Enterprising distribution executives are in an enviable position today. Here's how LDCs can take advantage of a ripe M&A market. **BY GEORGE N. KOUTSONICOLIS**

THE GOLDEN GOOSE

This past August, AGL Resources Inc., a natural gas distributor based in Atlanta, was trading at $47 a share. The next day, Southern Co. bought AGL at a 38 percent premium, allowing AGL shareholders to cash out at $66. While this might seem like overpricing, it was instead the calculated culmination of Southern Co.'s long-term strategy to take the Southeast.

AGL is far from alone in its acute desire for this kind of deal. All across the country, well-capitalized energy executives are looking to acquire local distribution companies. LDCs are, in fact, one of the few positive lights of today's energy story. This puts enterprising distribution executives in an enviable position: You have a power position to unlock value through a merger or acquisition.

WHY THIS IS HAPPENING

While natural gas often mimics the oil markets, differences in regulation and demand make the current picture drastically different between the two. The fixed costs of LDCs have increased, but these changes pale in comparison to the pricing challenges that upstream producers are facing.

Amidst this harsh up- and midstream climate, the intense appetite for downstream M&A is the inevitable result of one thing: investor demand for greater earnings growth.

When margins were strong and profitability was limited primarily by expansion capital, many utilities tapped financing markets. This newfound growth capital propelled some to become the best-known names in the gas space—the same companies who are today looking for downstream acquisitions. Accessing public equity comes with additional scrutiny from investors, including earnings calls. Public investors demand strong returns, and with many energy investments tied up in long-term bets, these large public players have limited options for continued earnings growth.

Let's go back to Southern Co. The electric utility has experienced 1.2 percent annual sales growth over the past five years. Compare that to AGL's 37 percent sales growth in the same time period, and it's not hard to see the selling point. Ironically, it was likely AGL's acquisition of another profitable company (Nicor Gas) that propelled AGL to have such growth in profitability.

HOW YOU CAN TAKE ADVANTAGE

If you're open to an acquisition or partnership, the first step is to discuss your idea with your board. Too often CEOs begin the process on their own, making a handshake agreement before mentioning a potential deal to key stakeholders. In these cases, the CEO could raise the board's ire, derailing a potential deal before the real conversations start. Bringing in an experienced investment banker early on can make these board conversations go more smoothly, as the outside expert can demonstrate the value more articulately.

Once you've garnered agreement, you need to determine your value. Whether you're working with an advisor partner or not, you'll need to have data about your market reach, geographic footprint and local regulatory climate. But to get the very best deal, you have to think about why another company would want your assets.

Look for Compatibility

As with any deal, a key selling point is synergy. This isn't just limited to geography, though the most apparent commonalities are among players in the same region. Could your finance and accounting systems be easily consolidated? Do you have the same infrastructure model? Synergies make the deal.

Complementary Service

While synergies are normally of utmost importance in an energy M&A deal, in the case of LDCs, geography is the most important point. Since these deals are more about economies of scale than they are about raw savings, focus on how the deal could extend your joint market reach. Capitalized players are looking for a partner that will give them a better sales trajectory in a market they already touch.

Profitability

When it comes to an LDC deal, potential buyers are looking for profits—strong profits. Most often, buyers are looking for the addition of an LDC to dilute low-profit areas of their business that they are unwilling to sell off. If you're able to demonstrate this, you'll get top dollar. You're the golden goose.

For instance, take the Duke/Piedmont deal. Duke Energy Corp. offered Piedmont Natural Gas Inc. $60 a share, despite the fact that the highest Piedmont had ever traded was $43 a share (and its price was expected to drop in the coming year). Duke was willing to pay the premium because of its investment in Brazil, made several years earlier. Since the Brazil entrance, the Latin American nation has experienced one of the worst recessions in the past century. This doesn't mean that this was a bad investment. Most analysts agree that Brazil is a good long-term play, which is why Duke doesn't want to pull out. However, because of quarterly earnings targets, Duke needs a way to appease shareholders in the short term. Piedmont's strong profits mixed in with the losses from Brazil will create an earnings report agreeable to Duke's shareholders.

OTHER FACTORS

A traditional acquisition means that a company is bought in totality, which for many LDCs might be the best option. However, it's far from the only choice. We've recently seen an uptick in alternative partnerships, including joint ventures and master limited partnerships. Together, LDCs and their partners are taking on large swaths of markets throughout the country.

As the distribution networks have traditionally been fragmented, there has always been plenty of room for consolidation. With today's incentives, we expect the coming years to be a period of great transformation.

The bottom line: This is a good time for LDC executives to seek M&A opportunities, and the most astute executives already are. ◆

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The United States made headlines earlier this year when Sabine Pass became the first terminal to export liquefied natural gas from the lower 48 states. It joins a growing number of "new exporters"—including Australia—who are staking their claim on the global market and changing the balance of global power when it comes to energy.

EXTREME WEATHER

Weather-related natural disasters topple homes, close businesses and challenge natural gas utilities throughout the year. From fierce tornadoes to historic flooding to rampaging wildfires, here's how utilities across the United States keep their customers safe and get the gas back on. Plus, we highlight the American Gas Association's Mutual Assistance Program.

BURNER TIPS: MILLENNIAL ENGAGEMENT

Millennials are a quickly growing sector of the utility customer market. They are more engaged online and communicate on-the-go more than any previous generation. So, what does that mean for the utility providers of millennials? It's simple: get connected.