



Pilko & Associates, LP

Transactions Roundtable Recaps

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4TH VIRTUAL TRANSACTIONS ROUNDTABLE

March 10, 2021

Hosted By



Recap of Themes from prior Virtual Round Tables:

In June 2020, attention was on safeguarding liquidity and bolstering the Balance Sheet. ESG was off the agenda and deals slowed down with Vendors struggling to provide access to sites and representative projections of future financial performance. Deals that did close were skewed towards a mix of cash and shares rather than all cash as buyers and sellers looked to create deal space.

In September 2020, there was increasing evidence of Financial Sponsors buying non-core assets from Strategies especially infrastructure assets. ESG conversations were returning.

In December 2020, ESG was back on steroids. Major oil companies were promoting active decarbonisation strategies and setting 2050 or earlier targets for net zero emissions. Activist investors were leveraging ESG focused funds to apply pressure on IOCs to transform further/faster. Chemical companies increased activity towards aligning with the Circular economy with signs that Specialty businesses focused on personal health care and hygiene were performing very well and looked very attractive.

March 2021 Update

ESG cuts across all business areas. Equity capital markets drove 2020 as a year of Energy Transition (ET) and Renewables. Massive outperformance of traditional energy stocks, although signs of a bounce back in Q1 2021 as the oil price recovers. In debt markets, big interest in green bonds attracting incremental investor demand.

M&A space: significant interest in ET especially SPACs (many of them looking for deals). ESG focus continues to catalyse shareholder activism. Engine #1 engagement with ExxonMobil most visible and leverage does not require a significant equity position. Banks are seeing increased demand for ESG health assessments from clients. As key dimensions: \$300B rotated into this space in the past 18 months. For assessments, high level generic metrics exist -- but sector specific metrics important as well. For example, Steel - emissions targets/changes in manufacturing process to reduce energy consumption and footprint.

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Companies start to align at a high level with benchmarks such as UN Sustainable Development Goals, then look at company-specific metrics. There are no hard and fast rules and companies are having to 'negotiate' the most relevant targets and metrics with investors and their wider stakeholders.

Companies such as 'Sustainalytics' are helping shape metrics and assessments in this space but the ESG frame of reference is still evolving with no clear consensus on ranking principles. No such thing as a crazy idea at this stage. Important that companies are able to talk about results achieved as well as initiatives planned. PE players have engaged their Limited Partners and customers in testing various approaches and constructive consultation is the way to go. A likely consequence is an avalanche of reporting requirements that will have to be worked through and developing clear messaging will be pivotal. Also question marks on the links between ESG activity and financial performance in the short to mid-term. Is share ownership attractive during a period of transition or can it wait until the change is apparent to avoid investing during a period of non-productive capital expenditure.?

Major energy players need to be thoughtful in balancing their investment portfolios. For most renewables, intermittency is a real issue. Adding adequate storage (batteries) doubles wind/ solar costs. The recent power supply interruption in Texas, was as much a failure to winterize assets (conventional and renewable) as it was an over reliance on intermittent supply sources, but a question mark over whether electricity consumers are willing to pay the costs to meet low probability design day conditions. Growing interest in geothermal as a possible base load reservoir. Chevron made investments in past few weeks. In theory, Nuclear is a good baseload but it remains deeply unpopular and the Vogtle plant delays and cost overruns in construction have further damaged the reputation. Given the issues with intermittent power supply, there is a logical prospect for Natural Gas to reassert its importance provided fracking resentment can be mitigated and LNG remains a very attractive mobile energy source.

Special Purpose Acquisition Companies (SPACs)

SPACs have increased their attractiveness during COVID and are now poised to have a massive impact on investment. If all the announced SPACs were to proceed, they would trigger 1 Trillion USD in M&A activity, so even a small

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percentage coming to fruition would be significant. They are attractive as an alternative to traditional/underwritten IPOs as they require an S-4 filing and not S-1, which means they can use forward projections of performance, are usually quicker to implement and maintain confidentiality pending deal success.

Many of the nascent SPACs are targeting Electric Vehicle supply chain opportunities in infrastructure or mining assets in the battery supply chain. As a caveat, the SEC is reviewing SPAC protocols which may lead to a tightening of requirements.

Impact of Change in US Administration on outlook for M&A in Traditional Energy and Renewables.

On CFIUS, no major shift in position although likely more emphasis on fundamental issues not political objectives. Concern at the ease of revoking permits (Keystone), uncertainty over permit extensions and approval of royalty rates. Expect a more aggressive regulatory environment and elimination of some tax breaks. There may also be heightened scrutiny of potential Anti-Trust issues.

Outlook for Chemicals

Generally recovering much more quickly than refining with market fundamentals looking increasingly positive. Deals such as the acquisition of Lonza Specialty Ingredients by Bain/Cinven at 13 X EBITDA underline the appetite for Specialty Chemicals Businesses with further growth projected to accelerate once Lockdown is lifted and vacations/stadium events and other large gatherings return. The industry needs to address both strengths and weaknesses: On the plus side, there are no real substitutes to match the unparalleled processability and cost effectiveness of synthetic chemical products with their unrivalled ability to reduce weight, insulate and extend shelf life. On the minus side, waste plastics (especially single use) are increasingly seen as a threat to sustainability. The industry has formed the AEPW (Alliance to End Plastic Waste) and there are encouraging initiatives to eliminate and reduce waste materials especially through increased recycling – both mechanical and ultimately, molecular.

The above rich discussion covered a wide range of topics. The forecasts tend to treat renewables and hydrocarbons as discrete – at times incompatible – sources of energy. An area to explore next time is how to optimise the integration across

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value chains because the reality is that both will co-exist for the next 30 years or so and identifying the optimal mix will create huge value.

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Comments on ESG

- ESG has become a central topic in every conversation
- Asset investments in high demand
- Energy transition/ alternative energy huge growth in equity indices
- ESG not going away -- becoming far more important in M&A, capital raising
- Further development of debt capital markets in energy transition for example "green" bonds
- Traditional O&G can potentially participate as additional pool of investors
- Leading players creating sustainability financing groups
- Significant steer away from hydrocarbon liquids seen as having a harder ESG story
- Natural gas under same pressure as liquids but no longer seen as the natural bridge to clean energy so declining investment appetite
- Large money managers/ index funds have hard time to compete on price so ESG is an effective asset gathering mechanism.
- A win for investors who have been governance focused in the past (pension funds, activists, etc.) as they can move more quickly and have complementary investments.
- The "Zeitgeist" (mood of the age!) has really shifted over the past year during the pandemic with social factors gaining everyone's attention during a prolonged experience of working from home.
- Gas producers doing better than oil players but both are losing out to wind, solar
- Caution that ESG is very broad area, companies need to resist boiling the ocean and instead select 2-3 topics of most relevance to their business environment and current situation and then focus on clear messaging.
- Methane reduction in upstream will increase in focus as an attention area.
- Leading European Oil/Energy players committed to net zero carbon by 2050 which is a very ambitious target that is not fully understood by the media as it would apply along the value chain from E&P to consumer end use.

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- For Chemical players, Circularity/pollution of plastics is as big an issue so reducing the footprint and recycling waste increasing in importance.
 - Carbon capture and storage -- not moving as quickly as anticipated 4 years ago. Government support seems hesitant and CO2 pricing does not seem to have helped.
 - Specifically looking at projects in NorthWest Europe.
 - Hydrogen is accelerating much more quickly than anticipated already have hydrogen fueling stations and investment in infrastructure.
 - Demonstration plants in China for green H2 in public transport that can be leveraged elsewhere.
 - The economics of H2 matter and government support will needed to gain traction and critical mass.
 - Greenhouse gas emissions from power generation continue to be relevant for electricity generation especially in efficiency and cost-effectiveness.
 - Hydrogen projects will need to take off in Industrial settings before residential use becomes widespread.
 - Renewable liquid fuels (biodiesel) > big project in CA Bay area
 - One participant commented - Have to have business case for projects > need returns plus lower CO2 with near term results
 - Plastics and environment are a primary focus for chemicals business
 - Interest in ESG today vs in March is 10X
 - Geothermal (GT)-- used to be a big topic many years ago...more recent entry of more traditional O&G players in Houston, and what now seeing is capital formation/ raising funding from VC investors ...re 2021/2022 -- looking for debt and equity financing for geothermal/ and tap equity markets for funding
 - Big difference vs 10 years ago Because:
 - Technology vastly improved as a result of learnings from fracking/ know how to visualise natural heat sources underground from surface of earth making exploration more efficient
 - Why not “drill for heat” instead of for O&G/ and using hydraulic fracturing tech to exploit sources
 - Some of smaller players could get absorbed by large O&G players
 - Solar and wind are still by far the biggest growth categories but start-up GT players trying to build awareness. Have to show cost competitiveness vs. solar, wind on cost per kw

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- \$25-30/ MW/hr (for solar, wind) -- GT has to compete against this/ make case that they can do so.
 - GT could be an option for baseload vs solar/wind as intermittent supply with battery storage

Economic Recovery

- Investors cautious on outlook for lower priced commodities
- Transition to all equity financed deals -- sellers have to accept more of this
- Lower premium Medium of Exchange (MOE) deals
- Upstream: area with most consolidation. Premia dropped from 30% to high single digits much more conservative premiums
- Have found funding with Ratings Agencies giving credit for guaranteed returns on midstream projects
- Large projects for midstream are dwindling/ peak is behind us/ companies increasingly have to fund projects organically as a result
- Views on Keys to success in JVs
 - Agree on corporate culture of JV
 - Especially when you have two very strong companies that come together
 - Which corporate culture will you use? Or create a new one?
 - Need to align early on. otherwise the JV will fail
 - Need to make clear the strategic purpose and check alignment.

China

- One of very few economies that has recovered and is strong (GDP growth in 2020)
- Don't expect a big change with Biden, although some tone change/ but not going soft
- Tariffs not likely to go down/ fair trade issue will persist will limit any softening of position in near term
- Changes with CFIUS? No -- don't expect this. May be even more aggressive especially inbound investment from China in tech areas.

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Outlook for 2021/ key principles

- Energy sector broadly; Corporates will have to take hard look at portfolios/ show attractive returns and cash flows for investors
- Additionally, energy transition/ ESG angle is important/ is where investors are headed
- Sellers: have to be creative / carve-outs/ divestitures/ may not get funded by capital markets
- Assets with ESG/ renewables / energy transition/ very easy to finance with far out EBITDA --public markets very supportive/ even with negative EBITDAs today
- More traditional O&G harder/ think early on how to fund investments
- Focus on size and scale. Bigger deals easier
- Engine No. 1 overture to ExxonMobil (XOM)
- Unclear where Engine 1 is trying to go as an activist
- May be as much as anything a marketing play to gain visibility by targeting an iconic brand.
- XOM and BP at different ends of spectrum on oil/ energy transition
- Clarity of purpose to use ESG as means of creating a turnaround in market cap.
- Reality check that NextEra is now same valuation as XOM, Chevron – an emphatic testament to where we are today
- Engine No. 1 -- has a website/ suggest we read the white paper/ shows angle of attack ([It's time to Reenergize Exxon. \(reenergizexom.com\)](https://www.reenergizexom.com))
- Big question: how will XOM respond publicly?

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Opening Comments

- Q4 likely to see some significant assets starting to test the market
- Valuations are recovering pending signs of profit recovery
- Some delayed pay-outs

Strategies to Maximize Vendor Value

- Refineries a Buyer's market
- Challenge not just getting deals done but avoiding last-minute concessions
- Best practice: as early as possible, bring in the experts on Financial and EHS/Operational Reliability.
- Sellers need to provide full disclosure by conducting thorough VDD ahead of populating folders in the Virtual Data Room
- Best practice is to conduct VDD as if you were bidder to identify risks clearly and positively with appropriate mitigation to
- Minimize uncertainty in the mind of bidder.
- Buyers routinely demand concessions of 2-5% of deal value within a few weeks before closing
- Sellers who are unprepared/ or have not conducted VDD end up extending the timeline and losing value
- Managing site visits in structured/ minimalist way/ supplemented with video evidence and a lot of VDD can maintain a brisk timeline and encourage a strong universe of bidders.
- Key to final signing/ avoid MAC clauses except for regulatory issues you can't control
- Significant use of rep and warranty insurance
- Unusual to have MAC clauses at closing if you have done VDD
- Working from home delays progress

Circularity/ESG Importance

- Focus on ESG/ circularity returning as liquidity concerns moderate.
- Seeing a real bifurcation in access to credit which results in focus on getting to investment grade as a theme/ ESG is tied to this: banks shrinking capital going into the sector and expect this trend to continue

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Valuations Outlook

- Valuations are challenging; on buy side bidders looking to offer mix of cash/shares and defer a percentage of the consideration. Sellers arguing for fundamentals reverting.
- Working capital much more difficult to predict and a significant negotiating challenge for both sides.
- On the Buy side try to conduct as much remote sensing as possible prior to engaging the seller so that material issues are identified early.
- Covid has delayed approvals – especially some approvals being valid for only a year making extended closing more difficult.
- DD -- harder to complete where site access is constrained and international visits are not practicable.
- Specialty Chems likely to rebound faster than Petrochemicals, Oil & Gas.
- Large corps are increasingly looking to shed non-core assets
- The next 18 months will be very active in selling non-core assets

Hydrogen

- Blue/green hydrogen is increasingly significant
- Traditional refineries face continuing/increasing regulation/ pressure
- PE players looking to transform facilities into energy hubs to increase attractiveness to buyers.
- PE players increasingly see themselves as industry experts and seek control (not minority stakes) based on belief they can identify value potential / ability to act on it/ and willing to make the investments and take risk/ but expect to see this reflected in purchase price

Oil Major Response to Financial Challenges

- Midstream -- sees now as good time to acquire/ but not a lot of high-quality assets being made available.
- Seeing big disconnect between public and private markets
- But not seeing a lot of distressed assets being sold/ no marquee assets being sold in midstream

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- Lots of challenges across the board -- fund dividends, etc.
 - And in Europe, to 'fund the pivot'
 - The majors have sold most of their pipelines. Anything you can put into midstream is an opportunity. Majors will continue to upgrade their upstream assets (next 3-4 years).
 - Expect majors to hi-grade their integrated facilities and reduce their carbon footprint
 - Expect to see NOCs get a bit more adventurous
 - Investing in power plants/ gas facilities/ pipelines/ terminals
 - ADNOC/ Apollo tie-up; brought in investors to invest in their real estate
 - Easier to get a big deal done that include infrastructure vs a small deal.
 - This is why, we are seeing big infrastructure deals (e.g. Canadian retirement fund wanted to place significant funds)
 - Major NOCs view JVs as increasingly useful
 - Seeking more active management of the portfolio to create more focus on new business development (outside of O&G)
 - Also, pressure to monitor cash cycle/ dividends/ Capex/ operating cash flow, etc.
 - More consistent valuations today than 6 months ago
 - Expect JV/Consolidation will be industry specific depending on degree of concentration and sectors that are out of favor
 - PE world will play an active role and will explore how to work with strategics in JV situations especially in Chems in Europe as they can exploit complementary skill sets and capabilities.
 - EU will see more chems focus on specialty chems
 - Consolidation of fertilizers/ Petrochemicals
 - See financial sponsors as catalysts to accelerate consolidation

China Recovery

- Recent JV deals in China consistent with long-term view of China as growth/ must participate market
- Strong, demonstrated ability to build assets at 2/3 the cost in half the time compared to USGC

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- Also, China seen to foster innovation -- business models, technical, R&D (lots of emerging, global champions in China across industries/ Petrochems probably will not be any different
 - Trade issues being watched carefully and current relationships very fragile but ultimately China has proven to be pragmatic/ commercial
 - Big Chinese players have a history of doing bad public deals and will be more careful going forward
 - Being more selective at which countries they're investing in
 - Chinese Co's looking at investing abroad/ but preferring to avoid any asset investments in the U.S.
 - See more partnership opportunities in China outside of Sinopec / PetroChina/ CNOOC creates more opportunities for investing in China
 - Anticipating more activity in the final part of 2020

Closing Comments

- Changes in M&A processes: more caution/ more JVs/ synthetic insurance examples
- Will see more structured deals/ partnerships/ driven by non-core exits how to participate in upswing / view on the future plays a role in this
- More willingness to have bi-lateral discussions and to explore unconventional structures