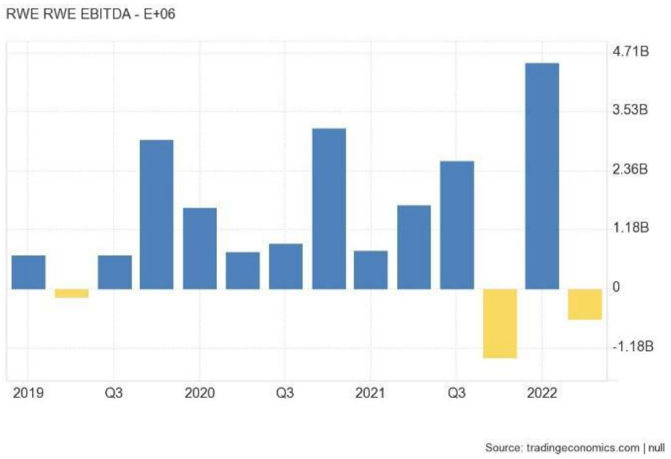
RWE Acquires Consolidated Edison's Clean Energy Business

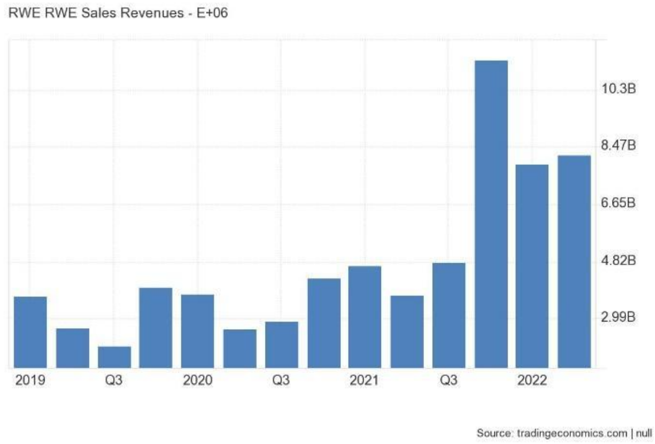
Introduction

On October 1, 2022, RWE [XETRA: RWE], a German power generation company that ranks third in the EU for the quantity of renewable energy it produces, announced its plan to purchase Consolidated Edison's [NYSE: ED] green energy division. As a result of the current US administration's Inflation Reduction Act, which provides a 10-year framework for investments in clean energy and significant tax breaks for its participants, it is one of the largest renewables mergers ever and by far the largest of Biden's presidency. The transaction, worth $6.8bn (about €6.8bn), includes an equity contribution through a mandatory convertible bond of €2.4bn to the Qatar sovereign wealth fund, with the remaining amount covered by a bridge loan. Con Edison was valued at an EV/EBITDA multiple of 11x in this transaction, nearly twice RWE's own multiple.

About RWE

RWE is a German electric-utilities company founded in 1898 with its first plant for electricity generation from coal. It then expanded into gas before moving into the nuclear business in the 1960s. Fast 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. In addition to Innogy, RWE also has its Generation branch, 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. Another branch is RWE Power, focused on lignite-based (also known as "brown coal", made from compressed peat) and nuclear power generation. Finally, RWE Supply & Trading, is 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. The group generated €24.5bn in revenues and €3.6bn in EBITDA (11% increase YoY) in 2021.





Recently, the RWE stock has been boosted by the European energy crisis, as it led to the firm being allowed to extend the duration for which it will be allowed to continue using heavily polluting lignite to generate electricity to 2030. It is to be noted that in the regions where the Russian invasion is taking place, RWE has no operations, assets, or personnel. There are contracts with Russia for 15tWh of gas, with 50% of that amount due for delivery in the next year, and for 12 million tons of coal, with 2 million tons of that amount due in that same time frame. There will be no new energy supply agreements made with Russian counterparts to minimize risk when possible, and RWE has stopped receiving any non-energy goods from Russia to diversify its fuel supply. Chief Executive Markus Krebber implies that RWE is "contributing to security of supply in Germany by temporarily increasing the use of our lignite-fired power plants" and is "thus also helping to displace gas from electricity generation, [whilst] investing billions of euros to accelerate the energy transition and are ready to phase out lignite [fully] by 2030." The invasion calls into question the possibility of these set goals even despite RWEs optimism, and some believe that this transaction is meant to fuel this transition by funding it.

About Consolidated Edison

Founded in 1823, Consolidated Edison, Inc., commonly known as ConEd, is one of the largest investor-owned energy companies in the United States, with approximately $13.6bn in annual revenues, $1.3bn in Net Income, and $63.1bn in assets.

Its regulated businesses are operated through subsidiaries: Consolidated Edison Company of New York (CECONY), Orange and Rockland Utilities (O&R), Con Edison Clean Energy Businesses, Inc., Con Edison Transmission, Inc. Customers. CECONY operates the largest steam distribution system in the United States, and O&R Utilities supplies electricity and gas in New York, New Jersey, and Pennsylvania. Clean Energy businesses develop, own, and operate renewable and sustainable energy infrastructure projects and provide energy-related products and services to wholesale and retail customers. Con Edison Transmission invests in transmission projects and manages both power and gas assets through its wholly owned subsidiaries, Consolidated Edison Transmission, LLC and Con Edison Gas Pipeline and Storage, LLC.

Overall, CECONY represents the vast majority of ConEd's operating revenue, ca.85% while O&R and their clean energy division sold to RWE amount to only around 7% and 9% respectively of yearly capital expenditures and operating revenues. The rest of the operating lines contained in Con Edison transmission are reported underneath CECONY revenues.

Deal Rationale

The Inflation Reduction Act, which Biden signed into law in August, is the primary reasoning behind the agreement. It provided large tax benefits for renewable energy initiatives and raised the value of US clean power portfolios nationwide. American Electric Power and Duke Energy, two of ConEd's main rivals, have also made comments indicating their intention to sell their unregulated green energy businesses (which are now in particular facing fierce competition), in order to "both simplify and de-risk[their businesses], " more specifically to the transmission side of the business. US utilities operators are showing a preference of investing their capital in transmission grid upgrades and renewable projects within their core, regulated businesses. Selling makes sense for ConEd, as anticipated. The company primarily manages utility-scale renewable projects in the west and south-west that total around 3.1 gigawatts and include solar farms in Texas and California.

But the majority of ConEd's clients are centred in the northeast. ConEd would incur significant costs to physically reach its main market, which would ultimately render an already expensive ESG initiative unsustainable. The geographical synergies of the agreement are further highlighted by RWE, which is already dispersed throughout the United States, and will thus rank as the fourth-largest renewable energy provider in the country following the acquisition.

There are further justifications for the disposal besides just the geographical synergies, however. ConEd expects to spend up to $15.7bn in capital expenditures between now and 2024 that it will not be able to naturally cover due to a decline in cash flow. By selling off its clean energy business, it avoids using the financial markets (through what was originally meant to be a $850m share offering) at a time when interest rates are sharply rising to combat inflation and stock market valuations are coming down.

With the transaction, RWE's US renewable portfolio capacity will increase to more than 7GW. But given that Europe is currently experiencing an energy crisis, it has already drawn criticism for opting to make a sizable acquisition elsewhere rather than invest in its home market. Activist investor group Enkraft Capital called the entire transaction "incomprehensible" given the circumstances, but investors may, however, commend it for diversifying away from Europe's troubled economies and stagnant political climate, and they should be pleased because the transaction's cash flow will (hopefully) enable them to maintain adherence with their updated decarbonization timelines as they re-scale up carbon-based fuel sources to combat the global energy crisis caused by the Russian invasion of Ukraine.

Deal Structure

RWE will fund its acquisition through debt and equity. Specifically, it will issue a mandatory convertible bond to a subsidiary of the Qatar Investment Authority (QIA) with an aggregate principal amount of around €2.43bn, whilst the rest of the $6.8bn enterprise value will be covered by a bridge loan. Later on, or when financial conditions improve, this bridge loan will be partially refinanced by an equity offering. The convertible bonds will be convertible into new RWE shares within one year, which would account for just under 10% of the company's current share capital. RWE intends to follow through on its commitment to pay a dividend of €0.90 per share in 2022 with a long-term pay-out ratio of 50-60%.

The acquisition values Con Edison Clean Energy Businesses at an EV/EBITDA multiple of 11x, a rather attractive price considering the majority of green and renewable energy companies trade at a multiple closer to 20x. RWE forecast the acquisition to increase EBITDA by $600m, making the deal accretive (post-PPA) right away. Nevertheless, there will be substantial interest payments and a high cost of debt due to the large amounts of debt assumed to finance this acquisition and rising interest rates. It's unknown how the company's bottom line will ultimately turn out as a result of this.

The Federal Energy Regulatory Commission, the Committee on Foreign Investment in the U.S., and the Committee on Antitrust must all approve the transaction in accordance with applicable antitrust laws. The agreement is anticipated to be finalized in the first half of 2023. Joe Biden's desire to enforce antitrust laws more rigorously, with five mergers already taken to court this year, may prove to be a hidden challenge facing this deal.

Market Reaction & Outlook

Following the announcement that RWE will purchase Con Edison's Clean Energy Business, RWE's stock jumped 7% the following week, while Con Edison's stock increased by 4% before tumbling 11% over the following two weeks. With increased profitability in light of Europe's energy crisis, RWE has been Germany's best-performing blue-chip company. RWE shares have risen 15% over the past year, whilst the wider German market has declined 21% during the same period.

The benefits of RWE spreading its operations out of war-torn Europe and its stagnant economies and into the US can be used to rationalize the purchase of RWE shares. However, activist investor Enkraft Capital, which owns 0.15% of RWE, expressed its discontent regarding the deal, stating that it was “incomprehensible” how RWE could spend €7bn an M&A deal in the US “amidst the biggest energy crisis Germany has ever seen”. They suggest that other big European utilities have more ambitious plans for their green transition. Enel, an Italian firm, and Iberdrola, a Spanish one, want to reach 129GW and 95GW, respectively, in green power-generation capacity by 2030, making RWE’s plan to reach 50GW in the same time seem uninspired. This, combined with the fact that it will have a large legacy business for some years, means that RWE’s valuation is lower than it should be, notwithstanding the prospect of a very profitable year and its rising share price, says Mr Kormaier of Enkraft Capital.

RWE has a history of being the target of environmental protests, due to their use of lignite, a particularly polluting type of coal. The recent acquisition is part of a much bigger realignment towards green energy, with plans to invest €50bn to increase renewable-power capacity from 25 to 50 GW within eight years and a pledge to fully phase-out coal by 2030. The acquisition of Con Edison CEB, is a step in the right direction to achieving this goal without sacrificing profitability.

Paul Patterson, an energy market analyst, claims that many other US utilities are also considering selling their competitive renewable assets in response to this deal and favourable market conditions. Investor-owned utility American Electric Power announced plans to invest in its regulated businesses on 4th October. They are planning a $40bn capital investment through 2027 that also includes distributed energy and transmission. Also on 4th October, Duke Energy announced it would spend $145bn for critical energy infrastructure, including about $75bn to modernize and harden its transmission and distribution infrastructure; $40bn for zero-carbon generation, such as solar, wind and battery storage, and extending the life of its nuclear power facilities; and about $5bn in hydrogen-enabled natural gas technologies.

Deal Advisors

Con Edison was represented by Barclays as financial advisors and Latham & Watkins, LLP as legal advisors. International teams from Latham & Watkins, Freshfields Bruckhaus Deringer, Hengeler Mueller, Cravath Swaine & Moore and Linklaters gave RWE legal advice on this deal.

