The next bubble?

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Financial investors have dominated M&A activity in the US power market for the past few years. Although most auctions for assets continue to be won by the private equity firms and dedicated power funds – taking advantage of exceptional financial market conditions – some auctions now attract bids from strategic players. Industry players have leaner and meaner balance sheets to draw upon, and are starting to get aggressive.

Most power plants coming up for sale stir up healthy levels of competition. Most notably, international investors have played an increasingly prominent part in generation sales. David Albert, managing director in the project and structured finance group at Morgan Stanley, explains: "The market for power assets is as robust as I have ever seen. Over the past two years we have seen significant interest from virtually every potential investor class: general private equity shops, power-specific funds, infrastructure funds and hedge funds."

Hedge funds in particular have become especially focused on the sector and currently own, as consortiums, multiple power assets located throughout the country. Infrastructure funds are also playing an increasingly active role in the sector, notes Albert. "They are looking for long-term stable cash flows and cash returns. Power plants with long-term generation contracts meet this investment profile perfectly."

Time to come back?

In the aftermath of Enron's bankruptcy, power companies – both utilities and those specialising in generation – began to cut back on their expansion. They re-examined owning generation assets, either to stay afloat, or to appease stock markets and ratings agencies, both of which looked unfavourably on unregulated and unhedged businesses. Many therefore spent the last few years divesting and consolidating assets rather than buying. Financial players have become entrenched, according to Jonathan Cho, analyst at Fitch Ratings. "It seems the ability for private equity firms to use a lot of leverage – more than most strategic investors are comfortable with – has given them the cost of funds advantage."

But strategic investors have become much less retiring in the last 18 months. Notes Albert at Morgan Stanley: "I expect the composition of bidding groups to change, as we are increasingly witnessing more strategics participate in auctions for assets." However, he notes that while there are more industry players involved in the auctions, with a few notable exceptions few have bid aggressively enough to win against financial sponsors.

But those exceptions are impressive, and include NRG buying Texas Genco for $5.8 billion in March last year; International Power's $1.14 billion purchase of the Coleto Creek project in April; the acquisition of a stake in Elwood Energy by J-Power in October last year and the purchase of Calpeak by Tyr in August – although the latter transaction involved Starwood Energy Group as a financial co-investor. In addition, BG paid $685 million, which it funded entirely from internal resources, for the Lake Road project.

Indeed, even financial investors have also noted the presence of strategics at auctions. Pat Eilers, director overseeing Madison Dearborn Partners' energy and power and chemical business, says it is clear that industry players are looking to join the M&A boom. "We are now definitely seeing more strategic companies appearing on the M&A landscape for power assets."

Moreover, in the race to add new generation capacity, particularly in coal, strategic players enjoy obvious advantages, including deeper reserves of in-house expertise and a an ability to wait longer to see a return on invested capital. TXU and NRG have recently announced coal projects, and the New York Power Authority has conditionally awarded NRG a contract to build a 680MW integrated gasification combined cycle (IGCC) project.

TXU announced plans last year to launch a number of greenfield developments and expansions of existing plants in the coal and gas sectors. It is developing two greenfield coal projects – Oak Grove and Sandow 5 – and the group will further develop its Valley, Tradinghouse, Morgan Creek and Lake Creek Gas plants. In addition TXU plans to expand its coal operations at Martin Lake, Big Brown and Monticello. However, TXU's $10 billion coal portfolio financing has encountered stiff resistance from NGOs and local governments, and increasing scepticism from lenders.

The most successful new coal project to date – LS Power's Plum Point coal financing – drew upon equity from one of EIF's power funds. LS Power is an experienced developer that also manages an equity fund, and might be considered a hybrid of the two types of investor. But it recently announced plans to sell most of its assets, including its stake in Plum Point, to Dynegy, a merchant generator with a year-long history, and to form a development joint venture with the buyer.

What price a strategic footprint?

Prices per kilowatt of capacity have risen substantially over the past few years. Notes Albert: "It used to be that assets were selling on current cash flow and as a result, prices paid were generally at a significant discount to replacement cost. But now many assets are starting to trade at close to replacement cost, as reserve margins are expected to decline and as capacity markets develop, which really represents a new trend in the sector," he says.

Capacity markets have been designed to reward generators for making capacity available, and to offer price signals to developers of new capacity, which can be assured of making some revenue even when power prices and fuel prices do not allow them to make a respectable, or even positive, margin. The most notable markets that offer capacity payments are the New York ISO market, and the New England ISO.

Capacity payments, for instance, played an important role in the financing for US Power Generating and Madison Dearborn's $975 million acquisition of the Astoria Generating portfolio in New York City. And they form a crucial component of revenues at K Road's Boston Generating portfolio, which operates on a merchant basis, and was handed back to lenders by owner Exelon because it could not make sufficient margins to service debt.

The introduction of capacity payments in New England has improved Boston Generating's fortunes substantially, so much that it completed a large and well-received $2.1 billion refinancing, led by Credit Suisse and Goldman Sachs, in December 2006. Energy Capital Partners' heavily leveraged $855 million financing for its NE Energy coal and hydroelectric portfolio also benefited from capacity payments available to New England generators.

The development in capacity markets is driven in part by the fact that reserve margins are coming down everywhere in the US, particularly in markets such as Texas, California and the northeast. "New generation is being built, but not as fast as demand is growing throughout the US and especially in certain markets such as ERCOT and NEPOOL" says Albert.

Whether this trend continues remains to be seen. Notes Jonathan Rod, a partner at Latham and Watkins, "So many people have predicted so many different things for asset prices. Three years ago you couldn't put together buyer and sellers because sellers thought their assets were worth more and buyers thought they were worth less. At present it is very unclear where the top of this cycle is in."

Financing forces

The main factor maintaining the dominance of financial investors has been ready financing in the B loan market. Financial players still find the first and second lien markets appealing, according to Eilers. "Certainly the financial markets have been extremely favourable for providing debt to pursue acquisitions."

The B loan market provides debt priced at rates roughly comparable to where merchant project finance debt was priced in the early part of the decade, and demands limited amortization of principal. But it also tends to clamp down on the ability of sponsor to take cash out of assets by sweeping excess cashflow towards prepayment.

Latham's Jonathan Rod says that while initial financing is being done in the B loan market, "people are looking at other alternatives for longer term, but to make sure the money is there at closing the B loan is still most robust alternative." Indeed, beyond some isolated examples of high-yield refinancings of B loans, few B loan borrowers have turned to alternative markets.

In fact, strategic borrowers looking to finance their purchases have frequently leaned on commercial banks to adopt some of the structures prevalent in the B loan. J-Power's acquisition of a 61% stake in Tenaska's Frontier project used a $185 million holding company loan from Mizuho that had the 14-year maturity of a commercial bank loan, but the amortization schedule and cash sweep provisions of a B loan. Commercial banks previously usually demanded cash sweeps from borrowers exposed to commodity or power price risk, but the Frontier loan is a leveraged financing of a contracted cashflow.

In the mean time, B loan structures are also becoming more aggressive. Arleen Spangler, director at Standard & Poor's, says that the apparently unlimited supply of funds in this market at present have had some surprising results. "We have even started to see PIK [payment-in-kind] tranches which we haven't seen before in this space, and it could be an interesting development."

The biggest longer-term risk to lenders is refinancing risk, since while cash sweep mechanisms are prevalent, they are not always applied to 100% of a project's available cash, says Spangler. "As a result, when it comes time to refinance, if the market is not as strong as now, they could face some critical funding issues. This inability to refinance caused significant problems for companies in 2002 and we are watching this cycle very carefully."

Such a doomsday scenario has become increasingly discussed in the last 12 months, and has few precedents, since the post-Enron liquidity crunch took most investors by surprise. One banker says: "People are getting more aggressive because they believe in the story and because outside equity – much of which is hedge fund money – wants to own a slice of the capital structure. In a number of recent acquisitions, for example, acquirors set up hedges on energy to stabilize cashflows, enabling them to add more leverage to the deal."

Strategic investors have less of a need to put in place these hedges, which can sometimes be expensive or limit a borrower's ability to exploit exceptionally high power prices. For instance BG Group, buyer of the Lake Road plant, is one of the largest importers of liquefied natural gas into the US, and has little need to limit its exposure to gas prices.

Two or three kinds of prices

This last factor, in particular, suggests that some strategic investors will, the US antitrust authorities permitting, return to dominate the US generation market, because even if they do not have substantial fuel reserves, as BG does, they possess a diversified portfolio that allows them to manage fuel price risk more effectively. But power prices, which have demonstrated a considerable lag behind fuel prices, are moving back in sync with reserve margins.

Or as one banker says: "It is all in the eye of the beholder. The market seems to think prices are reasonable, and the pricing trajectory has been straight up. If reserve margins continue to decline then we will see further tightening of the market and prices will go higher. If forecasts are wrong and demand comes in south of forecast or if there is a paradigm shift in terms of power, supply may go in other direction and then prices will come back down."

Still, according to Fitch's Cho, "private equity investors are not the natural owners of these types of assets, so eventually they will revert back to strategic buyers. But new acquisition activity will probably be driven by financial investors for some time yet." The strategic investors have not yet demonstrated that their internal advantages can outweigh financial players' capital advantages.