Robust outlook for 2013 deals

The first quarter of this year points to a robust platform for M&A activity. Despite deal value decreasing US$2.3b (8%) from US$27.6b in Q4 2012 to US$25.3b in Q1 2013, encouraging signs emerged, including progress on large European privatizations and divestments. Q1 2013 registered seven billion-dollar-plus transactions. Europe remained the driver of global M&A, accounting for 51%, or US$13b, of the deal value. This was underpinned by the Turkish privatization program, which included the sale of four power distribution grids for US$3.5b. The biggest deal of the quarter emerged from the divestment efforts of E.ON SE and GDF Suez, which agreed to sell their combined 49% stake in Slovak gas group Slovensky Plynarensky Priemysel AS for US$3.5b to Czech investment fund Energeticky a Prumyslovy Holding.

News that Chinese growth dipped slightly in the first quarter of 2013 disappointed those hoping for an increase in its recovery. However, despite market volatility and an uncertain global economic outlook, Chinese utilities continued to gain prominence in the global M&A market. 2013 could be a record year for outbound power and utilities (P&U) deals as thirst for investment diversification and growing policy support underpin P&U investment.

Capital is on the move and 2013 is shaping up as an exciting year. Portfolio management continues as the strongest theme in the global P&U market. As utilities continue to reshape their asset portfolios, we anticipate a robust M&A climate in 2013 that is likely to outpace last year.

Joseph Fontana
Global Transactions Power & Utilities Leader

Key findings, Q1 2013

- Despite seven billion-dollar-plus transactions, Q1 2013 global P&U M&A registers US$25.3b, down US$2.3b (8%) from the prior quarter. Europe remains the center of activity, driven by large divestments.
- Capital is on the move as European players divest transmission and distribution (T&D) assets and reinvest in emerging markets. Further, cross-border M&A rises 49% (US$3.2b) from the prior quarter.
- The US power generation market is again active, headlined by a number of asset sales, including Dynegy’s purchase of Ameren's competitive fleet. While power prices remain depressed, coal-fired generation retirements and tightening supply dynamics in key markets provide some optimism for power generators.
- Renewable M&A contributes 50% to global deal volume (23% to value); Asia Pacific emerges as the new clean-energy hub, contributing 66% to the total renewables deal value.
Q1 2013 activity and outlook: ingredients in place for a strong year ahead

Deal momentum on the rise; movement on key divestment programs and privatizations sets scene for 2013

US generation asset sales continue

Hybrid utilities in the US – those with regulated and non-regulated portfolios – continued to divest competitive power generation assets: FirstEnergy, Dominion and Ameren Energy announced sales in the quarter. FirstEnergy announced its intention to sell off non-strategic assets, including up to 1,181 MW of its merchant hydro asset portfolio.1 Dominion Resources struck a deal to sell three fossil-fuel-fired merchant power plants to private equity firm Energy Capital Partners LLC for US$650m. Dynegy’s acquisition of Ameren’s competitive business for US$599m was welcomed by investors. There is a growing sense that power prices may be on the rise, at least from the very low levels seen today. Upcoming coal retirements in markets such as Pennsylvania Jersey Maryland (PJM) and declining reserve margins in Electric Reliability Council of Texas (ERCOT) provide optimism. Prices don’t need to rise much: a US$1/mmBtu rise in gas prices could deliver Dynegy about US$330m (ERCOT) provide optimism. Prices don’t need to rise much: a US$1/mmBtu rise in gas prices could deliver Dynegy about US$330m in EBITDA.2

Continued divestment in Europe drives M&A volumes

Europe contributed more than 51% (US$13b) to global deal value in Q1, driven by continued divestments by large utilities. E.ON SE alone divested US$3.4b of assets in the quarter, including its joint venture (JV) with GDF Suez in Slovakia, gas operations in Hungary and a 43% stake in German-based E.ON Thueringer Energie AG. Local utilities and municipalities acquired most of the assets. RWE AG followed the trend, selling its Czech Republic gas transmission network, NET4GAS, for US$2b to German and Canadian infrastructure funds. This significant move will provide an impetus for further divestment: look for large investments in high-growth markets to start flowing. Capital is on the move.

Utilities continued their march toward higher-growth markets. In Q1 2013, E.ON SE raised its stake in MPX Energia SA for US$947m to further enhance its exposure in Brazil. Turkey completed privatization auctions for its power grids after the final four tenders raised US$3.46b. The highest bid – US$1.7b – for the Toroslar power distribution grid in southern Turkey was placed by Enerjisa, a JV between Turkey’s Sabanci and Germany’s E.ON.

The UK water sector has been very active over the past six months. The end of 2012 saw the sale of Veolia’s water businesses, while Sutton and East Surrey Holdings were sold in Q1 2013. News that South Staffordshire and Cambridge Water have been put up for sale by Alinda, and speculation around United Utilities or Pennon businesses, all bode well for robust activity in the sector.

Cross-border M&A rises 49% (US$3.2b)

Q1 2013 witnessed a surge in cross-border deal activity, driven primarily by Canada, Germany and Japan. Deal volume nearly doubled while M&A values shot up 49% from Q4 2012, to reach US$10b. For Canadian investors, expansion of clean energy portfolios and acquisition of natural gas assets in the US remained a key focus. AltaGas’ US$515m acquisition of a 507 MW natural-gas-fired plant from US-based Blythe Energy and Caisse de Depot et Placement du Quebec’s US$500m acquisition of US-based wind farms reflect the underlying trend. We expect continued growth in cross-border deals as buyers seek out high-growth opportunities.

Japanese investors focused on European renewable assets. Of the five outbound Japanese transactions in the quarter, four involved solar and wind assets, with Japanese trading house Mitsubishi Corp. participating in three of them (US$82m). Sumitomo Corporation’s purchase of Sutton & East Surrey Water plc, UK regulated water utility, for US$259m reflects the growing interest of Japanese investors in global regulated water assets. Marubeni Corp., Itochu Corp. and Mitsui are eyeing major expansion in Europe and in the emerging economies’ water sectors.3

Asia Pacific deal value more than doubled in Q1 to reach US$6.1b, driven largely by renewable energy transactions. Total renewable deal value in Asia Pacific reached a two-year high at US$3.8b, with hydro emerging as the dominant target.

Global P&U transaction snapshot

<table>
<thead>
<tr>
<th></th>
<th>US$2.4b</th>
<th>US$3.8b</th>
<th>US$0.7b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>T&amp;D</td>
<td>US$10.2b</td>
<td>US$0.2b</td>
<td>US$2.2b</td>
</tr>
<tr>
<td>Renewables</td>
<td>US$0.3b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Integrated, water and other*</td>
<td>US$0.1b</td>
<td>US$500m</td>
<td>US$2.2b</td>
</tr>
<tr>
<td>Americas (both North and South)</td>
<td>US$50.0b</td>
<td></td>
<td>US$50.0b</td>
</tr>
<tr>
<td>Europe (includes UK)</td>
<td></td>
<td>US$51.0b</td>
<td></td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>US$2.2b</td>
<td>US$1.3b</td>
<td>US$2.2b</td>
</tr>
</tbody>
</table>

*Regional deal breakdown excludes the sale of Veolia’s Moroccan water business for $484m in Africa.

Source: Ernst & Young analysis based on Mergermarket data

Table 1. Global P&U deal activity by segment, Q4 2012–Q1 2013

<table>
<thead>
<tr>
<th>Segment</th>
<th>Number of deals Q1 2013</th>
<th>Number of deals Q4 2012</th>
<th>Value (US$b) Q1 2013</th>
<th>Value (US$b) Q4 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>82</td>
<td>97</td>
<td>$25.3</td>
<td>$27.6</td>
</tr>
<tr>
<td>Generation</td>
<td>13</td>
<td>22</td>
<td>$4.9 ▼</td>
<td>$5.0 ▼</td>
</tr>
<tr>
<td>T&amp;D</td>
<td>10</td>
<td>15</td>
<td>$10.5 ▲</td>
<td>$6.5</td>
</tr>
<tr>
<td>Renewables</td>
<td>40</td>
<td>37</td>
<td>$5.7 ▲</td>
<td>$4.8</td>
</tr>
<tr>
<td>Integrated, water and others</td>
<td>19</td>
<td>23</td>
<td>$4.2 ▼</td>
<td>$10.2</td>
</tr>
</tbody>
</table>

Source: Ernst & Young analysis based on Mergermarket data

Table 2. Top five global P&U deals in Q1 2013

<table>
<thead>
<tr>
<th>Announced</th>
<th>Target</th>
<th>Target country</th>
<th>Bidder</th>
<th>Bidder country</th>
<th>Disclosed value (US$m)</th>
<th>Rationale</th>
<th>Segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 Jan</td>
<td>Slovensky Plynarenky Priemysel AS (49% stake)</td>
<td>Slovakia</td>
<td>Energeticky a Prumyslový Holding, a.s.</td>
<td>Czech Republic</td>
<td>3,467</td>
<td>Divestment by GDF Suez and E.ON Ruhrgas</td>
<td>T&amp;D</td>
</tr>
<tr>
<td>15 Mar</td>
<td>Four power distribution grids</td>
<td>Turkey</td>
<td>Enerjisa (JV of Turkey’s Sabanci and Germany’s E.ON)</td>
<td>Turkey</td>
<td>3,460</td>
<td>Privatization, investment in higher-growth market</td>
<td>T&amp;D</td>
</tr>
<tr>
<td>5 Feb</td>
<td>Chinese hydropower developer</td>
<td>China</td>
<td>Chinese investment firm</td>
<td>China</td>
<td>2,485</td>
<td>Expand hydro generation capacity</td>
<td>Renewable: hydro</td>
</tr>
<tr>
<td>28 Mar</td>
<td>NET4GAS, s.r.o</td>
<td>Czech Republic</td>
<td>Allianz Capital Partners GmbH; Borealis Infrastructure Management Inc.</td>
<td>Germany; Canada</td>
<td>2,043</td>
<td>Divestment by RWE AG</td>
<td>T&amp;D</td>
</tr>
<tr>
<td>21 Feb</td>
<td>Chinese electric power company</td>
<td>China</td>
<td>Chinese electric power company</td>
<td>China</td>
<td>1,508</td>
<td>Operational synergies</td>
<td>Generation</td>
</tr>
</tbody>
</table>

Source: Ernst & Young analysis based on Mergermarket data

Transaction outlook

- Portfolio management continues as the strongest theme in the global P&U market. We expect the upward trajectory of M&A to continue as companies continue to reshape their asset portfolios.
- The new era of cheap natural gas in the US presents opportunities for market players, whether that means taking a position on the commodity price, securing fuel supplies or looking to profit in export markets. Look for continued activity as a result.
- Financial buyers will continue to grow as a buyer group, targeting network assets in Europe. Their access to cheap capital to fund investment positions them well. Healthy valuations for regulated assets will tempt vendors. This is evidenced by speculation that Fortum will sell its Nordic electricity distribution network business later this year.
- The European owners of Urenco Ltd. are sounding out potential buyers for a significant stake in one of the world’s largest uranium enrichers. The whole business could be valued at more than US$15b. The potential deal would be sensitive and complex, but the strong future cash-generating nature of the enricher is expected to attract strong interest. Realizing some or all of that future value now through a sale will be appealing to both the utility owners and to the debt-burdened UK and Dutch Governments, which hold the other two-thirds stake.
- Chinese state-owned P&U companies and Japanese trading houses are likely to be at the front of the queue for prized regulated assets. Expect strong interest in any assets with predictable cash flows; 2013 could be a record year.
- M&A activity in Brazil will continue to grow, with operational wind assets the key targets. Declining profit margins due to new concession renewal terms may drive utilities to dispose of T&D assets in the near term. Watch out for restructuring announcement by Eletrobras, after declaring a US$3.4b net loss for 2012.
- With anemic electricity demand and rising capital expenditure requirements, conditions are ripe for billion-dollar mergers in the US to balance portfolios. Portfolio optimization by hybrid utilities will continue to fuel power generation M&A in the US.
Global snapshot

United States
- US utilities continue to move out of competitive generation assets in favor of investing in their regulated portfolios. Look for power generation asset deals to continue.
- At current valuations, utilities look expensive, trading above their 10-year average price/earnings multiple. This may impact their attractiveness in competing for capital, given the low-load outlook. However, on a yield basis, utilities still look reasonably valued versus corporate bonds and treasuries. Despite this, with relatively high valuations any shift in investor demand away from income stocks would impact utilities.

Canada
- The Canadian P&U sector is likely to continue to grow and diversify through acquisitions in 2013. Changing regulatory structures are creating increased uncertainty on pricing the deals. Most jurisdictions are struggling to incentivize the new generation, primarily due to uncertainties resulting from volatile fuel costs. There is a lack of support to build and operate in a merchant market, and companies are looking for long-term contracted supply with strong counterparties.
- We expect Canadian utilities to continue expanding their clean energy portfolio and invest in assets outside the domestic markets, especially North America.

Spain
- In March 2013, ratings agency Fitch downgraded five tariff deficit securitizations. In line with its announced intention to sell wind power units in France, Germany and Poland, Spanish utility Iberdrola sold its Polish wind assets (totaling 184.5 MW) to Polish utilities PGE and Energa for €203m (US$264m) in February 2013. The deal is part of a planned US$2.6b divestment through 2015 and is expected to result in further asset divestments this year.

Brazil
- The impact of the Government’s decision on renewal of electric concessions is being felt in the sector. Eletrobras posted a net loss of US$3.4b, citing new concession terms as the key reason. We expect the event to spark M&A as valuations cool and the consolidation of distribution companies gathers pace.
- Brazil’s latest wind energy auction produced some of the lowest prices for wind generation, prompting questions about the profitability of projects. This is likely to spur M&A activity as developers seek stake sales to generate capital.
Japan
- The Ministry of Economy, Trade and Industry is proposing to deregulate the Japanese power industry by 2018–20. It plans to split the nine regional power utilities into power generation, grid operation and retail companies. It is also recommending measures to activate trading in the power wholesale market and eliminate price regulation of electricity retailers. If adopted, the Electric Utility Industries Law is likely to be revised as early as fiscal 2014.

Tokyo Electric Power Co. (TEPCO) issued a request for a proposal to provide base load power for 15 years, starting from 2019 to 2021. We expect Japanese utilities to increase overseas investments, primarily to secure energy supplies. US shale gas, regulated water and renewable energy assets are the likely targets.

United Kingdom
- UK natural gas prices reached a seven-year high in March 2013, raising concerns over a further rise in energy bills, which have more than doubled over the past nine years. The country’s growing reliance on imported gas and the lack of availability of LNG are key concerns; LNG cargoes are being increasingly diverted to other markets where spot prices are higher than those in Europe. In response, Centrica Plc signed a 20-year deal to import natural gas from US-based Cheniere Energy, with deliveries starting in 2018 and prices linked to Henry Hub.
- The UK’s position on establishing a higher, and escalating, carbon price for emissions is now even more at odds with the rest of the EU after the latter’s 16 April decision to not ratify back-end loading of emissions allowances.

Germany
- Divestments by large utilities continue in early 2013. All major utilities announced big asset sales. While financial investors were the front-runners for regulated assets, municipalities remained active in acquiring retail businesses. RWE AG’s announcement of changing its business model sent strong signals to the market. The company plans to reduce its electricity generation business considerably and turn to energy management and services. E.ON announced it would shift its investment focus to distributed generation, renewables and markets, such as Russia and Turkey.

India
- The Indian P&U sector took steps to boost investor confidence. State electricity regulators implemented tariff hikes of 10%–30% across the majority of Indian states. The Central Electricity Regulatory Commission (CERC) indicated its willingness to allow companies to pass on increased coal prices to distribution companies. However, fuel shortages, weak financial health of electricity boards and regulatory constraints drove Moody’s to issue a negative outlook for India’s power sector.
- Despite increased international interest in investing in the sector, few transactions have been completed recently. We expect M&A in the country’s renewable energy sector to heat up, especially in the wind sector.

China
- China continued to strengthen its presence in the global P&U sector, participating in cross-border M&A and bidding for numerous greenfield projects, especially in the nuclear segment. While talks with EDF about joint development of new nuclear projects in Britain continue, China Guangdong Nuclear Power Corporation emerged as the front-runner to clinch a US$20b nuclear deal in Turkey.
- We expect Chinese companies to accelerate investments in global infrastructure assets. Europe will continue to be the focus for Chinese capital.

Australia
- The debate around privatization of T&D and generation assets continues. In early April, the New South Wales Government said it remained committed to its election promise to not to sell grid assets.
- Despite abundant coal reserves, electricity prices have skyrocketed over the past five years. A Queensland Competition Authority (QCA) draft report indicated that electricity rates will be allowed to rise by as much as 21.4% in residential tariffs over the 2013–14 financial year.

Russia
- Deal activity in Russia’s P&U sector is expected to increase in the coming quarters, driven by continued Government focus on privatization and consolidation of network assets. On 5 February 2013, VTB Capital announced a tender to sell the Russian Government’s 25.1% stake in TGK-5, a regional power generation company, for about US$36m. Several regional subsidiaries of Russian electric power grid operator MRSK Holding, including Centre and Volga, are expected to go private in 2013. A decision is expected shortly on RusHydro’s proposed stake sale in the InterRAO energy group to finance its investment program.

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Recent news that Chinese economic growth dipped slightly in the first quarter of 2013 disappointed those hoping for an increase in the recovery that began midway through 2012. However, despite market volatility and a global economic outlook that is far from certain, Chinese companies continued to rise in prominence in the global M&A market.

P&U is a core sector for outbound Chinese investment. Between 2008 and 2012, outbound M&A grew at a CAGR of 26%, with regulated T&D, water and renewable assets being the key focus. Outbound P&U M&A peaked in 2010 at US$12.7b, up from US$3.3b in 2008. Between 2011 and 2012, Chinese buyers acquired assets worth US$20.1b across 21 deals to access markets and acquire technology and intellectual property. Despite a slowdown in outbound investment last year, 2013 is shaping up to be a record year as growing investment appetite, on the back of strengthening policy support, coincides with the emergence of a number of attractive opportunities, mostly created through privatization and divestment programs in Europe. All the ingredients are in place for 2013 to challenge the highs of 2010.

Encouraging foreign investment policies, diversification of funds and geographic expansion are key drivers for outbound M&A. Promoting foreign investments has been identified as the key goal under China’s 12th Five-Year Plan. China is targeting 17% average annual growth in outward direct investment (ODI) with a total investment of US$500b. Wealth funds have been under increasing pressure to diversify investments and generate stable returns. Currently, China’s foreign exchange reserves of US$3.2t are mainly invested in low-yielding US Government bonds.

As utilities look to continue their divestment efforts, they need to be aware of what the new breed of buyer wants. Carve-out financials, clear and concise financial and operational information, and a well-articulated value proposition are essential ingredients for a successful program.

Where could the capital go?

Europe will continue to be the focus for Chinese capital, as overleveraged utilities and government privatization programs bring assets into the market. The US market is less attractive, as utilities are trading at a premium to their 10-year average on a multiple basis. However, asset deals are in the cards. Look for Chinese buyers to be active in the following regions:

- **Australia**: It is reported that a Chinese buyer is in talks to buy Hastings Funds Management’s 25% stake in transmission grid operator ElectraNet for up to US$415m. Marubeni Corp. is reported to be seeking a buyer for its 30% stake in the Millerran Power Station in Queensland, Australia.
- **Finland**: State-controlled utility Fortum is reportedly exploring the sale of its power grids for an estimated US$6.5b.
- **France**: GDF Suez is reportedly looking to sell a stake in its gas transport unit GRTgaz to reduce debt.
- **UK**: EDF is in talks with Chinese investors to build new nuclear power plants in the UK. A stake sale in Scottish Power’s network businesses is reportedly on the cards.
- **The Netherlands**: Partial privatization of TenneT Holding B.V. is seeking funding of US$650m.
- **Denmark**: DONG Energy is in the process of divesting assets worth US$1.7b during 2013-2014.
- **Ireland**: The Irish Government is preparing for the sale of Bord Gais Energy.

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Following a two-year high in 2012, financial buyers continued their aggressive stance. M&A deals by financial buyers increased US$1.5b (or 39%) in Q1 from the previous quarter, bolstered by two billion-dollar-plus transactions in the T&D and services segment.

US-based PE and infrastructure funds, such as Energy Capital Partners, emerged as the most active bidders, transacting in six deals worth a combined US$1.9b. In addition to the T&D and merchant assets, renewable energy assets in Europe and North America emerged as the key target segment.

We anticipate that investment in the sector from financial buyers will grow significantly in 2013, with a particular focus on network deals in Europe.

**Figure 4. Financial buyer deal activity, Q1 2011–Q1 2013**

Source: Ernst & Young analysis based on Mergermarket data

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**Segment analysis**

**Big-ticket European divestments and privatizations make T&D the leading contributor to global deal value in Q1 2013; renewables keep momentum, with deal volume at a two-year high.**

**Generation**

- Both value and volume are down 19.6% and 40.9% from the prior quarter, respectively, primarily due to a significant decline in European generation activity. The US dominates the segment as utilities shed merchant assets in favor of regulated assets. Totaling US$2.2b, Asia Pacific deal value is now five times higher than the previous quarter, driven by large domestic Chinese deals.

**T&D**

- Deal value jumps 61.5% from Q1 2012 to reach US$10.5b. Europe contributes nearly 100% of value, registering four billion-dollar-plus transactions. The deals are representative of ongoing divestments and privatizations in Europe, and the trend is likely to persist in 2013.

**Renewables**

- Value moves up 18.8% from last quarter and 42.5% from the year-ago period, largely on the back of activity in Asia Pacific, where deal value jumped to around 10 times its previous quarter value. Large Chinese hydro deals contribute the bulk (US$3.1b), with the remainder concentrated in solar and wind. Europe continues to dominate volume, hosting 19 deals of the total 40 in the quarter.

**Q1 average deal value increased 15% over the prior quarter due to a higher concentration of deals in the US$500m-plus category (25% versus 16% in Q4 2012). Q1 registered seven billion-dollar-plus transactions in the quarter, forming 60% of the total deal value. Lower-value renewable energy deals (average US$258.6m) continued to distort the average value number, reflecting the continuation of portfolio optimization by utilities and resulting in asset deals. Throughout 2012, global economic uncertainty kept a lid on large-value corporate M&A. We expect this to remain unchanged in 2013 unless utilities devise clear generation mix strategies.**

**Figure 5. Aggregate number of announced deals by disclosed deal size, Q1 2013 versus Q1 2012 and Q4 2012**

Source: Ernst & Young analysis based on Mergermarket data

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**Integrated, water utilities and others**

- Energy services emerge as the leading contributor to the segment, hosting five deals with a cumulative value of US$2b. The waste and water segment hosted eight deals, with a number of Asian investors snapping up European regulated water assets. With a widening gap between water supply and demand and significant investment required to replace aging infrastructure, the water sector is poised to become one of the most attractive segments for utilities. We expect heightened M&A activity in the coming months.

**Figure 6. Q1 2013 deals snapshot by segment**

Source: Ernst & Young analysis based on Mergermarket data

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*Size of bubble represents average deal value*
Doing the right deal in power and utilities

Doing the right deal right can make a power and utility business more competitive and profitable. Clients turn to Ernst & Young's Transactions Advisory Services professionals for advice and support through the life cycle of a transaction, from early stage to execution and post-deal activities. Whether the transaction involves acquisitions, alliances, joint ventures, sales, divestitures or securitizations, we help clients do the right deal at the right price. We help to determine the true value of an asset, set up the business and tax structure, optimize their position in the regulated revenue and pricing environments and execute the deal. We combine proven practices and consistent methodologies with fresh thinking, giving the advice our clients need to make informed decisions, potentially reduce risks and achieve successful outcomes.