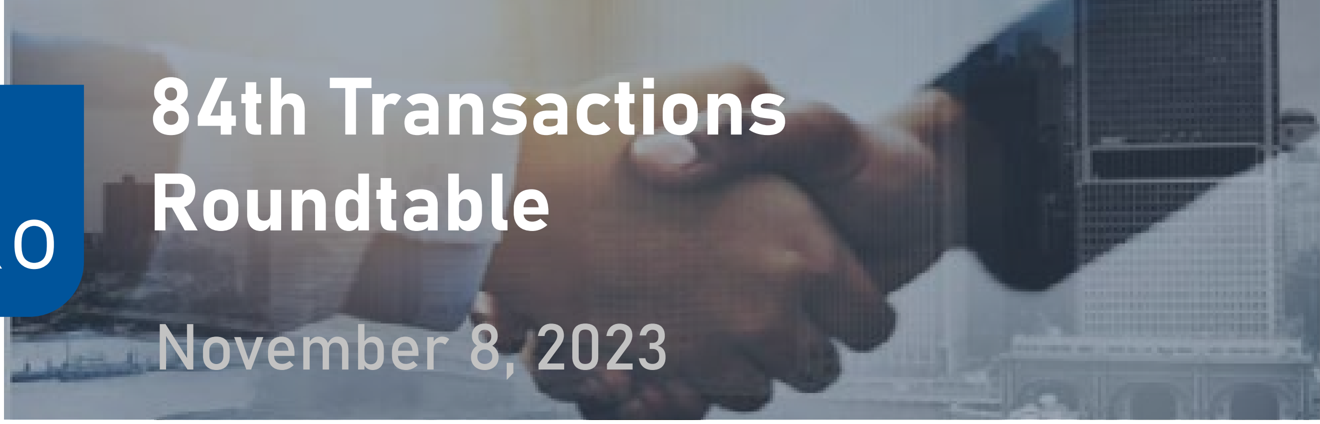

84th Transactions Roundtable

November 8, 2023

84th Transactions Roundtable Key Takeaways
Co-Hosted By:

MOTIVA Morgan Stanley pilko Skadden

Introductions

David Badal, Vikas Bharathwaaj, Jeff Romero provided opening remarks on the current state of chemicals and downstream M&A, and tax influence.

- The chemicals industry has experienced significant value destruction and is not expected to return to stability until 2027, which translates to poor M&A in the sector. While the M&A pipeline may be filling, will buyer and seller be willing?
- Regionally, the US is dealing with significant capacity overhang, Europe remains under significant stress resulting from reduced demand and insecurity of competitive supply, Asian producers are high on the cost curve, and China has constructed substantial overcapacity leading to losses both domestically and for importers – especially of polymers.
- High oil prices and high refining margins place the US in a unique Downstream market position which is expected to remain beneficial at least in the short term. Refining M&A remains low due to high interest rates (mainly P/E players), high P/E ratios and public investor appetite for stability.
- There is no clear path to net zero emissions and, while the US IRA will encourage the energy transition, there is no timeline. M&A in this sector remains low due to immature technology and concerns over sustained fiscal and monetary support.
- Broadly speaking, there will be 3 types of M&A in the short term: (1) growth capital (2) project financing and (3) strategic alliances.

Topics

1. How much influence is inflation/higher interest rates having on access to capital and is there an asymmetric impact on different industries and geographies?

    a. The trajectory and speed of interest rate changes negatively impacts price discovery and the "real" cost of capital, slowing M&A activity.

    b. Leveraged Private Equity buyers will be forced to use cost savings for future investment, slowing returns.

    c. Middle East and SE Asian National Oil Companies (NOCs) are highly cash positive and are conducting M&A on bilateral deals without recourse to debt financing.

    d. Energy transition projects are hampered by the rising rates and credit access by independent developers.

    e. Tax implications of the US IRA are complex and introduce new risks (see #8)

2. Is the chemicals industry set for further consolidation and how will regulators view further concentration?

    a. Some consolidation is expected by healthy larger operators over the longer term, however, divested assets will mainly be at the low end of the value chain or non-core assets of sellers. Acquisition to retire or shutter capacity is not attractive.

    b. Some corporations are focused on integrated value chains (crude to chemicals) which will be developed through JVs, greenfield, and internal consolidations.

    c. Due to the influence of major shareholders, the US refining industry currently ranks surplus cash utilization in order of priority (1) share buyback (2) buyout of JV partners (3) bolt on assets (4) M&A. Consolidation in refining by public owners is not expected.

    d. Consolidation risk is impacted by decreasing opportunities to effectively deploy capital with interest rate increases and spiraling capital project costs.

3. If portfolio change is achieved through strategic partnerships, what are the challenges in integrating different cultures and different financial strengths/liabilities?

    a. Partnerships will benefit from long term relationships tested over time.

    b. JVs allow expanding market access and value chain diversification with development of new skills and competences. Strategically regulated governance is important for relationships management. An increasing number of JVs creates more complex and broader governance issues.

    c. Larger operators must be aware of their own footprint when partnering with smaller strategic partners in order to learn from small company practices and avoid stifling the culture which made them successful.

Topics (cont'd)

4. Is unreliable operation of assets becoming a heightened concern in determining transaction value?

   a. Recent process industry incidents (explosions, fatalities, causing media exposure, government investigations, and financial damages) point toward (1) historical under investment in assets (2) loss of instructional knowledge (3) lack of leadership and board member knowledge of process plant operations.

   b. Unreliable operations result from failure to integrate previous acquisitions, lack of operational competency at the board and leadership level (see above), failure to establish an EHS board level committee, lack of good due diligence, lack of good technical and operational talent. These risks can be cumulative and competent due diligence will identify (and quantify) these risks.

   c. Demonstration of reliable operations by sellers provides confidence in valuation and streamlines deal progress.

   d. Impact of cumulative operational reliability risks is highlighted in "Failure to Learn, The BP Texas City Refinery Disaster" https://www.amazon.com/Failure-Learn-Texas-Refinery-Disaster/dp/1921322446

   e. WSJ – BP Toledo Refinery Explosion - https://www.wsj.com/business/energy-oil/bp-oil-refinery-brothers-tragedy-6e90f1b0

5. What does the refinery of the future (ROTF) look like? What equipment will become redundant or need repurposing to deliver renewable fuels/biofuels or power?

   a. Depending on the manufacturer, the definition of the ROTF will vary based on geographic location, "convertible" plant assets, scalability, regional demand, and future product profitability (with and without subsidies).

   b. In some cases, manufacturers may convert advantaged process units to supply hydrogen, hydrotreating (pyrolysis), and infrastructure support to adjacent operators.

   c. Post-COVID, there is decreasing pressure for biofuels conversion in favor of a balanced reduction of carbon intensity (CI) in traditional fuels. Demand will remain for traditional and lower CI transportation fuels. However, biofuels are competing with food supply and the incentivized supply chain is causing environmental and other long-term damage.

   d. ROTF utilities could be increasingly "green" with further electrification (in some cases with small modular nuclear reactors), green hydrogen, and other utilities which will more rapidly reduce/ eliminate reliance on fossil fuels-driven utilities. The Chinese are planning to power industrial parks with nuclear capability.

6. Is regional manufacture in "Major Market Holders" becoming more attractive than export from "Major Resource Holders?"

   a. Global supply chains which required years to build up strong relationships and improve efficiency should be carefully reviewed before unravelling and defaulting to near-shoring alternatives.

   b. There are geopolitical considerations (China, regional conflicts) which require responsive strategies to ensure security and profitability.

   c. European supply chains are at risk due to regulatory pressures and energy costs and supply security.

   d. The Chinese focus relentlessly on security of oil supply regardless of CI or other political considerations.

   e. The IRA provides US operators with tax advantages for onshore supply chains (see #8).

Topics (cont'd)

7. Is acquisition of existing assets currently more attractive than new builds?

   Purchase of an existing asset base (especially from an independent or private operator) requires due diligence on construction specifications/methods and asset integrity and maintenance to avoid future operability and reliability issues.

   a. Building is preferred in some cases by larger strategics, excepting cases where JVs with similar size operators make strategic sense. Building is also preferred when options for a preferred product (or unique circularity requirements) are highly limited.

   b. Purchase is an option if:

      i. project execution has been problematic.

      ii. feedstock and product sale supply chains need to be secured (although JVs can sometimes accomplish the same).

      iii. technology needs to be acquired.

      iv. market timing requires moving quickly.

8. Is IRA legislation influencing investment decisions or is it viewed as too short-term?

   a. Yes, the IRA is influencing investment decisions and, Yes, it is too soon to gauge the full impact.

   b. IRA has generated some opportunity but there is significant ambiguity that remains until the IRS/Treasury issues more guidance.

   c. The 3 areas of the IRA discussed were: (1) stock buyback excise tax (2) Corporate Alternative Minimum Tax (CAMT) for firms >$1B of financial statement income (3) transferability of tax credits. We also discussed the impact of the OECD's global minimum tax (Pillar II).

   d. Lack of clear guidance and heightened/more aggressive enforcement by the IRS increases transaction risk and uncertainty with future investment and ownership vehicles.

   e. Structuring is key to any potential M&A transaction, especially in light of the points above, which can have significant economic impacts on returns.

Many of the above topics are helpfully set in context by the Pilko sponsored M&A podcast:

How to do Better Deals and How to do Deals Better https://www.pilko.com/m-and-a-podcasts/

If you wish to discuss further any of these topics, please feel free to contact:

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