

BP: From International Oil Company to Integrated Energy Company

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On [August 4th BP announced](#) they would pivot the company from an integrated oil major to an integrated energy company. A subtle difference in language, but a staggeringly ambitious shift in practice.

The plan is well-intentioned and in keeping with some of the strategies at other European IOC's which we support. The core of their initiative includes:

1. A 10-fold increase in low carbon investment by 2030, with up to an 8-fold rise by 2025;
2. By 2030, aim to have developed 50GW of renewable generating capacity – a 20-fold increase from 2019;
3. And reduce their oil and gas production by at least one million barrels of oil equivalent a day, or 40%, from 2019 levels by 2030.

The scale and timelines associated with these proposals are remarkable, calling into question both the feasibility and perhaps credibility for the charted course. To be clear, we approve of their goals. We fully support the direction the company intends to head in. However, the speed at which BP intends to shift directions, combined with the scale, may result in unforced errors – a net negative to shareholders and society alike.

Here are some options for how BP can 20x its renewable capacity in the next nine years. Management can pursue a build out-strategy, an acquisition strategy, or, more likely, some combination of both. Given the scale of the acquisitions that would be necessary, getting good value for invested dollars will be difficult.

Acquisition targets may include companies such as Orsted, which currently has 10 GW of installed wind power capacity, a fifth of BP's goal, and a pipeline that will take total capacity to ~15 GW by 2025. Orsted currently trades at 5.3x sales, 53x ttm earnings, and 4.3 book ttm book value. These ratios don't tell the full story but are undoubtedly suggestive that such an acquisition may carry a premium price tag.

An acquisition of Iberdrola, which has 33 GW of installed renewable power (and a robust pipeline), would be an even better start. Iberdrola stock has jumped 78% over the past two years, bringing its market capitalization to \$80 billion, on a par with BP. With debt worth \$41 billion and the firm's equity roughly half of where it was two years ago, this type of acquisition also seems like a stretch. BP's management intends to finance part of the strategy shift with asset sales. If they accomplish the goal of selling \$25 billion worth of assets by 2025, an Iberdrola type acquisition may be more feasible.

Of course, investors need to ask how is management intending to sell \$25 billion in oil assets in the current market? Is BP planning on selling high-quality oil assets? Given the goal is to "high-grade" its portfolio, it would seem unlikely. The target assets are going to be assets that management does not think will be profitable at \$40 oil. It is hard to imagine they have many buyers for those assets.

If BP develops projects organically, offshore wind is a likely candidate. The market is still

underdeveloped, the GW scale project sizes afford fewer turns at the project development cycle, and their operating experience in offshore environments is likely modestly transferable.

Offshore wind is expensive, though; upfront costs run about [\\$2.9 billion per GW of capacity](#). Cheaper than nuclear, less costly than coal, but easily 2x more expensive than solar, onshore wind, and gas. Offshore costs will likely come down over the next ten years – [estimates suggest by about 35%](#). Note that this cost reduction is for the total cost throughout the asset's useful life, not an upfront cost reduction in build cost. A bulk of this discount comes from increased efficiency in energy production (reducing lifetime costs per unit of energy output), but not necessarily an equivalent drop in upfront capital. If BP outfitted their entire portfolio with offshore wind, inclusive of a generous 35% reduction in build cost, it would cost them ~\$90 billion. If we assume 70% could be raised via project financing; BP would need only to invest \$27 billion.

BP is unlikely to pursue a pure offshore wind strategy; they will want to diversify. Onshore wind, co-locating solar with energy storage, and perhaps an opportunistic slice of hydro, or geothermal may round out the portfolio. The [Gemini Project](#), currently being developed in Nevada, is representative of the solar project size that would be of interest to BP. The project costs ~\$1 billion and will include 690 MW of PV installations and a 380 MW energy storage system. If BP wants to diversify at least 25% of its renewable portfolio into solar + storage the estimated cost would be ~\$18.1 billion. Our rough back of the envelope now looks like the following:

- 12.5 GW of solar + storage for \$18 billion;
- 37.5 GW of offshore wind for \$70 billion;
- For a total CAPEX of \$88 billion, 70% financed via project financing resulting in a direct cash investment of \$26 billion.

If we assume that management successfully sells \$25 billion in assets and directs it all to pay down the firms' existing debt, the debt load following the renewable build-out will be roughly \$77 billion. Granted, much of the debt would be sitting at the project level, but it is still a significant debt load. Large oil firms generally target a return on oil investments of about 15%. BP said it expects returns of 8% to 10% from its low-carbon electricity investments (levered returns) that, when combined with their traditional oil and gas projects, result in overall returns of 12% to 14% by 2030. We are skeptical of their ability to achieve these lofty returns, meaning that just as the expected return profile of the firm is likely decreasing, they intend to load the balance sheet with debt.

Assuming this general idea is acceptable to shareholders, there is still a question of whether there are sufficient opportunities available with satisfactory rates of return. No doubt, the annual rates of change in renewable energy markets will propel a considerable amount of momentum behind these targets. Wind capacity is expected to grow by 50 GW globally per year for the next decade. Yet the devil is often in the details, and the execution challenges associated with turning this ship into increasingly competitive waters must be appropriately discounted before cheering premature success.

Renewable technology manufacturers are already facing increasingly tight margins, generally in the single digits, as a result of increasing pressure from both increasing costs and buyer demands for lower prices. The commercial success of energy storage (at scale, which is necessary to enable these capacities we are dealing with) is far from certain. [[A clever graphic](#) by Shayle Kann at Energy Impact Partners shows that long duration storage has yet to crest the peak of inflated expectations].

Orsted recently lost out to Shell and the Dutch utility Eneco in a sizeable offshore wind tender. Their CEO remarked: "the company will not be sucked into near-term price wars." It's not apparent to us that price wars in this space won't be rampant over the next ten years. Project origination will likely be fruitful for a long time – increases in peak demand are likely with an electrified transportation

industry – but we should not underestimate the increasing competitiveness and the challenges associated with project development at unprecedented scales. BP Chief Executive Bernard Looney said on a recent conference call that the company would only go after renewable capacity that came with the right returns – rather than chasing capacity for the sake of it. How BP fairs over the next few years in tackling these initiatives will be very instructive for how quickly and remuneratively large-scale renewable projects can grow.

As Dmitry Marinchenko of Fitch recently noted, “The energy transition will be bumpy for oil majors; they have little experience in renewables, and new investments will make them subject to the execution risk. Not all investments will probably prove to be successful.” We agree.

Effectively positioning an equity portfolio for a transition to a low-carbon economy means identifying risks and opportunities in a world that is both increasingly carbon-constrained but also increasingly susceptible to glowing narratives proffered by management teams under pressure to change. Better transition investing requires asking better questions about esg variables and the current operating context. Management teams will propose many strategy changes over the next ten years; investors need to be careful to avoid deriving too much comfort from the ambitious plans of many firms, as few will unfold as expected.

If you are interested in learning more about the investment opportunities in challenging to decarbonize industries, and which firms are setting themselves up to survive and thrive in a low-carbon economy, please feel free to contact us.

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