MARKET OUTLOOK M&A

Calm before the storm

While Q1 dollar volume was modest, 2017 will be a monster year for global chemical mergers and acquisitions

PETER YOUNG YOUNG & PARTNERS

This year is shaping up to be a record for chemical mergers and acquisitions (M&A) in terms of dollar volume, even as deal activity as measured by number of deals is moderating.

In this article, we will update the relevant economic and political environment, the chemical industry's equity market performance and equity issuance, the M&A results for Q1 with a comparison to last year and our predictions for the M&A and equity issuance markets for the rest of the year.

ECONOMIC, GEOPOLITICAL ENVIRONMENT

In our last article, at the end of February, we indicated that the global economic picture was stable overall, with specific countries going through difficulties. We also indicated there was a great deal of geopolitical turmoil and uncertainty due to tensions in the Middle East, problems in Asia due to North Korea and the South China Sea territorial dispute, upcoming elections in Europe, and concerns about what a Donald Trump presidency would do to trade and foreign policy.

Although many of these concerns remain, Trump has either been blocked from taking certain actions or has reversed many of his stances on foreign policy, the populist movement in Europe has lost momentum with the results of the French presidential election, the meltdown of the Chinese economy is clearly not happening in the near to medium term, and the global economy continues to experience a gradual overall recovery. Only the situation with North Korea has escalated.

EQUITY MARKET PERFORMANCE

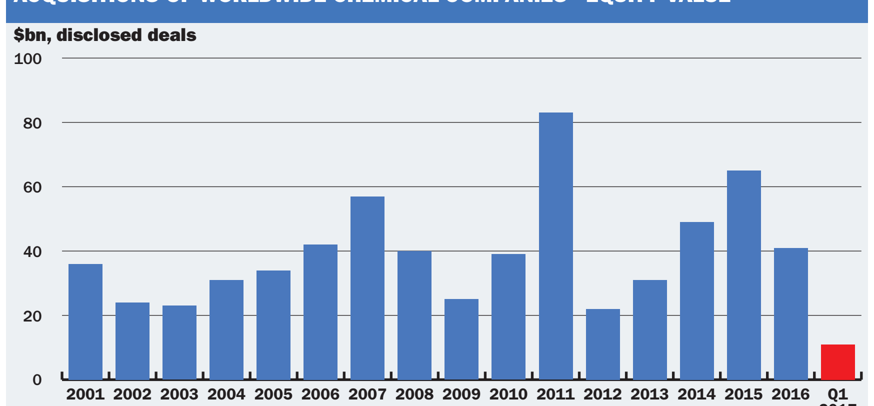
During Q1 2017, the global equity markets performed modestly well, with the S&P 500 increasing 4.6% and the FTSE 100 increasing by 2.0%.

US chemical companies did well, with the exception of fertilizer firms. The Young & Partners (Y&P) US Basic Chemicals index increased by 3.7%, the US Diversified Chemicals index gained 10.2%, the US Specialties index rose 9.3%, while the US/Canada Fertilizers index fell 4.9%.

All the Y&P chemical indices also did well in Europe. The Y&P European Basic Chemicals index increased by 4.0%, the European Diversified index by 11.0% and the European Specialties index by 9.0%.

Chemical company valuations have also been strong. By the end of Q1 2017, four of the seven Y&P chemical indices were trading at a price/earnings (P/E) premium to the overall market multiples and the rest were at very respectable multiples. This was also true for their EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) multiples.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES - EQUITY VALUE



SOURCE: Young & Partners

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Interestingly enough, the public EV/EBITDA valuations are currently equal to, or higher than the prevailing M&A valuations for both commodity and specialty chemicals. This is one of the reasons there have been a higher number of spin-offs and equity carve-outs since the beginning of 2016, with four completed in 2016 and three in just Q1 2017.

EQUITY ISSUANCE

The chemical equity issuance market was fairly weak in dollar terms in Q1, but strong in terms of numbers of offerings. $4.3bn of equity was issued from 26 offerings. This compares to $23.8bn of equity issued in all of 2016 from 81 equity offerings.

The totals continue to be dominated by Asian companies issuing in the Asian public markets for both IPOs and secondary offerings. Fourteen IPOs were completed in just Q1 2017 alone. All were Asian companies and virtually all were extremely small so that the total dollar volume was only $0.8bn.

At this pace, we expect to exceed the annual record number of IPOs set last year when 20 IPOs were completed, all by Asian companies. But the dollar volume will be low.

GLOBAL M&A ACTIVITY

Last year, the investment banking community expected a very high level of M&A in absolute terms and relative to the $65bn and 93 deals that were completed in 2015. That was not our opinion at any point during 2016, which we expressed in our public statements, and the year ended with only $41bn in deals in 94 completed transactions over $25m in size.

Members of the investment banking community had various reasons why they thought 2016 volume was going to be much higher. Certainly one reason was their tendency to assume that announced deals would close and in the timeframe that was announced. For example, most thought the Dow/DuPont merger was going to close in Q3 2016.

Although Young & Partners fully expects 2017 to end up with a record dollar volume in M&A, we do not expect a record number of deals. Further, Q1 2017 was a continuation of the moderate level of M&A in 2016. Only $11.2bn worth of deals closed in Q1 2017, a slightly higher annualised pace than last year. In terms of number of deals, Q1 was modestly weaker, with only 21 deals completed compared to 96 deals in all of 2016 (24 deals on average on a quarterly basis). These are healthy numbers, but they are not as high as the previous peak level in 2014.

Why do we think we will hit a record dollar volume in 2017? It is almost certain that one or more of the announced mega deals will close this year. The deals announced but not closed as of the end of Q1 were a massive $270bn (42 deals). A number of these deals are so large that just one or two could drive a record dollar volume for the year. We believe that it is highly likely that the ChemChina/Syngenta and Dow/DuPont deals will close, for example.

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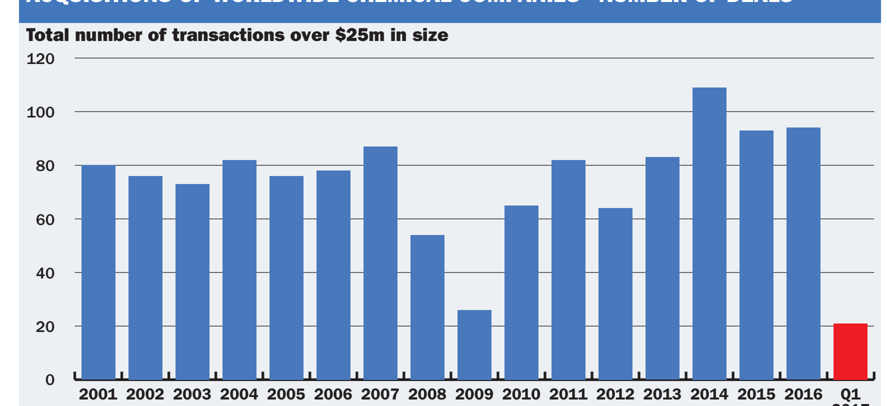
Note that we do not expect all of these deals to close in 2017, and some will not close at all due to antitrust considerations. Also note that although a mega deal represents a large dollar amount, it is still just one deal. It is our expectation that the number of deals completed in 2017 will be well below previous record highs.

There are three other trends worth noting. First, Asia continues to dominate the M&A scene with 43% of the deals closed in Q1 involving businesses located in Asia, and mostly in China. The rationale is simple. China's chemical industry is going through a period of consolidation. Part of this trend is a natural occurrence when high growth emerging markets start to slow down and part is being orchestrated by the Chinese government to reduce overcapacity.

The second trend is that private equity firms continue to struggle to regain the market share on the buy side that they lost three years ago. Even though they have substantial amounts of equity to invest and interest rates are still low, they are reluctant to invest in Asia/China, and they heavily favour the specialty chemical industry where competition from strategic buyers has been high. In Q1, private equity market share was only 5% of the number of acquisitions and 8% of the dollar volume.

The third trend is that commodity and specialty chemicals continue to follow different M&A cycles. In 2016, commodity chemicals started their recovery (valuation and volume) from their severe 2015 trough and specialties fell off their 2015 peak. In Q1, commodity and specialty chemicals appear to be continuing to follow their individual M&A cycles.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES - NUMBER OF DEALS



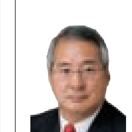
SOURCE: Young & Partners

OUTLOOK

In summary, we believe that, barring a major economic or geopolitical disruption, 2017 will be a solid year for the chemical industry overall in terms of profitability and strong public valuations in the Western equity markets. Of course, conditions in individual countries and regions will differ from the overall picture, both in positive and negative ways. Overall growth will continue to be a challenge and there will continue to be overcapacity situations in certain countries such as China.

M&A on a global basis will continue to be dominated by Asia and private equity will continue to struggle to regain their normal 20% to 25% market share as long as specialty chemical valuations are high and Asia located businesses dominate the M&A market.

We feel strongly that 2017 will be a record year for chemical M&A in terms of dollar volume as a number of mega deals will close. However, the number of deals that close will be moderate and well below previous records. ■



Peter Young is president and managing director of Young & Partners which is completing its 22nd year as a focused chemical and life science industry investment bank serving the M&A, financing and financial advisory needs of clients in North America, Europe, Asia and South America. Its focus is on providing in-depth industry expertise, excellent technical investment banking skills, and senior management on every transaction, without the conflicts of interest inherent in most other investment banks. Peter Young can be reached at **pyoung@youngandpartners.com** or 212-682-5555. **www.youngandpartners.com**