Retail M&A wave may be coming (Cites Analysis from AEG's Team)

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Platts (McGraw Hill Financial)

As retail margins improved in the past month, the number of competitive suppliers looking to sell their business appears to be growing. A wave of merger and acquisition activity in the retail marketing sector may be on the horizon, especially after the marketing assets of Hess attracted $1.025 billion, retail sources said recently.

Several companies who have built up a customer book and enjoyed the generally positive market conditions for retailers over the past few years are soliciting offers, and the price Direct Energy paid to Hess will have more companies in that mode, consultants said. The Hess purchase is "a signpost of more acquisitions to come in the marketplace," said Soner Kanlier, vice president of retail energy markets at consulting firm DNV KEMA.

"We see strong interest" from companies looking to buy or sell retail natural gas and power marketing assets, added Rob Potosky of Affiliated Energy Group. "We have a couple deals in the pipeline" where AEG represents a buying or acquiring company, and AEG does not expect any slowdown in M&A activity among energy marketers, Potosky said in an interview.

AEG
Affiliated Energy Group
Mergers and Acquisitions Division
Specializing in Retail Energy Markets.

The last two years have seen plenty of retail supplier M&A deals with values around $100 million or more, providing some context for the price fetched by the Hess assets, but AEG does not view current activity as the top of the market for such large deals, Potosky said.

The Direct purchase of Hess' assets marks "a watershed deal in terms of consolidation" in the retail market, said a source in the retail sector who asked not to be identified. "There are so many small players out there that there is a lot of room forconsolidation," the source said.

Kanlier agreed, noting that there are more than 1,000 power or natural gas marketers licensed in states with retail competition. Many of those firms are privately held, making financial data on many purchases hard to come by, and examining comparable deals very difficult, added Potosky.

Even so, a look at past retail energy marketing purchases, including many by Direct, shows that Direct paid quite a high price for the marketing assets of Hess. In addition to the 23,000 commercial and industrial customer accounts, the deal included Hess' wholesale natural gas marketing assets, spokesmen for both companies said. That wholesale gas marketing business was a factor in the purchase price, Direct spokesman Michah Hirschfield said, but he declined to break down the cost assigned to the different assets.

The deal is "transformative" for Direct in that it significantly boosts the company's presence in the C&I sector, and the wholesale gas marketing assets include purchase agreements with Marcellus shale gas producers to supply gas to customers, the company said. The gas marketing assets include about 30 Bcf of gas storage and 3 Bcf of pipeline capacity, while the power marketing assets include a tolling agreement from a New Jersey power plant that Hess jointly owns with ArcLight Capital Partners.

"The economics of the deal should not be analyzed in isolation from Centrica's obtaining, as part of the purchase, the 'extensive portfolio' of existing gas contracts," including the storage and pipeline capacity, Potosky said.

Hess in March said it would exit energy marketing and trading as part of its strategy to become a pure exploration and production company. The retail marketing assets of Hess were heavier on the natural gas side than the power side, with commercial, industrial and small business customers in 18 states in the Eastern half of the US.

Hess is one of the few retail power suppliers that provides demand response services, and being able to offer multiple services to large C&I customers is important to keep them satisfied, Kanlier said. For energy services, "C&I customers want the whole package," and now Direct can compete in that sector with Constellation, NRG Energy and other companies that specialize in the C&I sector, he said.

Besides trying to swallow the Hess marketing business, Direct earlier this year said it was acquiring Bounce Energy for $46 million. Bounce has about 80,000 residential power customers, mainly in Texas, but Direct has been eyeing expansion in the C&I sector, Kanlier said.

AEG last week said it has been retained by a mid-size retail marketer that sells gas and power who is seeking a buyer of certain assets or a strategic business combination. The marketer has a residential customer equivalent count of between 100,000 and 200,000. "This deal, which is not a distress deal, presents an efficient opportunity to enter or expand into the Midwest and Northeast" retail energy markets "with an attractive commercial and residential electricity and gas customer portfolio," Chad Price, executive vice president of AEG's commercial energy division, said in a statement.

The M&A transactions are being pursued while retail power marketers have been selling electricity when wholesale power prices have been on the low side for quite some time, enabling marketers to capitalize on what have been some healthy retail margins.

In July, the spread between retail and wholesale prices in eight of the nine cities tracked by Platts increased as wholesale prices came down during the month, the latest Retail Power Index shows. Pittsburgh, which generally has a small spread, saw its margin decline 10 cents.

For the second month in a row, Houston had the largest spread among cities in the RPI.

The RPI, established by Intelometry, shows default utility prices and a one-year forecast of default prices, along with wholesale power prices in nine cities with retail choice. The RPI also shows the difference, or spread, between wholesale power prices and the forecasted default utility price, indicating the headroom for marketers to operate in the different cities.

Sometimes retail suppliers prefer to merge with a company that has a customer base in different cities beyong their own as a way to increase market share, besides entering a new market and growing a customer base from the ground up. A ripple of consolidation in the retail sector began in the middle of 2011, when several retail marketers were bought by some of the largest suppliers, and the trend since then generally has been for the big suppliers to gobble up smaller firms.

Some of the largest deals for purely retail marketing assets since early 2011 include Direct's purchase of First Choice Power for $270 million plus working capital, NRG Energy's purchase of Energy Plus Holdings for $190 million, Constellation Energy Group's purchases of StarTex Power for $143 million and MX Energy for $175 million and Direct's purchase of Gateway Energy Services for $91 million.

Going back even further, transactions in 2010 included NRG's purchase of Green Mountain Energy for $350 million, Just Energy's purchase of Hudson Energy Services for $304 million, with NRG's 2009 purchase of most of Reliant Energy's retail assets carrying a price tag of $288 million.

In a bit of irony given Hess' exit from the retail marketing space, the company had a history of swooping in and buying distressed assets from other companies exiting the business, including a 2008 deal for Reliant Energy assets for an undisclosed price and actually being paid $44 million to take the customer book of Select Energy in 2006.

Comparable purchases are notoriously hard to find when examining retail marketing deals, noted Potosky. Instead of breaking down deals on a cost per customer basis or multiple of earnings before interest, taxes, depreciation and amortization, Potosky tends to examine the upstream supply contracts or hedging strategies, debt exposure associated with deals and marketing opportunities from entering new markets or buying retail supply contracts that expand a company's offerings, he said.

Compared with residential customers, C&I customers are much more expensive to maintain for retail suppliers, requiring account representatives and constant contact to keep those customers loyal, said Kanlier. "It's almost like dating," where companies work to keep the large customers from finding better energy supply deals with other companies, he said.

The purchase of Hess' assets "will make all the other competitors sharpen their pencils in C&I markets" to keep their customers happy, Kanlier said. He said he will be watching to see what NRG does in light of the expansion by Direct, particularly since there are companies that are known to be looking for buyers.

— Tom Tiernan