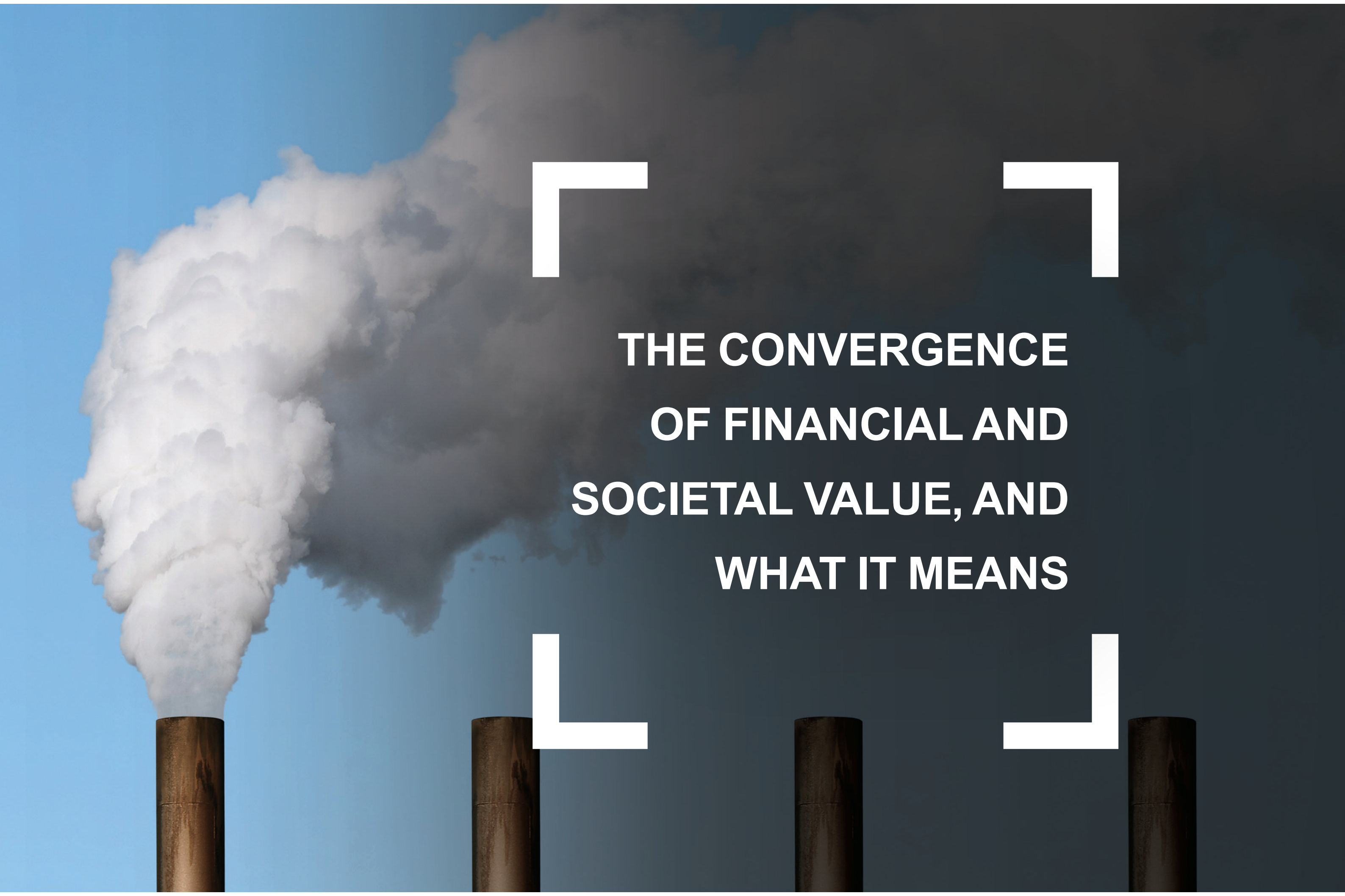
COMMENTARY



THE CONVERGENCE OF FINANCIAL AND SOCIETAL VALUE, AND WHAT IT MEANS

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"Value will change in the post-COVID world…the traditional drivers of value have been shaken, new ones will gain prominence, and there's a possibility that the gulf between what markets value and what people value will close."

– Mark Carney, United Nations Special Envoy for Climate Action and Finance and former Governor of the Bank of England

Context and definitions

Financial value: A reflection of a company's forecasted growth, returns and risk. When represented by a share price, a reflection of the market's view of how much you are able to grow your capital, what level of return you can generate from that capital and by how much that return needs to be discounted. (i.e. how risky it is).

Societal value: A measure of how a company contributes to broader societal wellbeing, or (if negative), a measure of the negative externalities (e.g. pollution, carbon emissions, plastic waste) a company may unwittingly create as a result of its activities.

Core premise

Until very recently, the market and society more generally were less aware of the broader positive and negative externalities businesses can create as a result of their activities. In addition to a lack of general awareness, the lack of a pricing mechanism enabling the "internalization" of these externalities prevented their measure from being priced into market value.

Specific measures and mechanisms like a carbon price are today being explored as ways to enable a more accurate and quantified picture of the societal costs of specific business activities, beginning with greenhouse gas emissions in particular. However, the market is already beginning to price this perspective into market value of certain assets, in particular in sectors with an increasingly clear and visible narrative connected to the creation of "externalities", long before the specific pricing or taxation mechanisms are fully in place.

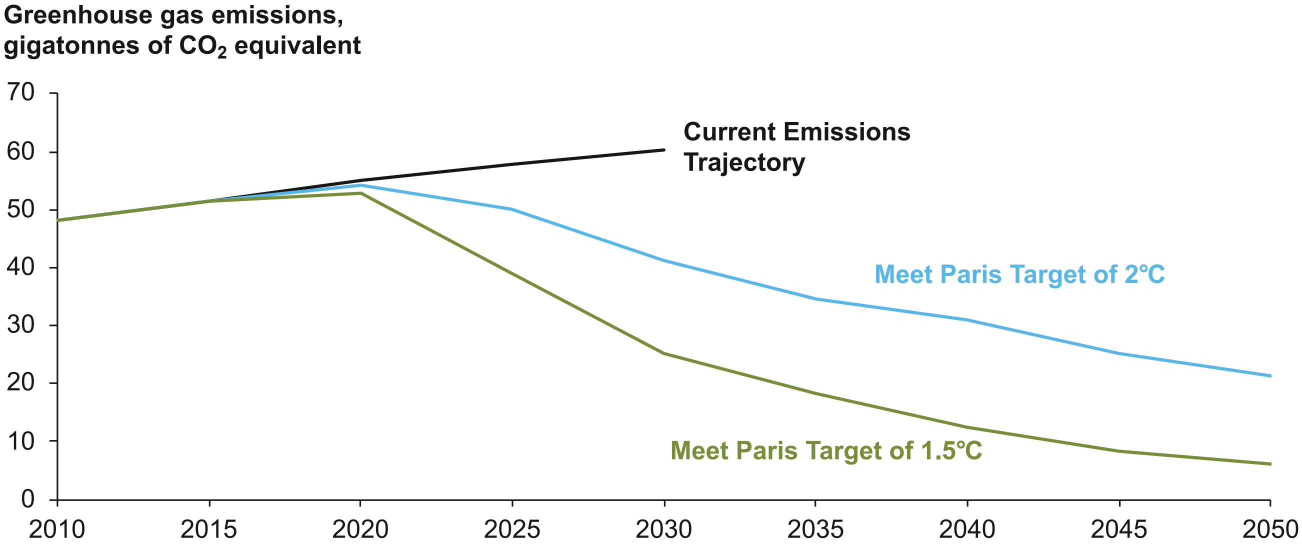
This sets up a clear but difficult choice for business leaders in those sectors – ignore the market signal and deal with potential consequences including fewer potential buyers of your assets, rising cost of capital, less demand for your product OR shift your business model to an equally uncertain future shape with exposure in markets with significantly improved externality profiles.

While this choice is difficult, it is fundamental to most strategy work being conducted in today's sustainability-focused macro environment.

Case example: Oil and gas

Perhaps the best example of this is in the production and sale of oil, and oil-based fuels. There is broad understanding of the impact carbon emissions are having on climate change. The Paris Agreement is a coordinated global effort to limit that impact to a manageable level. To achieve anything close to the targets set out in the Paris Agreement, the absolute level of carbon emissions being released into the atmosphere needs to decline dramatically. Whether it's through a carbon tax, a policy putting limits on usage or simply consumer choice, absolute levels of consumption must go down.

Exhibit 1: Global Greenhouse Gas Emission Forecasts (Current Trajectory & Paris Targets)



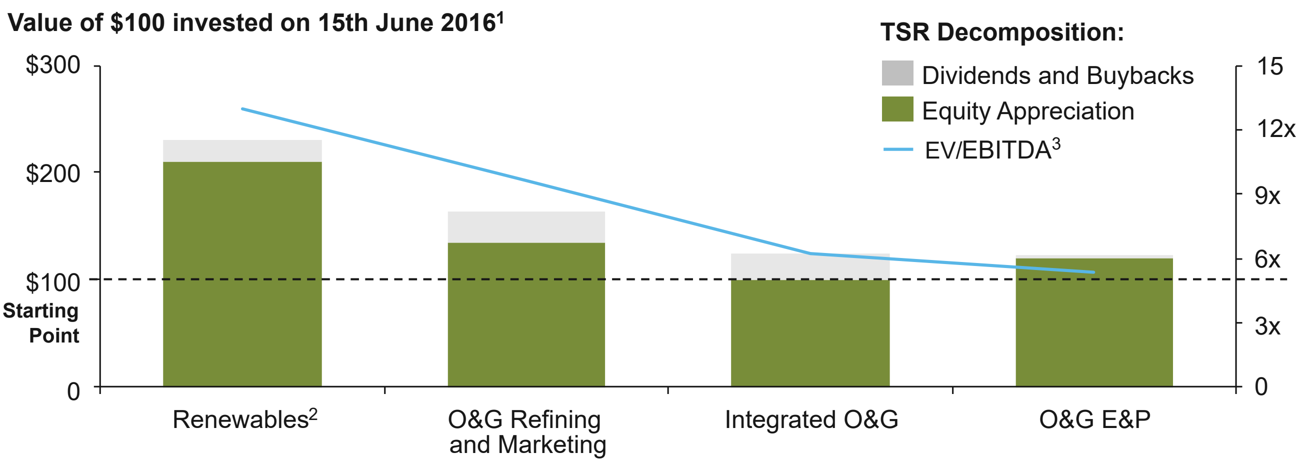
Source: UNEP Emission Gap Report 2019

As absolute levels of consumption go down, supply must go down, otherwise there will be downward pressure on prices. That means producers of carbon-based fuels will not be able to grow their capital (production), while also generating a good return.

The market's stance on the long-term value of carbon-based businesses is evident when looking at the total shareholder return of major companies in the oil and gas production and refining industries.

Over the last five years, traditional producers and refiners have failed to create meaningful value for shareholders. Compare that to companies that have reduced their exposure to carbon by shifting a large portion of their energy production to renewables, and the differences are stark. The market is valuing the cash flows of renewables businesses significantly higher than traditional oil and gas companies as concern for the long-term viability of "high carbon" cash flows continues to grow.

Exhibit 2: Total Shareholder Returns (TSR) for Renewables vs. Traditional Oil & Gas Companies



Notes: 1. Universe of global publicly listed peers with market cap > $1bn as of 13 May 2021; 2. Includes power generation companies and utilities with >50% revenue from renewables and biofuel refining companies with >25% revenue from biofuels; 3. 2021E.
Source: CapIQ

Management teams in these industries have begun to come around to how the broader market is thinking about value. Their response has been to move to a "harvest" model: return as much cash as possible to shareholders through dividends and buybacks, while only reinvesting enough to sustain the business and continue to pay out dividends. As is evident in their market performance, this is a value neutral strategy. The only way to break out and start to create real value is to "transition" their portfolios away from carbon-intensive business lines so they can start to profitably grow the capital base.

A closer look at the portfolios of the 46 largest companies (market cap>$1bn) within the global refining segment makes this evident. On average, the companies with 25% or more of revenues coming from biofuels have a five-year total shareholder return of over 40% (annualized) and an enterprise value to EBITDA multiple of over 18x. Compare that to the companies with less than 25% of revenues coming from biofuels that have an average five-year total shareholder return of 8% and an enterprise value to EBITDA multiple of 9x. A simple correlation of TSR to percentage of revenue coming from biofuels confirms the strength of the relationship.

Exhibit 3: Impact of Portfolio Shape on TSR

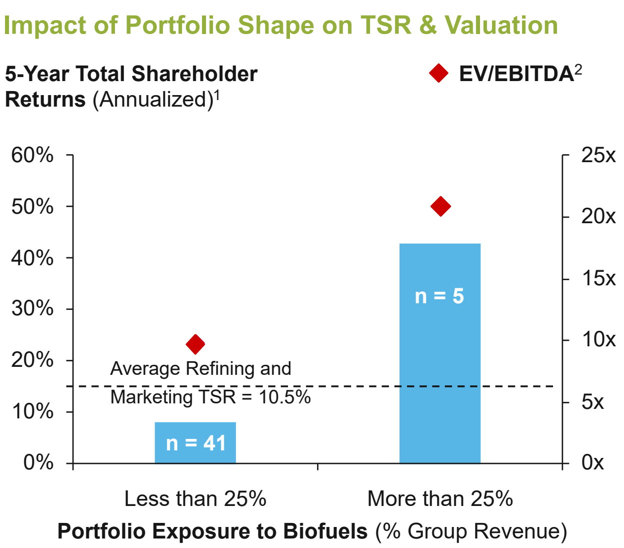
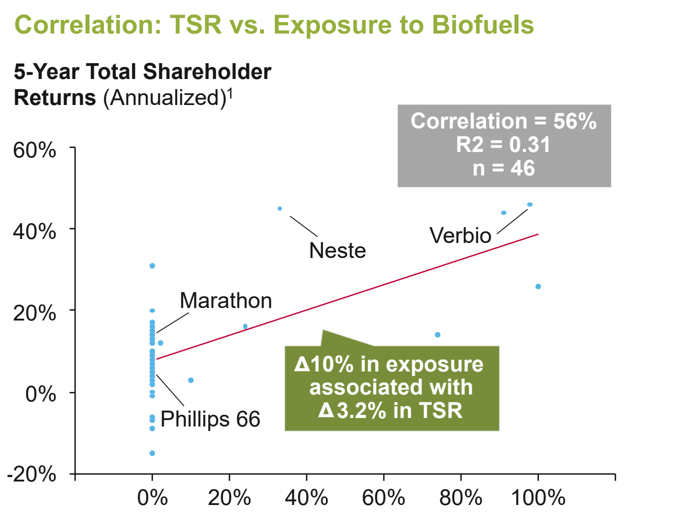


Exhibit 4: Correlation of TSR to Exposure to Biofuels



Notes: 1. Universe of global publicly listed refining and marketing peers with market cap > $1bn as of 13th May 2021; 2. 2021E.
Source: CapIQ

Though the outperformance of companies with higher levels of exposure to renewables are likely benefitting from the current momentum behind ESG investing, the reasons behind it are clear. As demand for carbon-based fuels declines, refiners will not be able to grow their capital base (production), will struggle to generate good returns on the current capital base, and may be at risk of large impairments due to stranded assets.

After oil and gas: Who might be next?

The fossil fuel industry is the first test-case because its link to greenhouse gas (GHG) emissions is the most visible and the most understood but other sectors will come next. A simple analysis of percentage of total GHGs by sector suggests that the sectors most likely to encounter these dynamics next include: Buildings, Agriculture/Food, Transport, Iron and Steel.

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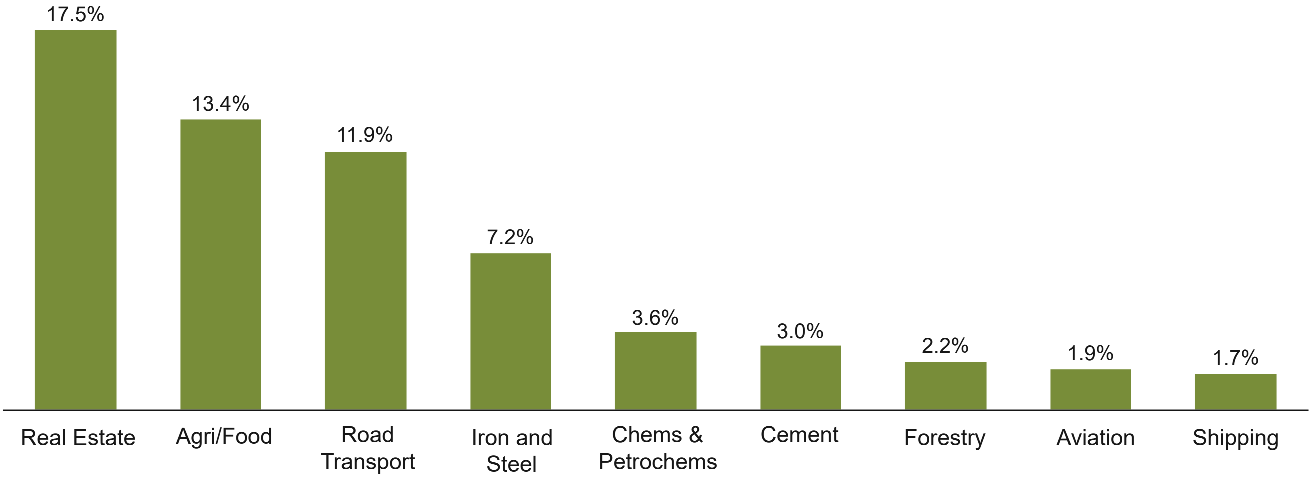
Exhibit 5: Global Greenhouse Gas Emissions as % Total by Sector

GHG Emissions By Sector (% Total)



Note: Sector list not comprehensive.
Source: Climate Watch, World Resources Institute

Companies in these industries looking to avoid the pressure on valuation currently being faced by oil and gas need to be proactive in decarbonizing their portfolios. A recent survey of the 60 largest listed meat and fish companies found that 75% of them have not put in place reduction targets set according to scientific guidelines for emissions. Few even disclose Scope 3 emissions that cover their supply chain, which is where the majority of their emissions comes from.

Due to the growing concern from all stakeholders on the risks of climate change, GHG emissions are currently the driver of stakeholder impact that is most closely linked to financial value, but it won't always be that way. As awareness grows around other major drivers of environmental or social impact and the risks associated with them, markets will price that risk into assets or companies with exposure to it.

Implications for business leaders

Portfolio shaping thus becomes the ultimate strategy lever in a sustainability-focused world, particularly when looking at strategy through the convergence of financial and societal value.

Portfolio transitions are inherently difficult journeys to embark on. The winners may be those that:

- Look at their business through the lens of its impact on a broader set of stakeholders.
- Adopt internal externality pricing mechanisms to send a clearer signal to the business about where "future value" resides.
- Work actively to resolve the tensions between the way the organization has traditionally thought about value and how that is likely to change.
- Begin the portfolio transition strategy sooner rather than later – these journeys take multiple planning periods to design and execute, and the odds are that the market's ability to price in externalities is going to accelerate over the coming one to two years.

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Marakon is a strategy and organizational advisory firm with the experience and track record of helping CEOs and their leadership teams deliver sustainable profitable growth. We get hired when our client's ambitions are high, the path to get there is not clear (or taking too long) and lasting capabilities are as important as immediate impact.

We help clients achieve their ambitions for sustainable profitable growth through:

- Stronger strategies and advantaged execution based on:
    a. A better understanding of what drives client economics and value
    b. Insight into changing industry dynamics and the context in which clients need to succeed
- A stronger management framework to generate better ideas and link decisions and actions to value
- A stronger organization with a more focused top management agenda and well-aligned resources
- A more confident and effective leadership team that's focused, decisive, and strategic

We have a joint team delivery approach where client ownership and engagement is paramount. Partners are highly engaged in the work product and supported by strong analytical and industry relevant capability. We work as advisers and catalysts in close, trust-based relationships with top management teams.