

Time for transition: Energy M&A 2022

Dealmaking in the age of COVID, digital disruption
and energy transition

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Foreword



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While world leaders have been gathering for COP meetings for decades, what made COP26 perhaps particularly notable is that the private sector also gathered in force, and with a commitment to be a key driver of decarbonisation.

In previous years, there have been murmurings from various corporates that to make social or environmentally driven investment decisions may not align with their fiduciary duty to act in the interests of shareholders. As shareholder activism has driven the debate into boardrooms from above, this attitude is rapidly reversing direction. While returns are generally seen as lower in the clean sector compared to, say, the oil and gas sector, being invested in the green transition is increasingly seen as a key route to preserving and protecting shareholder value.

In addition, voluntary and mandatory climate-related disclosures are aligning the drivers for investors across the board so that capital is increasingly driven by the metrics they produce. This is being reflected in, among other things, the plummeting cost of capital for green investments. Meanwhile, carbon-intensive investments are struggling to gain funding, with many facing insolvency.

Investments in the energy transition will principally take the form of M&A. The outcome of COP26 and the momentum it has generated means that European dealmakers in the energy sector will be even busier in 2022. Europe leads the world in the energy transition and the race to net zero is driving near-record levels of dealmaking – notably in wind and solar photovoltaic generation.

At the same time, the energy transition is both expanding and fragmenting the energy sector. For many, it has traditionally been focused on energy generation. The transition is bringing to the fore less visible technologies. Everything from traditional hydropower to grid-scale batteries, electrification of transport and hydrogen. It is also bringing into the mix sectors that have not traditionally been focused on energy, such as industrial decarbonisation, shipping and mining for the natural resources needed for the energy transition.

In parallel with this, there is a huge and growing story around energy transmission and distribution. Electricity networks will need to expand massively to facilitate electrification and new technologies. They are also becoming smarter with the use of digital technology to optimise the way power is distributed, traded and consumed. Further, new types of networks may provide investment opportunities for those looking for stable long-term assets, such as hydrogen and carbon networks.

Against this background, traditional fossil fuel-based players are decarbonising. For the oil and gas majors, this means acquiring or significantly enhancing their capabilities in renewables while simultaneously divesting selected carbon-intensive assets. This may be one of the reasons why 50% of respondents in our study point to distress-driven deals as a top sell-side driver.

Change is endemic in the energy sector, but the current transition makes the years since liberalisation of energy markets in the late 1980s seem almost steady-state in comparison. Despite the momentum and push for capital to be invested in the energy transition, there remain obstacles, not least the limited pipeline of quality investments, continuing concerns over COVID-19, financing difficulties arising from potentially unstable long-term revenue streams and diminishing rates of return. Notwithstanding these, our study finds that energy M&A will increasingly be an engine driving capital into propositions that match social and political ambitions for the green transition.

Shop, drop and COP: The energy M&A market in 2022

A 'flight to safety' to premium assets and also undervalued targets and distress driving energy sector M&A in 2022

Top findings

75%

are considering an acquisition and/or a divestment

45%

think COVID-19 will be one of the main M&A obstacles over the next 12 months

55%

see potentially undervalued targets as one of the top buy-side drivers

50%

expect distress-driven M&A to be a top sell-side deal driver

European energy sector M&A performed strongly in 2021. Volume was up 25% compared with 2020, while deal value rose 33% to US\$135bn versus US\$101.5bn in 2020. The deal volume for 2021 is the highest for on record since 2006.

Power and transmission (including renewable energy) stands out as the number-one deal generator, with a total of 442 transactions in 2021. This is far ahead of oil and gas (with 73 deals) and utilities (69 deals). In terms of value, utilities transactions totalled US\$43.5bn, power and transmission accounted for deals worth US\$46.8bn, while oil and gas transactions came to US\$37.9bn.

Private equity acquirers were out in force in 2021, deploying dry powder totalling US\$31.9bn through the year. This is the highest PE value for European energy sector deals since 2016. The majority of buyouts involved power and transmission targets, including renewables.

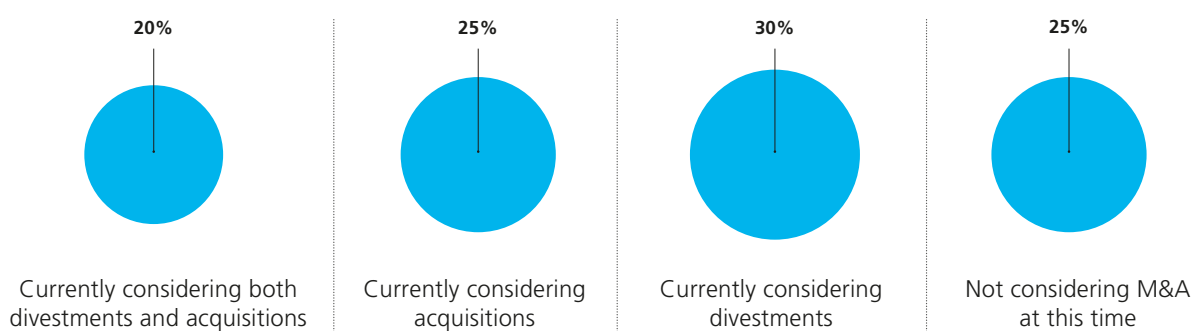
Although overall M&A activity was strong, dealmaking cooled somewhat as the year progressed in the face of resurgent COVID, rising inflation and turbulence on global gas markets. Volume dropped from 177 deals in Q1 to 116 in Q4 and value also slid, falling from US\$42.7bn in the first quarter to US\$17.6bn in the third, before rebounding somewhat to US\$39.7bn in the final quarter of 2021.

A fair COP?

Energy sector M&A is heavily influenced by the regulatory environment, more so than most other sectors, so it is no surprise that dealmakers kept a close eye on November's UN Climate Change Conference (COP26) held in Glasgow.

The final COP agreement fell somewhat short of expectations. But there were some notable achievements. Among them was the formal adoption of Article 6 of the Paris Agreement, which paves the way for stronger carbon markets.

Where does M&A currently fit into your corporate strategy? (Please select only one)



COP announcements seldom move markets. But COP26 appears to be an exception. The carbon price on the EU's Emissions Trading System (ETS) shot up in the aftermath of the summit, traversing the €70/tonne threshold for the first time on record. This is more than double the price at the start of 2021.

"COP26 has certainly promoted public discussion on climate change, resulting in increased pressure on private – and particularly listed – companies to improve their green credentials and to aim for transition to net zero carbon emissions," says Dr Holger Kraft from CMS Germany. "For many companies, acquisitions will be an important tool for coping with the new expectations as this will allow a relatively quick achievement of the goals compared to developing new green businesses from scratch."

Varinia Radu, Head of Oil & Gas for CMS CEE, agrees that COP will speed up M&A. "We expect

a firmer position on phasing out coal after COP26 and so even more accent on replacing the retired capacities with new ones. We see large players coming into these markets, some buying off the local developers or actively participating in capacity auctions."

Opportunities and obstacles

Our study reveals that dealmakers are racing to acquire new capabilities (particularly ones in renewables) and divest old ones that no longer fit their business models. Indeed, 2021 saw the highest-ever volume of deals involving power and transmission assets (including renewables).

"While we expect to see an acceleration of investment in renewables, energy efficiency projects and alternative fuel/storage solutions (such as hydrogen and Carbon Capture Storage) as certain stakeholders pivot away from carbon-intensive businesses, there will be continued

One of my takeaways from COP26 is the start of a move towards a more open and quantifiable measurement of emissions and environmental impact. We can expect that in time ESG and climate reporting will be elevated to a similar position as financial reporting. Businesses will need to build a clear sustainability strategy and targets, supported by robust measurement and accountability.

*Cecilia van der Weijden,
Partner, Corporate/M&A and Head of
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investment in traditional fossil fuels (e.g. the coal sector) at least in the short to medium term,” says Marc Rathbone, Head of Oil & Gas for Asia at CMS.

Against this background, three quarters of respondents are considering an acquisition and/or a divestment. Divestments predominate, with 30% looking to sell off assets or subsidiaries. Meanwhile, 25% are considering acquisitions and 20% of respondents are considering both divestments and acquisitions. All of this suggests that dealmaking is likely to gain momentum moving into 2022.

While the appetite for dealmaking remains robust, respondents are mindful of the obstacles that lie ahead. COVID-19 remains the number-one concern and is cited by 45% of respondents as a potential blocker – despite the fact that dealmakers have become increasingly adept at running M&A processes in the pandemic environment.

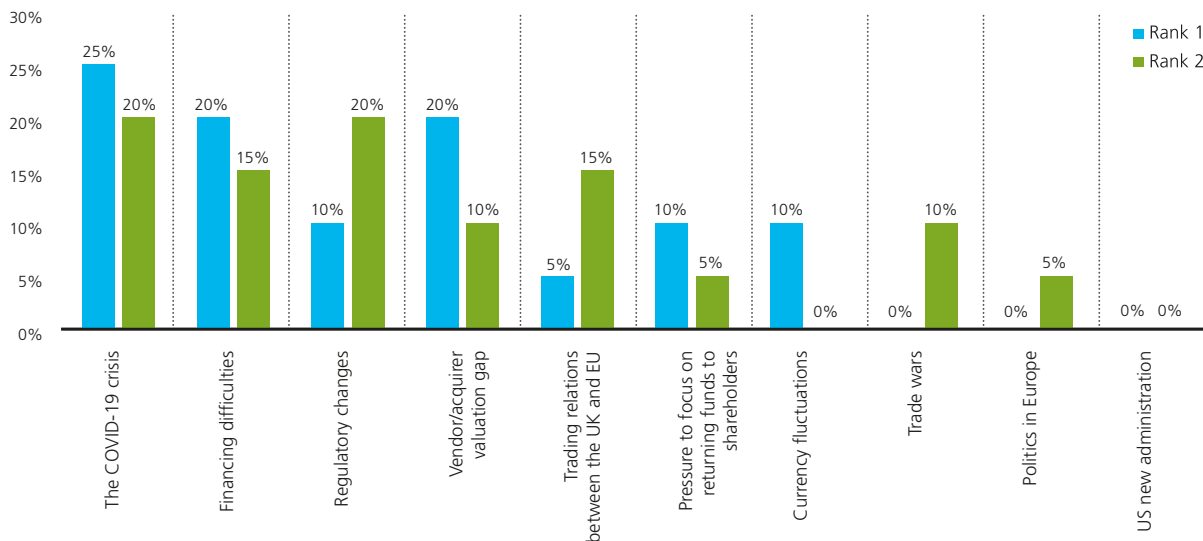
Financing difficulties and the vendor/buyer valuation gap are also highlighted as hurdles, cited by 35% and 30% respectively. Regulatory changes also figure prominently, although these are cited as a blocker by only 10% of respondents as the top choice. Rather than being an obstacle, regulatory changes are in fact the reason why many deals are done in the first place. Divestment of carbon-intensive assets is an example.

“Despite a strong push towards net zero, there are many challenges facing investors such as ensuring capital discipline, preserving shareholder value and ensuring

Technology and digitalisation is impacting the energy sector in much the same way as it is many other sectors. As a broad generalisation, technology facilitates efficiency, innovation, the streamlining of processes and the mitigation of risk. As a consequence of this, it is inevitable that technology and digitalisation will serve as an enabler for the energy transition.

Babita Ambekar, Partner, Corporate/M&A, CMS Singapore

What do you believe will be the principal obstacles to M&A activity in Europe over the next 12 months? (Please select top two)



that shareholders' expectations for decarbonisation are met," says Rathbone. "Just as some carbon-intensive projects are finding it increasingly difficult to obtain financing, or refinancing, and insurance, investment in cutting edge or new technology also has its challenges."

'Bargains' and distress drive deals

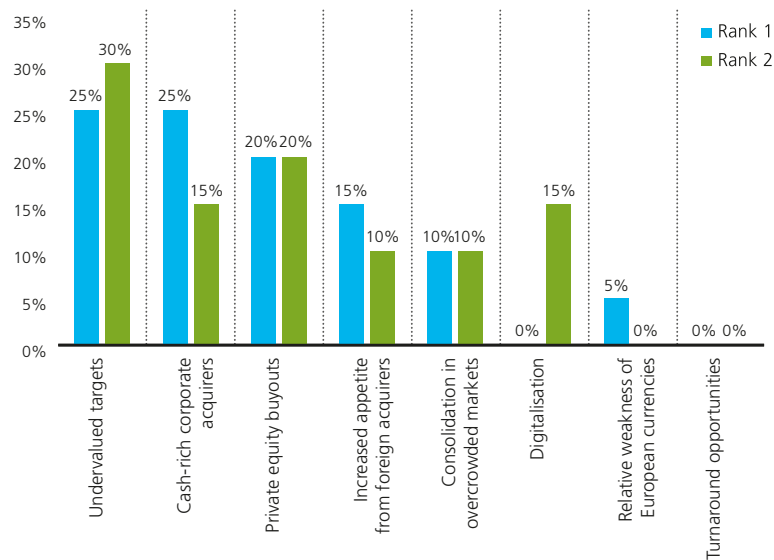
Respondents are clearly anticipating a bumper crop of bargains in 2022 with a majority (55%) expecting undervalued targets to be the leading driver of M&A activity. This finding is echoed by sell-side data, which shows distress-driven M&A as the likely top driver over the coming 12 months.

Corporate rather than financial acquirers are expected to be the dominant buy-side force over the next 12 months, but only just. While cash-rich corporate acquirers and private equity buyouts are neck and neck (each cited by 40% of respondents), corporates have the edge, garnering 25% of first-choice votes versus 20% for private equity.

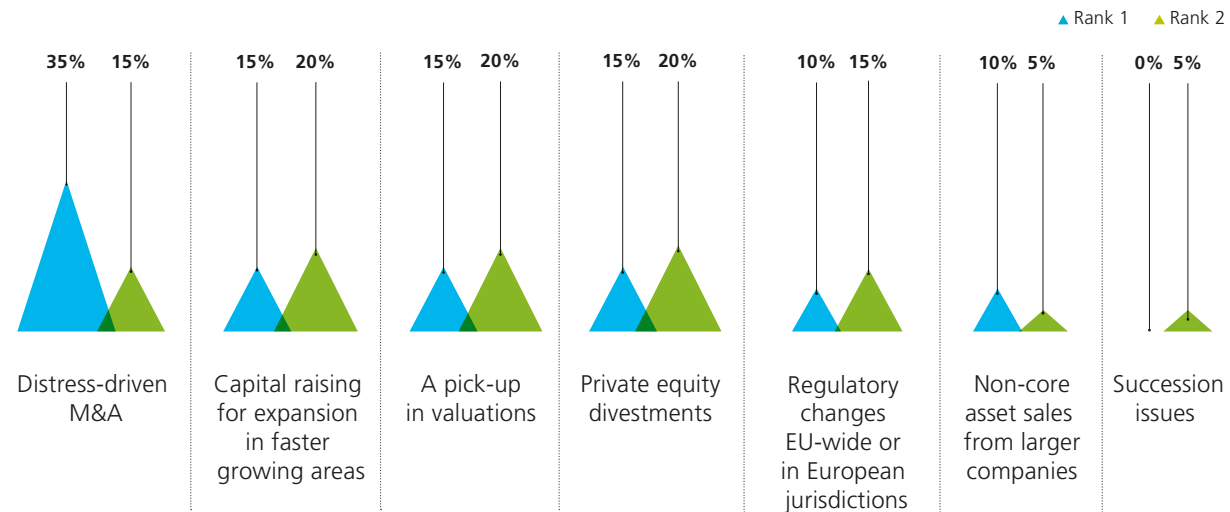
Digitalisation is seen as less of a buy-side driver in the year ahead. This suggests that respondents could be underestimating the importance of technology in driving the energy transition. Cecilia van der Weijden of CMS Netherlands agrees that technology and digitalisation remain a fundamental driver of deal activity: "New technologies and innovation are key to the energy transition. While the necessary technologies for the transition to net zero already exist, many of these technologies are not yet commercially available. The large-scale deployment of these technologies in a cost-effective way requires innovation."

Meanwhile, despite its lower position as a buy-side driver, Dr Holger Kraft of CMS Germany

What do you believe will be the greatest buy-side drivers of M&A activity in Europe over the next 12 months? (Please select top two)



What do you believe will be the greatest sell-side drivers of M&A activity in Europe over the next 12 months? (Please select top two)



believes that growth in technology-focused M&A is inevitable: “From our market experience, platform-based solutions such as virtual power plants have gained substantially increased attention from investors.

“It appears that virtual solutions will be an important trend in energy trading, and it is also possible that this trend will result in increasing M&A activities in that sector given that such investments will allow direct access to digital trade platforms and customers.”

Luis Felipe Arze, Partner, Corporate/ M&A from CMS Latin America, also feels that digitalisation and technology will be a major factor in deals. “Digitalisation will become a fundamental driver for the energy transition and an enabler for new M&A transactions, especially related to industrial trends linked to decarbonisation and decentralisation. The growing need for flexibility in the electric power system, for batteries and diverse types of storage technologies, presents an interesting opportunity to create value by

combining digital technology and thus reducing carbon emissions through the sustainable production and consumption of electricity.”

Cutting for the core

Environmental, social and governance (ESG) ESG factors are increasingly driving the energy M&A agenda and this is most notable when it comes to sell-side drivers. Tighter ESG rules – imposed by governments and institutional investors – mean that capital for carbon-intensive assets, and therefore the size of potential buyer pools, is dwindling. The race to divest is on.

The urgent need to decarbonise portfolios is likely to account for the high proportion of respondents (50%) who believe that distress-driven M&A will be the most important sell-side M&A driver over the next 12 months, with 35% selecting this as the number-one factor. This is far ahead of the next three sell-side drivers – capital raising, a pick-up in valuations, and PE divestments – each selected by 35% of respondents overall.

‘Distress-driven’ does not necessarily mean the assets in question are technically distressed – yet. But with the regulatory clock running down, businesses are looking to offload carbon-intensive assets when opportunities for optimisation have been exhausted.

Financing and funding outlook

Non-bank lenders/credit funds are expected to be the most readily available source of funding over the next 12 months, cited by 35% of respondents as their first choice. PE, meanwhile, is singled out by 25% of respondents – and with good reason. PE involvement in European energy M&A is on an upward trajectory, rising from 19% of total value in 2020 (US\$19.3bn) to 24% in 2021 (US\$31.9bn).

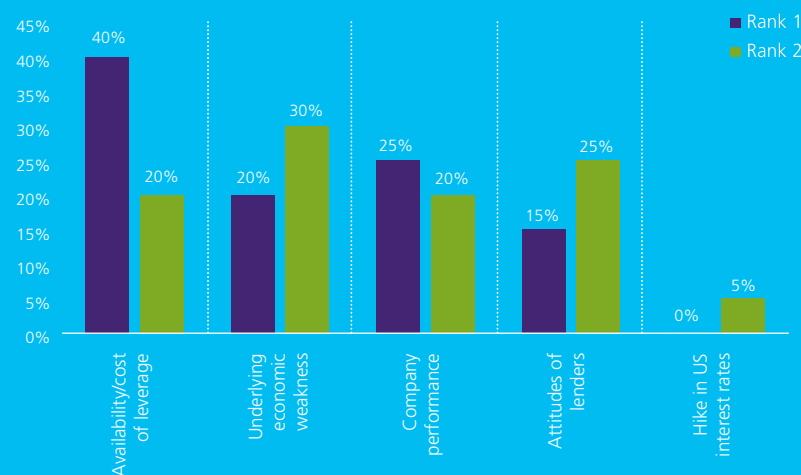
Meanwhile, 20% of respondents cite debt capital markets as providing the most available financing, while 10% are looking to dip into cash reserves to finance acquisitions.

Less prominent methods of financing are equity capital markets (mentioned by only 5% as a top choice) and bank lending (which no respondents cited as a first choice). “Traditional banks are not considering financing for high-value transactions,” notes the CEO of an Asia-Pacific-based renewable energy business.

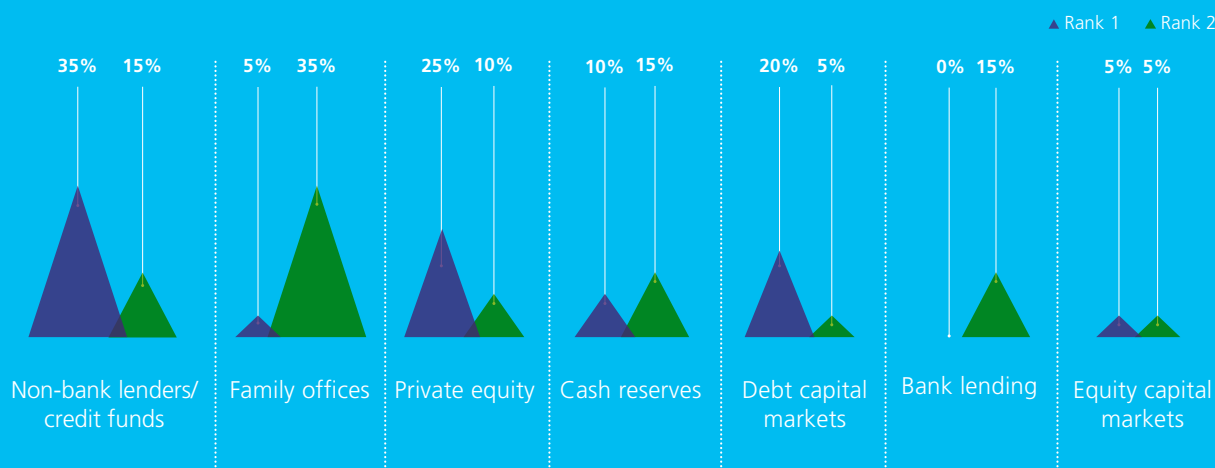
Tightening credit markets are a top concern looking ahead. Asked to highlight the greatest financing challenge over the next 12 months, most respondents point to the availability and/or cost of leverage. “Lack of leverage will be the most challenging factor

for buyers and COVID-19 means operating risks will be greater,” predicts the CFO of a Europe-based multi-source energy producer. Meanwhile, 50% of respondents point to underlying economic weakness as a top-two challenge.

What do you view as the greatest challenge to financing acquisitions over the next 12 months? (Please select top two)



What sources of financing do you think will be most available over the next 12 months? (Please select top two)



European regulations, post-Brexit divergence and FDI

Most energy sector M&A within Europe is transacted by European rather than overseas investors. Cross-border M&A between the 27 EU member states is – theoretically – straightforward, thanks to the single market and efforts by the European Commission to create a level playing field for dealmakers.

In practice, doing deals in Europe is not so simple. There is a significant amount of regulation to navigate. The UK's exit from the EU adds a further layer of complexity. Against this background, with trust and partnership a feature of many deals, pandemic-related travel restrictions continue to hamper or extend the timeline for dealmaking.

Environmental regulations are one of the most challenging types of legislation to comply with when doing a deal in Europe, according to half of those surveyed. The scope of the legislation is vast: environmental requirements are currently set out in more than 20 separate directives and regulations.

Not surprisingly, dealmakers are looking to professional assistance to help them navigate the maze of rules. "Our teams have to think about using external advisory firms to guide our due diligence process," says the Director of M&A at a European energy producer, who singles out environmental legislation as the number-one regulatory challenge.

Environmental rules aside, respondents also point to labour and employment regulations, antitrust rules and data protection as being among their top regulatory

challenges. Meanwhile, a quarter cite export controls/foreign direct investment regimes as a challenge.

Focusing on foreign direct investment (FDI), our study shows that respondents are split when it comes to the question of screening – the process by which governments vet foreign investment in strategic sectors, such as energy. Most respondents (60%) either agree or strongly agree with the introduction of FDI screening in the EU, while 30% either disagree or strongly disagree – among them the M&A Director of a Europe-based refiner: "Foreign direct investment regimes are a hindrance. With the EU trying to increase control of FDI, conditions will become more challenging in the future."

FDI screening is neither a new idea, nor is it unique to Europe. However, recent years have seen governments progressively tighten screening controls. One consequence of this has been increasing regulatory divergence between states – particularly in Europe, where screening requirements vary considerably from country to country. The EU's FDI screening regulation, which became fully operational in October 2020, goes some way towards addressing this. The new regulation is intended to drive greater harmonisation between FDI reviews in member states. However, it does not provide the EU with a veto and FDI reviews remain the responsibility of national governments.

Screening does not necessarily mean banning, but it can nonetheless act as a deterrent to

foreign investment, and the long-term effect of tougher FDI regimes remains to be seen. However, as noted above, most European energy M&A is transacted by European rather than overseas investors and is therefore not subject to the EU's FDI regulation.

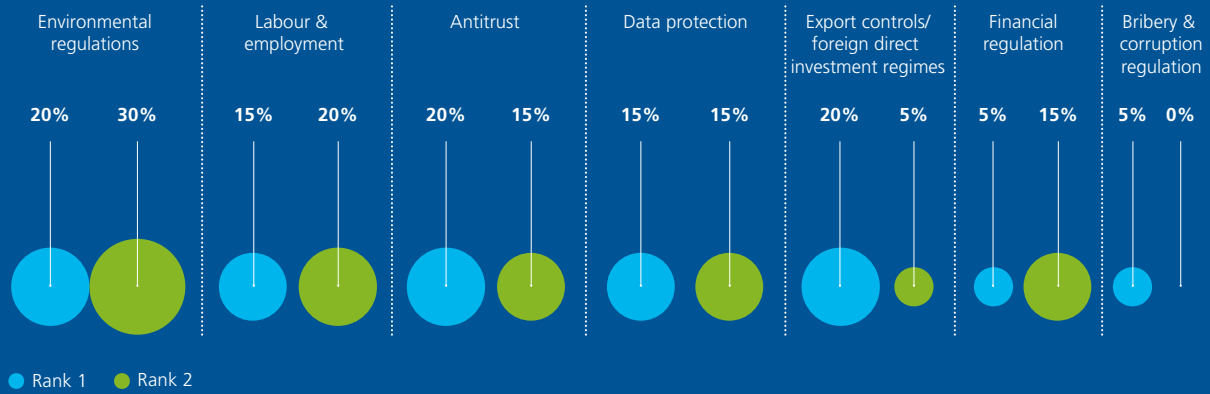
Although EU FDI rules are not intended to single out specific countries, media attention in recent years has focused on investments by China. From an energy sector perspective, China's involvement in European energy M&A has dwindled somewhat in recent years. In 2021, China accounted for 1% of deals by both volume and value.

Turning to the question of the UK post-Brexit, most respondents (40%) expect that the UK market will become more attractive in terms of desirability for inward investment.

Data from 2021 suggests the UK has retained its appeal. To put this in context, UK M&A accounted for 22% of all European deals by value and 14% by volume. European investment in UK M&A during this period accounted for 31% of overall UK deal value. By contrast, non-European investors contributed 21%. The last time M&A by EU-based sponsors in the UK exceeded that of other overseas investors was in 2015, on the eve of the Brexit referendum.

Looking at the broader European picture, respondents are overwhelmingly positive. Nearly two thirds (65%) say they are planning to invest in Europe in the next three years.

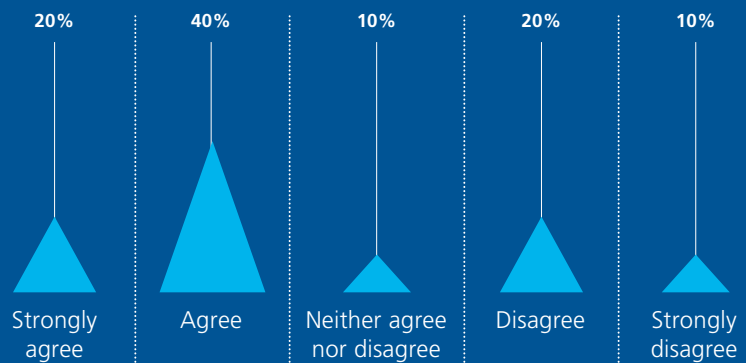
Which form of regulation do you find most challenging when doing a deal in Europe? (Please select top two)



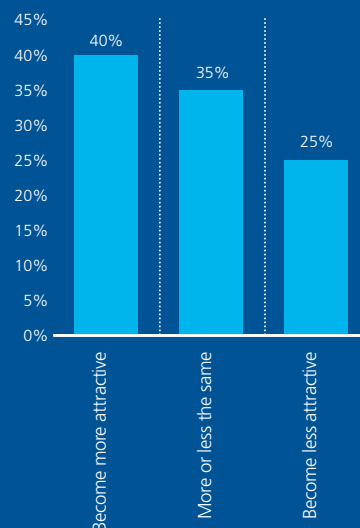
The massive availability of funds coming from the EU level for post-pandemic recovery, as well as to help the transition in countries that have committed to phasing out coal, is also an important driver for new investors coming into these markets. Notably, the availability of sustainable financing and emerging financing products such as green bonds will further accelerate investment and M&A activity across all energy sectors, including electricity storage and new technologies like hydrogen and carbon capture and storage. The Fourth Energy package transposition into national legislation in the EU countries in CEE is an additional comfort for long-term investments in terms of alignment with the common market rules for the electricity sector.

Varinia Radu, Partner, Head of Oil & Gas, CEE, CMS

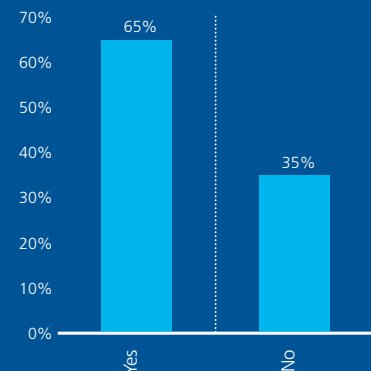
To what extent do you agree with the introduction of a mechanism for European screening of foreign direct investments into the EU?



How do you see the UK market developing post-Brexit in terms of desirability for inward investment?



In the next three years, are you planning to invest in Europe?



The COVID effect

The pandemic is by no means behind us as new variants emerge. However, dealmakers are better equipped to handle the situation and the challenges it creates

Top findings

50%

say the pandemic has increased their dealmaking appetite

40%

report that the pandemic has decreased dealmaking appetite

55%

expect shareholder activism to be a top trend in the aftermath of COVID

84%

say financial buyers are best placed to tap into COVID buying opportunities

The energy sector has endured numerous shocks since COVID-19 emerged in early 2020. The first phase of the pandemic saw oil prices plummet and demand for electricity collapse as businesses and industries shut up shop. Against this background, deployments of new infrastructure were suspended and M&A deals put on ice.

Nearly two years later, and thanks in large part to government bailout and stimulus programmes, the dust has largely settled. However, recovery has been accompanied by a new set of challenges, among them disrupted supply chains, labour shortages, rising inflation, resurgent investor activism and a tighter fundraising environment.

Our survey shows that respondents are divided over how COVID-19 has affected their dealmaking appetite to date. Half of the participants say the pandemic has stimulated their appetite for dealmaking, while 40% point to a decrease.

Getting vocal

Looking ahead, respondents point to greater shareholder activism, fewer cross-border deals and more carve-outs as the top trends shaping European energy M&A in the aftermath of COVID-19.

Activist shareholders took a back seat during the early stage of the pandemic. Now they are back, demanding everything from greater ESG accountability to spin-offs and divestments. Even energy sector businesses already intent on decarbonisation and reshaping their portfolios – notably those in the oil and gas subsector – fear that activists are going too far, too fast.

Shareholder activism is not going away and the growing momentum behind ESG provides activists with extra leverage. Legally mandated sustainability disclosures will only accelerate this trend. Respondents are mindful of the direction of travel: looking ahead, greater shareholder activism is singled out as the

number-one trend in the aftermath of the pandemic.

Activism aside, respondents expect to see fewer cross-border deals in the aftermath of the pandemic, in part because Europe’s complex regulatory environment sets an increasingly high bar for inbound acquirers. This view is perhaps not in line with what the evidence suggests, although FDI and additional regulations may impact this in 2022. In 2021, 13% of European energy M&A deals involved a buyer from outside Europe. This is broadly in line with past years. North America (with 36 inbound deals in 2021) has historically been the single biggest player, closely followed by Asia (35 deals in 2021).

Given the increasing pressure to divest non-core assets and raise cash to acquire new capabilities, it is no surprise to see that a significant proportion of respondents (25%) expect to see more carve-outs and spin-offs post pandemic.

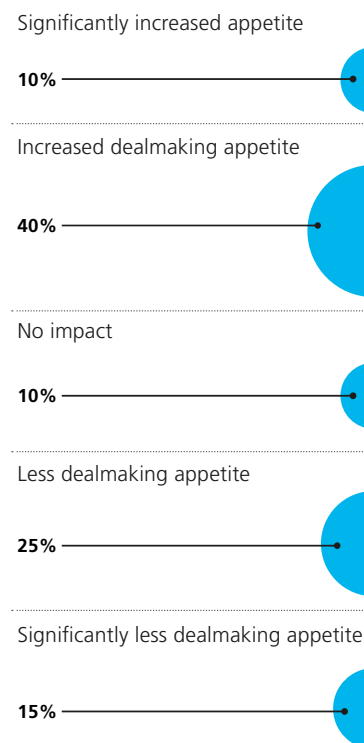
While the appetite for dealmaking clearly remains healthy, the ability to get transactions over the line remains a concern for some. One in five respondents expects to see more lapsed deals in the aftermath of COVID.

The many challenges of COVID

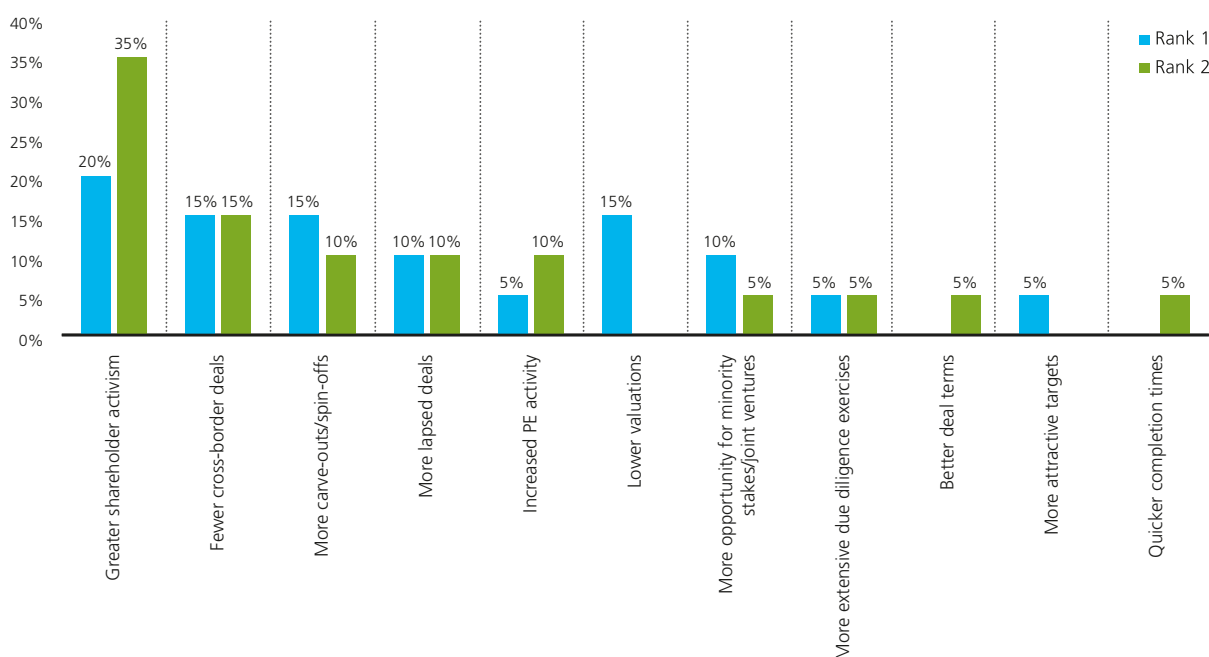
Respondents point to increasing due diligence complexity, fundraising difficulties and greater competition for assets as the three main M&A challenges they will need to tackle in the aftermath of COVID-19.

Due diligence complexity is highlighted as a top challenge by more than a third of respondents. Aside from the practical difficulties with executing the due diligence process – particularly the continuing uncertainty around travel restrictions – there is a growing list of new risks and rules to be taken into consideration, not least the need to scrutinise the ESG practices of the target.

What impact has COVID-19 had on your dealmaking appetite? (Please select only one)



What trends do you expect to see in European M&A in the aftermath of COVID-19? (Please select top two)



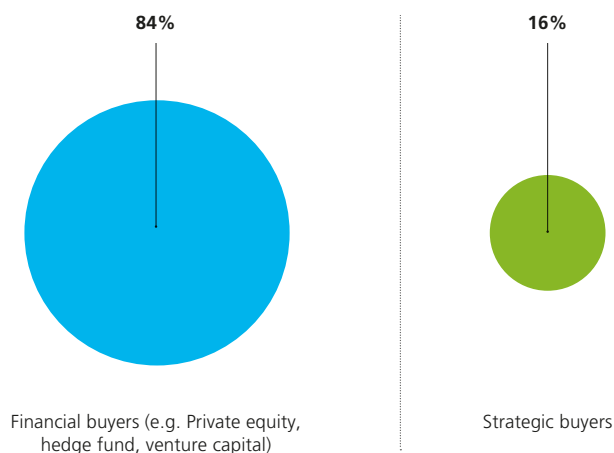
In addition to this, respondents worry about fundraising difficulties in the post-COVID world and the allied challenge of a difficult economic environment. Whereas 2021 has seen strong M&A activity across the energy sector, rising inflation, looming rate rises and a tighter financing environment are muddying the waters for some dealmakers.

Greater competition is also widely mentioned as a concern (cited by 30%). “For many investors, particularly those focused on Internal Rate of Return (IRR), it will remain a substantial challenge to get access to investments at all given the vast buy-side competition,” says Dr Holger Kraft from CMS Germany. “For strategic reasons, many market participants – particularly relatively new ones – accept purchase prices which cannot be justified from an IRR perspective.”

One of the factors in play is that the assets required to deliver the energy transition are increasingly TMT-like in character, with valuations to match. Examples include grid-scale battery energy storage systems and energy management platforms, as well as consumer-facing hardware and software needed for demand management. These digitally enabled assets are attractive to a wide pool of buyers, including fast-moving PE firms with deep pockets.

All of this is piling the pressure on corporate buyers – particularly at a time when many are battling to get their hands on new technologies and IP in the race to remain competitive. Adding to the pressure is the fact that dealmakers think financial buyers are better placed than corporates when it comes to taking advantage of buying opportunities presented by COVID-19. This belief is shared by 84% of survey respondents, despite the fact that financial buyers currently account for only 14% of deals by volume.

Which of the following do you feel is better placed to take advantage of buying opportunities presented by COVID-19?



ESG picks up pace

Environmental, social and governance criteria are reshaping energy sector M&A, from deal sourcing to due diligence

Top findings

70%

expect an increase in ESG deal scrutiny over the next three years

60%

say the energy sector is already affected by wider implementation of ESG

Environmental, social and governance – ESG – is much more than just an acronym. In the context of energy sector M&A, ESG principles now play a critical role in steering the corporate policies of both strategic and financial buyers as they look to address criteria from environmental performance to social justice and workplace safety.

“ESG factors are being given high importance, even in emerging markets,” says the CEO of an APAC-based renewable energy firm. “For regions to become more investment-friendly, this is the main criterion and governments are becoming involved in ESG-oriented policies.”

Luis Felipe Arze, Partner, Corporate/M&A from CMS Latin America, agrees with this assessment and sees it as a clear driver for M&A in 2022 and beyond. “There has been a growth in the M&A of ESG-focused companies, especially those related to renewable energy,” he says. “For potential buyers, ESG principles work as a positive screening to better position themselves on these issues, strengthen their corporate culture and offer better sustainability indicators in their businesses.”

Purposeful portfolios

First and foremost, ESG is transforming the way that capital is raised and allocated. One example of this is the rise of ESG funds, which are designed to deliver measurable environmental and social impacts, as well as healthy returns. The past 12 months has seen an explosion in the number of funds dedicated to delivering ESG objectives. Indeed, funds focused on ESG-related issues saw assets climb to US\$3.9tn by the end of September 2021, according to data from research group Morningstar. And energy funds are a prominent part of the ESG picture.

The rise of dedicated ESG funds is just the tip of the iceberg. Banks, pension funds and asset managers are all pivoting their operations towards ESG. There are

good reputational reasons for doing so. But increasingly, ESG compliance is becoming a matter of regulation rather than choice.

ESG rules

The EU’s Sustainable Finance Disclosure Regulation (SFDR) is the first big regulatory step in efforts to align financial services with green goals. Under SFDR, pension funds, asset managers and insurers must disclose how they weigh up ESG risks in their investment decisions. Alongside this is the EU taxonomy, which establishes a list of environmentally sustainable economic activities.

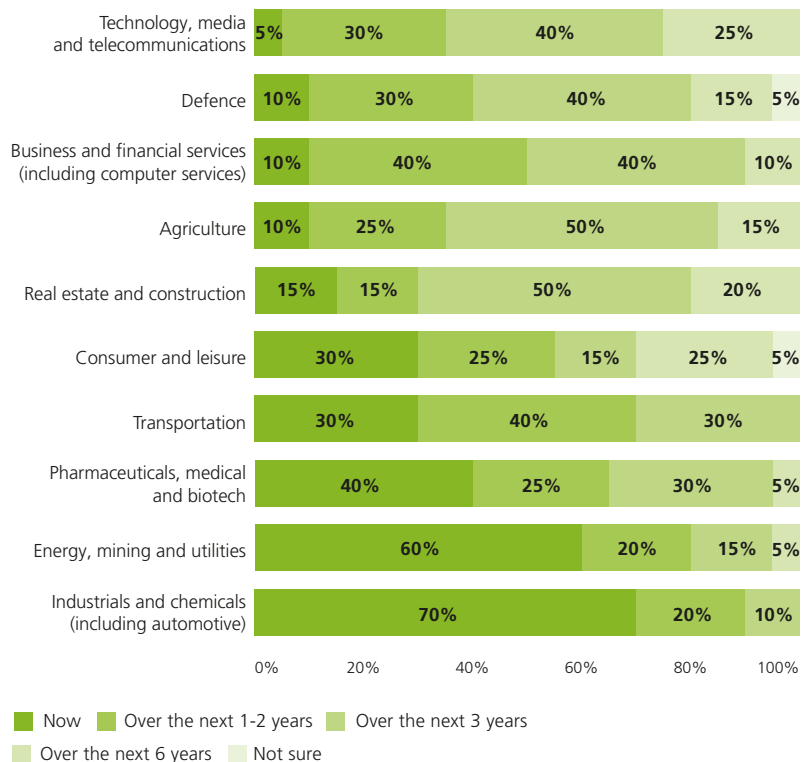
Meanwhile, the Task Force on Climate-Related Financial Disclosures (TCFD) is designed to improve the reporting of climate-related financial information. TCFD reporting is not yet mandatory. But in the UK, it soon will be. From April 2022, large UK-registered companies will be required to disclose climate-related financial data.

Not surprisingly, buyers are adopting an increasingly cautious approach when it comes to weighing up targets. “We have observed an increase in focus on ESG warranties and other related provisions in contractual documentation in recent times,” says Babita Ambekar from CMS Singapore. “Regulatory reform in Europe and certain other markets is driving a large part of the change.”

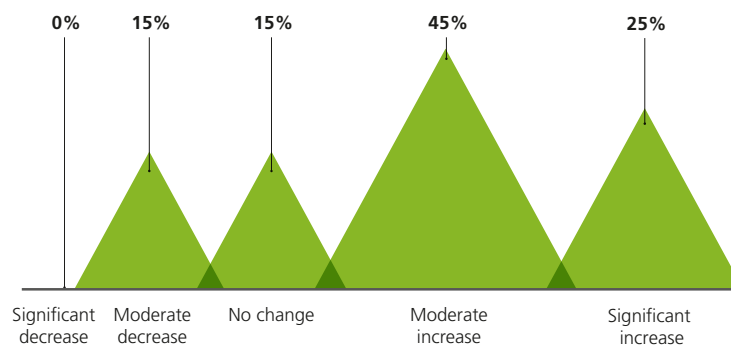
Most respondents (60%) say that the energy, mining and utilities sector is already being affected by a wider implementation of ESG factors. Meanwhile, a further 20% of respondents say that while they don’t think the industry is being affected now, it is likely to be affected within the next two years.

Given the rising tide of regulation around ESG, it is perhaps not surprising that seven out of

When do you think the industries below will be affected by a wider implementation of ESG factors?



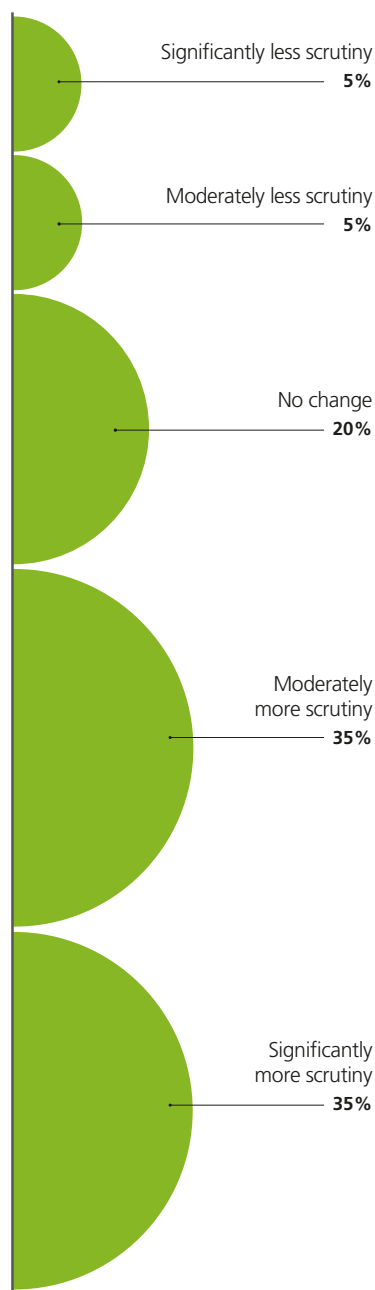
How do you expect ESG scrutiny to change in deals over the next three years?



ESG becomes more relevant in the acquisitions process, from the due diligence perspective, which is now carefully assessed. Also, companies active in the energy sector are more aware of compliance matters related to ESG and see the benefits of putting in place relevant strategies and internal rules meant to address the upcoming reporting obligations around sustainability.

Varinia Radu, Partner, Head of Oil & Gas, CMS CEE

How do you expect due diligence to change in terms of ESG factors in transactions in the next three years?



ten respondents expect an increase in ESG scrutiny in deals over the next three years.

In a similar vein, seven out of ten respondents also expect more due diligence scrutiny in terms of ESG factors in transactions over the next three years, with 35% of respondents expecting a significant increase in such scrutiny. When asked about specific concerns, climate change, water management and data privacy were all front of mind.

Despite all of this, respondents are confident about their ability to respond to the tighter regulatory environment. "Water management has become more efficient with the help of external advisors," says the CFO of a Europe-based multi-source energy producer. "We have good teams to understand the feasibility of new steps to enhance water management." Meanwhile, the Head of M&A at a utility for which sustainable development is a priority says: "Greenhouse gas emissions control is a risk that can be managed by understanding the corrective measures."

ESG impacts

The changing character of finance – and particularly its growing conditionality – is good news for the renewable energy subsector. Renewable energy assets are highly sought after by ESG investors, and this is driving a deluge of green capital that is playing a vital role in the continued expansion of sustainable energy.

But for the oil and gas subsector, the rise of ESG presents an existential threat. First, flows of institutional capital that were previously directed to oil and gas are now finding a home elsewhere in the energy sector. Second, activist investors are increasingly calling the tune when it comes to shaping corporate

policy, eroding the credibility of boards. Finally, ESG sensitivities are making the oil and gas majors increasingly reluctant to invest in new exploration and production for fear of reputational impacts.

"The response of oil and gas majors towards the energy transition and ESG has been varied," says Marc Rathbone, Head of Oil & Gas for Asia at CMS. "But most majors have taken big steps towards transitioning towards less carbon-intensive activities. Many of the majors, and to a degree some of the smaller players, are making notable inroads into the renewables sector through the acquisition or funding of renewables companies and projects."

Varinia Radu of CMS CEE agrees with that appraisal but suggests they need to speed up. "The oil and gas companies have been slow in shifting focus from traditional activities; however, we are now seeing more of their plans including investments in new technologies which have synergies with their core business, such as geothermal, hydrogen and carbon capture and storage (CCS)."

And that investment in new technology will be absolutely vital if the majors are to meet their ESG goals. "Our market experience shows that the big oil and gas players are very active not only in investing in renewable energy production facilities, but also in other assets such as virtual power plants," says Dr Kraft. "For example, Shell recently acquired the virtual power plant operator Next Kraftwerke. However, this focus on renewables is not exclusive to oil and gas players. Other market participants formerly associated with fossil energies, such as RWE, Vattenfall and EnBW, continue to be very active and to invest billions of euros in the field of renewables."

A new dawn for energy M&A

From COVID to consolidation, digitalisation to distress and technology to transition, the energy market is transforming like never before and M&A will be a key factor in that change

The year past (2021) has delivered a bumper crop of energy sector deals in Europe, notably in the power and transmission subsector. And the coming year is likely to be just as busy.

Energy transition is undoubtedly the primary driver for M&A in the sector and it is likely to remain so. In Europe, policy will continue to steer investment towards decarbonisation, digitalisation, deployment of renewables and the development of storage.

For traditional players, inorganic growth will be the swiftest route to adopt these new capabilities.

There are several key developments in play as dealmakers look to the year ahead:

1. Energy transition and ESG opportunities

ESG is now a mainstream concern. Continuing implementation of new ESG frameworks and regulations in 2022 will act as a powerful stimulus for M&A focused on renewables and energy transition technologies. “The energy transition is undoubtedly a key driver for M&A in the sector. For traditional players, inorganic growth will be the swiftest route to adopt new technologies and capabilities.” says Babita Ambekar of CMS Singapore.

2. Technology dictates

The digital revolution is happening in all sectors and the energy sector is transitioning from a traditional service industry to an extraordinarily complex multi-stakeholder system. Gaps and opportunities are available for digitalisation applications, with a focus on energy and associated sectors. Industries that have developed innovative energy technologies are extremely attractive. These include businesses related to key uses/applications, enabling technologies and smart grid technologies.

“Innovative technologies and those with a vision focused on the end user will generate great interest among international investors. For example, those that develop technologies for electromobility, electric transport, fuels

created from renewable energy sources and energy vectors, such as green hydrogen,” says Luis Felipe Arze, Partner, Corporate/M&A from CMS Latin America.

3. Maturity will accelerate adoption of renewables

The quality and performance of renewables is now well established. This extends not only to the hardware – such as wind turbines, solar arrays and battery storage – but also to the processes for deploying those technologies. The progressive de-risking of renewables will continue to boost their attractiveness, broadening the pool of available capital. “The infrastructure to support renewables initiatives is maturing and the advancement of battery storage technology, for example, has successfully accelerated adoption,” says Ambekar.

4. Green finance

Financial institutions – from asset managers and pension funds to banks – are pivoting towards sustainable finance as they align their business models with ESG principles. This is generating additional liquidity, fuelling increased M&A activity in energy transition assets.

5. ESG risks

Awareness of ESG-related risks is rising. For acquirers, this means there is a greater need during due diligence to scrutinise target companies for potential ESG hazards. These range from risks embedded in supply chains to historical pollution associated with the target’s operations. And constant vigilance is vital because the way risks are defined is likely to change over time.

As Cecilia van der Weijden from CMS Netherlands says: “Nowadays, investors and stakeholders are more frequently calling for ESG as an investment priority as public opinion, activist investors and NGOs are putting pressure on businesses. This year’s judgement against the oil major Shell is already impacting strategic decisions at large businesses. Under pressure of public opinion and the threat of litigation Dutch pension fund and institutional investor ABP announced to stop investing in fossil fuels.”

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Methodology

In the second quarter of 2021, Mergermarket surveyed senior executives from 240 corporates and 90 PE firms based in Europe, the Americas and APAC regions about their expectations for the European M&A market in the year ahead. Of these, we surveyed 20 global energy companies from the following subsectors: fuels, refinery and renewable fuels; multi-source energy producers; renewable energy producers; oil and gas companies. All respondents have been involved in an M&A transaction over the past two years. All responses are anonymous, and results are presented in aggregate.

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