Energy M&A trend: minority interest sales in regulated utility subsidiaries to raise equity capital

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In order to raise equity capital in 2021, a trend among major public utility holding companies, such as Duke Energy Corp. (NYSE: DUK) ("Duke Energy") and more recently, FirstEnergy Corp. (NYSE: FE) ("FirstEnergy"), was to sell minority stakes in specific regulated utility subsidiaries, rather than opting for the more traditional route of issuing stock or selling a minority stake in the parent company.

This approach has the potential to become even more popular as it provides regulated energy companies with a compelling option to strengthen their financial position while meeting their significant capital needs, which are likely to intensify as public utilities enter a phase of increased capital spending to fuel the country's transition to clean energy.

On Sept. 8, 2021, Duke Energy announced that it completed the first of a two-phase minority sale transaction with an affiliate of GIC Private Limited ("GIC"), Singapore's sovereign wealth fund and a seasoned investor in U.S. infrastructure. Pursuant to the terms of the transaction, GIC will acquire a 19.9% minority interest in the newly formed holding company of Duke Energy Indiana, LLC ("Duke Indiana"), which serves approximately 850,000 retail customers in Indiana. The total purchase price of $2.05 billion will be paid in a staggered, two-phase closing, structured in evenly split payments.

The first phase closed on Sept. 8, and Duke Energy has the discretion to determine the timing of the second closing, but it will occur no later than January 2023. Duke Energy stated that "proceeds from this transaction will help fund the company's $59 billion capex (capital expenditure) plan and satisfy all equity capital raising needs through 2025."

While GIC received certain limited governance rights commensurate with its minority investment in Duke Indiana (e.g., the right to designate two out of 10 board members, consent/veto rights over certain fundamental decisions, etc.), Duke Energy will continue to operate Duke Indiana and will remain the majority owner with an 80.1% stake in the business.

The closing of the first phase of the Duke Indiana-GIC transaction coincided with reports by Bloomberg and other news outlets that FirstEnergy was exploring a similar transaction. *See* Kiel Porter and Brian Eckhouse, "FirstEnergy Seeks Stake Sale in Transmission Business," Bloomberg Anywhere (Aug. 10, 2021) (https://bloom.bg/3ejxVR0).

On Nov. 7, 2021, FirstEnergy announced that it entered into a definitive agreement with Brookfield Super-Core Infrastructure Partners ("Brookfield"), a leading global infrastructure fund, to sell a 19.9% stake in FirstEnergy Transmission, LLC ("FET"), the holding company of FirstEnergy's FERC-regulated transmission utility subsidiaries (Federal Energy Regulatory Commission) for $2.4 billion. *See* FirstEnergy press release "FirstEnergy Announces Transformative $3.4 Billion of Equity Financings, Introduces Long-Term Earnings Growth Rate of 6-8%" (Nov. 7, 2021) (https://bit.ly/3GWMOF4).

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Pursuant to the terms of the all-cash transaction, which appear to be modelled largely after the Duke Indiana-GIC transaction, Brookfield will receive certain governance rights commensurate with its minority investment in FET, while FirstEnergy will retain the remaining 80.1% interest in FET and continue to operate its transmission business, which comprises one of the largest transmission systems in PJM. The transaction is expected to close in the first half of 2022.

While this type of deal structure in the regulated energy industry may appear to be a novel idea, it isn't actually all that new. For example, in 2014 The AES Corporation (NYSE: AES) ("AES") announced its sale of an aggregate 30% indirect interest in its Indiana retail utility subsidiary, Indianapolis Power & Light Company ("IPL"), to La Caisse de dépôt et placement du Québec ("Caisse").

Caisse, which received limited minority governance rights as part of its minority investment in IPL (e.g., board representation, consent/veto rights over certain fundamental decisions, etc.), is a Canadian long-term institutional investor that manages funds primarily for public and parapublic pension and insurance plans. The Duke Indiana-GIC and FirstEnergy-Brookfield transactions are substantially similar to the IPL-Caisse minority investment, which closed in 2015.

Why this approach to raising equity capital is coming back into vogue among energy industry giants after a multiyear hiatus is not entirely clear. However, the potential benefits of such a transaction structure to a publicly traded utility holding company, as well as the attractiveness of such an investment opportunity to institutional investors, are far more apparent.

Minority investment transactions such as these can offer public utility holding companies the opportunity to raise equity capital at more attractive valuations than issuing new stock at the parent company level, thereby avoiding any potential overhang on the parent company's valuation. For example, Duke Energy reported that the $2.05 billion purchase price in the Duke Indiana-GIC transaction represented a "significant premium to Duke Energy's current public equity valuation." *See* Duke Energy Corporation press release "Duke Energy partners with GIC to secure minority investment in Duke Energy Indiana, increases long-term EPS growth Rate" (Jan. 28, 2021) (https://bit.ly/3FpyvIA).

The strong valuation was also recognized by the investment community and utility industry more broadly: A Guggenheim Securities analyst noted that "(Duke Indiana) transacted at what we view as a very attractive multiple and is accretive to earnings and credit," while the 28-times regulated earnings multiple achieved by Duke Indiana was referenced by FirstEnergy executives on an investor call months prior to inking the FirstEnergy-Brookfield transaction. *See* John Downey, "Duke Energy CEO Talks Strategy Behind Big Sales, Environmental Deals and More," Charlotte Business Journal (Feb. 3, 2021) (https://bit.ly/3effTPR). *See generally*, "FirstEnergy Corp (FE) Q2 2021 Earnings Call Transcript," The Motley Fool Transcripts (July 23, 2021) (https://bit.ly/3J5SJJT).

Speaking of which, FirstEnergy reported (noted in Nov. 7 press release cited above) that it "achieved [a] historical premium valuation within the utility sector for the FET transaction" and that the $2.4 billion purchase price "represent[ed] an exceptionally attractive electric utility valuation of 40x LTM P/E" and "more than a 50% premium to the median LTM P/E for utility sector transactions."

In addition to the possibility of achieving a top dollar valuation, public utility companies can specifically tailor these minority investments to best meet their future capital needs, which are likely to become more significant as the country transitions toward a cleaner electric grid. For instance, each of the FirstEnergy-Brookfield, Duke Indiana-GIC and IPL-Caisse transactions appear to have been structured — in terms of sizing and timing — to address, at least in part, each parent company's projected capital needs as well as clean energy goals.

FirstEnergy stated that the Brookfield transaction, along with a simultaneously announced strategic investment by Blackstone Infrastructure Partners, would "provide funding for strategic capital expenditures, and address all of FirstEnergy's equity plans." Steven E. Strah, FirstEnergy's president and chief executive officer, went on to remark that the FirstEnergy-Brookfield transaction will be one of the "key catalysts to fulfill our long-term strategy and drive smart grid and clean energy initiatives for our customers and communities." First Energy press release.

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In a similar vein, Duke Energy stated that the two-phased structure of the Duke Indiana-GIC transaction "efficiently align[s] with the company's capital needs" and "allows Duke Energy to forego its previously announced plan to raise $1 billion of common equity." Duke Energy's chair, president and CEO, Lynn Good, added that "this transaction will allow us to accelerate our clean energy strategy across our regulated utilities." Duke Energy press release.

Similarly, AES' president and CEO noted that Caisse's minority investment in IPL, which was also structured as a series of transactions, "will support IPL's strong investment program in gas-fired generation and environmental upgrades." *See* CDPQ press release "AES Announces Agreement To Sell Minority Interest in IPALCO Enterprises, Inc. to La Caisse de Dépôt et Placement du Québec" (Dec. 15, 2014) (https://bit.ly/3efUgP4).

Most importantly perhaps, public utility companies know that today there is an active pool of qualified buyers ready to compete for a minority position in a regulated utility business. Large institutional investors, infrastructure funds and sovereign wealth funds are among the most active in this highly competitive space.

Why are experienced financial investors particularly drawn to acquisitions of approximately 20% positions in regulated utility businesses? Well, because these investment opportunities offer a rare combination of desirable attributes — such as negotiated governance rights and investor protections (including board representation), steady distributions, capex growth potential, targeted exposure to specific regulated businesses (as opposed to a broader portfolio of regulated and unregulated businesses), a lightened regulatory approval process and an investment sizing in the $1-3 billion sweet spot.

Finding an investment opportunity with all of these characteristics, as well as utility-style regulated earnings, is exceedingly rare and surely would not be achieved by simply acquiring $1-3 billion worth of AES, Duke Energy or FirstEnergy common stock.

While the sale of minority positions in regulated utility subsidiaries has emerged as an energy M&A trend of 2021, only time will tell whether this transaction structure becomes a go-to method for utility holding companies to efficiently raise capital.

About the author

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