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Capital markets shift amid volatility

Debt issuance, especially on the investment grade side, should continue to be strong while IPOs in the West will remain challenging despite high public equity prices

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In our last article on chemical capital markets, we pointed out that the chemical industry was not being treated in a consistent manner by the equity and debt markets. We commented on the strange behavior of chemical IPOs (initial public offerings) that has been in sharp contrast with public trading values. We also explained the overall strength of the debt markets, where the chemical industry is very much favoured. Although there have been occasional bumps in the high-yield market, the access to low-cost debt has been strong.

OVERALL EQUITY MARKET

During the first half of 2016, equity markets got off to a rocky start, plunging in January with some recovery in mid-February. Global markets also saw a drastic dip in the wake of the Brexit decision but quickly recovered.

By the end of Q3, the S&P 500 had increased by 7.7% for the year, while the FTSE Eurotop 100 increased by 13.2%.

The global equity markets will continue to be volatile, driven by the long list of economic, financial and geopolitical stresses, including the recent outcome of the US presidential election. However, the global flow of investment funds will continue to drive investors to the US and, to some extent, European equity markets as long as alternative places to invest continue to be less attractive.

How about interest rates? Interest rates on a global basis have continued to be low, with some countries issuing debt at negative interest rates. Although the US Federal Reserve increased rates very slightly earlier this year and may increase again in December, everyone realises that any increase will be extremely modest and will be overwhelmed by the low and negative interest rates elsewhere. Any increase will have a modest impact, although it will strengthen the US dollar.

The end result has been a relentless parking of funds in equity markets, other asset classes such as real estate, and safe haven debt such as US, Japanese, German and Swiss government and investment grade debt.

Emerging market equities, and to a certain extent select European equities, have been much less appealing to investors. High-yield debt is going through its own up-and-down challenges as desire for yield has clashed with investor concerns about default and other risks, especially since such a large portion of the high-yield issuers are shale gas and other energy companies.

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Stock markets have favoured the chemical sector due to strong earnings fundamentals

CHEMICAL STOCK PERFORMANCE

The stock market has been favouring the chemical sector due to the industry's strong earnings fundamentals. As a result, the industry has been trading at a premium to the overall market. There has been a moderate weakening of valuations recently.

With the exception of fertilizers, US chemical companies did well. Our Y&P US Basic Chemicals index increased by 5.8%, US Diversified Chemicals was up 4.9% and US Specialties gained 15.7% while US/Canada Fertilizers decreased by 9.9%.

In Europe, both basic and specialties did well. Our Y&P European Basic Chemicals index increased by 9.7% and European Specialties by 12.5% while European Diversifieds decreased 2.3%.

How about valuations? As of the end of 2015, six of the seven Y&P chemical indices were trading at valuations roughly equal to the overall market. By the end of Q3 2016, three of the seven Y&P chemical indices were trading at a last 12 months (LTM) price/earnings (P/E) premium to the market multiples. Fertilizers continue to suffer on negative fundamentals.

Even with some retreat in stock price performance, overall valuations of chemical companies are very still healthy.

Fortunately for chemical CEOs, there are far fewer shareholder activists going after new chemical industry targets. Given the high valuations of chemical companies, the fact that trading values exceed M&A values on average,

CHEMICAL IPOS YTD THROUGH Q3 2016

Company	Country	Amount
Suzhou Sunmun Technology	China	$46.5m
Wuxi Honghui New Materials Technology	China	$39m
Zhejiang Jiaao Enprotech	China	$33m
SKSHU Paint	China	$61m
ST Pharm	South Korea	$118m
Guangdong Dazhi Environmental Protection Technology	China	$31.4m
Shanghai Yahong Moulding	China	$25.9m
Advanced Enzyme Technologies	India	$61.1m
Sanxiang Advanced Materials	China	$26.5m
Sichuan Dowell Science and Technology	China	$41.7m
Guangdong Redwall New Materials	China	$67.5m
Shandong Head	China	$35.7m
Jiangsu Kuangshun Photosensitivity New-Material	China	$34.4m
PT Aneka Gas Industri	Indonesia	$65.1m

SOURCE: Young & Partners

and the self-initiated restructuring activities of the companies themselves, the undervalued company argument has been harder to make.

CHEMICAL DEBT AND EQUITY FINANCING

Similarly, the debt markets overall have been healthy, with the exception of sporadic choppiness in high-yield markets.

Global non-bank debt financing was $33.7bn through Q3 2016 versus $28.5bn for all of 2015, a major increase on an annualised basis. Investment grade debt was the major reason, with $28bn issued through Q3 2016 compared to $20.1bn for all of 2015.

This was offset by moderately weaker high-yield debt issuance. High-yield debt issuance was only $5.7bn through Q3 2016 versus $7.7bn for all of 2015. This year started out weak, but showed improvement more recently.

Through Q3 2016, $17.3bn of equity was issued via 56 offerings. This is a large number and a significant increase on an annualised basis versus $6.5bn issued for all of 2015.

However, these were dominated by Asian companies issuing in the Asian public markets for both initial public offerings (IPOs) and secondary offerings.

CHEMICAL IPOS

Private chemical businesses have had great difficulty going public. Our data going back to 1980 shows extremely low numbers and dollar amounts of IPOs each year.

Over that 34-year period, the highest dollar amount was $5bn in 2006 and the highest number of IPOs was 14 in 1995. For most of the years, the dollar volume was under $1bn and the number of IPOs between zero and three – astonishingly low numbers.

This year has been different. The number of IPOs has hit the historical peak of 14 in just three quarters. However, all of the IPOs were extremely small and all were Asian companies. The total dollar volume through Q3 was just $717m. The Asian, and principally Chinese, IPO market has been strong across many sectors and at attractive valuations.

Sadly, the IPO market is at a virtual standstill for Western companies, and investors continue to have a schizophrenic view of existing public chemical shares versus IPOs of chemical companies.

TRADING VERSUS M&A VALUATIONS

The inversion of the chemical trading and M&A values we have observed for some time now continued through Q3 2016. The "flow of funds" explanation for the high Western public equity valuations is part of the rationale. But it is also true that investors in public chemical companies value them on a different basis from corporate acquirers buying an entire company.

This will ultimately reverse itself, but only if a number of major macro factors change.

In the meantime, this has given public chemical companies an attractive currency to use to acquire private companies and has increased the number of corporate spin-offs. Unfortunately, not all of the spin-offs have done well for a host of reasons such as the relative valuation of specialties versus commodities, and the financial critical mass phenomena that we first documented years ago.

STOCK MARKET OUTLOOK

We believe that on a global equity basis, the "flow of funds" macro trend will continue to drive investors to the US and, to some extent, the European equity markets as long as the alternative investments continue to be unattractive. However, we will see increased volatility due to the outcome of the US elections and the rising economic and geopolitical risks around the world. We also believe that the larger Asian equity markets in Japan, China and India will hold up, but may also have greater volatility.

Chemical companies are finding it challenging to grow their revenues and earnings at the rate they have hoped. If there is a major downturn in global economic and financial conditions and/or a jump in global interest rates, we would expect the earnings and valuations of industrial companies, including chemicals, to suffer. We do expect to see some continued slippage in chemical industry valuations versus the overall market, but from the current strong base.

DEBT AND EQUITY FINANCING OUTLOOK

Investor demand for investment grade debt will continue to be strong. Issuance will be driven more by issuer needs rather than investor demand, with M&A related financing driving volume.

High-yield debt issuance will continue to show improvement over the very weak conditions in the second half of 2015.

Equity financing volume will continue to be modest given the market's historic bias against the chemical sector and the sector's limited need for equity capital.

The IPO market is at a virtual standstill for Western companies, and investors continue to have a schizophrenic view of existing public chemical shares versus IPOs of chemical companies

However, equity issuance, both secondary and IPO related, will continue to be dominated by Asian issuers as Chinese and other Asian companies seek liquidity and funding on the Asian stock exchanges. Western IPOs will continue to be dormant.

OUTLOOK SUMMARY

In summary, we believe equity and debt markets will continue to have sporadic periods of volatility. We expect chemical public valuations to continue to erode moderately from a high base and debt to be easily available. IPOs will be few and far between in the West and healthier, although very small in Asia (principally China). Investment grade debt issuance will continue to be strong and issuer driven, and high-yield issuance will be volatile. ■

Peter Young is president of Young & Partners, an international investment banking firm that focuses on chemical and life science industry M&A, financial advisory and financings. Young & Partners has served a global client base of companies in Europe, North America, Latin America and Asia for the last 21 years.