Total/Equinor climate risk CDS trade: IEA update

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Our recent trade note "Short Total. Long Equinor (and/or iTraxx ESG)", AFII, 2 March 2021, has performed decently since publication, with Total CDS widening more than Equinor and/or iTraxx ESG. As shown in Table 1the differential has gone from 5/7/-13bp at trade inception to 10/14bp/-9bp [Total – Equinor spread on the 5yr/10yr/Total – iTraxx ESG S35] currently, generating non-annualized IRRs in the region of 2-3%.

Table 1. CDS spreads and trade dynamics. IRR has been calculated using a 5%/10% margin requirement on the 5y/10y points, which we believe is a conservative estimate. Not annualized. Transaction costs excluded.

	5yr			10yr		
	2 March	19 May	Change	2 March	19 May	Change
Total	30	38	8	55	64	9
Equinor	25	28	3	48	51	3
iTraxx ESG	*43*	*48*	*5*	*n.a.*		
Differential	5	10		7	13	
Unlevered return		0.26%			0.61%	
IRR		2.56%			3.04%	

With the update from the International Energy Agency as of 19 March 2021, namely the statements around "The trajectory for oil demand in the NZE means that no exploration for new resources is required" and "No new natural gas fields are needed"[1], we see a further relative widening of spreads as likely with the following arguments:

- Equinor continues to be extremely well supported by its domestic government and we believe it is likely that Norway will view further exploration and drilling in the Arctic as aligned with the IEA planning. We do not agree, but that is likely what will be argued. Refer to "Our activities in the North", Equinor home-page, accessed 19 May 2021.

- Total on the other side is more dependent on further new explorations and developments, with less supportive (and non-government owners). Recent controversy around an Ugandan pipeline illustrates Total's difficulties, see for example "Total gives greenlight in Uganda", EnergyVoice, 11 April 2021. The IEA report is likely to induce more stress on Total's balance sheet as more 'assets' are now becoming stranded.

A reprint of the original report is provided in the following pages.

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[1] "Net Zero by 2050 – A Roadmap for the Global Energy Sector", IEA, 18 May 2021. The quotes are from page 101 and 102 respectively.

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Reprint of original 2 March AFII report.

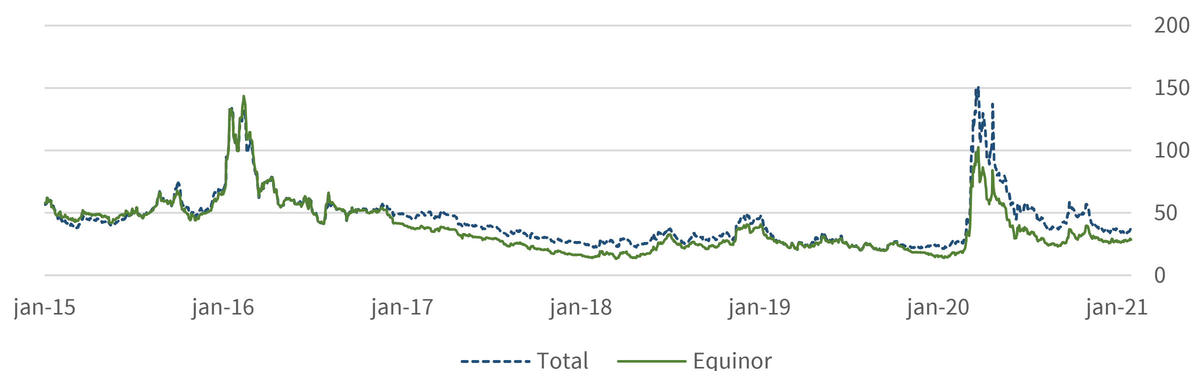
Short Total. Long Equinor (and/or iTraxx ESG).

We believe a market neutral relative value trade combining a credit short on French oil major Total (Ticker: FP FP, rated AA) versus a long on Norwegian oil major Equinor (EQNR NO, AA) could be attractive. From the perspective of a world locked into rapid climate change, Equinor's near monopolistic access to arctic production facilities (and added benefits from receding ice shelf) trumps Total's large exposure to hydrocarbon production in areas more likely to succumb to severe physical climate change risks as well as rife with social conflict.

Suggested trade structure:

- Sell €10mn of EQNR 5y CDS protection @25bp alt 10y @48bp.
- Buy €10mn of TOTAL 5y CDS protection @30bp alt 10y @55bp.
- Entry level: 5/7bp of spread differential. Target: 50-100bp spread differential Stop-loss: -10/-15bp spread differential.
- *Alternative 1*: sell €1.2mn of iTraxx ESG S34 index protection 43bp for a carry neutral 5y trade, marginally carbon positive trade.
- *Alternative 2*: Short Total vs Sell €10mn iTraxx ESG S34 @43bp (no position on Equinor), for a carry positive, carbon reductive trade.

Figure 1. Total and Equinor 5y CDS spreads. Source: MarkIt.



More specifically, this hypothetical trade is designed to benefit from potential crystallization of risks across a number of factors: **projected physical climate change exposures, , idiosyncratic/M&A reputational risks, central bank policy support and owner support**. We believe the companies are on similar trajectories when it comes to climate transition in terms of potential impact on credit quality. Please note that the trade does not provide additional capital to the oil sector. The *Alternative 2* format would be net carbon negative.

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Technical trade consideration/alternatives

On identifiers: Total (TOTAL, CTELF1E5 Corp) refers to the company that is looking to be called Total Energy. Equinor (EQNR, CSTOI1E5 Corp) refers to the company formerly known as Statoil. iTraxx ESG refers to the newly introduced iTraxx MSCI ESG screened index (MSCIESG, MSCIESG CDSI S34 5Y Corp) that consists of 85 European credits with credits with low ESG scoring removed from the original iTraxx Main. [2]

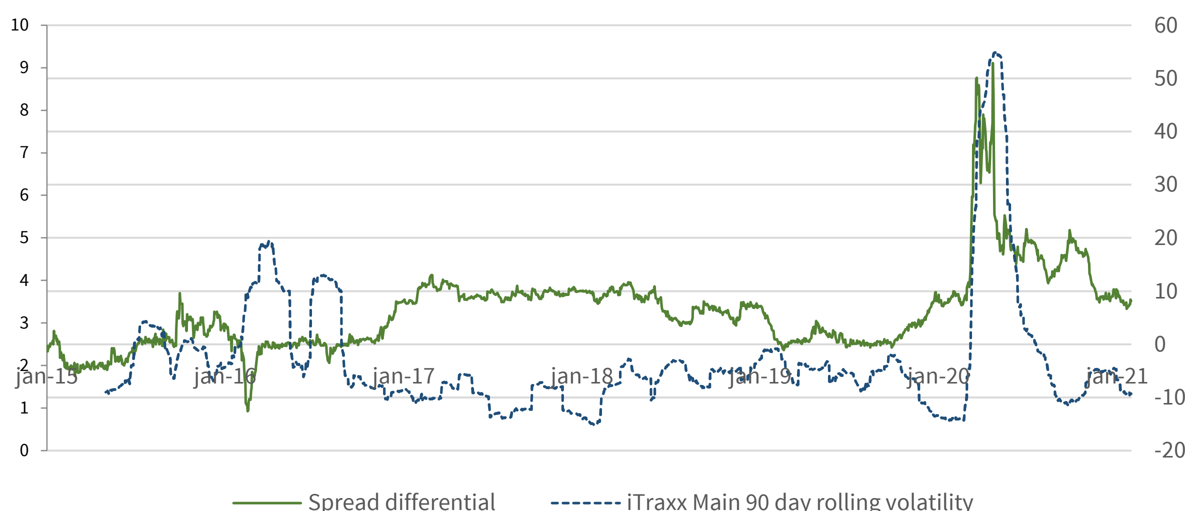
The trade in its basic format is notional neutral (10x10), meaning that the trade also is carbon-neutral under the assumption of similar carbon intensity of Equinor or Total. We find that at the current juncture it is extremely hard to make a holistic estimate of oil company emissions, especially in terms of intensity terms. The trade has a slightly negative carry and roll-down – the two alternative trade formats are suggested as ways of reducing the negative carry and/or change carbon exposure.

Alternative 1 suggests adding protection selling on iTraxx Main ESG index for a carry neutral package. Given a small, yet positive, carbon footprint of the ESG index, this alternative ends up adding carbon exposure to a portfolio.

Alternative 2 is for investors avoiding funding fossil companies at all, could look at exchanging all of the Equinor long risk exposure to the ESG index. Effectively this would make the trade carbon negative, as on a notional neutral basis, the ESG index has a significantly lower carbon footprint than Total. Alternative 2 is long both Total idiosyncratic risk as well as oil sector systemic risk.

We also believe the trade is long tail risk volatility: for example, in the covid/OPEC sell-off in March 2020 both names underperformed the market significantly. As illustrated in Figure 2, the spread differential blew out at the same time as market volatility rose, which should be an attractive feature of a hypothetical trade.

Figure 2. Tail risk correlation. Spread differential Total - Equinor 5y CDS; volatility of iTraxx Main on-the-run. Source: MarkIt, Bloomberg.



[2] For an overview, please refer to "First of its kind ESG Index – iTraxx MSCI ESG Screened Europe Index", Markit, 12 May 2020. AFII has previously discussed the good usage of such products from a sell protection perspective in "ESG in CDS indices", Anthropocene Fixed Income Institute,14 Aug 2020.

Trade motivations

We believe it is useful to look at the trade as a cheap option on higher fossil controversy/economic risk in the intermediate time frame. There is a considerable literature on "Inevitable Policy Response" (IPR) which basically posits that at some point, physical climate change will force an overshoot in policy to radically reduce greenhouse gas emissions. We ask the reader to view the trade idea out of the perspective that there is a non-zero probability for IPR inside the trade's life span. If that scenario does not crystallize. The key factors that could be affected in IPR related scenarios include:

- Physical climate change effects
- Reputational risk effects
- Central bank policy effects
- Owner/government support

Physical climate change effect: Total has bigger physical climate risks in its production base

Equinor benefits from geographical opportunities as its operational base is affected positively by climate change. Specifically, the eradication of Arctic ice is enabling more exploration of the Barent's Sea and thus securing development supply for the long-term.[3] Recent court rulings indicate the domestic, if not international, support for pushing further north with oil exploration.

Figure 3. An ice-free Arctic as illustrated by the Equinor's predecessor Statoil.

Total has a much higher dependency on projects closer to the equator, e.g. the recent Mocambique LNG mega-facility.[4] Higher volatility in weather effects has its obvious first order physical effects, but also second order effects such as people dislocations with associated conflict risks. Mocambique, for example, is right now suffering from elevated political violence leading to Total reducing its operations there.

Risk to our view: Climate change does not progress as projected by the general climate science community. Total may reduce this risk through its effort to expand into Arctic as well. For example, in Norway's recent auction of near-Arctic drilling rights,[5] Total won 3 licenses. But again this shall be compared to Equinor winning 17.

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[3] See for example "Equinor gearing up for fresh Barents Sea well", Offshore Energy, 30 Nov 2020. In a stroke of irony, the prospect discussed in the article is called "Isflak", "ice floe". Recently, the Arctic iceshelf has thinned enough for year-round through transport of fossil fuels (LNG), see "A step close to year-round shipments on Northern Sea Route", The Barents Observer, 18 Jan 2021, or Longest Arctic Sailing Season Tops Off a Year of Climate Disasters", Bloomberg, 12 Dec 2020.
[4] "Total secures Africa's biggest debt financing with LNG deal", Financial Times, 16 July 2020.
[5] See "Norway awards oil and gas exploration rights to 30 firms", Reuters, 19 Jan 2021. Other winners in the auction were Equinor, Aker BP, Shell, ConocoPhillips, Lundin Energy and Eni.

Figure 4. Sample deal flow for Total. Source: Total.

Reputational risk: Equinor has a (much) more defensive M&A risk after previous failed operations.

We believe Equinor has little appetite for high-risk M&A after a recent string of costly ventures into North America,[6] and with strong public dislike of such ventures.

Total on the other side has ventured into a string of what we would appreciate as high-risk. The Saudi-Aramco joint venture[7], for example, puts the company at risk of reputational damage from operations such as running retail outlets under the brand in the theocracy.

Conflict zone exposure is another area where we would be wary on Total. As noted above, a brewing conflict in Mocambique has hit Total, and to illustrate the reputational risk to the company – which may occur even if the company is able to perfectly manage all its operations in a compliant way in the zone – we refer to this quote:

> "Total has, indeed, signed a security pact with the Mozambique government that will see state troops protect the project site. That the Mozambique government is more focused on defending LNG projects while a humanitarian crisis in northern Mozambique is getting worse may not go unnoticed for long by investors with ESG concerns."

- Business Day, 31 January 2021

Actions in conflict zones can be sticky: the management of Europe's largest E&D company Lundin Energy (formerly Lundin Oil – another company that has undergone a name- if not capex change), has senior management mired in allegations and criminal investigations of genocide after projects in Sudan in the early 00s.

We would also note Total's recent JV's with Adani Group in India that could associate the company with one of the biggest EM coal players,[8] as well as political risk in India, cf. "How two of India's richest men [Adani, Ambani] became the target of farmer boycotts", Fortune, 23 Jan 2021.

[6] See "Equinor criticizes its failed US upstream strategy", Argus Media, 9 October 2020.
[7] Total and Saudi Aramco have a number of joint ventures, for example in retail fuels (link) and petrochems ("Aramco and Total sign deal for $9bn petchem venture", National News, 8 Oct 2018).
[8] "Total deepens ties with India's Adani in $2.5bn green energy investment", Financial Times, 18 January 2021. The article discusses a recent transaction for Total to buy solar generation assets from Adani, but also

Central bank policy: ECB support for fossil companies such as Total is waning

Total bonds are currently included in the ECB's CSPP, whereas Equinor bonds are not (as a a non-euro issuer). Banque de France recently announce a limited, but still important, decision to divest from high carbon in some parts of its internally managed portfolios,[9] and it appears that the ECB is leaning that way in monetary policy portfolios as well.[10]

In comparison, Norges Bank has no monetary policy support in terms of asset purchases that could be relevant for Equinor. However, the full intention of Norges Bank's investment management arm (NBIM, "the Oil fund", is run under the governance of the central bank, Norges Bank), is to act as a shock absorber to the country's dependence on oil which in turn is correlated to the future of Equinor. We believe that this absorption mechanism operates as a tail-risk protection measure for Equinor in such that way that it is credit supportive.

Risk to our view: Total could be considered a European champion, thus making it unlikely that CSPP fossil exclusion policies would apply to it. EU has a history of bending green principles when it comes to large European corporate interest, c.f. Nordstream2. This would mean that Total could expect a policy support similar to a company like Equinor.

Owner/government support: Extremely strong and well-funded support for Equinor

Equinor has broad government support through the Norwegian government's 30% stake of the company. Recent policy changes, as exemplified by the "move" of the Arctic drilling rights, suggest a significant community backing of the company's activities, and we believe this would be galvanized in the case of difficulties for the company. To quote the announcement of the 25th licensing round:

"New discoveries are necessary to ensure continued activity, ripple effects, employment and governmental revenues throughout the country. […] The overall objective of the Government's petroleum policy is to provide a predictable framework for the profitable production of oil and gas in the long term."

- Government of Norway, 19 Nov 2020.

In contrast, the biggest shareholder of Total is Amundi,[11] the asset-management subsidiary of Credit Agricole (ACAFP). Both Amundi and ACAFP are positioning themselves as frontrunners in sustainable investing. Second biggest shareholder BlackRock has also made some commitments in the direction of climate change mitigation and ESG investing. We believe that owner support will be low in cases where Total is hit by reputation/deal risk, which may drive uneconomical and

highlights the joint venture operations in fossil gas, gas terminals and retail petrol outlets announced in 2018.

[9] " Politique d'investissement responsable : renforcement des exclusions en matière d'énergies fossils", Banque de France, 18 Jan 2021.

[10] "Christine Lagarde expected to make ECB a climate change pioneer", Financial Times, 3 Jan 2021.

[11] Numbers on equity and bond holdings from Bloomberg.

credit negative divestment patterns. Total's recent announcement to leave the American Petroleum Association is indicative of the company's sensitivity to reputational risk.[12]

Risks to the view: Although the Norwegian government support for Equinor is strong, the Norwegian government also has a history of dropping support on the basis of political controversies, c.f. Eksportfinans in 2012. Note that the government held no equity stake in Eksportfinans, so the government did not suffer direct economic losses at that time. More recently, the government has been unwilling to provide support to the Norwegian Air, at a time that it has almost been par for the course for governments to bail out their dominant carries.

We believe the implied support for Total may be higher than suggested by the pure equity ownership structure. A hint to this is seen in the case the recent Cyprus/Turkey confrontations. Total has drilling rights in the region, and we believe that has been a driving factor for the French Navy to engage in the conflict. Total is number three in the retail power market (behind EDF and Engie), operate 3,550 retail outlets and has 36,000 employees in France. As such, it is not inconceivable that the Fifth Republic will offer support to the company in a tail-risk scenario.

Assumptions around energy transition readiness

This note has assumed a similar devotion of Equinor and Total to the energy transition. Please note that we are not making a statement as to the absolute level of those commitments, or whether we believe they are sufficient.

[12] " Total withdraws from the American Petroleum Institute", Total press release, 15 Jan 2021.

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