82nd Transactions Roundtable

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82nd Transactions Roundtable Key Takeaways

Hosted by

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Overview

1. Rising interest rates slowing M&A generally. Strong cashflows in the energy sector being used to pay down debt, buy back shares and increase dividends with less consensus on what to do next.
2. ESG/Energy Transition still a hot topic after a year of intense debate and pressure but less overwhelming than in 2021 as security of supply and resilience seen as more pressing in the current geopolitical and economic environment. Timeline and criteria for implementation remain unclear.

Impact of high inflation/Interest rates

1. Access to capital still good for major players but capital discipline is a dominant behaviour especially for refining investments with enterprise scale affecting weighted average cost of capital (WACC) more than Strategic/Private Equity (PE) structure. The advantage will go to those players who do not require immediate access to capital markets.
2. Current high refining margins may postpone refinery sale or closure, but impact is on timing of implementation rather than the decision to exit.
3. Especially for major operators, there are buy-side optics (ESG, energy transition) which will limit the appetite for purchase of refinery assets (potentially as much as higher interest rates.)

Refinery of the Future

1. For existing refineries to survive, there is a need to improve energy efficiency, process safety, maintenance procedures and turnaround efficiency. Future investment in existing assets will be optimization versus capacity focused. License to operate remains critical with operational flexibility as important as total output and carbon footprint reduction an imperative.
2. The conventional wisdom that large integrated refineries will be the survivors is being challenged as access to feedstocks is increasingly important especially for renewables and biofuels.
3. New processing technologies such as pyrolysis are being evaluated to convert the waste materials from food production and mitigate the fuel vs food dilemma. There is concern over the scaleability of renewables and alternative fuels technologies.
4. Marine access increasingly important for both inbound logistics of feedstocks and outbound logistics of refined products.

Refinery of the Future (cont'd)

5. Supply chains for renewables feedstocks are under increasing pressure and some future feedstock logistical paths are in nascent stages.
6. Access to human resources will be increasingly vital as perception of the industry has blunted interest in refining. Investment in automation/digitalization will increasingly be a factor as competency in the workforce shrinks.
7. Uncertain future regulatory action and legislation which will impact future investment and strategy continues to evolve.

Regional manufacture inside Major Markets

1. Globalisation probably peaked before the COVID pandemic and has been adversely affected by recent geopolitical events.
2. Socioeconomic drivers are:
    - i.) The race to net zero/green world.
    - ii.) Hyperlocalization (speed bump or high hurdle?)
    - iii.) Cold War 2.0 with increasing geopolitical competition and pressure to pick a side.
    - iv.) Plastics transition with intensifying pressure on single-use plastics.
3. There will continue to be a place for world-scale manufacture from advantaged feedstocks with export to major markets.
4. Renewable fuel production may require assets to be close to feedstock sources as some of them degrade rapidly after being harvested.
5. The behaviour and economic growth of China will have a major impact on how globalization evolves.

Energy Transition Themes and The Inflation Reduction Act (IRA) impact on investment decisions

1. The act is intended to promote domestic energy production (including production from fossil fuels) and the energy transition.
2. IRA is stimulating a lot of discussion and analysis but no strong evidence of affecting decisions.
3. Options depend on core competences in: CCUS, renewable fuels, H2 production and handling, etc.
4. Need to balance corporate and shareholder expectations: how is economic value created from "doing the right thing"?
5. ESG investment is very challenging with activist stakeholder pressure not aligned with economic sustainability.
6. Important to develop a holistic Carbon strategy both for internal activity and partnering with complementors.
7. Hard to identify the role for major players in EV mobility as majority of vehicle charging takes place at home or at work.

Improving asset performance before sale

1. Asset value dependent on ability to demonstrate safe and reliable operation but distinction between safe and reliable operation and maximizing operational efficiency.
2. Asset operation is most vulnerable between announcing a sale and close of the transaction.
3. Fix then sell has the additional advantage that improvements will help performance even if a transaction is not concluded.
4. M&A activity is becoming increasingly volatile with windows of opportunity narrowing. Time is not your friend in a transaction and some players are prepared to sell tired assets recognising that the buyer perception of attention areas will adversely impact value.
5. Providing plans for future investment to potential buyers late in the transaction process hasn't traditionally moved the needle for transaction value but does build confidence.
6. Important to provide full disclosure in the Virtual Data Room (VDR) and the VDD Report to avoid surprises after signing an SPA and to avoid comebacks post-closing. Buyers are quick to pick up on the significant impact of Sellers attempts to mitigate the historical reduced maintenance/capital investment prior to a decision to sell.

Outlook for refining margins and chemicals profitability

1. In the current market and for the short term, there are limited foreseeable negative structural forces which will depress demand and refining margins.
2. Limited ability to add capacity to system and imports will be challenged by transportation costs, so supply side is unlikely to change (if anything, turnaround activity has been put off, which could reduce supply in the future.) Turnarounds and maintenance previously deferred may be unavoidable in 2023.
3. Main threat is on the demand side. Consumers adopt a graduated response over time to increasing prices: downgrade from premium fuels, reduce fill size and frequency, curtail other discretionary spending, downsize vehicle, etc. Some demand destruction over time but behaviour not highly elastic.
4. E10 and E15 demand will affect fossil fuel content but food/fuel dilemma exacerbated.
5. For Chemicals, main impact has been the major reduction of Chinese PE imports in 2022 (due to economic slowdown and the questionable economics of continuing overcapacity being built.) There is some hope that Spring 2023 will see a return to a positive trend, but the consensus view is that there will be a supply overhang from several world scale units starting up in a recession, which will keep pressure on integrated ethylene/polyethylene margins. Europe is more affected by supply curtailment as a result of feedstock and power shortages and price escalation.

Build vs. Buy

1. Build costs negatively impacted by inflation and continuing extension of equipment delivery dates which also affects schedule.
2. Acquisitions slow to close because no deal space exists when the Bid/Ask gap is too wide. Deals will close only when the synergies are perceived to cover the bid/ask spread.
3. Overseas buyers are attracted to N. American assets as feedstock availability is secure and competitive inside major market.
4. Risks still persist for overseas buyers with no experience operating in the US and potential CFIUS issues.
5. Acquisitions seen as opportunistic has very limited scope to adjust scale or operation and location has to make sense.
6. Maybe opportunities in Latin America from a market and feedstock (conventional and renewable) availability perspective but huge variation in country risk.

Value Chain integration and extension

1. Chain extension can help avoid value leakage, however, maintain balance or run a risk of value destruction.
2. The risk of going beyond the corporate skills and competences can be mitigated by operating through Joint Ventures although partner selection and governance structure is critical.
3. Even if JVs are not stand-alone, important to establish a Board for each venture that is knowledgeable on the business concerned.
4. Important to enshrine what dissolution would look like so that venture termination does not become a barrier to exit.
5. Cross venture synergies can be a challenge versus integrated operations. Trading activity can mitigate independence and optimize asset value.

Abandonment and sale of late life assets

1. Important to make a clean break.
2. US bankruptcy law favors return of liabilities to former seller, chilling prospect of sale to smaller and less financially stable buyers.
3. Buyers should be pressed to put up large bonds, priced to default risk.