Industries
Energy, Utilities & Mining

Energy Deals*

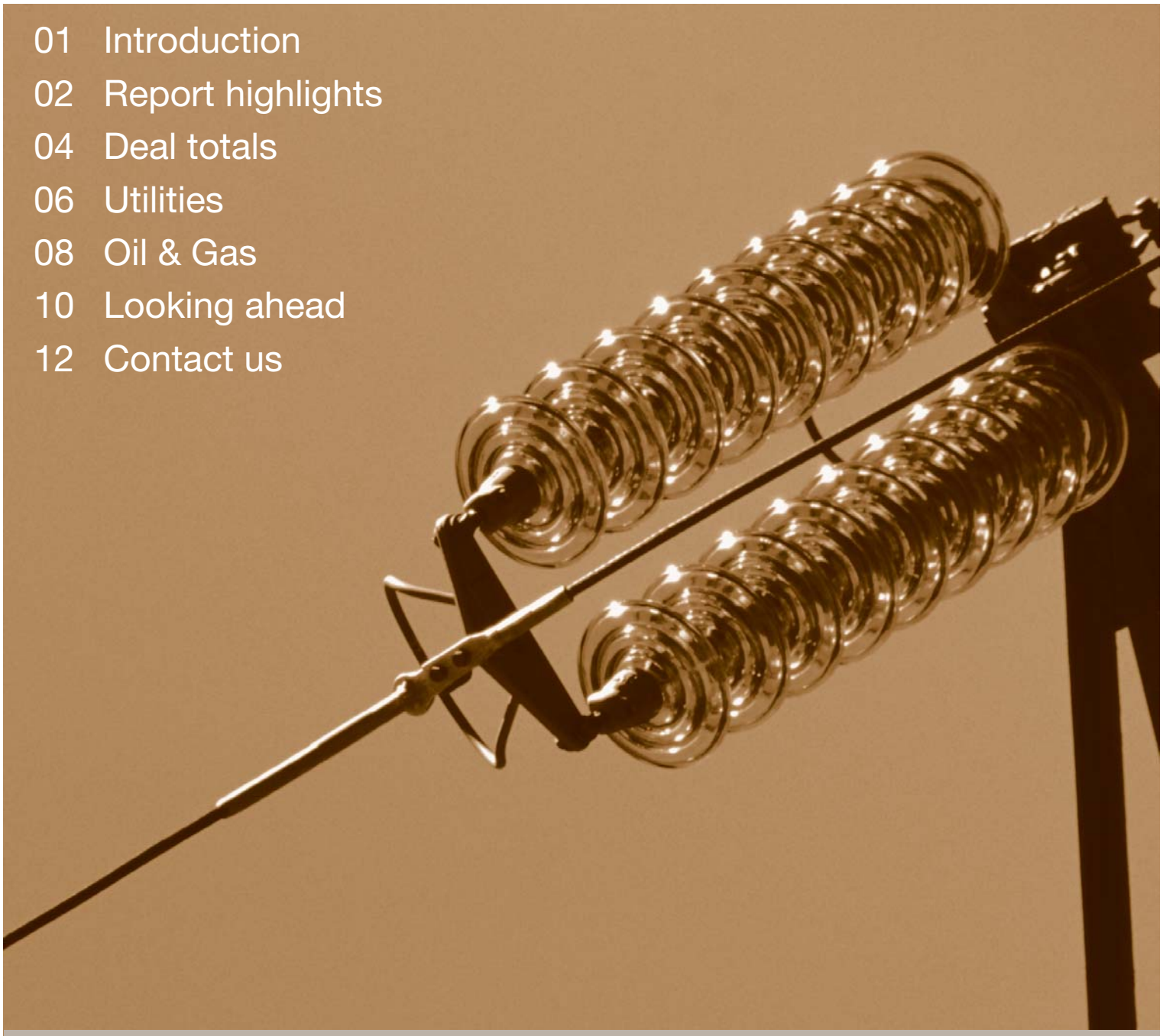
2009 Annual Review

Mergers and acquisitions activity within the Turkish energy market

*connectedthinking

PRICEWATERHOUSECOOPERS

Contents



Methodology and terminology

Energy Deals 2009 includes analysis of cross-border and domestic deal activity in oil, gas and electricity markets in Turkey. The analysis is based on publicly available information and encompasses announced deals as of 31 December 2009, including those pending financial and legal closure. Deal values are the consideration value announced or reported and figures relate to actual stake purchase and are not multiplied to 100%. All presented totals of deals are inclusive of estimates for deals with no reported value. Note that 2008 utilities deal values as well as 2008 total deal values were updated due to the annulment of the tender for the privatisation of Baskent Dogalgaz. This document is also available at www.pwc.com/tr/energy.

Faruk Sabuncu
Energy, Utilities & Mining Leader

Engin Alioğlu
Partner, Transactions

"Not granted an exception, Turkey will not emerge undamaged from the ongoing turmoil in financial markets already frustrating 2009 investment plans around the world."

These were the closing comments of our Energy Deals 2008 report. It is hardly surprising that M&A activity has fallen back from its peak in 2008 and, despite the same deal activity in terms of deal numbers, the total deal value in the Turkish energy market contracted by 67% y-o-y to US$1.7bn. Now, what is vital to understand is whether this is merely a repercussion of the ongoing credit crunch and regulatory uncertainties or whether more fundamental shifts in M&A strategy can be expected to occur as the credit markets recover.

In this vein, this report examines the rationale behind the overall trends in 2009 and the key individual deals. We also highlight, in a series of deal dialogues throughout the report, some of the critical issues for companies engaging in deal activity within the sector, drawing on our experience as an advisor to players in major deals across the sector.

Looking ahead, it is true that the transaction values in 2009 are graying the short-to-medium-term picture. However, the composition of the utilities in the privatisation basket, including the big tickets in the gas distribution, electricity distribution and electricity generation sectors, keeps expectations high about a more exciting deal environment in 2010. On the other hand, this should not be taken as blind hope, as we remain cautious given the warnings echoed everywhere about the growing threat of fresh global asset bubbles: what matters is not the realisation of tenders but the seamless closing of transactions. With this in mind, we hope to see the ongoing regulatory challenges and financial problems ironed out and translated into record-breaking deal values in 2010.

02 Report highlights

Sustained activity but a lack of 'mega deals' to boost deal total

Significant existing interest in the Turkish energy market was sustained in 2009 in terms of deal activity, with a total of 19 deals. Nonetheless, due to the stormy financial climate, this fell short in terms of deal values of one-third of the 2008 figure at US$1.7bn. Unlike 2008, none of the transactions qualify for the title 'mega deal', representing a backward move to pre-2008 values. The largest deal value, US$485mn, was posted in the privatisation of Osmangazi Power Distribution Company.

Utilities continue to be the most attractive deal field

In the absence of a gas distribution privatisation, power distribution fulfilled its lifeline duty towards the end of the year, making up 70% of total energy deal values. The lack of improvement on the legislative front to remodel the incentive structure, on the other hand, simply added to uncertainties in the renewable energy market and worsened the already bottlenecked project finance environment. On the other hand, almost nothing happened on the oil and gas front in 2009, except for two minor deals amounting to US$55mn, versus three deals totalling US$649mn in 2008.

Local deal makers in privatisations versus foreign players in generation asset deals

The absolute dominance of local interest in privatisation was maintained, while foreign players favoured participation in power generation deals. The main reason behind the low foreign interest in electricity distribution privatisations was the low profile of the tendered regions and of course prolonged uncertainties in the legislation in general, and tariff structures in particular. Another field of attraction for foreign investors was the natural gas import and wholesale business, which hosted three transactions.

Privatisations to go full power in 2010

The privatisation tenders left incomplete in 2009 are to constitute the main transaction base in 2010, given the Turkish government's dedication to fully liberalise the power distribution market by 2011. The launch of four regions immediately after the conclusion of the tender process for the last batch of three regions would support the feasibility of this ambitious goal. Despite the long wait for market liberalisation, privatisation of the state generation assets has already climbed up high on the government's agenda and is expected to take place with the launch of a considerable portfolio in 2010. Last but not least on the privatisation agenda is the resumption of the process for Baskent Dogalgaz and the expected launch of IGDAS tender. Considering the busy liberalisation agenda in 2010 and mirroring the high investment appetite, we believe a new record year for energy deals is brewing, likely to exceed US$6bn.

04 Deal totals: a pit-stop year

The total value of energy deals in 2009 was capped at US$1.7bn, well below the 2008 record, and resulted from the global credit crisis as well as legislative and regulatory fatigue at the domestic level

Not unharmed by the global downturn, the deal environment in Turkey, although sustaining the total number of deals, failed to reach 2008 deal value totals, mostly due to the lack of 'mega transactions'.

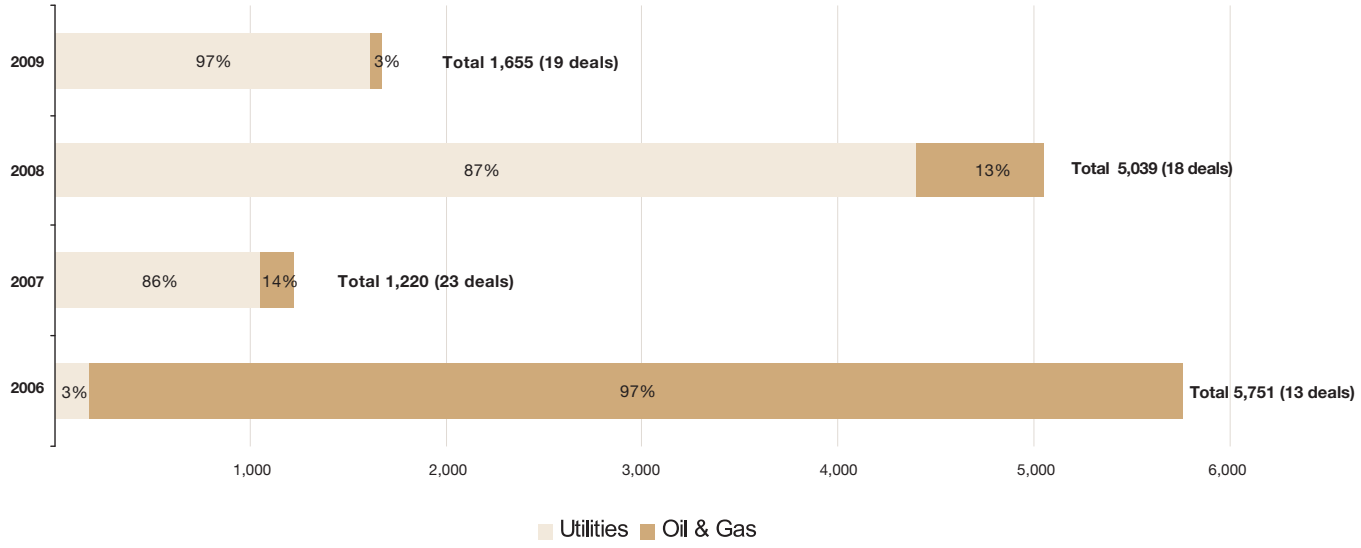
In 2009, the Turkish energy market hosted a total of 19 deals in the public and private spheres; all in the power market except three in the natural gas and two in the oil & gas arena, with a total value of US$1.7bn and an average of US$87mn per deal. This is well below the 2008 average figure of US$280mn out of 18 deals totalling US$5bn, but still higher than 2007 levels, mainly on the back of the electricity distribution tenders during 4Q09.

Figure 1: **Total Energy Deals in 2008 and 2009**

	FY08*			FY09			YoY change	
	Number	Value (US$ mn)	Average Value (US$ mn)	Number	Value (US$ mn)	Average Value (US$ mn)	% number	% value
Utilities	15	4,390	293	17	1,600	94	13%	-64%
Oil and Gas	3	649	216	2	55	27	-33%	-92%
Total	**18**	**5,039**	**280**	**19**	**1,655**	**87**	**6%**	**-67%**

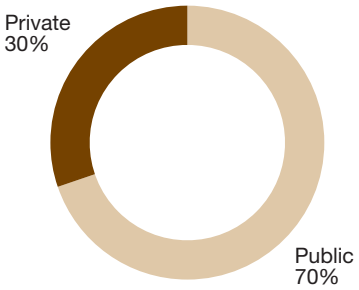
* 2008 Utilities total deal value altered due to cancellation of Baskent Dogalgaz privatisation.

Figure 2: **Total deals between 2006 and 2009 by value (US$ mn) and number of deals**



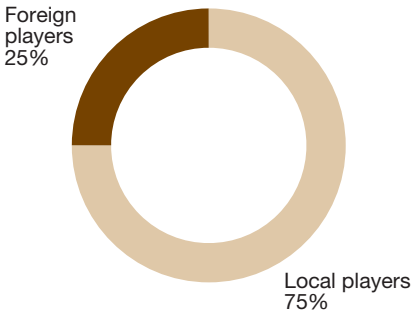
With the continuation of tenders to privatise the power distribution companies, the share of 'public' deals by value increased to 72% in 2009 from 62% year ago.

Figure 3: **Public vs. private deals by value**



A closer analysis of the transaction participants' origin reveals the fact that, despite being pre-qualified to bid for the privatisations of the electricity distribution companies, foreign players chose not to do so, mainly due to the relatively lower profile of the respective regions and also ongoing uncertainties in the legislation indicating almost nothing about the post-transition period market dynamics. Instead, the foreign presence was very much felt in the generation deals, though keeping the foreign share in the context of 'deal origins by value' at just 25%. Contrary to the large share of foreign-local partnership in 2008, none was present in the deals in 2009.

Figure 4: **Deal origins by value**



Western Europe continued to be the most active origin in terms of participants. The interest proved sustained only by the German conglomerates, whereas Norway, Canada and Russia have been the new joiners to the Turkish deal arena. Again in line with 2008, none of these participants was a private equity firm but all were industry players with long-term investment prospects.

Energy Deal Dialogue:

Valuation challenges in the current environment

The current economic climate has created major challenges in assessing current market value for companies, valuation practitioners, auditors and users of financial information. So called 'fair value' remains one of the hottest topics facing both financial investors and energy and utilities businesses.

The ever increasing investor, regulatory and accounting pressure on companies to focus more attention on valuation has coincided with the credit crunch and difficult economic conditions. Throughout the year equity stock prices have dropped dramatically and capital markets appear to have deviated from the fair value of underlying businesses. This has even affected the market values of listed power and gas utilities businesses, seen historically as 'safe havens' by investors. Although in recent months there has been a pick-up in stock markets, the sustainability of this trend is yet to be confirmed.

The global slowdown means that assets or businesses will probably generate lower cash flows than previously expected and impairment may well be required. The companies with the highest risk of impairments are those which are highly leveraged and face being re-financed in today's current weak capital markets where credit margins have risen sharply.

In difficult times, such as these, there are clear benefits for regular and robust valuation processes, incorporating a rigorous review of cash flow projections, discount rate parameters as well as, where available, evidence from transactions in the market. Our experts believe that three key questions have to be addressed in valuing power and gas assets. Firstly, to what extent are projected cash flows at risk from the slowdown in the 'real economy' and the increasing volatility in commodity markets? Secondly, to what extent will these businesses be subject to re-financing risks in the near future? And thirdly, how reliable are the most recent transactions comparisons as indicators of market value?

06 Utilities: the only vitality zone in 2009

Although the total number of deals in the Turkish utilities market in 2009 was higher at 17 versus 16 in 2008, the total value shrank to US$1.6bn from US$4.4bn in 2008. The power market was again the more active zone with 12 deals

Privatisations of power distribution companies during the last quarter of 2009 proved a true lifesaver. This year's package included the Osmangazi, Yesilirmak and Coruh regions, making up an aggregate consumption amount of 11.4 TWh in 2008 (5.8% of total domestic consumption). The total bids for these regions reached US$1,154mn.

The electricity generation assets subject to transactions in 2009 tended to be at the non-operational stage, i.e., either only the licences have been exchanged or the projects have been at the very early construction phase. However, the legislative stagnation to improve the incentive structure in the renewables market began to display its repercussions in the acquisitions slowdown.

The long-awaited tender for the construction and operation of the first nuclear power plant in Akkuyu concluded with a single bid by a Turkish-Russian consortium. However, the court case regarding the lack of competition and transparency during the tender process did not end in favour of this JV and the tender has recently been annulled.

Figure 5: **Utilities deals in 2009**

Date announced	Target	Stakes in %	Acquirer	Acquirer nationality	Deal value (US$ mn)
4-Mar-09	Borusan Enerji	50%	EnBW	Germany	n.d.
9-Mar-09	Palmet Enerji	13%	Manitoba Hydro Int.	Canada	n.d.
19-Mar-09	Yesil Enerji	95%	Statkraft	Norway	98
23-Mar-09	E.ON Turcas Kuzey Elektrik	70%	RWE	Germany	n.d.
23-Mar-09	E.ON Turcas Güney Elektrik	70%	RWE	Germany	n.d.
24-Mar-09	Egemer	99%	AkEnerji	Turkey	0.4
13-Apr-09	Enerco Enerji	40%	OMV	Austria	n.d.
11-Jun-09	EWE Dogalgaz	100%	EWE	Germany	n.d.
17-Jun-09	Borasco Elektrik	15%	OMV	Austria	n.d.
17-Jun-09	Borasco Elektrik	10%	Metcap	Turkey	n.d.
22-Jul-09	Entek Elektrik	15%	Aygaz	Turkey	24
20-Aug-09	Bosphorus Gaz	31%	Gazprom	Russia	n.d.
10-Oct-09	Galata Wind Enerji	100%	Agaoglu Enerji	Turkey	n.d.
12-Oct-09	Power Station (Portfolio of wind projects)	100%	RES	UK	n.d.
6-Nov-09	Yesilirmak Elektrik	100%	Calik Enerji	Turkey	442
6-Nov-09	Osmangazi Elektrik	100%	Eti Gumus	Turkey	485
6-Nov-09	Coruh Elektrik	100%	Aksa Enerji	Turkey	227
Total					**~ 1,600***

n.d: not disclosed
*Includes estimated deal value for undisclosed deals

On the gas distribution front, in 2009, we witnessed the cancellation of the 'mega tender' of 2008, i.e. privatisation of Baskent Dogalgaz, following the payment failure by the winning bidder and also some other problems based on the lack of appropriate tender conditions from square one. The new tender, now run by the Privatisation Administration, is expected to take place in early 2010. A long awaited transaction, the privatisation of IGDAS, on the other hand, has yet to be kicked off, leaving expectations for the upcoming year equally uncertain.

Nonetheless, the deal wheels in the natural gas sector were lubricated by interest from foreign utility companies in the midstream zone. Gazprom increased its shares in Bosphorus Gaz, a Turkish company holding a licence to import 750mcm of gas per year from Gazprom itself. Another private natural gas importer, Enerco, licensed to import 2.5bcm of gas per year also from Gazprom, got to be a deal subject and sold its 40% share to OMV. In this way, the Austrian company added gas import to its existing operations in fuel retail and power generation markets in Turkey. EWE, which already operates in the gas distribution sector with its 80% share in Bursagaz and in Kayserigaz, this time entered the natural gas wholesale business.

Such examples underline the very important fact that the large foreign utilities continue to invest more in their integrated energy business in Turkey.

Energy Deal Dialogue:

Covering every angle: tax and accounting principles in financial models

A financial model is only as good as it is accurate, which is why it is essential that every relevant factor is built in from the very beginning, including the tax and regulatory environment.

Regulatory requirements and tax and accounting principles need to be taken into account by the model makers before they start to set up the complex sheets of calculations. It is not only a set of accounts to be mapped, but also a series of principles that have direct effect on the ultimate aim of the investor; dividends.

Financial modelling is a crucial step during effective deal making. Along with other parameters like the commercial environment, models are used by decision makers to assess where and when they should make investment.

The model maker has to have alternative methods to increase the commercial profit that will form a base for distributable dividends depending on the cash availability of the company. Meanwhile, he will also be expected to reduce the tax liability in the framework of the applicable legislation, where possible.

Building a financial model for all or part of a business requires understanding and analysis of a variety of complex factors. These include both detailed technical knowledge of deal drivers and in-depth industry knowledge.

PricewaterhouseCoopers has been the leading tax advisory firm in Turkey offering Financial Model Tax Advisory services to numerous unique energy projects and a multinational client portfolio for the last 15 years in the domestic energy sector.
Our M&A Tax specialists can add significant value to every transaction, whether by minimising transaction tax costs, managing long-term sustainable tax rates and cash flows, and ultimately planning ahead for a tax-efficient exit. Our leading-edge technical knowledge combined with our in-depth industry knowledge allows us to understand the specific factors driving each individual deal.

08 Oil & Gas: no signal

Almost nothing happened in the Turkish oil and upstream gas markets, mainly due to the bottlenecks and inconsistencies in regulations

In a quite stagnant deal environment in the oil and gas sectors, only small movements were seen in the upstream oil and fuel retail segment, which could just make up 3% of the deal total.

2009 was almost a perfect replica of 2008 in the Turkish fuel retail market, with ca. 90% of it being concentrated in the hands of the top six players, still limiting the attractiveness for the remaining market actors and, not surprisingly, failing to ignite the deal fire. The only deal in this segment hit the news just before the year end when Aygaz sold 4% of its stake in Opet to the Koc family. The sale of Dogan Holding's share in Petrol Ofisi to OMV, on the other hand, would contribute to the subtotals on our tables, if the transaction were to be signed.

In addition to the unfavourable market sharing, the regulatory uncertainties were also an important reason for the halt in the transactions. First, the Competition Authority opined that the long-term ususfructus contracts between the fuel retailers and the dealers carry the potential to distort free competition in the market. This immediately triggered speculation as to whether the duration of such contracts would be reduced to five years, which is the rule for any dealership relations in other markets than fuel retail, and also blacked out both contractual sides' investment and organic growth calculations. However, no concrete action has been taken so far to clarify whether this opinion by the Competition Authority will prove to be an applicable regulation. In the event it goes into effect, one of the results would be mergers among the companies eyeing each other's dealers, rather than competing individually with other hunters for each dealer.

Figure 6: **Oil & Gas Deals in 2009**

Date announced	Target	in %	Stakes Acquirer	Acquirer nationality	Deal value (US$ mn)
1-Oct-09	Toreador Turkey	100%	Tiway Oil	Norway	11
28-Dec-09	Opet Petrolculuk	4%	Koc family	Turkey	44
Total					**55**

Stormy conditions worsened in July and August 2009 in the fuel retail market when the one-off price cap regulation was applied. It is a widely accepted fact that this only gave mixed signals to investors eyeing this market and raised question marks about consistency in regulation.

Compared to the fuel retail segment, the concentration picture is looser in the Turkish LPG market in that 59% of the market is shared among top five out of 63 licensed LPG retailers. However, this is enough to cloud the prospect for brisk M&A news in this market. The ongoing contraction in the bulk and cylinder LPG segments pushed some LPG retailers to acquire licences to operate in the fuel retail market to diversify their product portfolio by using the existing infrastructure, but did not end in M&A activity between LPG and fuel retailers.

Heading up on the value chain, no transaction hit the public attention in the storage segment, which is still failing short to provide enough capacity for the fuel retailers to fully comply with the National Stock Requirement regulation. However, the problem in finding appropriate land to construct storage facilities in the vicinity of important ports always constitutes a good reason to believe in the possibility of looming acquisitions followed by limited capacity increases.

Energy Deal Dialogue:

Ensuring deals deliver value

Pre-deal promise followed by post-deal disappointment is the biggest hazard facing deal-makers. Making sure you deliver synergies is a tough task. High multiples in the utilities sector put an even greater premium on achieving performance improvement and cost reductions. In privatisations and emerging market deals understanding the level of potential improvement at the pre-deal stage is crucial in determining the winning bid.

Companies need a much clearer pre-deal view, not just of the level of cost reduction and performance improvement that will be possible but just of how they are going to achieve it. With intense competition for utility assets, a robust analysis of the target company is vital to verify the operational value improvement potential and allow the acquirer to compete with real assurance in the bidding process.

The importance of a pre-deal review that goes far beyond tax and financial due diligence to focus on operational systems, processes, organisational structure, people, stakeholder and regulatory relations is especially important for companies moving out of their own main markets or area of expertise.

PricewaterhouseCoopers provides an independent, objective view of the operations strategy and effectiveness and quantifies the impact on EBIT and cash for banks and investment committees, including:

- comment upon management capability to deliver improved performance based upon strategy development, execution and track record;
- review historical KPIs, performance improvement plans, focusing on cost, quality and delivery;
- validate any underlying operational assumptions, including capex;
- identification of risks, further opportunities and quantification of upside;
- benchmark performance against industry best practice;
- advice on the approach (how the improvements will be delivered) to hit the ground running in the first 100 days and to maximise success thereafter.

10 Looking ahead

The utilities market remains the hottest deal arena given the big ticket privatisations. However, the decrease in regulatory uncertainties remains the key condition in addition to the gradual recovery in credit channels

The current financial crisis and economic downturn had a significant dampening effect on energy markets, pushing down share prices of listed companies in a distressed funding environment in 2009. Capital markets have been very thin and restricted the main focus of the transactions to the pursuit of smaller asset acquisitions, especially in the power generation market, and share acquisitions in the natural gas import and wholesale segments to a lesser extent.

Looking ahead to 2010, however, we still assume the utilities market will stay the hottest deal arena given the government's commitment to finalise ongoing and upcoming privatisations. We expect that the big ticket character of the assets to be privatised in both electricity and gas markets, namely Baskent Dogalgaz, IGDAS and the remaining large electricity distribution regions expected to be put on the shelf, will boost the total deal value to the extent that it will reach a pre-crisis level and attract more foreign investors.

On the electricity generation front, we believe that the investments in the thermal power market will increase to surpass those in the renewable market. What underlines this opinion is not hard to anticipate. With the absence of sound incentives and regulatory quality rising as the backbone of competition during the crisis, the Turkish renewable energy market will come to fail in terms of attracting foreign investment. Together with the lack of domestic technical know-how in this market, attention will shift to the non-renewable investments on the back of their lower up-front investment costs and higher efficiency to underline higher IRRs over a shorter time span. In addition, the advantage of integrating generation with distribution will trigger buying activity by the new operators of distribution companies. On the other hand, we regret to see the slow-motion in the wind licensing process since 2007, and accordingly think that, once finalised, these licences would again revive the transaction instinct, as, looking forward, it will obviously become harder to get licensed to operate in this segment.

Still in the same market, the privatisation of the generation assets, which has already been kicked-off with a very tiny portfolio, would add momentum to the deal arena, but only if more attractive items are put on the shelf.

Another generation-related issue is of course the expected relaunch of the tender for the nuclear power plant. Given official statements that this will happen as soon as the necessary amendments in the tender legislation according to the decision of the Council of State regarding land allocation, the determination of offtake prices and the qualification process of the bidders come into effect, it will surely occupy the deal environment in 2010.

Our outlook for the deal potential in the Turkish oil and upstream gas markets, on the other hand, remains doubtful given the existing market-related constraints and regulatory uncertainties. The only exception to end in transaction would be hidden in the fuel storage market, on the back of strict EMRA enforcement related to the National Stock Requirements.

Consequently, on the back of the busy privatisation agenda, it is realistic to expect strong deal prospects in 2010, with a total deal value likely to exceed US$6bn.

Energy Deal Dialogue:

Understanding the value

Valuation is the foundation of effective deal-making. Assessing and fully understanding target value is critical not just for the commercial effectiveness of the deal but also as the basis for negotiations with regulators. Companies need to identify the purchase accounting adjustments that may be needed in the transaction and then see these implemented effectively.

IFRS 3 has significantly changed the way companies account for business combinations. These changes have turned acquisition accounting and purchase price allocations into an important pre-deal consideration with significant implications for future reported earnings of the combined business.

Clarity on the likely impact of IFRS and business combinations in due diligence is required by acquirers and the analysis will influence acquisition decisions – proper planning is critical to understand the EPS impact of future amortisation charges on acquired intangible assets and to minimise the risk of goodwill impairment.

In the energy and utilities market space, in particular, this can trigger larger swings in reported profits, reflecting impairments or fluctuations in derivatives values, and create questions and uncertainties around fair value across all parts of the value chain.

The challenge is to explore how the evolving standards can heighten transparency by ensuring that the bases of external financial reporting and internal management are as seamless as possible.

PricewaterhouseCoopers' practice has a specialised energy and utilities industry team with deep sector and technical accounting knowledge. We can help our clients to consider the impact of IFRS (and in instances where relevant, differences with US GAAP) on the deal economics as part of the due diligence process before a decision is taken whether to acquire. PwC can also provide insight into the impact of business combinations on regulatory planning, another critical aspect of pre-transaction planning. PwC can also support its clients in dealing with the complexities of IFRS 3 post acquisition.

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