79TH TRANSACTIONS ROUNDTABLE

7 December 2021

Hosted By

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7 December 2021 Summary

Overview

- Record M&A year driven by emergence from COVID, looming concern on potential tax changes and potential new lockdowns in 2022, that could impact deal closure. Strong market in tech/digitization and "energy transition" assets and Strategic Oil & Gas balance sheets have recovered to allow acquisitions to resume as part of portfolio optimization. Private capital, Private Equity, Sovereign wealth and Family office funds have become much more active and significant and represent significant "dry powder" which will need to be deployed over the coming months/year. As a result, significantly more competition for assets, so that Strategics have to think/act more like financial investors to achieve seller valuation expectations. More instances of Joint Venture dilution as investors seek to enter new segments without assuming all risk. Large corporate players divesting heavy CO2 emitting assets and seeking to rebalance, and as a result, assets are being transferred to "Shadow emitters" with less transparency on emission targets and less influenced by Activist pressure. Need to conduct diligence remotely during COVID has made it difficult to initiate deals and extended the timeline for completion and altered the risk profile as greater reliance on historical/atypical performance data. Lack of in-person meetings has also extended deal negotiation timelines. Overall, a very positive M&A environment with momentum projected to continue through 2022, pending Omicron impact.

Balancing The ESG Agenda

- No slowdown in M&A but increasing impetus to develop metrics/tools to give businesses a better way to measure and communicate progress on transition. Much confusion and pushback on standards from both political and corporate sources. Many targets aspirational with heavy reliance on technologies that are not yet mature. Companies using their business models to tell the ESG story may be a more practical way of having the conversation than adopting macro metrics from elsewhere. Increasingly, ESG is becoming a binary initial filter as a check the box exercise – for example EU buyers of US assets having to assess whether the ESG investor story will help/hinder their existing narrative. EU is ahead with the US playing catch up quickly. If the initial screen is positive, scrutiny turns to the investment cost to integrate the target and capex to transition assets to new ESG metrics. Analysis is complicated as expectations are currently being driven more by investors and stakeholders than Regulators or Governments as a result there are no clear official standards and companies are having largely to "self- regulate." In addition, CEOs need to be mindful that an operational excellence base is still at the core of any ESG story and any major incident quickly and will seriously undermine any ESG credentials. Carbon pricing is still fuzzy but becoming clearer and, as it extends its influence, it will increasingly play a more tangible role in quantifying asset valuations. At present, asset pricing is volatile ranging from bargains to bubbles with speculation and sentiment clouding valuations. The pace of transition is critical and delicate. We will not know for several years whose bets have paid off.

CIFIUS and Regulatory Impact

- CIFIUS and other regulatory bodies have made decisive interventions over the last year with action by the Biden administration to block deals due to CIFIUS and other regulations.
- China was at the top of the list 5 years ago and today it is difficult to even place a call to a Chinese buyer. The current Administration has been particularly aggressive towards hydrocarbon production and logistics assets including permitting, which creates a challenge for Bankers having to sort out who the credible buyers even are due to uncertainty on eligibility and impact on timelines of excessive scrutiny. Overall, a fundamental shift from 12-18 months ago, not a positive development.
- More generally, FDI/antitrust regulations have risen to top of agenda for deal makers given increasingly interventionist approach and is regularly one of the key deal "do ability" considerations assessed at early stage.

Deal Consequences of the Energy Transition

Deal Screening criteria have changed:

- Need to look at ESG/decarbonization performance/potential.

- Used to mainly look at growth rates, now have to make critical assumptions on Downstream changes driven by a changing external environment.
- Deal activity two to three times more than in recent years, but more complex assessments of growth/decline and the pace of decarbonisation is a major factor that drives complexity.
- Calculation of Scope 3 Emissions is fraught with pitfalls and opportunities to game the system. Many companies are more focused on Scope 1 and 2.
- Chemical Companies are more focused on the circular economy where there is a better-defined business case. In addition to the "Recycle/Reduce/Repair/Re-use" mantra, Chemical companies are exploring alternative/sustainable feedstocks and major O&G players are pushing CCUS (Carbon Capture Utilisation and Storage.) Also, much activity in exploring H2 and even NH3 as alternative fuels.
- Oil Sands players need to demonstrate 1st Quartile emissions performance in their sector which has led to significant consolidation.
- Geographical sensitivities also come into play with different approaches, for example, between EU and Africa.
- Regarding skills/competencies: O&G have particular expertise (e.g., managing major engineering projects.) No one understands offshore construction better. Good fit with offshore wind.
- Retail businesses more challenged (e.g., gas stations/EV charging). Might need to partner with other retail experts or sources of private capital. Can't just access cheap capital from "upstream" business.
- Sector is grappling with investor base transition, renters vs. long term owners. Difficult to understand what drives their different decisions.
- Trying to please investor base is difficult.
- Regarding fundamentals: difficult to balance ESG with profits/temporary vs. long-term returns issue/how to bridge the divide.
- Oil Majors have a role in underwriting investments in mid-stream infrastructure.
- For the Middle East, a balanced energy transition is critical. The UAE recently commissioned the first green aluminum plant.

- Sovereign Wealth Funds take a longer-term view of what's right for the planet, for our children, etc. while balancing with the fact that the wealth of the region is largely derived from Oil and Gas.
- Energy transition costs are seen more as a "blip" in industry similar to what other industries have faced. The reality is that incumbent business models in many cases are already broken and there are clear signs that selective investments in transition have already shown a positive return.

Best Practices in Due Diligence (DD)

- Sellers are conducting much more high-quality Vendor DD and producing a far wider range of reports to inspire bidder confidence and to reduce time needed for buyers to examine the Virtual Data Room and submit questions where information is missing, unclear or inconsistent.
- If going to play in deal with rep and warranty insurance, need a threshold level of DD to have been done for insurers to underwrite and Sellers requiring Buyers to procure R&W insurance within a tight deal timetable recognise that vendor DD is critical to support that.
- Oil & Gas/Chemicals have been reluctant undertake the level of DD work that other industries have been doing -- often too satisfied with minimal disclosure on an "as is, where is" basis. Investment Bankers are moving to adopt this more thorough practice which increases the pool of potential buyers - especially those who enter the process late. Buyers gain assurance from the inclusion of independent/objective reports from experienced 3rd party advisors who are familiar with the assets/business
- Due Diligence can help promote buyer confidence and maintain deal momentum and a contested auction.
- Virtual site visits which began during Covid were helpful -- but still need feet on the ground/supplement virtual with on-site. Many buyers are sending smaller teams.
- For multi-site/multi-geographic situations: On-site is important/virtual can be a complement.
- Post SPA signing can cause Buyers to take a breather instead of using the time to get out and visit sites and develop relationships. This is important especially on issues related to process safety/maintenance/Management etc.

- Important to have clarity on the future Operating model: integrate or keep separate. For example, integrating specialty chemicals into a commodity chemicals company or keep separate? Have seen some disasters.
- Post-SPA: really changing the mode of operation/pivot to more of a "partnership" to get more information.
- Can't work on everything, but need to look at the biggest risk/ opportunity areas.
- Generally, visit 70-80% of sites and use a triage process (based on highest revenue/highest projected growth/greatest operational/EHS risk.)
- Locked Box versus Working Capital Close:
  - Can be a cleaner process overall but setting up a deal takes longer. Requires more outreach to buyer/seller teams.
  - Common for International deals in London market. Not as common in the US. Approach depends on geographical dispersion and the scale and complexity of working capital adjustments on closing. No firm rules as there are exceptions to practices used.

Earnouts

- See Earnouts frequently, where there is skepticism on the reality/fuzziness of performance projections.
- Definitely see Earnouts as a tool.
- Difficulty is around defining appropriate metrics after the target has been integrated into the acquiring business, making line of sight continuity a challenge.
- Deals are complicated to get done.
- Earnouts should be a "small part" (<20%) of value difference between buyer and seller; Earnouts can help bridge these smaller gaps.