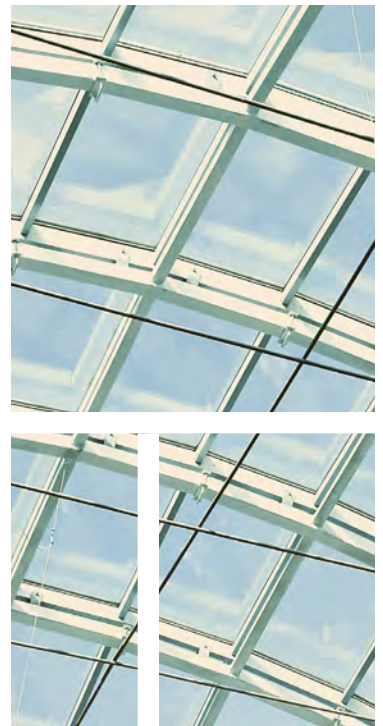


Long-Term Trends Underpinning Utility Services M&A



Investor interest in utility services will remain high given the numerous attractive tailwinds that underpin the sector's resiliency and growth potential. For telecom, power, gas and water/wastewater, regulatory and public pressure to improve aging infrastructure will grow due to the need to enhance reliability, safety and efficiency, while also minimizing environmental impact. In turn, these utilities will call for high-quality, reliable and safe service partners to meet their critical infrastructure requirements.

M&A momentum in utility services will continue in 2022 due to keen investor interest and strong valuations for high-quality platforms, thus presenting sellers with plentiful opportunities. Leaders within Lincoln International's Energy, Power & Infrastructure Group gathered to discuss the trends and themes expected to play a role in ongoing investor interest in the space for the year ahead.

FACTORS DRIVING ACTIVITY IN THE UTILITY SERVICES SECTOR IN 2022

Multiple industry tailwinds will underpin strong, regulatory-driven growth over the next several decades.

Replacement, upgrade and maintenance of aging infrastructure is supported by regulatory actions motivating utilities to make required investments.

Aging Infrastructure: The American Society of Civil Engineers recently rated the United States' infrastructure a C-minus. The country's aging infrastructure, which is the result of decades of underinvestment, has and will continue to demand significant replacements and upgrades. Numerous regulatory actions drive utilities to spend more on maintaining and upgrading infrastructure. Continued investment will be driven by the need to improve safety, quality and reliability, and address heightened ESG pressures. Given this, it is no surprise that there are increased federal and state-level regulatory initiatives, like the Infrastructure Investment and Jobs Act. While we have not yet seen the impact of this latest bill, we expect the public sector to benefit from the significant allocation of dollars.

Rate Cases Provide Built-in Funding Mechanisms: Rate cases provide utilities with a built-in funding mechanism for upgrading, replacing and maintaining infrastructure and allow utilities to generate a return on such investments, supporting incremental capital outlays. Rate cases are justifiable if infrastructure replacement improves public safety and reliability and/or reduces harmful environmental impacts.

Continued reliance on outsourced service providers.

Workforce Management / Labor Availability: Utilities are faced with an aging and retiring in-house workforce, which has led to a shortage of skilled laborers. Navigating the labor shortage will continue to be challenging and utilities will continue to rely on outsourced service providers. Service providers that invest in diversifying their recruiting approach and prioritize attracting, retaining and developing talent will prevail in this constrained labor market.

Continued Shift to Outsourced (Third-party) Service Providers: Utilities have shifted toward outsourcing an increasing share of non-core functions to third-party service providers over the past several decades. This shift has enabled utilities to reduce fixed costs, respond to overwhelming repair needs, properly maintain high cost-of-failure assets and focus on core operations. Utilities seek to "lock-up" high-quality, reliable and safe service providers, which have the ability to meet growing infrastructure requirements.

THE INCREASED ROLE OF ESG

Investors are holding institutional investors increasingly accountable for how they deploy capital, with growing calls for ESG-responsible investing. For private equity, there is increased pressure from limited partners (LPs) to highlight the positive environmental, social and/or sustainable influence generated within their respective portfolios. As such, the ability to quantify and communicate such impact will become exceedingly valuable.

Fortunately, the role of ESG in the utility services market is bright. From the buildout of renewables to the social priority of having access to clean, safe drinking water, the telecommunications, power, gas, and water/wastewater sectors all offer substantial opportunities for private equity to participate in the rapidly evolving ESG landscape.

DYNAMIC, YET STABLE, OPPORTUNITIES FOR PRIVATE EQUITY

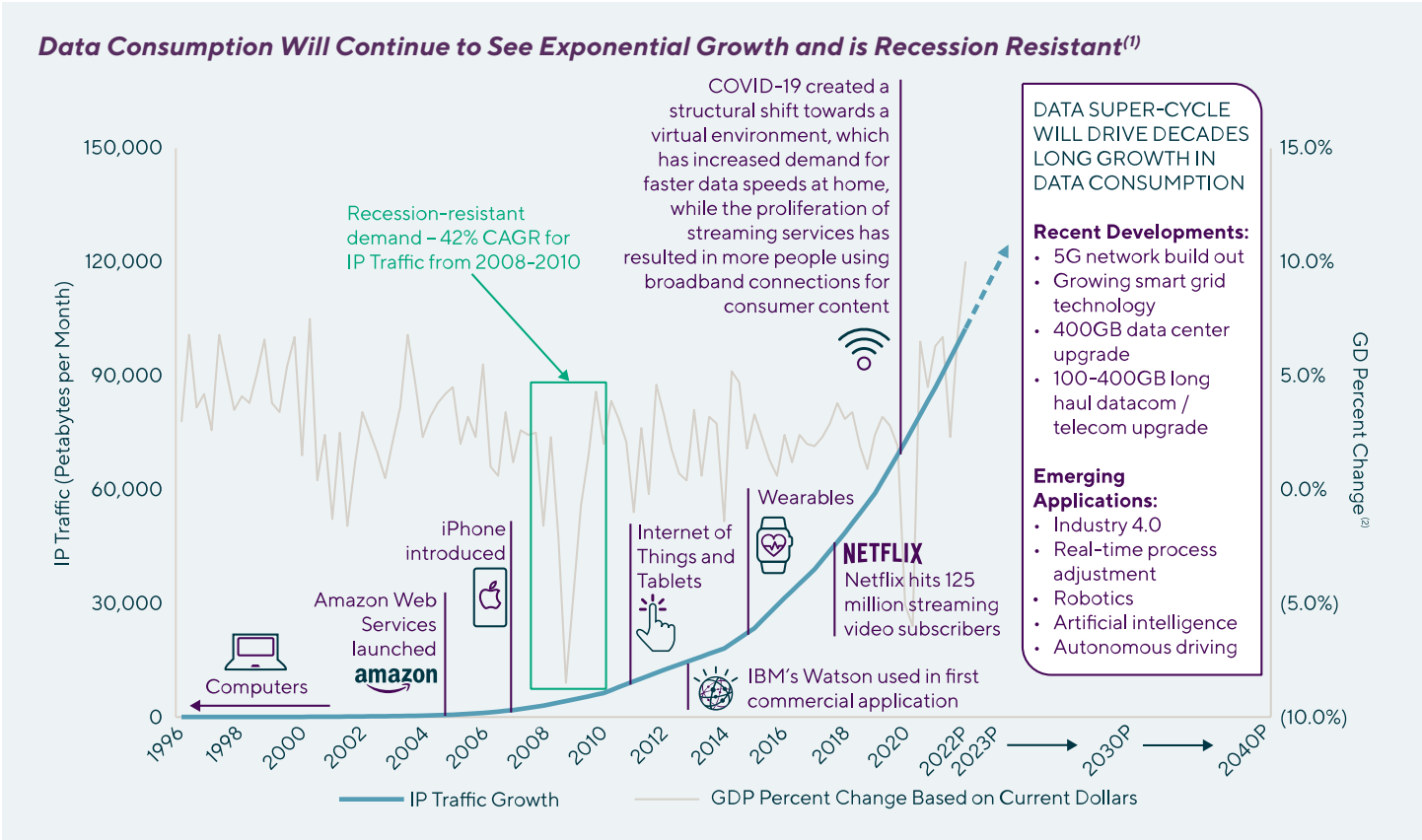
The utility services sector has experienced a "mindset shift" among investors over the past several years. Today, investors view participants as outsourced services providers rather than "specialty contractors" or "construction companies."

There is ample opportunity in the sector to consolidate a fragmented market typically comprised of regional or local businesses, expand geographically or build a platform of broader service offerings. Additionally, the highly resilient, non-discretionary demand drivers that underpin the sector provide long-term visibility, resiliency and stability for PE investors.

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The telecommunications industry is exhibiting tremendous growth as the 5G rollout continues to take hold. Rapidly growing demand for data consumption across commercial, government and consumer sectors is driving the need for denser networks to support increased speed, coverage and capacity. Over the last decade, the proliferation of streaming services has heightened the demand for fast and reliable connectivity and has grown exponentially. This trend has been accelerated in recent years, with a tremendous surge in people working from home and schools shifting to virtual classrooms. Competition and technological innovation define the industry today, and telcos are required to invest significant capital in upgrading and maintaining network infrastructure to support demand for data and remain competitively viable. In recent years, the industry has experienced rapid convergence to appeal to the digital age and is expected to benefit from the growing adoption and popularity of smartphones, the internet of things (IoT), artificial intelligence (AI) and connected cars.



Today, the 5G rollout is transforming the telecommunications industry and driving the convergence and interdependency of wireless and wireline networks. To adequately provide the network connectivity for 5G, fiber must be within ~500-1,000 feet of every wireless customer. Increasing demand for more broadband connections and faster service, coupled with the growing dependence on wireless connectivity, is driving intense competition in the wireless market, resulting in significant investment in infrastructure.

Compared to other utility sectors covered in this publication, the telecommunications sector has a light-touch regulatory policy environment. Investment in next-generation networks is primarily funded through service providers' operating and capital budgets v. rate cases. The United States wireless industry has invested around \$300B in deploying "next-generation" networks over the past ten years and is expected to invest another \$275B in 5G technology, including fiber-optic cables, small cells and other 5G network infrastructure. Though there may be some short-term hurdles in the rollout of 5G technology, the arms race between Verizon, AT&T, T-Mobile and others will create substantial opportunities for the installation, maintenance and repair of networks by third-party service providers for years to come.

verizon expects \$21.5B in capital expenditures in 2022 as it continues to ramp-up spending on its network and deploy more 5G services on its C-band spectrum. Specifically related to its C-band 5G network buildout initiative, Verizon spent \$2.1 billion in 2021 and expects that figure to rise to \$5B-\$6B in 2022. - **Verizon Earnings Call (Q4 2021)**

AT&T expects \$20B in capital expenditures in 2022 as it is focused on investing in 5G and fiber to meet substantial, long-term demand for connectivity. AT&T plans to unload its WarnerMedia unit to focus on its mobile and fixed broadband businesses. - **AT&T Earnings Call (Q4 2021)**

T Mobile expects \$13.5B in capital expenditures in 2022 as it plans to bring Ultra Capacity 5G to 260 million people this year and 300 million in 2023. T-Mobile claims that it is delivering nearly 5x more geographic coverage than Verizon and nearly 2x more than AT&T. - **T-Mobile Earnings Call (Q4 2021)**

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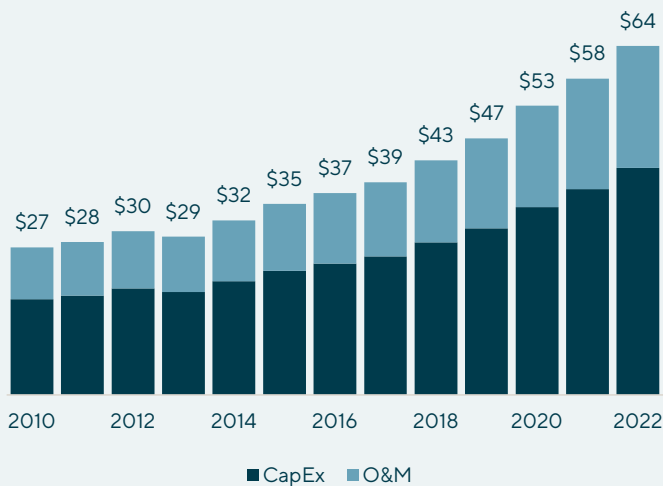


POWER

Most of the power transmission and distribution (“T&D”) infrastructure in the United States was built decades ago, incorporating technology developed in the mid-20th century that was designed to meet consumer needs at minimum cost. Since the United States electrical grid was built, growth in electricity demand has far outpaced the expansion of the network’s usage. From 1988 to 1998 alone, demand rose 30% while capacity increased only 15%. Historical underinvestment in the electrical grid has resulted in congestion, outages and unreliable power delivery. The United States has more blackouts each year than other developed countries – the grid loses power 285% more often today than in 1984 and annually costs the United States economy as much as \$150 billion⁽³⁾.

As demand for reliable power delivery continues to increase, utilities face pressure to invest in infrastructure upgrades and perform maintenance to enhance an already aging base of electrical infrastructure. Furthermore, the average number of weather-related events and other natural disasters occurring annually has been consistently trending upwards, which has increased the number of power outages and brought greater scrutiny to the state of the industry’s infrastructure. The \$33B market for outsourced operations and maintenance of T&D infrastructure is expected to grow at a CAGR of ~8%-9% through 2025. Several favorable underlying utility investment trends will fuel this growth, including rate case dynamics that compel incremental capital outlays, grid modernization and hardening, and the ongoing renewables build-out. Further, utilities continue to increase the share of maintenance, repair and installation work outsourced to third parties, and the wages paid for those services continue to grow.

Utility Expenditures on Distribution Infrastructure⁽⁴⁾
(\$ in billions)



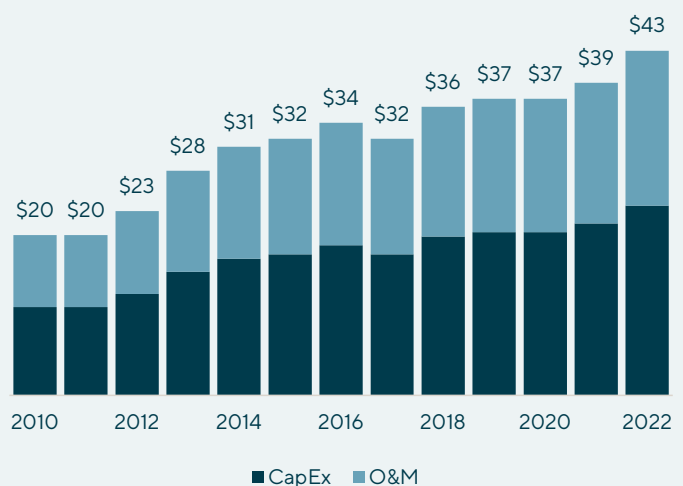
CapEx-Funded Jobs

- New pole and line erection
- Pole / line replacement and repairs
- Hardening activities
- Undergrounding
- Grid automation

O&M-Funded Jobs

- Line minor repairs
- Pole component minor repairs
- Transformer minor repairs

Utility Expenditures on Transmission Infrastructure⁽⁴⁾
(\$ in billions)



CapEx-Funded Jobs

- New tower / pole and line erection
- Tower / pole replacement and major repairs
- Renewable generation tie-in
- Battery installations

O&M-Funded Jobs

- Line minor repair
- Pole / pole component minor repairs
- Control / switch minor repairs

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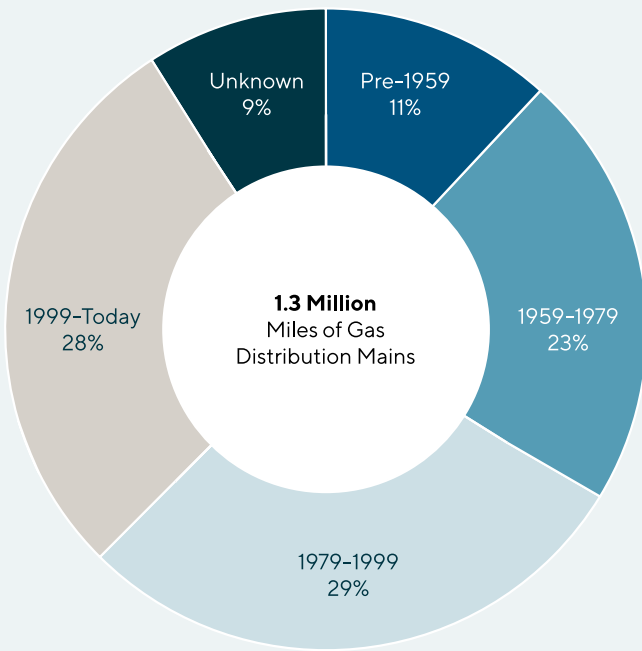
NATURAL GAS

Natural gas represents ~25% of the energy consumed in the United States today, and consumption is projected to grow across residential, commercial and industrial applications faster than the rest of the energy sector over the next few decades. Natural gas provides several benefits compared to traditional fossil fuels (e.g., coal). It is the cleanest-burning conventional fuel, producing lower levels of greenhouse gas emissions, and is a cheaper, safer and more reliable source than alternatives.

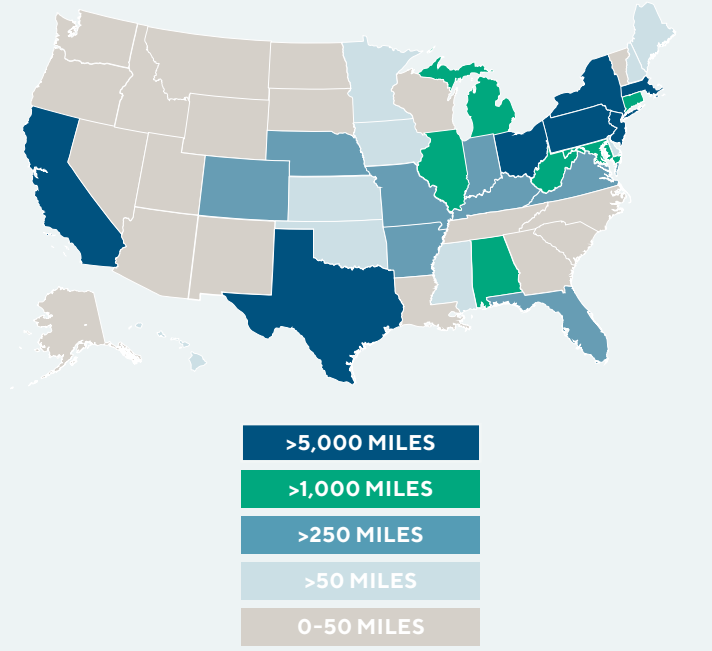
Despite natural gas' appealing characteristics, a significant portion of the infrastructure is approaching the end of its useful life, with 35%+ of distribution pipeline installed 40+ years ago and ~15% installed 60+ years ago. More specifically, cast and wrought iron pipelines are among the oldest energy pipelines constructed in the United States. Many of these pipelines were installed 60+ years ago and still deliver natural gas to homes and businesses today. However, the degrading nature of iron alloys, the age of the pipelines, and aging pipe joint designs have significantly increased the risk involved with the continued use of such pipelines.

As the United States continues to develop and place more demands on energy transportation, the continued inspection, maintenance, and replacement of this aging infrastructure is mandatory. Following multiple recent major natural gas pipeline incidents, the Department of Transportation (DOT) and Pipeline and Hazardous Materials Safety Administration (PHMSA) issued a "Call to Action" requiring utilities to expedite the repair, rehabilitation, and replacement of high-risk mains and service lines. Of the 1.3 million miles of main pipeline in the United States, 75,000+ miles are categorized as leak-prone for replacement, representing over 21 years of backlog (at current replacement rates) and \$180+ billion of spending. To fund increased infrastructure maintenance costs, regulated utilities seek rate cases (consumer rate increases) from state utility commissions to cover the costs of planned (and often necessary) infrastructure upgrades. Rate cases are justifiable if investments improve public safety, infrastructure reliability, reduce the environmental impact from lost natural gas (in the case of leak-prone mains), or reduce the cost to ratepayers over time due to the reduction of lost natural gas due to leaks.

Gas Distribution Mains by Decade Installed⁽⁵⁾



Total Leak-Prone Main, by State⁽⁴⁾



While there is increasing political pressure to decarbonize electricity generation by shifting to wind, solar and other renewable sources, this transition cannot be achieved simply through policy preferences; this shift presents technological, financial and logistical challenges. United States energy demand is expected to more than double by 2050. Given these realities, complete dependence on renewables may be out of reach. Looking forward, new generating capacity will be in the form of natural gas and renewables as more coal and nuclear plants are retired. Natural gas is the cleanest-burning conventional fuel, producing lower greenhouse gas emissions levels and offering a stable energy supply (i.e., the United States is a net exporter of natural gas) that utilities can use in conjunction with solar and wind power. Natural gas will serve as a foundation and complement to renewables, aligning very well as a backstop to their inherent intermittency and helping meet the growing global demand for sustainable energy⁽⁶⁾.

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Over the last ten years, an economic analysis by the American Society of Civil Engineers (ASCE) placed the water-related infrastructure investment gap at \$434 billion for drinking water, wastewater, and stormwater combined. Although there have been strides in recent years to address current and future needs, the ASCE Infrastructure report card still scored storm and wastewater infrastructure with D and D+ grades, respectively, in 2021⁽⁷⁾. Currently, the United States plans to invest ~\$1.1 trillion on water infrastructure over the next 20 years, but the total need over this time frame is \$3.0+ trillion. To close the gap, the United States would need to increase its investment in water infrastructure by \$2.2 trillion over the next 20 years, or ~\$109 billion per year.

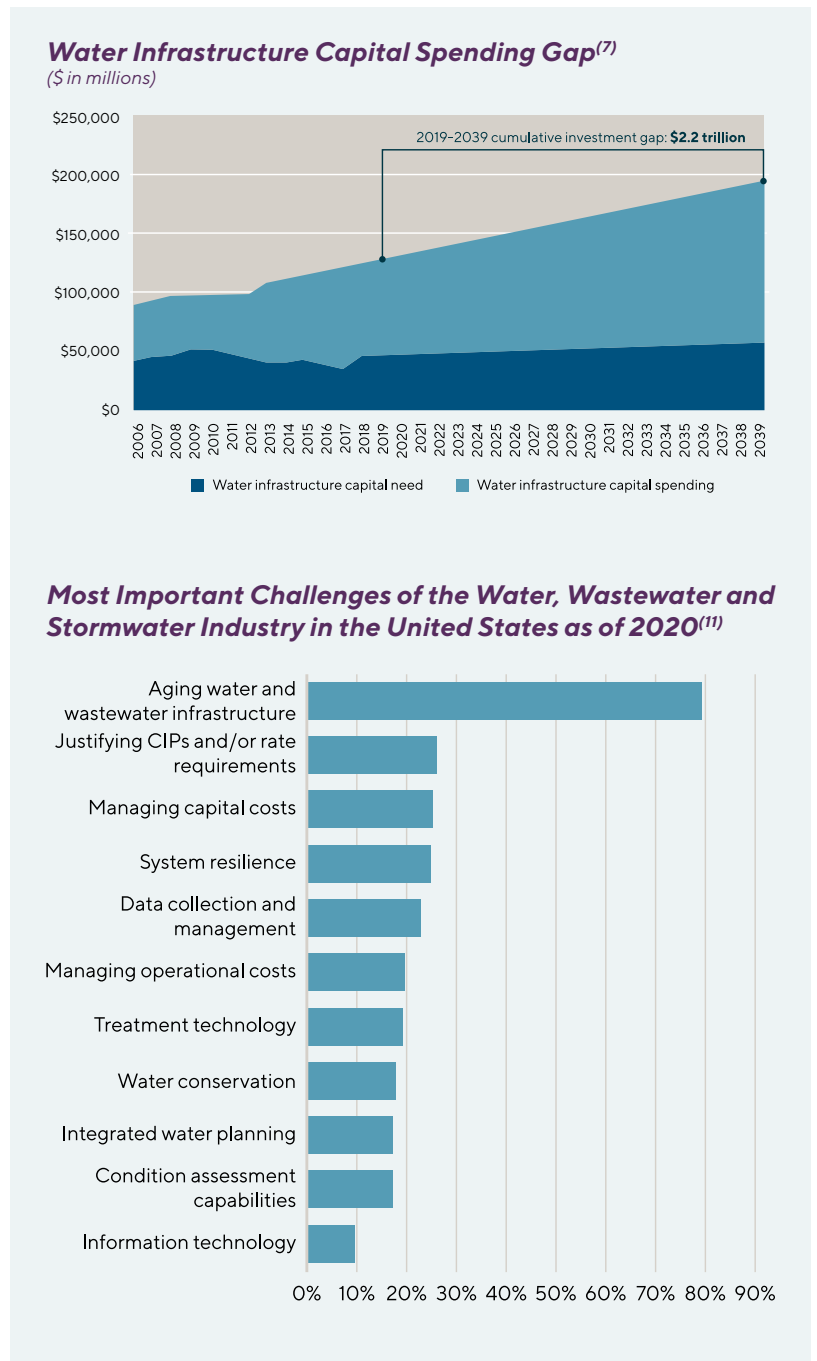
The United States population is expected to reach ~340 million by 2023, up from ~330 million today. This will require an increase in water infrastructure capital spend across the nation. In addition to a growing population, the United States has strict regulatory and compliance requirements that mandate water utilities to provide safe, reliable water treatment solutions. As urban and rural populations grow, water & wastewater treatment (“W&WWT”) facilities will need to accommodate a more significant portion of the nation’s waste and stormwater demands. With over 16,000 W&WWT plants in the United States, and the vast majority of them close to functioning at or above their capacity, the need for investment and upgrade continues to intensify⁽⁸⁾.

On average, the wastewater pipes making up the infrastructure in the United States are roughly 45 years old. With projected lifespans of 50 to 100 years, groundwater and stormwater are increasingly entering deteriorating pipes as inflow and infiltration⁽⁹⁾. The adverse effects of inflow and infiltration include additional and accelerated damage to pipes and potential contamination to vital ground and drinking water sources – namely, lead poisoning. These factors make updating water infrastructure a top priority.

For stormwater, estimates suggest there are 3.5 million miles of storm sewers, 270 million storm drains, and 2.5 million stormwater treatment assets across the United States⁽¹⁰⁾. However, even though municipalities are required to map their stormwater systems, the data for the sector is few and far between, typically tracked through legacy, manual processes, resulting in a reactive approach to maintenance. Without accurate reporting on the infrastructure’s state, and an increase in rainfall trends and urbanization, many are fearful the actual capacity of the system is less than the system was designed to accommodate.

Generally, utilities are behind in accounting for the condition of their assets and the planning and funding for short- and long-term maintenance. This is especially true in critical water-related infrastructure. To best address this rapidly aging infrastructure, storm and wastewater-specific reporting, planning and funding will be essential – especially efforts with sustainability in mind. Strategizing and implementing green infrastructure provides endless benefits for water infrastructure by reducing runoff, minimizing erosion, and improving water quality.

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(1) Source: [US Telecom | The Broadband Association](#)

(2) Source: [FRED](#)

(3) Source: [US Department of Energy](#)

(4) Source: FERC data only includes major investor-owned utilities, defined as: one million megawatt hours or more; 100 megawatt hours of annual sales for resale; 500 megawatt hours of annual power exchanged delivered; or 500 megawatt hours of annual wheeling for others (deliveries plus losses)

(5) Source: [PHMSA](#)

(6) Source: [Washington Post](#)

(7) Source: [US Water Alliance](#)

(8) Source: [Water & Wastes Digest](#)

(9) Source: [2021 Report Card for America's Infrastructure - Wastewater](#)

(10) Source: [2021 Report Card for America's Infrastructure - Stormwater](#)

(11) Source: [Statista](#)

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