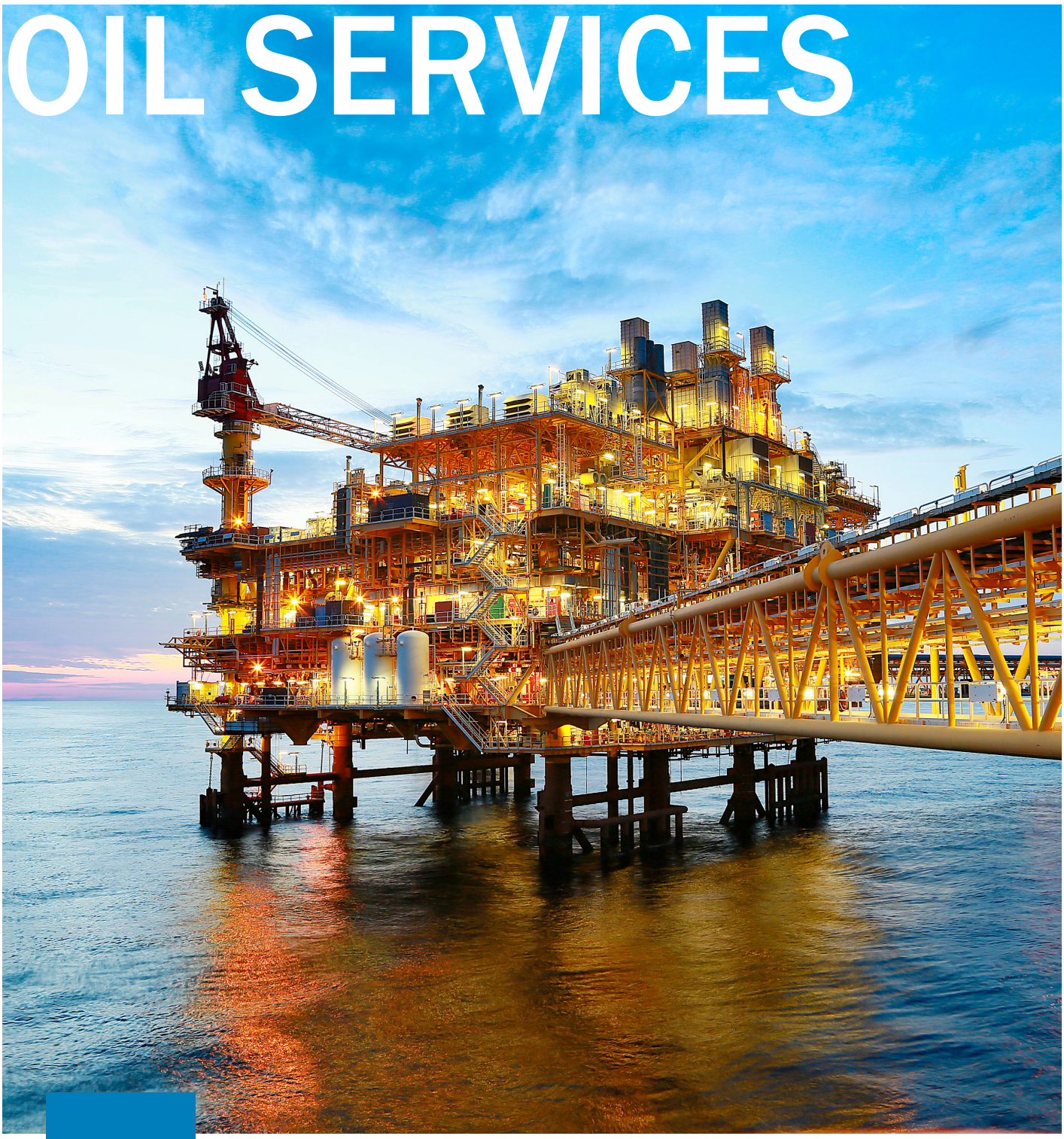
ESG FRAMEWORK OIL SERVICES



PZENA Investment Management

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01 A Strong ESG Proposition Adds Value

As committed value investors, Pzena seeks to buy good businesses at low prices, focusing exclusively on companies that are underperforming their historically demonstrated long-term earnings power. Through bottom-up fundamental research we seek to determine whether such earnings shortfalls are temporary or permanent, and each investment decision weighs risk and return potential by considering all issues material to a company's prospects.

Because ESG issues can have a material impact on a company's earnings over time, they are evaluated like any other investment issue. Pzena's integrated approach to ESG ensures that an understanding of material ESG risks and opportunities is incorporated into the research process. As many ESG issues will play out over a long timeframe, they require a future-oriented perspective, consistent with our long-term, buy-the-whole-business approach to investing.

02 What are ESG Industry Frameworks

ESG frameworks provide an overview of the ESG issues relevant to an industry which are part of our bottom-up, company-specific analysis. These frameworks distill material investment issues that can have an impact on a company's financial performance; help identify and quantify additional potential risks and opportunities; and prioritize the most material ESG issues by industry.

Specifically, the frameworks:

1. Ensure coverage of key material ESG issues within an industry;
2. Provide a sound basis for quantifying and assessing these issues;
3. Provide a way of prioritizing issues for each company-specific situation.

While these ESG frameworks are relevant to all companies in a specific industry, company-specific nuances always determine any variation to, and prioritization of, our research into these areas. The issues highlighted in a framework do not reflect all potential ESG issues for a company but are a guide to what we think are the most common and material issues. Company-specific materiality will always be evaluated on a case-by-case basis by our investment team.

We developed these frameworks from a comprehensive set of inputs that we evaluated as part of our proprietary research process. In so doing we referred to a wide range of third-party ESG data sources, including SASB (the Sustainability Accounting Standards Board), MSCI, RepRisk, and company-reported information.

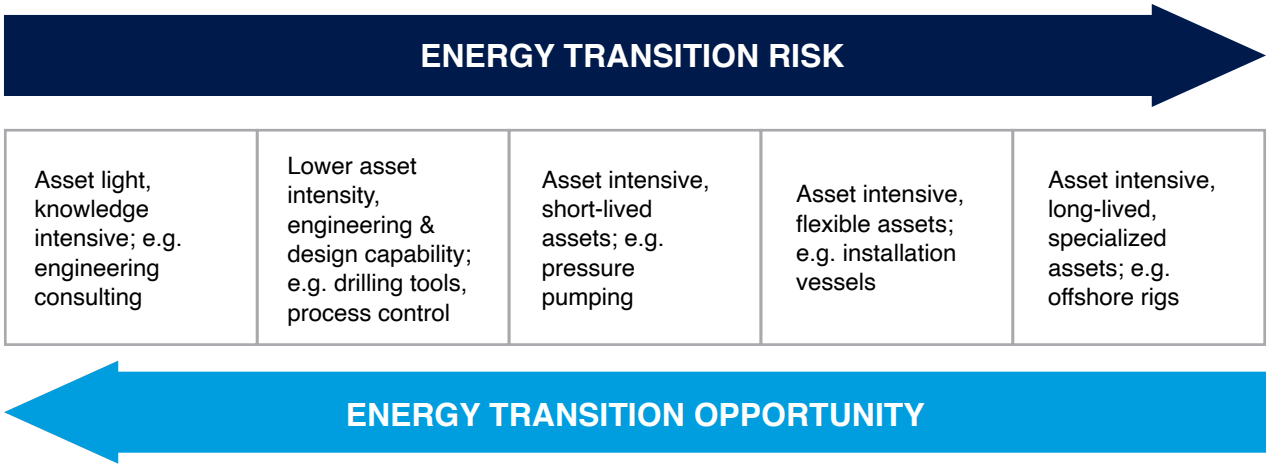
03 Oil Services Framework

PRIORITY	ISSUE	RELEVANCE TO INVESTMENT THESIS
1	**Energy Transition**	• How will the current business mix be impacted by the energy transition? • Is the company in a good position to potentially exploit emerging opportunities? • How high is the execution risk? • Changing regulation in operating jurisdictions
2	**Business Ethics**	• Shareholder value leakage, fines, reputational damage, etc.
3	**Environmental Management**	• Costly clean-up fines, reputational damage, and increased cost of capital
4	**Resource Scarcity**	• Unsustainable resource use could lead to increased operating expenditures over time
5	**Workforce Health & Safety**	• Reputational damage • Litigation costs
N/A	**Governance**	• Shareholder value leakage or mismanagement of acute issues

We believe effectively handling the energy transition is of primary importance for the oil services industry. The energy transition is both a threat and an opportunity for these companies. The threat of the energy transition is in the potential reduction of the future addressable market for the oil services industry and the potential for lower returns on capital in the future. The opportunity is for new businesses that will enable the energy transition, which need material engineering expertise that the oil services industry could be uniquely suited to provide.

The energy sector encompasses a wide diversity of sub-industries and, within them, many different businesses with varying asset intensities. The companies within the oil services industry most at risk from energy transition are asset intensive companies where the assets are very specialized. Offshore drillers fit this description. Offshore drilling rigs are among the most expensive assets in the industry and have an asset life of 25–30 years. The rigs require capital spending on periodic maintenance, and they have high operating costs. So, if the revenue for the industry is weak and there is excess capacity, it takes a long time for capacity to be taken out. Drilling rigs are very specialized equipment, thus offering very limited potential to be repurposed to serve another market. This in turn causes the industry to price very aggressively in lean times, pressuring profitability and return. Installation vessel companies are in a slightly better situation. Offshore installation vessels are also long-lived, expensive equipment that have high carrying and operating costs. However, the vessels are more flexible and can potentially be repurposed to install offshore wind farms, leading to lower risk/higher opportunity from energy transition.

At the other end of the spectrum are knowledge-based companies with human capital as their primary asset, such as the Engineering & Construction players. A downward pressure on revenue impacts their profitability, but these companies can respond faster by restructuring the workforce. Moreover, as the primary asset in this industry is engineering talent, and the opportunities in the energy transition are nascent industries with material engineering needs, the E&C companies should be able to build good, differentiated offerings.



While the above discussion provides a broad framework for thinking about the energy transition risks and opportunities for the oil services sector, the assessment of a specific company requires a bottom up process that considers its unique business mix and competitive advantages. For example, Baker Hughes, discussed below, has an asset intensive business in Turbomachinery; the division's material exposure to liquified natural gas (LNG) makes it uniquely suited to compete in some of the emerging energy transition opportunities.

04 Application of the Framework: Baker Hughes

Baker Hughes is a diversified oil services company held in multiple Pzena portfolios. Baker Hughes is the second-largest oil services company; It has a broadly diversified line-up of products and services across all the major geographical markets, and, while it, and the broader industry, has material ESG considerations, Baker Hughes is one of the better-positioned oil services players to effect the energy transition, and is managing its ESG exposure well. The company has also reduced its cost structure in this downturn substantially.

How Baker Hughes rates on the broad framework issues

PRIORITY	ISSUE	BAKER HUGHES MATERIALITY	ISSUE DETAIL	BAKER HUGHES STATUS
1	Energy Transition	High	• Risk to current business • Positioning for emerging opportunities • Capability gap and execution risk	Leading Leading Leading
2	Business Ethics	Medium	• Business controls and processes • Outstanding legal risk	In Line In Line
3	Environmental Management	Medium	• GHG* reduction targets and scope • Progress on GHG reduction • Responsible management of other environmental impact	In Line In Line In Line
4	Resource Scarcity	Low	• Need for scarce resources in business • Management of scarce resources	In Line In Line
5	Workforce Health & Safety	Low	• Safety incident metrics	In Line
N/A	Governance	Low	• Broad structure and independence • Responsiveness to shareholder concerns	In Line In Line

**greenhouse gas*

Managing the Energy Transition

Baker Hughes is well positioned to manage the demands of the energy transition partly because the Turbomachinery and Process Solutions (TPS) segment has a dominant position in the LNG market, having over 90% market share of the installed base. LNG demand is projected to grow faster than overall oil & gas demand as it takes an increasing share in electricity generation from coal, particularly in emerging markets like China and India. TPS is a very significant segment for Baker Hughes's future earnings:

- TPS generates about 30% of Baker Hughes's revenues and about 35% of TPS' revenues are from the LNG market;
- The LNG installed base is around 430 MTPA (Million Tonnes per Annum), and it's expected that another 100–150 MTPA of capacity needs to be added in the next few years;
- Baker Hughes will generate service revenue from its installed base, and equipment revenue from new installations, repairs, and upgrades;
- The company sells upgrades to convert its gas turbines to run on hydrogen.

The TPS segment is also well set to take advantage of any opportunity in the emerging Hydrogen and Carbon Capture markets. Both these markets need extensive gas handling equipment similar to the LNG market that Baker Hughes dominates. As Hydrogen and Carbon Capture efforts develop and mature, Baker Hughes is among the best positioned to derive meaningful revenue from the supply of equipment and services. Such revenue could provide material upside to our current projections.

Current revenue depends on oil & gas industry spending, and, consequently, it will be impacted in the long term by falling oil & gas demand resulting from the energy transition. However, even the most aggressive energy transition scenarios forecast oil & gas demand peaking sometime in the next decade, and then declining by low single digits per year thereafter. Given the natural decline rate of oil & gas production of 5–8% per annum, it is estimated that the oil & gas industry might need to spend upwards of $9 trillion in cumulative real dollars to 2050 in order to meet expected oil & gas demand. This implies that there will be substantial revenues for the oil services industry from oil & gas extraction for the foreseeable future and, given the dynamics of an industry in transition, we expect the stronger players to gain share. We expect the company to generate prior levels of profitability from lower revenues due to substantial cost restructuring.

Business Ethics

While there are two outstanding investigations against Baker Hughes, we do not view the financial exposure as material. The US Department of Justice and Securities and Exchange Commission (SEC) are investigating Baker Hughes on its dealings with Unaoil. Unaoil acted as a middleman in the middle east and central Asia for most of the major oil & gas players and is charged with bribing officials in these countries to win contracts on the behalf of its principals. Baker Hughes is under investigation for its dealings with Unaoil in Iraq, though evidence of wrongdoing has yet to been found. Baker Hughes has recently strengthened its processes to guard against such issues. It undertook a comprehensive review of its Code of Conduct policies in 2019, and provides extensive training to its workforce on key elements, including its anti-bribery and corruption policy. The company's exposure to this issue is not likely to be material and we believe the company's provisions adequately reflect the potential risk as of now.

The SEC has also recently initiated an investigation of Baker Hughes regarding sale of products and services to projects that might have been impacted by US sanctions. In response, the company is conducting its own independent review of its controls and processes for complying with US sanctions.

The oil & gas industry operates in some challenging geographies and Baker Hughes's business practices compare well with industry peers.

Environmental Management

Baker Hughes has adequate focus on responsible usage of environmental resources. For example, Baker Hughes has:

- A target to reduce its Scope 1 & 2 emissions by 50% by 2030. The company is making good progress on this commitment and reduced its emissions by 31% in 2019 compared to its 2012 baseline;
- Adopted better water management as one of its goals in 2019 and is in the process of establishing appropriate metrics and targets.

Other ESG Issues

We do not believe that Baker Hughes has material risks in the other components of our oil services framework. The company is not overly dependent upon a scarce resource in its business operations. Baker Hughes has adequate reporting on its workplace safety, and its metrics are in line with the industry. General Electric (GE) is the largest shareholder in the company but is committed to reducing its stake over time. GE's stake and its intention to liquidate its position does create an overhang for the company's stock, but GE has proved to be a rational seller to this point.

Engagement with Baker Hughes

Pzena is one of the largest shareholders of Baker Hughes and we have held a position in the company for over three years. During this time we have had regular engagement with the management team, including meetings and calls with the CEO and/or CFO. In addition, we have engaged with divisional heads, the corporate secretary, and the chief sustainability officer. The focus of these discussions was primarily Baker Hughes's strategy and its response to near- and medium-term challenges. We had discussions on the company's response to the energy transition and have communicated our perspectives on the company's plans and strategies to management. We continue to engage with the company effectively on its material ESG exposures.

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