

# E.ON, Innogy and RWE light up the German energy industry: a €43bn structural reshuffle

**Innogy SE (ETR: IGY) – market cap as of 06/04/2018: €21.2bn**

**E.On SE (ETR: EOAN) – market cap as of 06/04/2018: €19.9bn**

**RWE AG (ETR: RWE) – market cap as of 06/04/2018: €12.2bn**

## **Introduction**

On March 10<sup>th</sup>, German electricity-utility company RWE announced it had reached an agreement to sell a 76.8% stake in Innogy to the other major German energy company E.On. The deal is characterized by a complex swap of assets between the firms that – as a whole – reaches €43bn in value. This event will definitely reshape both the German and the European energy markets in the years to come.

## **About E.On**

E.On is a German company headquartered in Essen that provides a wide range of energy services going from generation to retail and distribution. It offers also solutions for energy management for firms.

E.On was formed in 2000 through the merger of energy companies VEBA and VIAG. It later acquired British Powergen in 2002 and in 2003 it entered the gas market through the acquisition of Ruhrgas. In recent times, E.On reduced its nuclear capacity and investments due to German regulation and separated its fossil energy businesses into a new company, Uniper, which started operating on January 1<sup>st</sup>, 2016. Then, it floated a 53% stake in such business on the Frankfurt Stock Exchange in September 2016. In 2017, it agreed to sell its remaining stake in Uniper to the Finnish power company Fortum. E.On has been recently improving its profits, with a YoY growth in net income of 58%, from €900m to €1.4bn. The main reason seems to be the decrease in debt expenses rather than an improvement in the operating performance, given that sales figure slightly dropped from almost €39bn in 2016 to €38bn in 2017.

## **About RWE and Innogy**

RWE is a German electric-utilities company, headquartered in Essen, North Rhine-Westphalia and listed on the Frankfurt Stock Exchange.

It was founded in 1898 and started operating in 1900 with its first plant for electricity generation from coal. It then expanded into gas and in the 60s into the then-promising nuclear business. Flash forward to the 2000s, it entered the UK market purchasing the British company Innogy, at the time the leading electricity supplier in the UK and the number two in the gas market. After a few years of turmoil, in 2015 the company decided to undergo a strategic restructuring, shifting away from the heavily taxed nuclear sector and from traditional resources to renewables. To this end, it concentrated all renewables operations under the subsidiary Innogy and listed it on the Frankfurt Stock Exchange in 2016. Over the last two years, Innogy has proven to be a solid player, with €4.3bn in EBITDA and €1.2bn of Net Income.

The RWE group is composed of 3 more divisions besides Innogy. The first one is RWE Generation, one of the leading power generation companies in Europe. In Germany alone, its power plants currently provide one third of supply, but it is also a major player in the Netherlands and in the UK. The second one is RWE Power, focused on lignite-based and nuclear power generation. Finally, RWE Supply & Trading, a leading European energy trading

house and an active player in the global wholesale markets for energy and raw materials in both their physical and derivative forms. As a whole, the group generated in 2017 €44.6bn in revenues and €5.8bn in EBITDA (6.5% increase YoY), with an incredible boost in net income from a loss of €5.7bn to a positive €1.9bn, due to several factors such as an increase in both gas and oil prices and a general increase in demand in all its core segments.

## Industry overview

The German energy sector is deeply influenced by government regulations. In 1998, the country went through a process of liberalization of the industry, abandoning the semi-monopolistic model that assigned providers to consumer areas. Following this process, four companies dominated the market: E.On, RWE, EnBW and Vattenfall, the so called 'Big Four'. Together, they controlled 73% of the market in 2010. By the end of the year, the German government enacted an ambitious plan to implement the 'Energiewende', an 'energy transition'. It established targets to cut down the level of carbon emissions with respect to 1990 levels by 40% by 2020 and by 80-95% by 2050. Furthermore, the country has adopted the EU goal of having 16% of total national energy needs coming from renewable sources by 2020 and 60% by 2050.

In 2011, in response to the nuclear accident of Fukushima, the German authorities established that they would phase-out all nuclear reactors by 2022. The announcement of the 'Energiewende' posed a difficult task to Germany's energy suppliers. As a reaction, they performed several actions aimed to minimize the effects of the plan, such as separating green energy and fossil fuels businesses in different companies. The effects on consumers was also harsh: in 2017, German households paid the second highest electricity tariffs in the EU, 49% more expensive than average.

As a consequence of the German government efforts in this direction, renewable sources of energy play a large and growing role in the sector. The goal of regulators is to ensure an affordable and reliable clean energy supply. Such commitment poses enormous difficulties to the market and the government: the inconsistent generation of energy by solar and wind power creates the necessity to upgrade the transmission lines and to provide other sources of energy during periods when the demand is too high, or supply is too low. Moreover, solar and wind power generators incur higher maintenance costs, thus contributing to a high overall energy fee. The implementation of such sources has also affected the reliability of supply: in fact, interruptions have risen by 30% in the last three years in Germany.

The government, however, has been striving to balance those difficulties by heavily subsidizing green sources of energy: indeed, renewables surcharges account for 23% of the price paid by consumers for electric power. Nonetheless, the sector has signaled that it progressively less reliant on incentives: or instance, in March, Vattenfall won the auction to build Europe's first wind farm entirely without subsidies in the Netherlands. The significant drop in the cost of renewable sources plays a big role in this newly acquired independence: for example, in 2010 it cost \$250 to produce one megawatt-hour with solar energy, while it now costs only \$50 on average.

Meanwhile, Germany's main energy providers suffer pressures by the public too. They are accused of still relying too much on fossil fuels and nuclear plants, and they are often viewed as the responsible for the high energy tariffs. However, in the composition of the price of electricity, power providers have control on 20% of the tariff only. The remaining 80% is dedicated to paying taxes, grid fees and renewable surcharges: therefore, there is little margin for optimization of costs and improvement of profits, implying margins squeeze over the last years for power providers. However, the situation for German energy companies has recently improved significantly: in 2017, the supreme court ruled that a tax on nuclear plants was illegal, thus granting nuclear power providers a refund of €6bn on surcharges collected between 2011 and 2016.

## Deal structure

This unorthodox transaction is the latest move by E.On and RWE to streamline their respective portfolios. Largely an asset swap, little cash will change hands between the two. The transaction consists primarily of E.On's acquisition of RWE's 76.8% stake in Innogy in exchange for shares and assets. The breakdown of the transaction is as follows:

- E.On acquires RWE's 76.8% stake in Innogy and receives around €1.5bn cash payment from RWE;
- RWE receives 440m newly issued E.On shares, representing a 16.7% post-money stake in E.On;
- RWE's consideration also includes asset carve-outs, such as E.On's Renewables business, Innogy's Renewables business, Innogy's German and Czech Gas Storage business, E.On minority stakes in RWE's nuclear plants Gundremmingen (25%) and Emsland (12.5%) and Innogy's 37.9% stake in Kelag.

E.On will acquire the above mentioned 76.8% Innogy stake for a total consideration of €17.1bn (including FYE17 and FYE18 dividends) plus the cash payment plug, thus valuing Innogy's total equity at €22bn. E.On will launch a voluntary public tender offer for Innogy minorities at €40 per share, representing a 28% premium on the unaffected Innogy share price and an implied 2018E EV/EBITDA of 10.5x. Innogy has €21bn in net debt and 2018E EBITDA in the range of €4.1-4.2bn.

## Deal rationale

Both RWE and E.On are repositioning themselves within the European energy landscape by refocusing their respective portfolios. Both CEOs believe their companies are now better suited to compete in a transitioning market. RWE will become a diversified energy producer with the third largest renewables portfolio in Europe, while E.On will become the first European company with downstream operations exclusively and a focus on intelligent networks and innovative customer solutions.

E.On has been focused on re-allocating capital to its strongest business units and improving its financial position over the past two years. This deal, in addition to the spin-off of Uniper (their fossil fuel assets) in 2016, have largely accomplished this. The main strategic benefits on the acquisition side of the asset swap with RWE are the strengthening of its energy networks and customer solutions business. Innogy was acquired at an implied 10x EV/EBITDA multiple. On the divestment side, it also crystalized value in its renewables business at 11x EV/EBITDA, which was the 10<sup>th</sup> largest portfolio in Europe and only represented a 15% contribution to overall E.On's EBITDA. These divestments of non-core assets helped make the swap slightly net cash-positive.

E.On will benefit from the increased scale and specialization, especially as competition intensifies in new distributed energy model. It aspires to create a new platform for energy transition (such as decentralized generation, e-mobility, storage and digital energy solutions), plus potential opportunities in adjacent businesses such as broadband. The integration with Innogy could potentially help attain this vision through its investment in the grid & infrastructure businesses (FTTx) and its e-mobility charging points.

In its customer solutions business, E.On will increase the number of customers its serves to 50m from 31m in 2017, while its energy networks RAB will increase from €23bn to €37bn (its core operations generating around 60% of EBIT in 2017). The Innogy integration will also provide cost synergies for E.On: it expects to cut a

maximum of 5,000 jobs – equating to less than 7% of its workforce – and to realize €600m to €800m in synergies annually by 2022 (10%-15% of controllable costs).

For RWE the deal is seen as a growth avenue through renewables, it gives up part of the non-core units in Innogy while gaining scale in renewables as well as gaining a stake (16%) in a stronger combined entity, E.On. From RWE's point of view, the reorganization of its portfolio also seems to be advantageous. That said, no synergies are forecasted. Therefore, assuming that the valuation is correct, this is largely a NPV-neutral transaction, but with upside given by potential superior performance of the pro-forma organization due to factors like scale.

### **Market reaction**

The deal was well received by the market, who probably perceived it as a fundamental redefinition of the strategic approach of the companies bringing more focus and efficiency. Innogy's share price jumped up from €34 to almost €39, close to €40 purchase price paid by E.On. RWE's share price from €18 to a stable €20. Finally, E.On's share price itself increased from €8.40 to €9.50, later stabilizing at €9 per share.

### **Financial Advisors**

Perella Weinberg Partners and BNP Paribas are acting as financial advisers to E.On. RWE is being advised by Bank of America Merrill Lynch and Citigroup. Finally, Rothschild provided a fairness opinion to RWE's Supervisory Board.