6TH VIRTUAL TRANSACTIONS ROUNDTABLE

14 September 2021

Hosted By

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The ESG Imperative

- From a historical perspective, buyer concerns over the last 40 years have expanded from scrutiny of financial and environmental issues to include evaluation of Process Safety, Management systems, reliable operation and more recently ESG. Concerns on Cybersecurity are continuing to increase.

- ESG has moved to the forefront of deal issues and dominates the conversation today. With trillions of dollars rotating into this space, there is evidence of higher multiples for ESG related investments/ stocks.

- ESG increasingly viewed as a way to transform companies so they remain competitive, and as a value driver not just a compliance tool (box ticking).

- Still a perceived gap between the rhetoric and reality. Stakeholders/ Shareholders expect appropriate standards to be applied and clear reporting on plans and progress with transparency on how goals will be achieved.

- Haven't seen specific impact on deals but ESG attractiveness seems to be a 'binary' filter in determining which deals to pursue. Some exposures are considered decidedly bad and don't even get an evaluation. An example in automotive space -- suppliers to ICE engines/ getting much worse valuation or investors not even looking at them. Lots of examples of ESG unfriendly companies not getting investments. Per Investec's recent Annual GP Trends Survey, 62% of GPs avoided Investments on ESG grounds.

- Net Zero Asset Manager initiative getting lots of attention. Over 120 of them today with $ 43 Trillion under management (representing half of the entire asset management sector globally). Engine 1 shows the pressure on pubicly listed ESG-unfriendly companies where an activist with less than 1% shareholding can build an alliance with key institutional shareholders (e.g., BlackRock, Vanguard, State Street) to effect major change. ESG factors are becoming fundamentally embedded in any future investment (not a side show). Funds are no longer ESG vs non-ESG. ESG is making its way into all funds. 61% of the 400 LPs polled by Prequin In 2020 believe ESG will be an Integral part of the Industry over next 3 years.

- The banks will Increasingly set carbon Intensity targets for clients and finance ESG friendly businesses which will present less credit risk to the Institution. An example is JPMorgan's recent announcements to finance $2.5 Trillion over the next 10 years in long term climate solutions and carbon targets for O&G, Electric Power and Auto sectors, including $1 Trillion for green projects such as renewable energy and clean technologies.

- What do you do to get out of an ESG-unfriendly business? Maybe seek out a family-investor with less concern than public markets or a player in regions where EGS has yet to become a dominant filter. ESG has completely transformed the attractiveness of subsectors. e.g., catalysts used to be generically hot, but no longer the case for refinery catalysts. Standard Industries is an example of private company investing in non-ESG friendly company via acquisition of Grace. Innovation In operations, supply chains and products is key. Examples in Europe Include Orsted (backed by Goldman Sachs) and Neste.

- The lack of standard guidelines for achieving net zero or carbon neutral emissions is a major risk to ESG goals, as companies and countries create their own definitions. There is widespread inconsistency and confusion on Carbon emissions standards -- Difficult to compare different metrics and calculation methodologies. Also need ringfencing around carbon release issues we can actually control/influence. Expect to see standardization start to emerge in the midst of what are a lot of 'hollow' pledges today. Most of emissions are Scope 3 and influencing is a major undertaking. Definitions vary widely and how you attribute scope 3 today is unclear e.g., a direct customer is scope 3, but not an indirect customer. The goal is to get behavioural change. Perhaps COP 26 (2021 United Nations Climate Change Conference in November) will help bring clarity.

- Multiple pathways to achieving "Net Zero": Decarbonisation of products (renewables); Sequestration and storage (CCS) or reinjection/re-use;

Nature-based solutions. But polarization in discussions/ public narrative e.g., CCS -- good (return to solid state and put underground) vs bad (perpetuates use of carbon-fossil fuels). Any widely accepted framework will involve legislation and need to be collaborative. When rules of the game are unclear, it's difficult to make decisions. No consensus on how to calculate scope 1,2,3 with double-counting accusations/ lack of official body to provide a clear response/ measurement.

- Carbon trading and carbon offsetting is becoming an increasingly popular way to mitigate Carbon emissions. Carbon futures markets/funds/indices didn't exist until very recently and today is valued over $250B. Carbon price per ton is key factor to determine whether offsetting costs would be bearable for Industry.

- Environmental Justice (EJ) a growing topic - no longer business as usual in O&G sector. Current Biden administration taking an unprecedented level of interest/ focus on the topic. EJ issues showing up in deals where energy is produced/transported with impact on neighbouring communities. How will this show up in deals? Route selection for projects (e.g., pipelines), permitting processes, certification etc. No longer 'business as usual'.

- How are O&G companies accelerating revenues from ESG favored businesses? Do shareholders benefit or will they have to accept lower returns for a few years? Investors like to see stable cashflows so try to avoid significant discontinuities while improving scope 1,2,3 performance. Longer term goal to grow the various value streams. Value creation? Rent extraction or a mechanism to ensure an externality captured? A view expressed that the internal price for CO_2 needs to exceed 147 $/MT to promote a realistic chance of achieving 2050 goals.

- Chemicals Perspective. Decarbonisation versus Circularity. Recognition that, although the Chemicals industry creates 6% of all GHG emissions, through: weight reduction, improved insulation and shelf life extension of perishable goods, petrochemicals can be net positive. Circularity is the bigger challenge given prominence of waste from single use plastics. Major commitments on reduction and recycling/reuse by 2030. Investments targeted to reduce scope 1,2 primarily. ESG consideration now part of every investment decision.

- Markets around the world will evolve standards at a different pace, harmonization of standards will be a long journey.

- How do investors balance ESG/non-ESG businesses? Who will support non-friendly businesses in the future? Investors want to see positive change. Traditional O&G companies will have a hard time ever becoming carbon neutral so the focus/ objective is for them to improve, and this will help them be viewed as 'more ESG friendly' (no absolute target, the emphasis is on the direction and rate of change).

Trends in Deal Technology and techniques to conduct due diligence during Covid - particularly for international transactions

- Approaches to Due Diligence (DD) on international deals during COVID. Initially lots of uncertainty on how to do it Where travel is constrained, geographical reach is key with a need for local availability of seasoned ops and tech advisors. Important to prioritize DD as may only get physical tours of 25-30% assets. Ranking criteria are: Where is : Profitability? Growth potential? EHS/ESG challenges? Operational challenges?

- Also need to leverage new technologies e.g., site tours with virtual tools can work well. Started with video meetings/ drone videos. People increasingly creative with Go Pros attached to helmets with live video feeds/ remotely guided by buyer's DD team. Companies are using technology to provide more visibility (e.g., videos of inside of a reactor) that you would never obtain in person.

- Started to discover that this really helped -- in some cases better than 25 experts sent to a site with lots of time lost on travel. Won't go back to old methods with inefficiency but selective verification still valuable as Sellers virtual tours will not pick up on all issues of concern to a buyer.

- Contracting during COVID. Where deals have been in a Seller's market (e.g., Upstream O&G, Chemicals) there has been resistance to providing indemnities. Rep and warranty policies are what buyers are being encouraged to use to manage risk and be competitive in auctions. How well is RW&I insurance working? The dynamics have changed over the last 5 years. AON have advised that claims have been paid out which can provide protection where there are concerns over a Seller's survival or the deal involves jurisdictions that may be unfriendly to the new owner. Seeing WI superseding indemnities for risk management and transfer. In Europe, premiums can be as low as 1.5%. In the US in the range 3-5% with duration up to 7 years. Some industries, such as refining, more of a buyer's market with the seller needing to demonstrate distinguishing benefits such as biofuels and waste oil recycling plus attractive logistics that offer potential for e.g. "Energy parks". Separate environmental Insurance policy solutions may be available.

Future outlook

Deals will continue to evolve. SPACS (Special Purpose Acquisition Companies) will play an increasing role in some sectors. Decarbonisation will continue to drive the tradeoff between use of Oil & Gas versus renewables. Both energy sources are likely to play significant roles in the foreseeable future, but success will depend on being able to provide a convincing narrative on the direction and pace of change towards net zero emissions.