acquisition of Electrica Muntenia Sud by Enel was another pivotal feature of the Romanian energy sector,” says Miruna Suciu, a partner at Musat & Asociatii. She adds that the trend towards renewable energy has not yet gained momentum, but that several projects (mostly involving wind power) are in the pipeline. Deals have also been consistent in Hungary, but generally in the form of smaller investments.

The CEE energy and utilities market is evidently active and healthy, but many projects are in need of further financing to take them to the next level. Companies in the area are generally state-owned enterprises that are crying out for updates to their infrastructure and operational practices. Furthermore, few of them measure up to the latest standards in emissions, security and efficiency. These outdated business models are attractive to strategic buyers in search of potential tactical advantages. Many of them have been Western companies, which bring valuable experience into the market as well as capital. Among the high-profile companies investing in CEE are large Western European utilities such as E.ON, RWE, Enel, and Iberdrola.

The success of strategic acquirers is partly due to the fact that financial buyers have been less competitive in the last year, although they are not completely absent. National

investment groups such as the Czech-Slovak group J&T and Russian investors PCM and IES have made long-term development plans within their home nations. Also, the Czech Republic's PPF Investments recently took over several small local private gas distributors and suppliers in Romania. This is typical of the type of investments they tend to make in the current market: small, or in burgeoning sub-sectors such as renewable energy. According to Ms Dotzenrath, it is not surprising that the private equity industry has played only a minor role in investing in the energy and utilities industry. "There are a few reasons for the relative unattractiveness of this sector in CEE," she says. "First, it is not as easy to cut costs as it is in other industries, so a major part of the private equity 'operating model' is not possible. Second, this industry is very capital intensive, which lowers free cash flows. Finally, the industry has steady cash flows but limited growth opportunities, except in some selected geographies like Turkey."

Knowing the landscape

There are always operational issues to address in any business, and the CEE energy and utilities sector is no exception. One of the pressing issues is the ongoing need for capital, since tangible assets often need to be repaired or replaced on a regular basis for companies to comply with safety and emissions regulations. Another issue is the current trend towards renewable energy. CEE nations that are either part or becoming part of the EU must produce a certain quota of renewable energy, which is putting pressure on them to quickly develop the industry and infrastructure to the required level. This has been particularly tough on oil and gas suppliers, which are expected to find alternative sources of energy within a short timeframe. Consequently, the number of greenfield and brownfield investments in thermal and hydro power has increased rapidly.

Many companies across CEE may be struggling to keep up with the pace of change, and they are not helped by the lack of transparency in local laws. The issue has become more apparent as interest in the region grows, with many potential overseas investors put off by onerous,

unclear or missing legislation. To use Romania as an example, a total of 87 permits are required to install a wind farm. In addition, countries that have recently joined the EU need to revise their legislation to meet EU standards, which adds another layer of complexity to the process. "Following the gradual opening of the market, the Romanian legal framework has been going through an extensive process of alignment with the European directives and standards," says Ms Suci. "These changes have further deepened competition among all players in the market, at every level, and the entry of top European players has pushed standards even higher. Going further, the implementation of European environmental standards on energy-related matters will pose additional challenges to the entire Romanian economy." Furthermore, the implementation of the EU directive concerning the unbundling of supply and distribution activities, combined with the lack of accompanying legislation, will have implications for M&A and investment.

Future growth

Although consolidation has been an important feature of the sector in the past few years, there are hurdles to cross-border deals that may limit the ability of foreign companies to take full advantage of the opportunities on offer. "Cross-border consolidation is unlikely to occur at a rapid rate as most CEE governments play a major role in their local utilities," observes Ms Dotzenrath. "These companies are deemed to be of special strategic significance to their governments and are unlikely to be sold to foreign investors. However, domestic consolidation is gathering pace and shows no sign of slowing down."

In addition, consolidation within the energy sector is not consistent across the board, as some industries lack the drivers that lead to widespread M&A. "In Romania's electricity market, for example, we are unlikely to see consolidation as most of the active companies are leading European players," points out Ms Suci. "However, the potential alliances and consortiums formed at European level among these players could be echoed in the configuration of the Romanian energy sector. Oil compa-

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nies, on the other hand, have shown an increasing appetite to explore M&A initiatives, as in the case of the tentative acquisition of Mol by OMV, or the acquisition of the majority stake in Rompetrol by KazMunaiGaz," she says.

Appetite for investment in the CEE energy and utilities sector should prevail over the next few years. Privatisations and greenfield investments should make up the bulk of activity. Also, Turkey, Croatia and the Former Yugoslav Republic of Macedonia are being considered for EU membership, and their inclusion would open up the region to further capital inflows. Renewable energy will continue to be an exciting area for overseas and local investors. Finally, as the price of oil continues to soar, the cost of refining hydrocarbons has become more affordable, leading to investments in upstream sectors that were not financially viable in the past. As the legislative framework improves, both foreign and domestic investors will be able to reap the benefits of transparency as well as opportunity. ■