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Not just light bulbs

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When **General Electric Co.** announced a 6% earnings drop on April 11, its worst quarterly performance in five years, investors were aghast. It was well below analysts' estimates, with four of its six segments underperforming expectations. The stock plunged 13%, its worst single-day decline in 20 years, and pulled the rest of the stock market down with it.

"It makes it hard for investors, especially in this environment, to have conviction, I think, that you guys really are a safe, reliable growth company — which is kind of the core of the value proposition you guys have put forth to the investment community," Steve Tusa, an analyst at **J.P. Morgan**, lectured GE executives on a conference call.

Yet buried deep in GE's financial statement were results for its Energy Financial Services unit, which had 44% profit growth in the quarter, to $145 million, with sales more than doubling to $770 million. Its energy unit's profits grew 32%, to $907 million, on a 21% sales jump to $5.6 billion, with its margin improving from 14.8% to 16.1%. And profits at its oil and gas unit were up 58%, to $161 million, on a 34% sales increase to $1.5 billion.

While its combined energy business makes up only 18.7% of its sales, versus 15.7% a year ago, it contributes 28% of its profits, versus 19.5% a year ago.

"The energy business is going to be our horse," GE chief financial officer Keith Sherin said on the call.

Indeed, GE has been busy in the energy world and promises to continue to be so. Record high prices for oil and natural gas have kept the sector humming, and GE — as it has through its history — is only too willing to provide equipment, services and financing to keep it that way.

But GE has also been making strategic investments in each of its energy business lines, leveraging information it gets from selling equipment and doing financings, creating a growth center in what analysts are starting to think is just another unfocused, sluggish conglomerate needing to be broken up.

"Energy has always been a big part of the business, going back 125 years to Thomas Edison," says Alex Urquhart, president and chief executive of GE Energy Financial Services, where a lot of the investment is going on. "When I joined in the early 1980s, GE was doing energy financing and was principally involved in the U.S. power business. But over time, it's evolved, from power to everything energy, from financing to investing and from the U.S. to worldwide."

GE's biggest acquisitions have been in oil services. With only a small machinery business in Italy and a pipeline inspection services provider in Britain it bought in 2002, GE came out of nowhere in January 2007 to purchase privately held drilling, completion and production equipment provider Vetco Gray for $1.9 billion in cash. That was a pricey 10 times Ebitda and a 100% return for private equity investors **Candover Investments plc**, **3i Group plc** and **J.P. Morgan Partners LLC**.

Eight months later, GE turned around and bought U.K. oil drilling inspection company Sondex plc for $582 million, or $9.27 per share — a rich 36% premium for a company that did only $137 million in sales in its most recent fiscal year. Then, this past January, it bought Hydrill Co., the pressure control unit of pipemaker **Tenaris SA**, for $1 billion.

"Wall Street kind of yawned," Dan Pickering, research chief of **Tudor Pickering Holt & Co. Securities Inc.**, wrote of GE getting deeper into oil services. "But we're clearly at a point in the cycle where it's capturing the interest of more than just the industry players."

Rumors have even swirled that GE might also make a play for one of the three oil services giants, **Baker Hughes Inc.** But that's been discounted as too big a bite — Baker Hughes has a market capitalization of $24 billion — and the possibility is more unlikely now, given GE's weakness on Wall Street.

GE has also bought oil and natural gas in the ground. About two years ago, it partnered with **Sunland Resources LLC** to acquire natural gas and oil reserves in northern Louisiana from a consortium led by **Caruthers Producing Co.** for $101 million. Most recently, on April 1, GE Energy Financial Services formed a partnership with a unit of Houston oil and gas company **Union Gas Corp.** and investors to buy oil and gas reserves from two fields in East Texas and the Texas Gulf Coast from an unnamed seller for $115 million. GE is investing $104 million as the 90% partner and Union Gas is investing the rest as the 10% partner. Union Gas Production Partners LP plans to invest $29 million more to develop proved reserves over two years.

GE also expanded into natural gas transportation. In 2004 it bought CrossCountry Energy LLC from then-bankrupt Enron Corp. with **Southern Union Co.** for $2.45 billion, adding about 7,500 miles of pipeline. The next year, it and Canadian institutional investor **Caisse de Dépôt et Placement du Québec** bought Southern Star Central Gas Pipeline Inc. from private equity fund AIG Highstar Capital LP for $362 million.

More recently, in June of last year, it bought a 37% interest in **Regency Energy Partners LP**, an owner of natural-gas-gathering and storage assets in Texas, Louisiana, Oklahoma and Kansas, and an intrastate pipeline in Louisiana, from **HM Capital Partners LLC**, formerly Hicks, Muse, Tate & Furst Inc., for $603 million. (**Goldman, Sachs & Co.** and **Vinson & Elkins LLP** advised GE, while **Lehman Brothers Inc.** and **Hughes & Luce LLP** assisted HM Capital.)

Natural gas distribution has been a newer focus. In April 2007 it bought a natural gas distribution company in Lakewood, Colo., with operations in Colorado, Nebraska, Wyoming and Hermosillo, Mexico, from **Kinder Morgan Inc.** for $710 million. Seven months later, SourceGas LLC, a joint venture between General Electric Co.'s GE Energy Financial Services and **Alinda Investments LLC**, bought natural gas distribution unit Arkansas Western Gas Co. from **Southwestern Energy Co.** for about $224 million in cash, about $45 million more than some analysts thought it was worth. Arkansas Western serves 151,000 residential, commercial and industrial customers in northern Arkansas and owns 5,700 miles of gathering, distribution and transmission pipelines, an underground storage facility and related gas distribution assets.

GE is also interested in natural gas storage. In February 2007, it purchased a preferred equity interest in the Bobcat underground salt dome storage project in Louisiana from Haddington Energy Partners III LP, a Houston private equity fund focused on energy, for $65 million. GE has an option to convert its preferred interest to 50% common ownership within 90 days of the project's commercial operation. (**RBS Securities Corp.** advised Haddington.)

"The Bobcat project benefits from its strategic location in the natural gas infrastructure grid, strong growth forecasts for U.S. gas demand and a need for more storage in the Gulf Coast markets," Dan Castagnola, a managing director at GE Energy Financial Services in Houston, said at the time.

Ken Culotta, a partner at **King & Spalding LLP** in Houston who counseled Bobcat on the deal, says such assets will be critical to natural gas infrastructure. "As LNG starts coming in, storage will become that much more important," he says.

GE has also bought power assets. In 2006 GE Energy Financial Services picked up the Linden, N.J., power plant from Goldman Sachs and a 40% stake in a 400-megawatt, natural gas-fired power plant in Ireland from a unit of **Gama Holding AS**, both for undisclosed amounts. GE found both investments because it supplied turbines for the plants; in particular GE helped finance construction on the Linden plant. "The Linden power plant had been owned by a number of people," Urquhart says. "But we improved its performance and efficiency and have taken advantage of access and transmission and added a transformer to bring additional power to New York City."

There have been other power investments by other units of GE. In July 2007, GE Corporate Lending bought a 50% stake in power projects owned by utility holding company **DTE Energy Co.** for $805 million (**Morgan Stanley** advised DTE). The deal enabled DTE to partially monetize its investment and use the proceeds to repurchase its stock.

After the Irish power plant acquisition, GE got to know Gama, which also owned a 1,150-megawatt hydroelectric and a natural gas-fired power plant in Turkey, was developing 855 megawatts of renewable and 1,000 megawatts of thermal generation projects in Turkey and has been awarded a $1 billion water pipeline project in Jordan.

The two started talking about what they could do together, and in December, GE Energy Financial Services ended up buying half of its power and water unit, Gama Enerji AS, for an undisclosed sum.

Turkey's energy demand is rising 7% to 8% per year. The two are talking about investing $3 billion in power and water projects in the region by 2011. "After having closed that investment, our relationship built from there and we started talking about what more we could do around the world," says Andrew Marsden, managing director and European leader at GE Energy Financial Services. (**Fieldstone Capital Holdings Ltd.** and

Milbank, Tweed, Hadley & McCloy LLP advised Gama, while **Hergüner Bilgen Özeke** assisted GE.)

GE's ambitions in power are big: This past August it reportedly wanted to buy power plant developer **Calpine Corp.** with hedge fund **Harbinger Capital Partners** once it emerged from bankruptcy. But Calpine rebuffed the offer as not "strong enough to bet the company on," with elements that weren't "economic in nature," Reuters reported a source as saying.

GE is also big in alternative energy as part of its "ecomagination" program. It's invested in electric cars ($4 million in Norwegian electric car manufacturer **Think** and undisclosed amounts in lithium-ion battery developer **A123Systems**); wind power (a 125-megawatt, $120 million wind farm in Texas being developed by Dublin wind power developer **Airtricity Inc.**, the 120-megawatt Stanton wind farm in Texas with wind power developer **Invenergy Wind LLC** and three wind parks in New York); and solar (it bought a majority interest in five solar plants in California it's developing with **SunPower Corp.** in January for an undisclosed sum).

It's doing the same in Europe. Last year, GE swapped its German wind farms and $26 million for a 15% stake in French alternative energy group Theolia (Theolia tapped **Société Générale**'s Philippe de Vulpian for financial advice while GE turned to **Rothschild**).

"In Europe, one of the hottest areas is renewables, driven by the requirement by the EU that 20% of power be renewable by 2020 and talk that it will be increased further," Marsden says. "Developers need capital."

Overall, GE plans to invest $5 billion on energy projects per year and another $5 billion on water. And in January it raised its 2010 renewable energy investing target by 50%, to $6 billion, having already invested $3 billion.

Have valuations become too rich? Marsden says competition has materially increased in Europe over the years, with a host of infrastructure funds and renewable energy funds in the market creating more demand, which has led to higher prices and lower returns. "You have to look harder and act smarter and make sure you have investments that get you the right return," he says.

GE has had its share of flops. Remember Enron Corp.'s debacle in India with the $2.9 billion Dabhol power plant project? General Electric owned 10% of the project, as did **Bechtel Corp.**, which stalled when its sole customer and partial investor, the Maharashtra State Electricity Board, refused to agree to a rate hike and stopped paying its bills. Hoping to salvage the project, a financing unit of GE and Bechtel bought out Enron's 66% stake in 2004 for $22 million after Enron filed for bankruptcy. But the two couldn't iron out problems with Maharashtra, and GE eventually sold its stake in 2005 in a settlement that some estimated at only $145 million.

Urquhart says there have been other wrinkles with investments, including one power station he wouldn't name in which the customer didn't buy all the power and didn't have adequate transmission capacity to sell the rest to others. "We took our lumps on many of the early international transactions, but through renegotiation and growing pains in the end they worked their way through."

Urquhart, whose unit numbers 350 people, says he sources many deals through his 70-member dedicated origination force, which is constantly talking with partners, customers and sellers looking for deals. He says he's also helped along by the energy and oil and gas units and works closely with many of the investment banks that are selling and financing assets. "Our doors are open," he says.

Urquhart says he sees further opportunities in renewables such as wind and solar amid high commodity prices and concerns about global warming. He says power and water continue to be a hot area for investment in India, which he visited recently ("they have tremendous needs," he says), as well as in Southeast Asia, where there are also oil and gas plays. Urquhart says Brazil's new oil and gas finds will need capital, as will its ethanol industry; he's looking at an investment in Canada's oil sands; and his unit recently established an office in the Middle East.

High commodity prices have meant higher premiums, but Urquhart says the assets his unit is looking at are fairly valued. "If they're not, we don't look at them," he says.

Urquhart says his unit doesn't do deals based on the exit, although he's moved in and out of oil reserve deals when the timing was right. "We're not like some of the investors in the space, who have raised the money with a date certain they'll pay it all back," he says. "When it makes sense, we exit transactions. If our partner thinks it's the right time, then it's the right time."

Some analysts want GE to sell units and focus on what it does best. "Evidence is mounting that GE is too big and complex to manage effectively," **Citigroup Inc.** analyst Jeff Sprague wrote in a recent report. "We appear stuck in a framework where something is always underperforming."

With its energy units firing on all cylinders, GE isn't likely to sell. "Energy has a tremendously bright future," Urquhart says. "We're well positioned and open to capabilities, so I hope we'll attract more people to explore relationships."