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Secondary Market in UK Offshore Wind — Spinnakers Out

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In the News

The M&A secondary market for UK offshore wind assets is taking off.

Despite the pandemic, 2020 saw significant transactions in the UK offshore wind market fill the pages of the financial press. While the UK offshore wind market has not generally been found wanting for large transaction values (which enable developers to monetise the development premium on capital employed to reach financial close, and risk share the equity required for the substantial capital expenditure involved in the construction phase), this current spate of deal making represents a subtle but significant change in the nature of the market.

The nuance in this latest M&A deal spree is that they were successfully run as competitive auction processes and, as such, represent the transition of the UK offshore wind market into full maturity as an asset class.

Conditions for the Maturing of the UK Offshore Market

In order to reflect on the subtle shift in the maturity of the market that these transactions represent, it is worth reflecting on the evolution of the market to date.

The UK Government's subsidy for offshore wind, through the allocation of Renewable Obligation Certificates (ROCs) and more recently Contracts for Difference (CfDs) through the Low Carbon Contracts Company, have been very successful in establishing and developing the UK offshore wind sector (for more information on ROCs and CfDs, see Practice Notes: ***Renewables Obligation (RO)-key features*** and ***Contracts for Difference (CfD)- key features***, respectively).

The support for the sector has increased the proportion of the UK's generating capacity coming from offshore wind, as well as demonstrably lowering the marginal cost of production by incentivising participants to carry out further R&D as well as facilitating gains in engineering efficiencies through repeated processes.

On top of the localised government incentive structure, the global macro liquidity conditions created by a decade of quantitative easing have also been a boon to the renewables industry in general, and offshore wind in particular. With vast assets under management to be deployed and an alignment of yield expectations and tenors of cash flows from offshore wind, the sector has seen increased participation from infrastructure and other asset managers, increasing liquidity and lowering the cost of capital in the sector.

The increasing sophistication of the financing structures including wrapped holdco and multi-source packages with export credit agency (ECA) covered tranches has also increased the quantum of debt financing available with debt instruments being provided by both traditional sources such as project finance banks but also pension funds and insurers. This has further improved optimisation in capital deployment by developers, as well providing a ready pool of liquidity to sell down interests to at financial close.

The more recent driver is the increasing focus on environmental, social and governance (ESG) considerations and decarbonisation goals by financial markets, in turn driving appetite from a far broader range of potential investors, including oil and gas majors. This final thematic, when added to the subsidy regime, the liquidity conditions and the financial sophistication has produced the conditions for this fully mature and highly competitive market.

Transactions Run as Competitive Auction Processes

Prior to last year, the majority of previous sell downs of equity in the UK offshore wind sector were transacted on a bilateral basis, with the buyer being afforded the opportunity for detailed due diligence (DD) and negotiations on the nature and terms of the partnership for the development of the assets. However, both Humber Gateway and Doggar Bank A and B were run as competitive auction processes. Developers using competitive auction processes for the sale of minority interests materially changes the dynamic of the negotiations and the strategy to be employed by would be successful bidders.

What are the Implications?

Pressure on valuation

The main purpose of a competitive auction process is to increase valuations for the sellers. With competitive tension driving valuations, potential bidders will need to be prepared to adjust their valuation models to factor in potential operational synergies and future ancillary revenues such as asset life extension assumptions.

Pressure on the terms of sale

Perhaps more interestingly for lawyers, is the familiar tension that competitive auction processes bring to negotiations of the sale and purchase agreement (SPA) and other sale documents. Potential bidders will need to be clear as to what their own pressure points and red lines are in respect of both the sector as a whole as well as the transaction perimeter itself in order to keep mark-ups focused and competitive.

Limited or no negotiation of underlying Project Documents

With an auction process for a minority interest, the perimeter of documents on which the buyer is able to engage and the scope for material amendments is significantly limited. Bidders in a competitive auction process will not necessarily be given the opportunity to amend material project documents such as the EPC contract, operation & maintenance (O&M) or offtake arrangements (for more information on EPC contracts and O&M contracts, see ***Practice Notes: EPC contracts – overview*** and ***Key issues in operation and maintenance (O&M) contracts for renewable energy projects***.

Pressure on decision-making relating to due diligence

The increasing pressure for bidders to rely on vendor DD reports, with only top up DD provided by their own advisers during an auction process, is likely to require decision makers within bidders to be able to quickly form a view of material risks.

Coupled with the time pressure inherent in competitive auction processes, this means that bidders need to very quickly appraise themselves of the technical, financial and legal risks present in the transaction and determine its impact on their valuation and bid strategy with respect to the sale documents.

Pressure to appraise financing terms

Bidders in an auction process will typically find themselves buying into the asset with project financing already in place. As such, part of their DD will be to evaluate the nature of the recourse package and sponsor support required, as well as potential change of control issues that might differentiate themselves as a bidder: for example, these could include the requirement to provide guarantees, letters of credit or other forms of credit support for equity commitments for certain equity commitments in the case of funds or SPV bid vehicles.

With increasingly sophisticated and complicated project financing structures for construction assets being available and employed within the UK offshore wind sector, potential bidders need to be able to efficiently diligence and understand the scope and nature of the financing package into which they are buying.

Pressure on speed of execution

Sellers look to use the competitive tension from an auction process to drive forward the process. Potential bidders in an auction will need to be ready to move quickly from the non-binding offer stage to full mark-ups and completion of DD. Sellers are less likely to accept delays due to internal approval processes or additional diligence requirements.

It should be expected that the time pressure bidders will face is likely to steadily increase as the auction model is employed more regularly and the pool of competitors deepens.

A wider pool of participants

The recent auction processes for UK offshore wind for minority interests demonstrate that a number of more passive investors with smaller internal operational and technical expertise of the sector are increasingly interested in participating in the secondary market.

The limited scope for negotiating amendments to the material project documents as well as the more focused investment case nature of the sale process lowers the barriers to entry for the market. This in turn helps deepen the pool of potential bidders and supports the competitive tension required for auctions to operate as intended.

The wider pool of potential bidders also facilitates greater recycling of capital by developers and early adopters by bringing in minority passive investors not previously involved in the sector.

The additional benefit for the developers of attracting more passive investors into taking minority interests is the ability to retain additional margin in ancillary revenue associated with the project such as under the EPC, O&M, power trading activities and management services arrangements.

The other noticeable dynamic in the more recent offshore wind auction processes has been the participation by oil and gas majors.

The Opportunities

Integrated deal teams ready at the outset of the process

Bidders who can effectively coordinate and synthesise the technical, financial and legal elements of an opportunity will be able to maximise chances of success in an auction process by being able to focus diligence, keep mark-ups of transaction documents light, and ensure those material risk items are identified early for resolution. Bidders that fare well in these processes are also those that are ready at the outset of the process as the competitive tension is such that bidders that remain in preparation mode during the process are unable to move as nimbly.

The right adviser teams are appointed early on

With the time pressure and strategic considerations of an auction process, crucial to success is having the right team of advisers, technical, financial and legal. Advisers that know the sector well and who are able to quickly and efficiently identify likely risk areas before the transaction has started will give potential bidders the ability to focus resource and ensure the mark-ups of transaction documents remain as competitive as they can be.

Getting good advisers who know the sector will also allow for more efficient management of transaction spend.

Bidders with high-quality adviser teams and well-structured internal decision-making lines have the ability to use speed to their advantage. Bidders that are able to pre-empt an auction process in order to offer sellers certainty of terms early in the process will also have a real competitive advantage in the bid process.

Conclusions

There are signs of further secondary market activity in post-commercial operation date (COD) offshore wind assets, as investors who have bought in at financial close look to realise the higher risk yield of construction by selling down further stakes to funds and asset managers looking for the long term stable yields afforded by owning the assets over the operating life.

The continued pressure on valuations resulting from the increased number of participants in the mature UK offshore wind market, at all stages of the project development, is likely to place increased pressure on some developers in the UK offshore market and we may begin to see them focus their expertise and capital on other offshore wind markets such as Sweden, Ireland and the United States.