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Transactional Trends for Chemicals and Energy in 2011
by George Pilko, Chairman

The outlook for chemical and energy deals has been compared to the weather in London - continually changing. During the past four years chemical and downstream energy transactions have shifted from a strong Sellers Market dominated by PE Buyers (2007); to a Buyers Market where strategic buyers with cash, debt capacity or other "currency" could negotiate very attractive bargains; to a market which is gradually becoming better balanced - at least in chemicals. These shifts in deal dynamics are the result of:

- The severe global economic downturn followed by the slow, but sure, recovery currently underway.
- The collapse in equity prices since their peak in October 2007 followed by the recent surge in prices to two year highs.
- Unpredictable capital markets which cause uncertainty in how acquisitions can be financed.
- Wild swings in oil prices coupled with soft North American natural gas prices.

Given these shifts, we are sharing our perspective on how deal dynamics will change during 2011 and what Buyers and Sellers will need to do differently to be successful.

Our perspective is based upon our ongoing Transactional Advisory work on the largest and most complex chemical and energy transactions globally – $450+ billion of transactions involving operations in 57 countries. In addition, we have organized over 35 Transactions Roundtables since 2000 involving Senior Deal Leaders and Deal Advisors to compare notes on Best Practices for handling high profile Acquisitions and Divestitures. Finally, during the past 90 days, I have spoken with Deal Leaders at the Oil & Money Conference in London and the GPCA Conference in Dubai about their intentions for 2011.

How Chemical and Energy Deals will change during 2011

- **Leverage is shifting--again –** As the chemical business recovers from the sharp recession, valuations are increasing and Sellers are regaining negotiating leverage. PE firms have dry powder and are bidding aggressively for chemical businesses being offered for sale. On the other hand, the market is quite sloppy for refining assets in Europe and North America with a limited number of serious Bidders for assets being offered for sale.
- **Asian/Middle East Buyers will Dominate –** Buyers from these regions have fewer obstacles in obtaining funding for deals and are typically willing to take a long term, strategic view of acquisitions, often seeking to build their technology portfolio and human resource base through such deals. They will clearly be the most active buyers during 2011 and will build upon their successes of the past 2-3 years.
- **The End of "Forced" Sales –** The forced sales during the Great Recession have come to an end. Operating companies are still "tweaking" their portfolio but, with the exception of BP, most companies can be more relaxed in how they bring assets to markets.
- **Sale of Better Assets –** After two years of only less than stellar assets on the market, we are seeing Sellers gradually beginning to offer higher quality assets for sale, at least in the chemical industry. Refineries for sale remain in the first or second quartile.
- **Merger/Consolidation –** As equity values recover, selected companies will use their stock to merge with other companies. These deals are often driven by a combination of: a) lack of a CEO successor; b) need to reduce costs or increase buying power; c) desire to increase market share; and, d) focus on upstream/downstream integration.

What Buyers and Sellers Need to do Differently

As a result of the changing economic and deal environment, Buyers and Sellers are shifting how they manage transactions.

Increased Focus on Operational Risk Issues – Chemical and energy companies have gradually learned that Operational Risks (OR) can be as important as EHS-related issues when considering an acquisition. The logic is straightforward - many companies scrimped on Maintenance CapEx during the Great Recession. As a result, their Operational Risks have increased, sometimes unknowingly. The other reason is that recent large well publicized incidents have sensitized Buyers. During an increasing number of Due Diligence assignments, we are expending as much effort on Operational Risk issues as we are

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on traditional EHS issues. This is because buyers and sellers are realizing that operational risk issues can greatly impact future capital expenditure demand- thereby impacting valuation and ROI; not to mention the potentially devastating effects of a "black swan" event on operating performance, market capitalization and corporate reputation.

Use of Remote Sensing® to Gain Negotiating Leverage – Knowing more than your counterparty is a reliable strategy to gain negotiating leverage during transactions. Remote Sensing® is a technique we have developed for Bidders during the last ten years to understand the EHS and OR situation at a target company before the Data Room opens without the knowledge of the Seller. This process is surprisingly effective in identifying the key issues at the target company and can be used effectively for a wide variety of transactions. During corporate mergers, Remote Sensing® is often the only form of Due Diligence which is available to the Buyer.

Demand by Buyers for More Extensive Due Diligence – As Buyers get increasingly focused on Operational Risk issues, and they gain negotiating leverage in deals, they will demand (and receive) more access to conduct Due Diligence prior to submitting their final bid. No longer will Sellers be able to "stampede" Bidders into making bids with totally inadequate information. The result will be more access to records and documents, more time on sites and more access to a broader range of personnel.

Pressure for More Indemnity Protection – As negotiating leverage shifts from Sellers to Buyers, we will see Buyers demanding (and receiving) more extensive indemnity protection for EHS-related issues. During the 1990s, many Sellers were surprised after closing by the magnitude of EHS Claims they faced as a result of providing broadly defined indemnities to Buyers. The key for Sellers, of course, is to understand their Risks and Liabilities before opening a Data Room as well as carefully crafting indemnity provisions to limit opportunities for Buyers to "claw back" a major percentage of the purchase price. Another alternative will be for Sellers to reflect OR and EHS deficiencies in reduced valuations – effectively cashing out the issue upfront.

Need for Sellers to Understand What They are Selling – Vendor Due Diligence has become Best Practice on chemical and downstream petroleum deals. These VDD efforts will be increasingly important as Buyers conduct more extensive Due Diligence and squeeze Sellers for more comprehensive Indemnity Protection. In the absence of thorough VDD, Sellers are in the uncomfortable position of negotiating on issues where the Buyer knows more about the issue than the Seller. Often time, Sellers can act on the VDD results to correct deficiencies and improve the "curb" appeal to reduce "deducts" and improve the attractiveness of the assets offered. Here, the value of good preparation to "control your own destiny" and deal affirmatively with real or perceived issues up front can preserve value and deter excess liability terms to the buyer that can tie up cash in reserve accruals.

Focus on Transition Planning/Post Closing Integration – There is a growing realization that a high percentage of acquisitions do not meet their financial targets. As a result, Buyers are being more overt about Transition Planning as well as Post Closing Integration. This process should begin with the Data Collection during Remote Sensing® – that is, identifying issues as early in the deal as possible which will need to be dealt with at closing. Integration should start on the day of closing which requires Transition Planning to be handled between signing and closing.

Conclusions - We are entering a time when chemical and energy deals will likely rise to a very exciting level- satisfying more than two years of pent-up demand. With buyer-seller leverage balance beginning to approach parity, or at least a more normal equilibrium, the value of skilled due-diligence development and negotiating strategy will have a much greater effect on deal returns than in the preceding 10 years.