

# European Integrated Utilities From Headwinds to Tailwinds

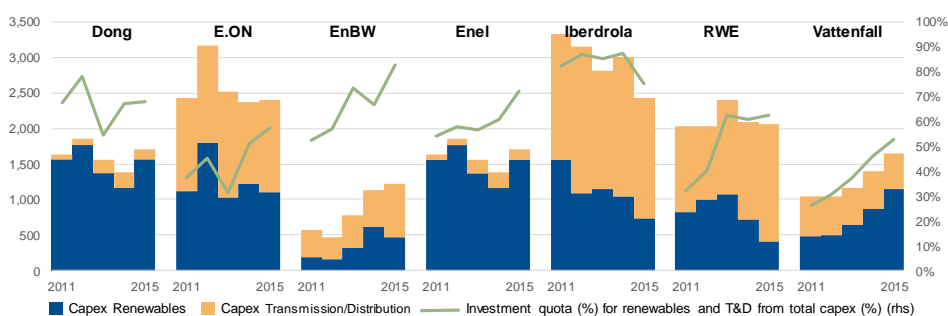


The decentralisation and decarbonisation of the European utilities landscape has been burdening European utilities for over five years. In order to escape a vicious cycle of market share losses, the erosion of operating profits, the rise of leverage, and a negative rating migration, most European utility incumbents are modifying business models and generation portfolios to recreate value and preserve high credit quality. While funding is cheap, investments in sustainable activities such as renewables and grids/networks are expensive, which means utilities have to find the right balance between externally funded capex and a recalibration of business models. Positive effects from this ongoing sector transformation are finally kicking in, and Scope Ratings (Scope) expects the end of a difficult period.

## Restructuring strategies aimed at preserving credit quality

European utilities use two main restructuring strategies to create value and preserve access to external funding. Most European integrated utilities choose an asset rotation strategy, i.e. disposing or mothballing of stranded assets or non-core utility segments to either finance an increased exposure to more-sustainable and robust segments, or roll back debt. Other utilities, like German incumbents E.ON and RWE, have instead chosen a demerger strategy. While most integrated utilities initially chose not to shift towards more sustainable and robust segments, they have now caught up, as shown in more capex being directed towards renewables and the regulated transmission/distribution (T&D) segment (Figure 1). From Scope's perspective, this strategic transition supports credit quality. The transformation is costly, but utilities are benefiting from low interest rates and an increased use of hybrid debt instruments, which helps keep debt under control.

Figure 1: Renewables capex for major utilities (EUR bn)



Source: Annual reports of utilities, Scope Ratings

## Strategies to come to fruition after the peak of the investment cycle

While the corporate and portfolio restructurings have eroded discretionary cash flows and credit metrics during such phases, Scope believes that it is likely that these strategies will succeed in the long run. On the one hand, Scope considers that two factors mitigate the overall business risk: a greater focus on regulated assets and renewables, and a higher diversification of power generation capacities by increasing the granularity of the generation portfolio. On the other hand, unless wholesale power prices hit new lows, the historical pressure on leverage and interest coverage is likely to fade: new assets are now contributing to cash flows, and there is less pressure on discretionary cash flows after the peak in the investment cycle.

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### Strategic repositioning of integrated utilities

Not all integrated European utilities face the pressure to restructure. While Southern European and British utilities have not been hit hard by the erosion of electricity wholesale prices like in Germany or in the Nordic countries and some utilities have traditionally been strong in renewables or non-European markets, e.g. Iberdrola, DONG, SSE, most utilities were forced into corporate restructuring. However, they are adopting different strategies.

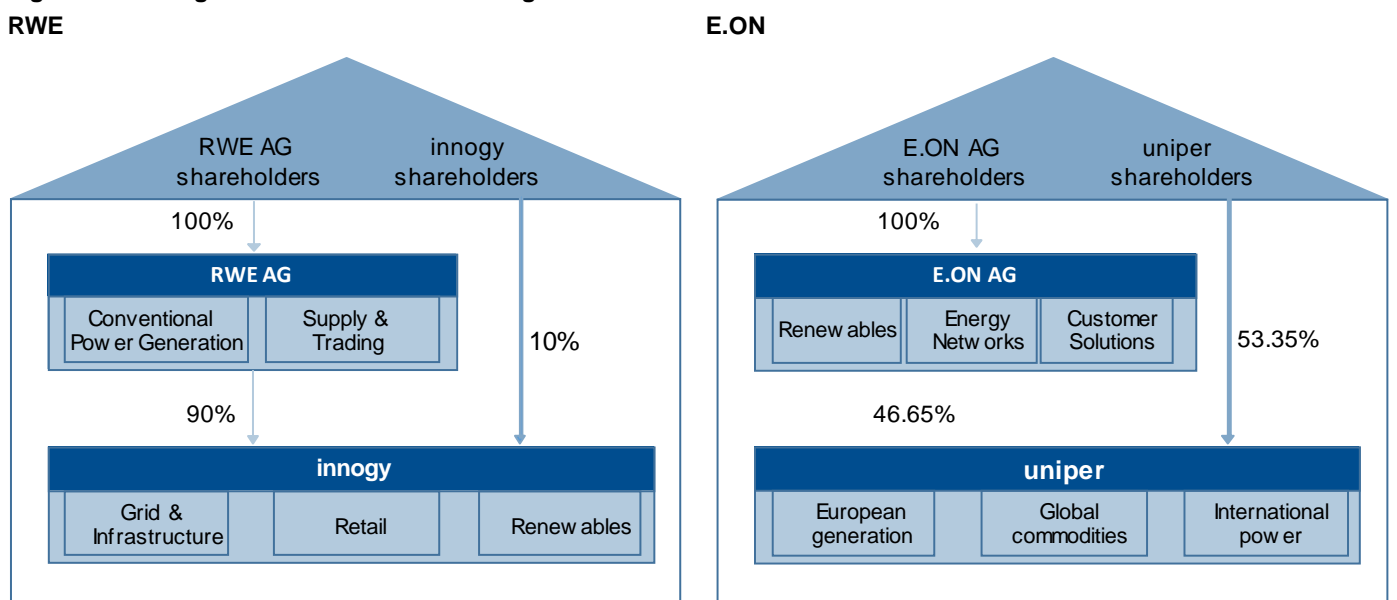
#### German demerger strategy

The two major German utilities (E.ON and RWE) are applying similar restructuring strategies, including a demerger of the original company into:

1. A robust entity primarily comprising the fully regulated and 'green' business, and
2. An entity comprising the conventional generating assets and supply/trading segments.

E.ON has retained the more robust segments – regulated and renewables – under its old roof and spun off unregulated activities under the company 'Uniper' in mid-September 2016. RWE will do the opposite, with a spinoff of the renewables and grid segments under the name 'innogy' (scheduled for Q4 2016).

Figure 2: Envisaged new structures of demerged utilities



Source: RWE, Scope Representation

Source: E.ON, Scope Representation

#### Starting over with a clear focus on preserving or improving credit quality

While this strategy weakens the business risk profiles of spun-off utilities, given the reduced integration and diversification effects, the new entities have more flexibility to pursue the individual company alignments to the energy market. Moreover, the groups are taking the opportunity to restructure each entity's financial risk profile by allocating debt optimally, taking into account the risk-bearing ability and growth prospects of the business model.

#### Asset rotation strategy

The majority of integrated European utilities have decided to apply a less drastic strategy, focusing instead on asset rotation. This strategy was notably pursued not only by EDF, EnBW, ENGIE, ENEL, Vattenfall, EDP, but also by E.ON and RWE prior to their demergers. This asset rotation strategy focuses strongly on de-risking the EBITDA mix, i.e. disposing of volatile non-core assets, and investing in renewables and T&D activities (Figure 1) or more non-European assets, which for some utilities already cover a large portion of annual investment budgets<sup>1</sup>.

<sup>1</sup> Among others, Enel announced that it would allocate more than 60% of its total capex 2016-2019 to Latin America, North America and other Non-European markets. Iberdrola intends to allocate more than 40% of its investment programme 2016-20 to non-European markets, mainly North America and Latin America.

### Smooth transition, but some disadvantages

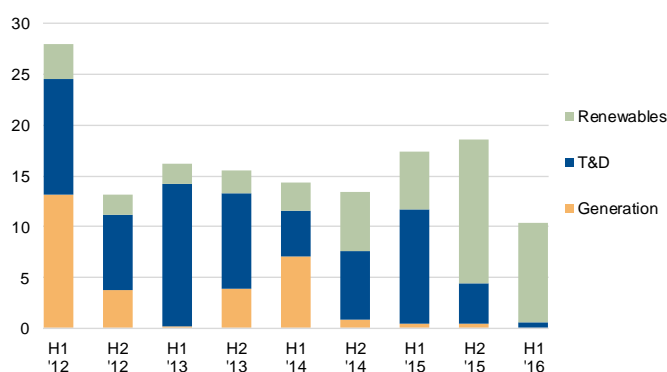
While a spin-off is less drastic than a demerger, it presents disadvantages. Scope notes that the wave of disposals of upstream and stranded generation assets have come at discounted prices, leading to losses or impairments. Moreover, the run to invest in robust assets such as renewables and grids/networks has driven up price premiums<sup>2</sup>. Such imbalances erode the credit quality of utilities, as discretionary cash flows come under pressure during such transformations.

### Energy transformation strongly impacts M&A activities

### Expensive industry transformation, with M&A geared towards renewables, T&D and non-European activities

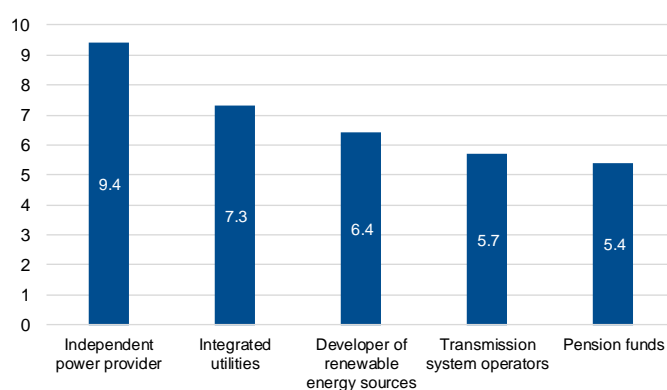
Although all utilities have established their own project development divisions, the in-house development of green power capacities would be too time-consuming because of delayed cash flows and construction risks. In order not to lose further ground to new entrants in the European power generation market, most utilities have undertaken M&A activities. As displayed in Figure 3, M&A since 2013 has been geared more towards promising segments, i.e. renewables<sup>3</sup> and T&D (totalling almost 90% of deal volumes over the past 3.5 years), while deals involving conventional power generation have slowly disappeared. Table 1 provides examples of such transactions over the last two years.

**Figure 3: Europe M&A deal value by segment (by subsector, USD bn)**



Source: Ernst & Young<sup>4</sup>, Scope

**Figure 4: Utilities' WACC hinder potential investments (Indicative WACC in %, nominal pre-tax)**



Source: McKinsey & Company<sup>5</sup>, Scope

<sup>2</sup> According to Ernst & Young, key European T&D utilities have been trading at a 41% premium in 2015.

<sup>3</sup> Mitigating the project risks is usually accomplished by creating separate legal entities with limited credit recourse in case of breach of debt covenants. In this matter, the YieldCos became over the last years a popular option for utilities to shift the risks and easily raise capital.

<sup>4</sup> Ernst & Young: 'Power transactions and trends', quarterly releases Q1 2013 to Q2 2016.

<sup>5</sup> McKinsey & Company: 'Beyond the storm – value growth in the EU power sector', December 2014.

**Table 1: Examples of recent M&A transactions within European utilities' asset rotation strategies**

Date	Utilities	Object of the M&A	Amount
Q3 2016	Vattenfall	Disposal of German lignite assets	EUR 2.3 bn - 2.8 bn
Q2 2016	EDF	Disposal of Polish coal-fired power plants	up to EUR 480 m
Q4 2015	E.On	Sale of E&P entity	EUR 1.3 bn
Q4 2015	Enel	Repurchase of Enel Green Energy S.p.A.	EUR 3.1 bn
Q4 2015	EnBW	Acquisition of majority share in Verbundnetz Gas AG	EUR 125 m
Q3 2015	ENGIE	Acquisition of SolaireDirect S.A.	EUR 200 m
Q3 2015	EnBW	Intended bid for insolvent PROKON eG	EUR 640 m
Q2 2015	GAS Natural Fenosa	Acquisition of Gecal Renovables SA	EUR 295 m
Q1 2015	RWE	Sale of E&P entity	N/A
Q1 2015	E.ON	Disposal of Italian coal- and gas-fired power plants	N/A
Q4 2014	Verbund	Disposals of French gas power plants	N/A
Q3 2014	MVV	Acquisition of wind farm operator Windwärts	N/A

Source: Scope Ratings

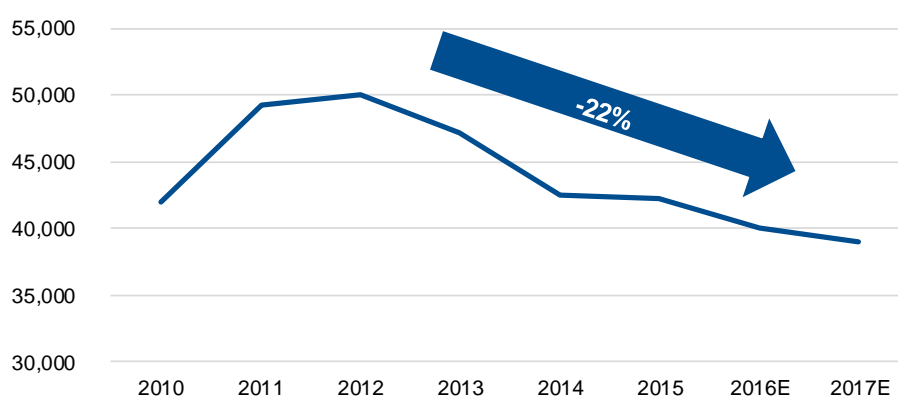
### Stiff competition for assets from non-energy corporates

While the 'buy' strategy helps quicken the conversion to cash compared to the 'build' strategy, Scope notes that the secondary market for renewable and T&D projects is difficult to enter as utilities are facing stiff competition from non-energy corporates. Assets that enhance utilities' credit quality also tend to attract other types of investors. The largely secured cash flow streams appear to be attractive for investors with long-term horizons, such as insurers, pension funds, and other investment companies which often have lower WACC hurdle rates for new investments (Figure 4).

### Investment cycle past its peak

After years of intense debt-financed investment or asset rotation programmes, as well as the resulting pressure on most utilities' balance sheets, Scope expects an improvement. First, utilities can benefit from increasing cash flow contributions from recent investments. Second, the investment cycle of European utilities seems to have passed its peak (Figure 5). According to Capgemini Consulting, the capex of European utilities for the next two years are projected to be at least 20% below the peak in 2012. This is also confirmed by the capex guidances of major European utilities.

**Figure 5: Investments trends 2010/2017E (EUR bn)**



Source: Capgemini Consulting<sup>6</sup>, Scope

<sup>6</sup> Capgemini Consulting: 'Transition énergétique et excellence opérationnelle, la transformation numérique au secours des "utilities"', November 2015.

**Regulation: weaker support for grids and renewables ... but easing competition for assets**

### Regulations are key to further sector developments

Besides external, non-controllable factors such as growing electricity demand and the increase in commodity prices, Scope notes that regulatory support is likely to diminish for new renewable capacities and grid expansions. On the one hand, the achievement of the so-called 'grid parity' for some renewable energy sources, as well as governmental pressure to limit rising electricity prices, have led to a phasing-out of direct incentives such as guaranteed feed-in tariffs and prioritised grid access. On the other hand, lower interest rates are negatively impacting remuneration for the expansion of electricity grids and gas networks. Overall, new investments in these asset classes are likely to generate lower returns, which discourages potential stakeholders and could ease competition from non-energy investors. Moreover, the promotion of tenders for new renewable energy projects in some countries, such as Germany, is likely to lead to slower expansion and fewer distortions in the remaining conventional power plants.

**Capacity remuneration mechanism would be a salvation for stranded power plants**

The implementation of a capacity remuneration mechanism in Germany and Scandinavia would come as a relief for integrated utilities. The remuneration of available spare capacity, like in the UK or some eastern European countries, could take pressure off the balance sheets of utilities that are not perceived sufficiently green and whose gas, hard coal and lignite power plants are being pushed out of the merit order.

**First signs of positive cash flow effects from corporate transition**

### Negative credit impact slowly bottoming out

Scope believes the pressure on credit quality is slowly fading, not only because of the restructurings but also due to the bottoming-out of commodity prices and greater clarity over major utilities' future setups. While credit metrics remain under pressure in the short term, we already see evidence for some utilities that the strategy of substituting volatile margin business for robust ones is finally coming to fruition. Scope regards that the transitions of the major European utilities are complete, with positive effects on cash flow expected by 2018 at the latest.

**Overall more-robust business risk profiles**

Scope regards the corporate restructurings along the energy value chain as positive for the companies' business risk profiles.

Effect	Effect on business risk profile	Scope's view
Market position remains weakened	<b>NEGATIVE</b>	Utilities are unlikely to regain their historic market dominance. This is due to the fundamental changes in the sector's competitive landscape with new players in the market such as independent power providers, insurers, pension funds and other investment companies. However, the overall business risks are consistently decreasing.
Granularity of generation portfolio	<b>POSITIVE</b>	The transition towards uncorrelated renewable energy capacities not only 'cleans' the power generation portfolios and recovers capacity utilisation, but also leads to better diversification, achieved by the higher spread across small-scale power plants.
Geographical diversification	<b>POSITIVE</b>	The rotation of the power generation portfolio may lead to an improved geographical outreach, as most European utilities are showing good progress in expanding their business in developing countries, which constitute the fastest growing market in terms of renewable energy. Scope considers that the inherent risk linked to developing markets is mitigated by secured business targets, i.e. renewable energy, transmission/distribution, or conventional power plants in markets with an undersupply of electricity (Asia, Middle East, Latin America).
Asset quality	<b>POSITIVE</b>	The acquisition of new and young assets will have a positive impact on financial statements as the renewable energy plants have an average lifetime of 20 years.
Profitability and Efficiency	<b>POSITIVE</b>	The shift to regulated and secured business stabilises and even increases revenue streams and EBITDA margin.

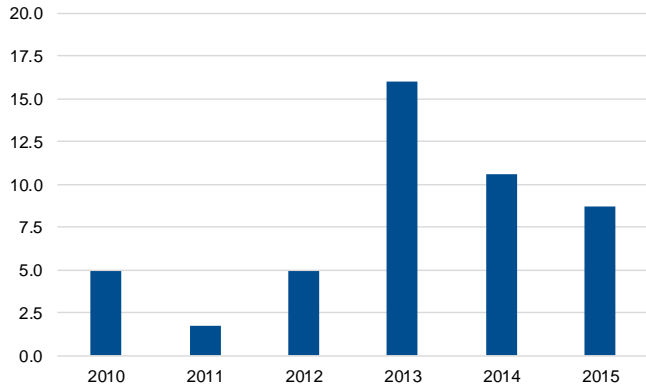
Effect	Effect on business risk profile	Scope's view
Increasing exposure to grids/networks	<b>NEUTRAL</b>	The exposure to exploration, production and generation activities has diminished, while the capex in transmission and distribution has increased and gained importance within the business model. Although this exposure may dilute overall profitability, particularly after adjusting capital costs for new investments, the reliability of full cost coverage from T&D activities provides improved visibility on the robustness of the business model, even in a weak economic environment.
Environmental, social and corporate governance (ESG) aspects	<b>POSITIVE</b>	The decrease of exposure on conventional polluting energy generation is seen positively in term of ESG norms. In the past, CO <sub>2</sub> emissions of utilities due to coal and lignite lines have been an unfavourable factor, both in terms of customer appeal and expensive environmental mitigation fines.

### Transformation enhancing financial risk profiles in the longer run

Regarding the financial risk profiles of integrated utilities, we note that the heavy investment programmes and interim pressure on EBITDA and cash flow measures are likely to fade over the next few years, if we do not see new troughs in commodity and electricity wholesale prices.

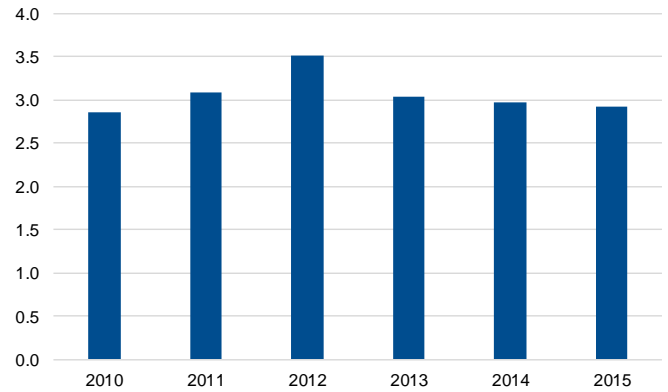
Effect	Effect on financial risk profile	Scope's view
Free cash flows	<b>NEGATIVE in the short term</b> <b>NEUTRAL in the mid and long term</b>	The imbalance between asset prices for disposed and acquired/operating assets, in conjunction with shrinking operating cash flows, has led to negative cash flows for many integrated utilities. It seems sustainable assets were only disposed of to keep financial debt under control. As the investment cycle is likely to be past its peak and recent investments will eventually enhance operating cash flows, Scope believes that free cash flows are likely to be positive again.
Discretionary cash flows	<b>POSITIVE</b>	Faced with eroding profits and dividend payments, utilities have adapted their strategy. Although utilities will remain attractive as a dividend play, many companies have adopted more modest dividend policies over the past few years. This approach will also help preserve value and keep leverage ratios under control.
Credit metrics bottom out	<b>NEUTRAL TO POSITIVE</b>	Until the end of the business restructuring, Scope expects leverage and debt protection measures to remain an issue for utilities as (i) the asset rotation plan partially covers the costs of new investments and (ii) lags in either the construction or grid connection of new projects could delay expected cash flows.  In the long term, Scope expects European utilities' financials to improve as the transition to new business models are coming to an end. utilities should therefore be less exposed to market fluctuations and volatility. Scope expects an overall decrease of investment capex by 2020 at the latest, and a deleveraging starting in 2018, which will benefit leverage and interest-coverage ratios.
Increased usage of alternative financing	<b>POSITIVE</b>	The use of hybrid debt has helped reduce leverage levels. As these securities are not fully recognised as debt by other rating agencies, many European utilities had the possibility to increase debt without their credit ratios deteriorating. As shown in Figure 5, Scope estimates that just in 2015, close to EUR 9bn of hybrid debt was issued by European utilities. A third was used solely to strengthen the balance sheet, and the remainder used to replace existing hybrid debt upon call.
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**Figure 6: Usage of hybrid debt of European utilities (EUR bn)**



Source: Dealogic/Natixis for CapGemini<sup>7</sup>, Scope

**Figure 7: Development of leverage (net debt/EBITDA) of European integrated utilities**



Source: Scope

<sup>7</sup> Capgemini: '17th European Energy Markets Observatory', November 2015.



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