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Energy and Infrastructure

A Legal 500 Tier 1 Practice: M&A and Acquisition Financing

A Move Towards Unregulated Growth

- Focus on unregulated 'growth' assets driven by energy transition and digitisation trends.
- The policy/legislative environment may shift to support nascent technology, as seen with the UK's Energy Act 2024. However, as energy transition markets expand regulators will eventually extend regulations to protect customers (rather than Investors) in those markets, like the anticipated regulation of heat networks in the UK.
- To protect investment in 'growth' assets and new technologies, Investors will look to contractual protections and using alternative structures (as explained in more detail below).

Changing investment thematics are leading to increased interest in non-traditional 'growth' opportunities

1. Global trends in infrastructure investment are pivoting towards energy transition and the "digitisation and electrification of everything". To find such opportunities, asset managers (and underlying investors) (Investors) are increasingly looking at investment in 'growth' companies, that is, companies which are developing and rolling out nascent technology such as next generation battery storage and EV charging platforms.
2. By their nature, 'growth' assets make for higher risk (and potential reward) and require more active investment strategies and ongoing growth funding. A different risk mitigation toolkit is also required compared to traditional infrastructure investment in regulated assets which often also benefit from subsidies or licensing regimes.
3. The digitisation of traditional/"non-digital" infrastructure, where Investors modernise and upgrade existing infrastructure to avoid being stranded with unsustainable assets, may also create new and often transformative opportunities. Robotics and automation, smart monitoring systems, and AI are being introduced to enhance efficiency to existing systems and operations. Some Investors (and their portfolio companies) are partnering with technology specialists to leverage synergies in the broader digital landscape – this can be through making investments into start-ups or growth businesses.
4. An important factor for success as nascent sectors eventually come under the regulatory purview will be for Investors to continue to deliver on the business model whilst navigating regulatory changes and challenges in a competitive landscape.

Key contractual protections for minority investments in growth deals

5. This article explains some of the key investment features and protections (some borrowed from venture capital) that Investors should consider when negotiating 'growth' deals, especially where the investment is structured as a minority stake and where founding shareholders are seeking new investment.

a) Enhanced / Liquidation Preferences – an Investor with a liquidation preference will be able to recover their investment (plus, if agreed, a multiple of that) ahead of any other shareholder in a sale or liquidation scenario where a return is not achieved. Enhanced liquidation preferences include a "participating preference" right which allows the Investor to recover its investment and then also to 'participate' in the distribution of any remaining proceeds on a pro rata basis (although these rights are less common).

b) Anti-dilution ratchets – if an early-stage Investor subscribes for shares at a price higher than the subscription price set for a subsequent equity fundraising round (***Subsequent Round***), they would be disproportionately diluted on the Subsequent Round. To protect against this dilutive effect, the Investor can negotiate an anti-dilution ratchet (outside of the usual pre-emption rights) that would, when exercised, ratchet up the number of shares to be issued to the relevant investor in the Subsequent Round to "compensate" for the shares they would have received had their earlier investment been made at the lower subscription price. The extent of the ratchet mechanic will vary depending on the negotiated position.

c) Convertible loan notes – convertible loan notes give the Investor an option to convert loan notes to equity in the Subsequent Round at a pre-agreed discount to the subscription price. These can be issued to mitigate the 'valuation gap' where Investor and company pricing expectations are not aligned at the point of investment.

d) Pay to play provisions – given the market is experiencing a difficult fundraising period, growth companies seeking investment may look to incentivise Investors to continue to provide growth capital in the future, for example, by providing enhanced veto or board representation rights if they participate in Subsequent Rounds. In some cases disincentives are used and Investors may lose existing rights if they choose not participate.

e) Preferred equity - these instruments provide lower-risk, debt-like characteristics (including return of capital ahead of ordinary shareholders and junior debt) with, in the current higher interest rate environment, attractive returns (closer to equity-like returns) especially when compared to the lower investment risk being taken. Terms of preferred equity instruments are subject to commercial negotiation (rather than market norms) and can therefore provide a flexible funding solution. Investors holding only preferred equity, however, will not participate in any upside returns and, as such, these alternative structures are likely to remain a consideration for so long as the risk-reward balance remains attractive.

f) Governance rights (including reserved matters) – these should be carefully considered by Investors alongside the above deal protections and the scope of governance rights negotiated should reflect the size of the Investor's stake and also take into account any other expertise or opportunities that an Investor brings to the table.

6. Compared to traditional infrastructure investment with predictable risk profiles, an Investor's approach to deal strategy and risk assessment needs to adapt to capture and optimise 'growth' opportunities while also anticipating challenges from emerging technologies and future regulation.