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Distress and Deals Continue to Persist in Energy Sector

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At the end of last year, the power market began to lose steam. The credit market wasn't as strong as it was at the start of the year and many people began speculating "doom and gloom" for the market. However, over the last few months, the power market has picked up and is beginning to show resiliency. As we explore below, there has also been a healthy amount of merger and acquisition (M&A) activity, highlighting that investor confidence is returning, even if only slightly.

The second quarter (Q2) of 2019, in particular, saw strong deal value compared to Q1, according to a recent report from PwC. The report notes that although overall deal volume decreased in Q2, deal value increased by nearly 55%, making it the highest-value quarter since Q2 2018. This was influenced by the absence of mega-deals ($5 billion or more) for the fourth consecutive quarter. In terms of raw numbers, 13 deals were announced in Q2, which represented a 19% decrease in deals verses Q1 2019.

So far this year, the biggest deals announced include:

- J.P. Morgan Asset Management agreed to acquire El Paso Electric Co. for $4.3 billion.
- ENMAX agreed to acquire Emera Inc.'s regulated electric transmission and distribution assets in Maine for $1.3 billion.
- IST3 Infrastruktur Global Fund and Greystone Infrastructure Fund agreed to jointly acquire Alberta PowerLine Limited Partnership, an electric transmission project owner, for $1.3 billion.
- John Hancock Funds announced its minority share acquisition of a commercial renewable energy portfolio from Duke Energy Renewables for $1.3 billion.
- AEP Energy Supply LLC agreed to acquire Sempra Renewables LLC and its assets for approximately $1.1 billion.
- NextEra Energy Partners agreed to acquire NextEra Energy Resources LLC's, portfolio of six wind and solar projects for $1 billion.

Of these deals, the largest was the acquisition of El Paso Electric by J.P. Morgan. Under the agreement, J.P. Morgan agreed to acquire the company for $68.25 per share in cash, representing a total value of approximately $4.3 billion. The transaction represented 35% of total deal value for the quarter.

Despite M&A Activity, Distress Still Remains in the Sector

While M&A activity was healthy during the first half of the year, the sector continues to experience significant distress. According to Debtwire's Distressed Energy Watchlist, which highlights bonds and loans of levered borrowers that are either engaged in balance sheet restructurings or face pressure to reduce debt, 69 borrowers and 54 bonds are under distress watch, as of Sept. 16, 2019. The key drivers of distress in the merchant power sector include historically low spark spreads (a function of depressed natural gas prices), the growth in renewable resources, and the de-coupling of load growth (electricity demand) from economic activity (due to energy efficiency and demand-side management programs).

On the renewables front, producers are increasingly pairing solar or wind generation with battery storage as technology continues to improve, addressing intermittency issues and making these generation assets more sustainable. At the same time, these factors are impeding demand growth as traditional utilities and power companies (nuclear, coal, etc.) still don't see the increased demand they hoped for. The renewable resources that have been put in place (wind and solar) don't need fossil fuels to operate, which hurts traditional producers' bottom lines. Many cities and states are also implementing laws regulating that a certain percentage of their power consumption must be from renewable resources, and this regulation-based push for renewables hasn't helped non-renewable producers.

Apart from power, the exploration and production (E&P) market has also seen its share of distress. Declining oil prices have been a staple for the last year, and there are still a number of defaults in the sector.

According to a recent report from Haynes Boone, while there was a dip in the number of bankruptcy filings among oil and gas producers in 2017 and 2018, this year has seen an uptick. The report notes there have been 26 energy bankruptcy filings as of Aug. 12, 2019, with 20 filings since the beginning of May, marking a significant degree of distress in the sector.

Many E&P companies produce both oil and natural gas, and despite a modest recovery in the North American oil market in the past two years, natural gas prices are significantly lower than they historically have been. The recovery in oil prices has been lackluster this year, so the low price of natural gas has further exacerbated sector stress. The North American E&P sector did experience a large wave of debt restructurings a few years ago, but there is still more balance sheet restructuring activity on the horizon.

Looking Ahead to the Remainder of 2019

As we look ahead to the end of 2019, we believe renewables will continue to drive deal momentum in the power market as certain states across the U.S. continue to boost their renewable targets and federal incentives begin to fall off. Specifically, battery storage will likely become an even more important tool to support the grid and further investment into battery technologies should be expected. High valuations and federal regulatory pressures could also continue to keep the number of mega-deals low, with some observers believing the days of mega utility deals are now behind us.

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