Large scale and complex energy deals: Five priorities to drive success post-close

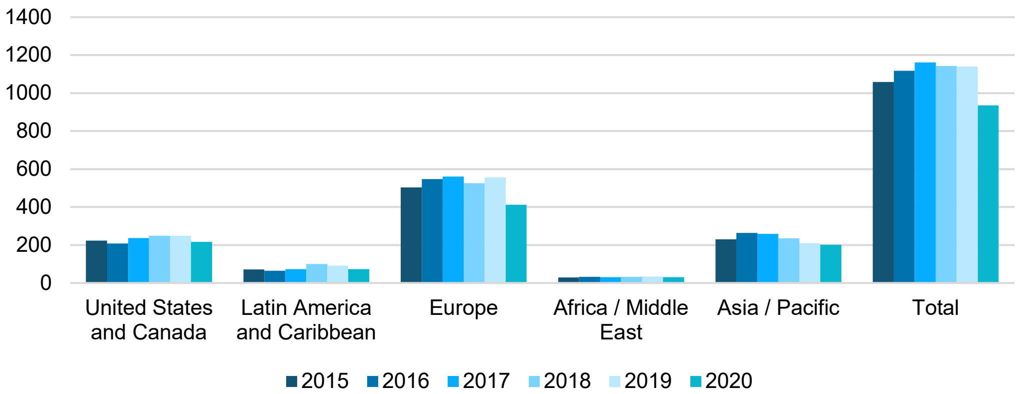
September 2021

Introduction

Up to 90% of M&A deals are regarded as failures[1] and 83% of M&A deals fail to boost shareholder returns[2]. Post-transaction playbooks are a known tool, helpful in managing activity to realise value and manage risk during the transition period after a transaction. CRA has a successful record in supporting clients navigating the post-transaction process in the utility sector, including complex carve-outs and business integrations. As there is plenty of literature in the field, we do not aim to provide an exhaustive list of considerations but to shine a light on five that, in our experience, should not be overlooked after transactions close.

The pandemic presented the entire global economy with significant headwinds. M&A deals in the energy and infrastructure space experienced a 17% decrease in volume from the 2015 through 2019 average. As economies emerge from global lockdowns, we expect to see a rebound in the number of transactions as markets get back on track[3]. Acquisitions can present an effective route to gain greater resilience, enhance or even pivot one's business model as companies look to reposition themselves through cost optimisation at scale, improve portfolio efficiencies and offer opportunities in digitalisation and transformation. Essentially, transactions are driven by the belief that a new owner is better suited to create and capture value from a specific business. To deliver on this belief, a successful and thought through post-transaction approach is key.

Figure 1: Overview of closed M&A transactions from 2015 through 2020[4]



The energy sector in particular faces multiple challenges, such as increased pressure to transition to less carbon-intensive sources, regulatory uncertainty, changing customer behaviours and demands increasing pressure on legacy retail models. Together, with opportunities presented by a technological shift towards smarter, more digitally enabled business models, the utility space seems ripe for further M&A activity. Our research shows that utility[5] transactions have been increasing as a share of overall transaction

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1 Martin, Roger L. "M&A: The One Thing You Need to Get Right," *Harvard Business Review*, 16 May 2016.

2 Galpin, Timothy J., and Mark Herndon. The Complete Guide to Mergers and Acquisitions: Process Tools to Support M&A Integration at Every Level. Jossey-Bass Publ., 2000.

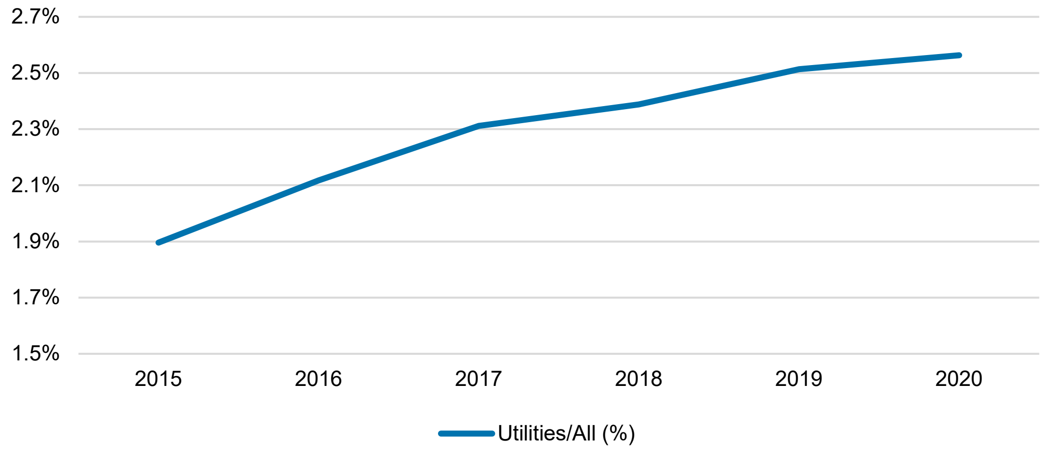
3 UBS Impact of COVID-19 on infrastructure, March 2021.

4 Capital IQ, 2021.

5 Electric Utilities (Primary) OR Gas Utilities (Primary) OR Multi-Utilities (Primary) OR Independent Power and Renewable Electricity Producers (Primary).

volumes since 2015, as Figure 2 shows. Renewed focus on a green infrastructure agenda from the Biden administration, implementation of the European Green Deal as well as further commitments at COP26 this year represent a strong sustainability drive despite the COVID-19 slowdown. With the global business community reacting to challenges of meeting regional net-zero ambitions, as well as newly emerging opportunities enabled by increasing interconnection across industries, a further flurry of transactions in the coming years appears likely.

Figure 2: Proportion of closed utility M&A vs. all closed M&A from 2015 through 2020[6]



M&A activity in the energy and infrastructure space comes in many forms: companies looking to rebalance their level of vertical integration; new entrants building market share; energy majors looking to improve business performance or acquisition of new skills to transform towards digitalisation or technology; or PE funds and active asset management companies simply looking for stable long-term returns. While the source of investment might be diverse, focus on realisation of expected target value from such acquisitions remains constant. It is therefore imperative not to underestimate the process following the transaction closing—be it carving-out assets, integrating assets into existing structures, optimising the value of the asset through transformation or a combination thereof.

The first of our five priorities focuses on the benefits of informed management of the transition process, which requires both understanding the change “hitting” the organisation, and thoroughly understanding the industry. We then touch upon how data clarity and understanding the situation at hand help deliver post-deal target value. In our third point, we highlight the importance of adaptable leadership able to steer the organisation in a new direction. Digitalisation is a key topic in the 21st century energy industry and therefore in section four we discuss how IT representation and literacy is required across leadership levels. Finally, we look at how incorporating ESG (Environmental, Social and Governance) early on in any post-transaction process should go beyond disclosures and become a genuine foundation for the overall business strategy to drive long-term value. While this could be a topic on its own, it will likely be featured during due diligence, so the period soon after close provides an excellent opportunity to ensure it is properly thought through and integrated into the business’ DNA to drive additional value.

6 Capital IQ, 2021.

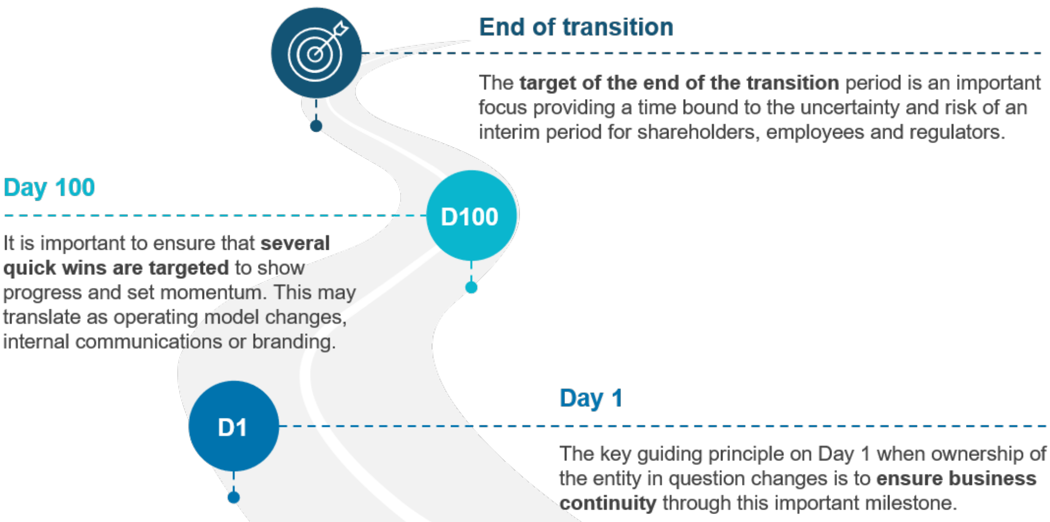
1. Informed management of the transition process

Any transaction can be disruptive to the operations of the acquired asset(s) as managing such shockwaves to the system requires competence and experience. There is no one-size-fits-all process for post-transaction stabilisation and subsequent optimisation, given different market and regulatory environments, various groups of stakeholders and the need for a tailored strategic vision and timeline for each of the assets. It is thus vital for a dedicated programme management function to not only manage the post-transaction process, but also act and adapt to the needs and context of an organisation.

In the period following transaction completion, business continuity is crucial to protecting underlying value. For example, a retail unit might prioritise customer satisfaction and acquisition over other metrics, while the overarching aim of a power distribution system's operator might be to minimise outages or focus on managing the interface with the regulator at time frames relevant to future regulatory periods. Health and safety priorities will manifest differently in a power generation unit or gas distribution operation compared to a commodity-trading house. Individual companies will have distinct portfolios of risks they need to track and mitigate within business-as-usual, while programme management focuses on managing transaction-specific risks. Both processes need to be aligned to assure identification of interdependences and hand-over outstanding risks at the end of post-transaction work.

Go-live or Day 1 comprises an important transaction milestone as the period up until then is often tumultuous with requirements shifting frequently. A clear plan aligned with management should be drawn up and tracked including legal requirements, operational considerations, internal and external communication needs as well as functional changes to minimise uncertainty. Transition service agreement(s), where required, ensure continuity and actively consider transition risks. Programme management must be mindful of the wider market context—for example maintaining power and gas positions in traded markets or ensuring continuity in billing to customers.

Figure 3: Overview of key transaction milestones from Day 1 onwards

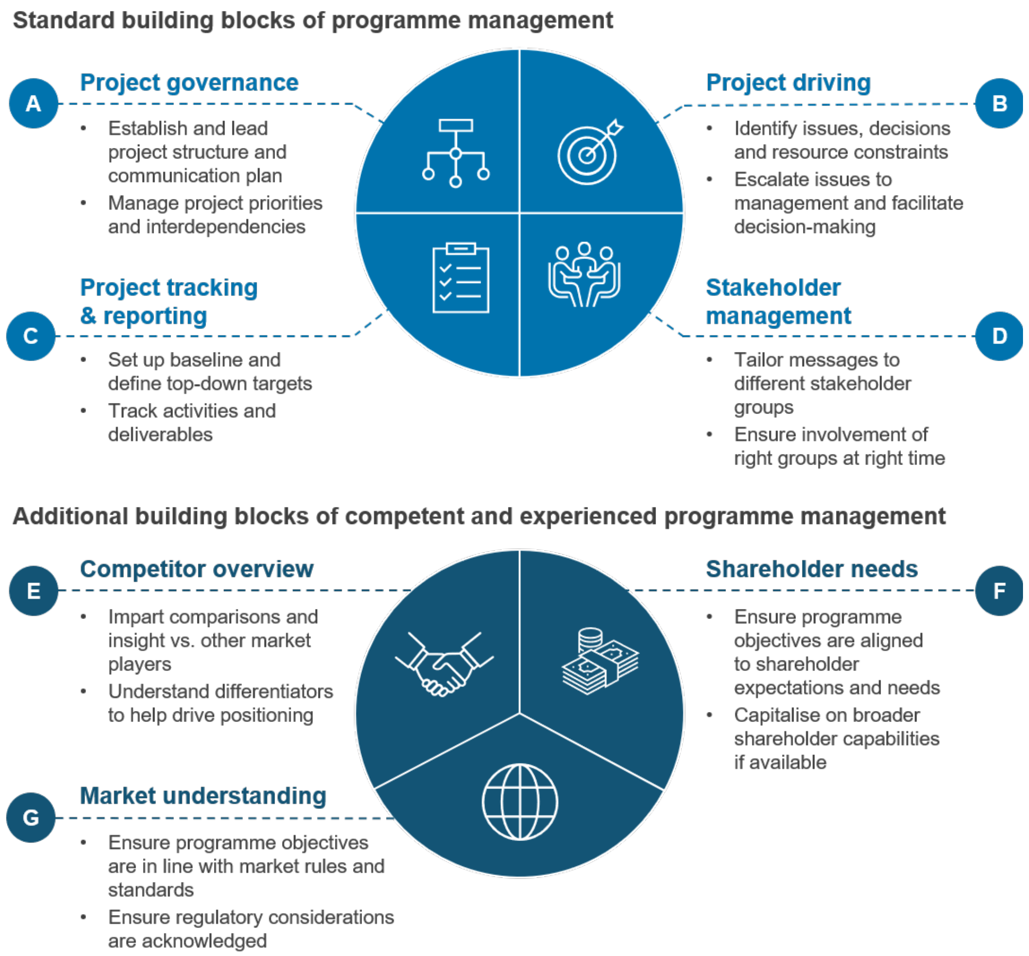


A more complex transaction may encompass multiple dynamics and priorities with varying views between shareholders, management and individual business units. Managing such complexities requires sensitive engagement focussing on developing an understanding of the differing motivations, operational priorities and business-defining demands from regulators, shareholders and customers. Utilities and energy infrastructure organisations can find themselves in complex situations unique to the industry. It is vital to seek a management team that understands transactions, large complex programmes, operational nuances of the given organisation and the wider market and key stakeholders. Examples of such complex situations include:

- Understanding of potential implementation costs to optimise the CAPEX spend of a regulated business;
- Awareness of M&A-driven changes to the current sales strategy and positioning in energy retail markets;
- Refinancing for the newly acquired organisation requiring credit and/or ESG ratings.

Figure 4 shows high-level building blocks of a standard transition programme set-up; added-value blocks represent the supplementary knowledge and skills that enhance programme management's ability to better support informed steering and maintenance of value.

Figure 4: Summary of standard and added-value programme management building blocks



Programme management traditionally focuses on supporting the transition process, governance, reporting and stakeholder management. As per Figure 4, value-add for programme management is provided by understanding the priorities and nuances of the acquired organisation. What makes the real difference here is understanding the differing drivers in competition and the wider market to develop a clear actionable plan for integration or separation. Adding value in managing the process requires depth and understanding of the shareholder needs, capabilities and ambitions, business model, regulatory environment and industry-specific technical considerations. This especially holds true in situations where new shareholders are bringing experience from different geographies and have to quickly adapt to understand an asset's local realities.

2. Data clarity to deliver post-deal target value

Validating pre-transaction assumptions is a necessary step to ensure a successful deal outcome, as core strategic steps should always be made on a grounded fact base. To do so, clarity on data availability, including reported metrics, is essential. Depending on the type of transaction, the initial focus may vary from looking at synergies and optimisation levers (in case of mergers) to evaluating the business and financial optimisation opportunities (for acquisitions or carve-outs).

Definitions and understanding of data points and KPIs usually vary between stakeholders, creating potential risks of misunderstanding and misinterpretation of information. Figure 5 provides an example for a case in the energy utility sector (retail and distribution), which could serve as a framing idea for areas to consider when building such an understanding.

Figure 4: Indicative example framework to review corporate facts and figures for an energy utility

Customer portfolio

- Customer segmentation
- Regulated/non-regulated customer relationship
- Value per segment/customer
- Portfolio synergies

Route to market

- Volumes purchased: sales vs. hedges (re-trade)
- Profile composition (book structure, synergies)
- Contracting: collaterals, RTM types and conditions
- Volumes sold per type of contract (risk and tenor)
- Subsidy timelines (FiT, CfD) and succession plans
- Commercial optimisation means and value addition
- Governance – risk processes, limits and their impacts

Cost treatment and clarity

- Allocation per product vs. overhead – internal logic
- Transfer pricing – logic, links
- Outsourcing level incl. pricing stability (legacy contracts)
- Allocation of staff to activity – different org. models
- Regulatorily relevant cost – levers

Financial forecasting and planning assumptions

- Forecasts of revenue and cost - budgeting approach
- Granularity and level of cash flow and liquidity forecasting
- Cash pooling historically in place/not in place
- Dividend policies, cash distributions in place
- Leverage – limits, reasoning why, navigation space
- Tax approach and procedures in place

Let's take transparency on customer portfolio as an example of a metric to examine further, following a transaction. In the case of an energy retail business, it is imperative to understand how value is created and what role each customer segment plays. A review may reveal that presence in certain segments is due to legacy or internal politics, rather than strong business rationale. Other segments may appear initially less profitable but could gain an important portfolio or strategic role over time. For such a situation, we recommend scenario modelling and customer value lifecycle analysis, leading to a value management capability. For one of our clients, gaining clarity of potential outcomes across customer segments, founded on clear datapoints, helped define post-merger priorities to generate value early on.

Analysis of sourcing contracts and subsequent financial implications is another example area for significant action following deal completion. Each acquired entity may have contracts in place with varying conditions on collateral requirement, payment terms etc. In retail, the volume of procured commodity may vary, depending on the customer portfolio, procurement and hedging strategy and trading capabilities. It is therefore imperative to keep in mind that new ownership may trigger a shift in the sourcing “status quo.” As contracting conditions might change, the whole cost of business might subsequently change. The sourcing situation should thus be reviewed promptly to allow sufficient lead time for any necessary adjustments and contract negotiations following a successfully completed transaction.

Definition and treatment of overheads also often varies from entity to entity. Clarity on the cost dynamics, any potential transfer pricing and outsourcing models in place are important starting blocks for further cost reviews. Jumping prematurely into detailed cost allocations without understanding the overall logic risks missing important points or making hasty decisions that may have a negative impact later.

One of our recent transaction engagements focused on understanding how corporate finance and controlling processes operate. Working with a regulated network utility, we structured an approach to support the client’s finance department in structuring data in a more reliable and granular manner to better track the value delivery and streamline stakeholder reporting. Based on our experience, we first recommend running a quick check on core figures by validating the initial data from the pre-transaction phase and linking them to available controlling sources. Such an exercise provides insights into the organisational set-up, its data flows and level of automation vis-à-vis manual processes. Secondly, we suggest gaining understanding of how granular financial planning is. This step is particularly crucial should the corporate financial structure change after the transaction, for example through increased leverage and subsequent covenants. Additional interventions, such as more granular liquidity tracking or cash flow adjustments to a new dividend or payment policy schedule, require time. Finally, any adjustments need to provide clear reporting channels while meeting shareholder requirements to minimise ad-hoc communication and repetitive data collection.

3. Leadership capability

To drive successful post-transaction activity, exemplary leadership from senior management is crucial. It is not uncommon, especially for senior leaders, to have developed themselves within the paradigm of the legacy culture, strategy and operating model. Such embedded leadership habits might pose transition challenges as most post-transaction activities are inherently disruptive. Dealing with and managing large change programmes may therefore require additional skills beyond the realm of an organisation’s current operating model and leadership qualities. Nevertheless, no outside executive knows the business better than the current leadership team, making the incumbents vital to driving upcoming changes.

Buy-in from the leadership team of the acquired asset creates momentum and can overcome blockers as the programme develops. Top management members are closest to data, risks, culture and awareness of important nuances to consider as the post-transaction work progresses. The commitment of current leadership to the revised strategy and vision also empowers middle management and trickles down through the organisation. Uncertainty at the top sows uncertainty across the organisation and can further trigger employee attrition and loss of talent across all levels.

The current leadership team can risk making suboptimal decisions through unconscious bias. Being wedded to the incumbent organisation often comes with reluctance to organisational change or strategic decisions that originate from the new stakeholders. Prior commitments, pet projects or personal ambition can all create friction, subsequently throwing spanners into the transition process. To mitigate these risks, we recommend identifying positive traits and existing frictions early on. Several dimensions such as motivation, remuneration and experience need to be considered. Compatibility and adaptability of varying leadership styles present in top management can then be a real differentiator to the outcome of delivered value.

Step 1 – Ensure continuity through initial period of flux

A management team capable of producing positive outcomes usually employs multiple leadership styles tailored to individual situations. Styles might range from assertive and directive approaches to more democratic and coaching-focused decision-making. Both ends of the spectrum can drive value in different moments, particularly if sufficiently communicated to ensure buy-in across the organisation. Additional support for a leadership team in the form of programme management, coaching and training then ensures continuity through the busiest periods of any transition.

Step 2 – Profile leadership through 360-degree feedback and observation

Through the transition period, leadership capabilities should be reviewed with an eye on the future skills required for the acquired organisation. Profiles should be based on as much data and evidence as possible, for example from tools such as 360-degree feedback, evaluations from an impartial specialist agency and your own observations compared against concrete skills identified for the future. Depending on the ambition, required skills may include: change leadership, profound IT literacy, agile management or turnaround experience. We also recommend understanding the unique value-adds of each member to make the leadership team function as a comprehensive and diverse unit. Mixing archetypes such as doers, visionaries or challengers would be one possible lens, and many approaches are available to aid such assessments. Sometimes it might even be sufficient to reshuffle functional responsibilities of different members to better align with current organisational needs.

Step 3 – Implement changes

Any gaps identified can be filled deliberately and professionally through upskilling existing management or amending accountabilities of different members to better align with current organisational needs. It is not unusual that the makeup of the leadership team might need adjustments, in which case it is recommended to develop a road map for such leadership transformation, optimised around external strategic priorities, regulatory timelines and internal operating model transitions. Having a long-term view of vacancies and replacements is crucial to ensure business continuity and avoid any sense of instability in the organisation by unsettling the middle management through leadership unpredictability. Where possible, employing the existing leadership team to onboard new members and help them settle is highly desirable. A leadership team must be able to work with one another effectively, and the timing in making any change is key in minimising impact and mitigating risk. A balance should be struck between not endangering the business continuity but also not prolonging inefficient constructs.

4. Prioritising IT

Western European utilities are seeking to reduce costs across operations, however IT spend is growing at a CAGR of 4%+ per year with addressable market size expected to reach over €20bn by 2023[7]. While utilities have been somewhat slow to the digital game, data and digitalisation are changing the industry with systems and data analytics becoming a growing proportion of investment. Remote operation and predictive maintenance are now commonplace, and new ways of running assets through the use of AI and drones to monitor and identify faults in power lines are on the rise. Digital solutions are key in the distribution space in enabling and monetising new products and services such as vehicle-to-grid, storage and demand-side response aggregation. Energy retail is facing pressure from digital attackers and incumbents are increasingly looking to new online products and services that are less cumbersome than traditional Enterprise Management Systems (EMS). A transaction can create additional pressure to consider IT, both to ensure business continuity and to improve future performance.

IT is a necessity as much as a driver of future value for a company. Notwithstanding the large sums that energy and infrastructure companies spend on cybersecurity, system choice can now either constrain or enable a business' ability to innovate, compete and create value. Examples include new products and services, better understanding of customers and more efficient operational or technical processes. IT also has fast become a regulated requirement, such as smart meter infrastructure being considered critical national infrastructure, meaning there are tighter burdens on the control and operation of associated systems.

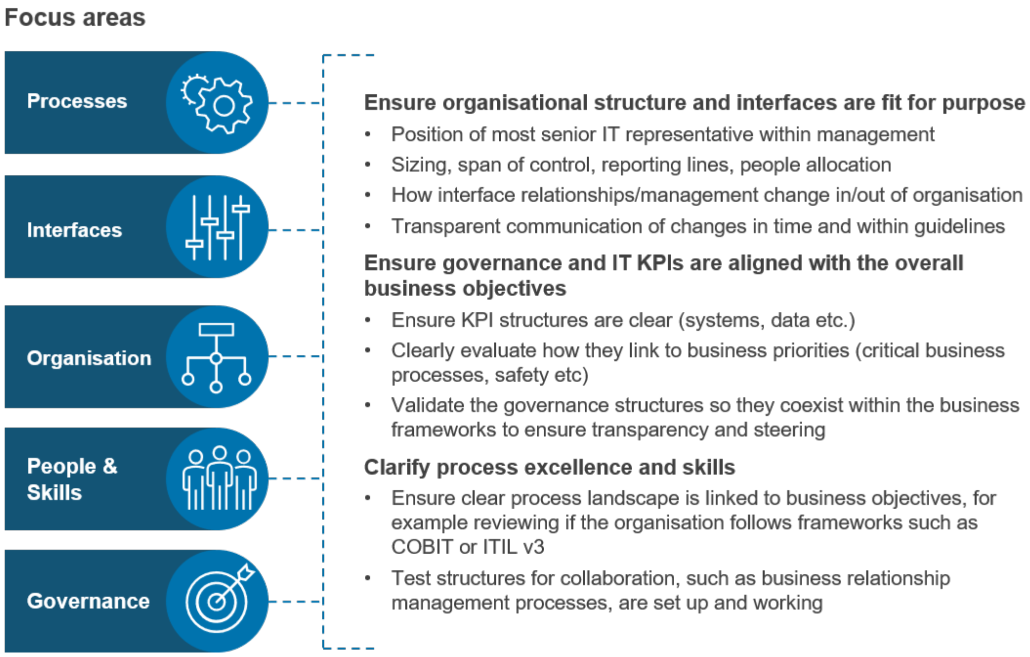
As a result of a transaction, IT system separation or consolidation, data transfers, licensing changes and contracting decisions may all be challenges in the short term. Financial decisions around IT asset ownership, capitalisation policies or outsourcing of software as a service are all levers for an organisation's performance. The COVID-19 pandemic has shown just how important IT, and the proficiency to effectively deploy and use digital solutions and tools, can be in enabling remote working. This further highlights the importance of reflecting on the skill level of IT within the organisation.

In leading post-transaction work, it is important that the IT, digital and technology skills are reviewed and, where required, prioritised to ensure the best decisions through the process and for the future. To link back to our previous theme around the importance of a well-configured and aligned leadership team, given the relative quantum of spend and impact on the business, positions such as a Chief Information Officer (CIO), Chief Digital Officer (CDO) etc. are important, as well as overall skill level and set-up of IT within the organisation. As of 2019, 96 of the FTSE 100 companies had a CIO, showing the importance of this function. As shown in Figure 6, we recommend reviewing the IT

7 International Data Corporation, September 2019.

operating model along five focus areas to gauge overall IT leadership capabilities that are aligned to business needs.

Figure 5: Overview of IT operating model areas to focus on during a post-transaction transition



As a final thought, some utility and energy businesses might want to go a step further and continuously ask themselves the question: to what extent is IT not only a core capability to have, and to what extent are they essentially becoming an IT or technology company rather than just an IT-enabled company?

5. Reviewing and cementing ESG

ESG is fast becoming a cornerstone topic of the transaction space especially given the focus around COP26. A meaningful approach to ESG is a must with increased scrutiny from leading institutional investors, the public as well as regulators. Focussing on sustainability, positive impact on communities and responsible management practices creates additional value and has a real impact on company financing. A sample of 231 M&As[8], shows that ESG-compatible deals outperformed ESG-incompatible deals by an average of 21% on a five-year cumulative return basis. This is encouraging investors to flock to companies that are considered leaders in the space and to quickly focus on improving ESG ratings. Tangible consequences of an ESG focus means the likes of green bonds can unlock much more favourable interest rates compared to other financing options and subsequently help finance new strategic priorities. In one survey, 53%[9] of respondents noted walking away from deals due to negative ESG assessments relating to a target.

Tying ESG to business strategy is crucial to satisfy potential investors and embed required practices into operations while riding the wave of post-transaction changes. It is

8 ESG Compatibility: A Hidden Success Factor in M&A Transactions, Cornerstone Capital Group, 2017.

9 Private Equity firms that are ‘ESG strong’ are likely to be winners, ERM 2020.

therefore opportune to review the ESG maturity of the company and seek to embed ESG as a foundation of the overall company strategy soon after Day 1. Through the post-transaction activities, required data should be available, operating model refined, management reviewed and market and regulatory context understood to define an ESG framework.

As shown in Figure 7, using a maturity framework, the acquired asset can quickly be evaluated for strengths and weaknesses regarding its ESG approach. Measures can be put in place to develop maturity with the overall aim of ensuring that strategic decisions are aligned with key ESG principles. One of our gas industry clients recently faced with the daunting challenge of creating an ESG strategy from scratch. Nevertheless, maturity assessment uncovered a relatively robust pipeline replacement programme, clear approach to human capital development and wide community development focus. While none of these have been previously implicitly linked to sustainability, they formed a strong foundation for the organisation's new ESG strategy.

Given the rising prominence of sustainability in general, organisations can be overloaded with disclosure requirements from shareholders, rating agencies and industry associations. Within such a universe, it is not uncommon for organisations to lose sight of what is material to their ESG strategy. In the case of our client, we strived to clarify expectations with key stakeholders — i.e. shareholders, company management and key departments such as HR, Regulatory Affairs and Business Development. Aligning understanding on short- and mid-term priorities then led to a clear road map launching company-wide programmes across prioritised environmental and social areas within the first year. Moreover, reporting was optimised to meet shareholder needs and the client accepted the decision to publish a sustainability report to improve the company's standing in the financial markets.

Figure 6: Overview of ESG maturity framework

Maturity is applicable to Environmental, Social, and Governance approaches

	Fulfilling fundamentals	Contextualising within the organisation	Embedding ESG into strategy & operations
Analysis	**Data collection & calculations** • Assure available sources and data quality • Set-up processes and calculations	**Baseline & forecast** • Evaluate results and use against a baseline • Use current BAU assumptions to forecast	**Ambition setting & targets (KPIs)** • Feed into business strategy based on scenarios • Define quantifiable targets based on analysis
Business focus	**Meeting reporting requirements** • Provide both int. and ext. disclosures • Maintain reporting frequency	**Scenario development & risks** • Evaluate possible future scenarios and quantify impact	**Practical implications** • Drive risk mitigation, develop business opportunities, include in decision-making
Organisation	**Organisation has roles for ESG reporting** • Provide sufficient reporting capabilities in place within the business structure	**Organisation has responsibility for ESG** • Central team analyses and evaluates ESG results with clear accountabilities	**ESG is fundamental to business strategy** • Significant focus is put on ESG organisation-wide including Board sponsorship
Net position of Value	**Financial trade-off** • ESG might still be seen as value destructive	**Financial neutrality** • Financial returns not contrary to ESG impact	**Financial benefits** • Financial returns enhanced by a holistic ESG policy with identified opportunities

Conclusion

There are countless playbooks and texts regarding successful post-M&A activity. Our paper does not attempt to exhaustively cover all angles to successfully align acquired businesses with shareholder interests. Instead, we draw attention to five considerations for the post-transaction process within the energy and infrastructure space that we have found relevant in recent engagements, and which have, again and again, proven crucial for success: (1) informed management of the process that understands the market, shareholders and competitive environment through deal completion and beyond is a key enabler. This facilitates an appropriate level of risk management, maintains business continuity and maximises beneficial outcomes. (2) Data availability and quality are then critical factors for informed decision-making and suitable contextualisation to avoid expensive mistakes. (3) Ensuring the acquired organisation's leadership team is up to the new challenge and can use data-driven approaches to guide long-term success. (4) An effective IT operating model with representation at the most senior levels is important to drive future value. (5) Finally, focussing on the ESG maturity of an acquired asset in the early stages post-transaction to help secure long-term value.

About CRA's Energy Practice

Charles River Associates is a leading global consulting firm that offers strategic, economic and financial expertise to major corporations and other businesses around the world. CRA's Energy Practice provides services to a wide range of industry clients, including utilities, ISOs, RTOs, large customers and investors. The Energy Practice has offices in Boston, Houston, London, Munich, New York City, Toronto, and Washington, DC. Learn more at www.crai.com/energy.

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