M&A Insights: Opportunities and Trends in Utility & Infrastructure Services

The utility and infrastructure services market is poised for growth, driven by the critical need for infrastructure modernization, the transition to renewable energy sources and the increasing reliance on outsourced service providers. In the below perspective, Lincoln International provides an update on the state of the M&A market, insights into the utility and infrastructure services sector and trends shaping the industry.

2023 Landscape: Year of M&A Hesitancy

The 2023 M&A landscape was characterized by strategic recalibration as stakeholders navigated through a year of economic uncertainty. Global M&A deal volume dipped to decade-low levels, influenced by rising interest rates, geopolitical concerns and adverse macroeconomic factors that compressed valuations. Despite this downturn in M&A activity, private debt fundraising remained robust. Institutional capital funding has dramatically outpaced capital deployment, leading to a more competitive market for lenders and improving conditions for borrowers.

- **Global M&A deal volume slowed materially to levels not seen since the Great Recession:** Private equity (PE) firms grappled with the complexities of closing acquisitions amid economic uncertainties and geopolitical tensions. The combination of higher rates and macro-environmental factors contributed to lower valuations, making deals more challenging.
- **Deal launches became more selective, with fewer companies brought to market:** Those that were brought to market faced increased scrutiny – anecdotally, over half of M&A deals launched in 2023 did not close[(1)].
- **Private debt fundraising showed resilience:** The number of funds in the market has more than doubled since 2020[(1)]. The influx of capital into private credit and a scarcity of M&A activities to absorb it facilitated a shift towards more borrower-friendly conditions.

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Navigating H2 2024

As 2024 progresses, Lincoln has observed that M&A activity remains subdued through April 2024. The market is adjusting to a 'higher for longer' interest rate environment, with diminishing expectations for multiple rate cuts this year. Interest rates remain above 5%, and reductions are not expected to be as aggressive as initially hoped at the end of 2023, contributing to a slower recovery in M&A markets. Despite these challenges, private equity and private debt markets continue to hold significant dry powder, and interest in the Utility & Infrastructure Services sector remains robust. The market is cautiously optimistic that deal activity will accelerate in the second half of 2024 and into 2025.

- **Improving macroeconomic and interest rate outlook:** The expectation of a near-term recession has significantly decreased as inflation trends have continued to moderate and rate hikes have paused.
- **PE's record dry powder will fuel M&A activity:** Eventually, PE firms need to deploy capital amidst a backlog of transactions. North American PE funds are sitting on a record $2.1 trillion in dry powder[(2)].
- **Valuation expectations are converging:** The valuation gap that deterred deal closures in 2023 shows signs of narrowing. Buyers are increasingly becoming more competitive, and sellers are recalibrating expectations.

Exploring the Dynamic Utility & Infrastructure Services Market

The utility and infrastructure services sector is primed for continued growth, driven by several factors shaping the industry. The combination of aging infrastructure, a focus on sustainability and decarbonization and increasing regulatory stringency has created a "wall of work" for infrastructure maintenance, replacement and modernization. Moreover, utilities across all markets have increasingly outsourced non-core functions to third-party service providers over the past several years. Initiatives like the Infrastructure Investment and Jobs Act (IIJA) and the Inflation Reduction Act (IRA) further support the industry's growth.

Industry Trends and Observations

Renewable Energy Shift

The shift towards renewable energy is a catalyst for change in the industry. The global focus on decarbonization and the transition to clean energy has intensified, driving significant pools of capital to invest in infrastructure modernization and expansion. In the U.S., the clean energy transition accelerated in 2023, bolstered by state and federal initiatives. A record $303.3 billion of energy transition financing was deployed nationwide for clean energy technologies, including power grid enhancements, renewables, electric vehicles, battery energy storage systems and other renewable energy infrastructure[(3)].

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The electric grid plays a critical role in electrification and energy transition. Expanding and modernizing electric grid infrastructure is essential to accommodate growing electricity demand and adapt to changing grid operating characteristics. The electric grid requires significant investment in ongoing maintenance, modernization and expansion to ensure reliable and affordable power. This includes strengthening aging infrastructure, addressing future grid resiliency and modernization efforts, adapting to a changing energy supply and meeting rising electricity demand due to electrification. Power consumption is expected to triple by 2050 and renewable sources are projected to provide 45%-50% of global generation by 2030 and 65%-85% by 2050[(4)]. This growing demand for energy, including that from intermittent renewable sources, presents a long-term opportunity for utility system modernization and the transition to a cleaner energy future, further underscoring the sector's growth.

Continued Outsourcing

Despite a substantial cumulative increase in utility expenditures over the past 25+ years, the utility workforce has decreased by approximately 30,000 between 1998 and 2023[(5)]. The gradual decline of the utility workforce, driven by an aging workforce, increasing costs and staffing constraints, is prompting utilities to rely on outsourced service providers. Utilities across all end markets have been outsourcing an increasing share of non-core functions to third-party service providers, which is expected to continue. Over the next five years, outsourced infrastructure spending is projected to grow at a 6%+ CAGR[(6)]. Currently, approximately 45% of electric transmission and distribution and gas distribution work is outsourced – this is projected to increase to approximately 50%+ over the next five years, with utilities opting to outsource work as more of their workforce retires in the coming years[(6)].

Regulatory and Federal Support

Governments and regulators are increasingly focused on the sector to enhance safety, reduce emissions and ensure fair pricing for consumers. Various legislative and regulatory actions, such as the U.S. Energy Policy Act of 2005, FERC Order No. 1000 (2011), PHMSA's "Mega Rule" (2020) and updates to pipeline safety regulations and the Protecting Our Infrastructure of Pipelines and Enhance Safety Act (2020), have been taken to address these concerns. Significant attention has also been paid to weather events, outage mitigation and grid modernization through state regulatory proceedings and national legislation.

The passage of the IRA and the IIJA bolsters the growth prospects for the utility and infrastructure services sector. The IRA, signed into law in 2022, includes $370 billion in investments to support antiquated infrastructure by incentivizing companies to invest in clean energy, transportation and environmental sustainability. The $1.2 trillion IIJA is a bipartisan infrastructure support program focused on improving and modernizing the nation's infrastructure, including roads, bridges, public transportation, water systems, broadband internet and the electric grid. The increasing regulatory stringency and heightened focus on safety, reliability and emissions reduction demonstrate the government's commitment to modernizing and improving the country's infrastructure.

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Service Provider Consolidation

Industry consolidation among service providers is a key trend that underpins the sector, as larger, scaled providers are equipped to meet the complex needs of utilities and provide consistent service across utility footprints. Scaled service providers cater to customers' diverse and evolving needs by offering more services over a larger geographic area than smaller regional providers. These scaled providers have a competitive advantage in institutionalizing safety programs, attracting talent and delivering consistent quality. Moreover, utilities are focused on streamlining procurement to improve efficiency, reduce costs and manage increasingly complex infrastructure.

PE investors remain active in the sector. Over the past decade, there has been a shift towards viewing participants as critical outsourced service providers rather than traditional contractors. This shift in perspective highlights service providers' increasing importance and value as essential partners in maintaining and modernizing critical infrastructure. The fragmented market landscape offers ample consolidation opportunities, geographic expansion and opportunities to develop a broader service offering. We expect the wave of consolidation in the industry that we've seen over the past decade to continue.

Notes and References:

1. *Source: Lincoln's State of the Market*
2. *Source: Prequin*
3. *Source: BloombergNEF*
4. *Source: McKinsey and Company – Global Energy Perspective*
5. *Source: U.S. Department of Labor / U.S. Bureau of Labor Statistics*
6. *Source: C Three Group*

Lincoln Perspective

The utility and infrastructure services sector's foundational strengths, long-term stability and growth prospects make it an appealing market for investment. The industry is underpinned by resilient, non-discretionary demand drivers that result in long-term visibility, resiliency and stability. This market is expected to experience sustained growth, driven by the ongoing need for infrastructure modernization, the transition to renewable energy sources and the increasing reliance on third-party service providers. As customers, governments and regulatory bodies prioritize safety, reliability and emissions reduction, the sector is well-positioned to benefit from the resulting investment and support. PE investors who recognize the potential of this sector and capitalize on the available opportunities are likely to succeed while contributing to the development of more resilient, sustainable and efficient energy infrastructure.

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