Capital market contradictions

Chemical companies are trading at healthy valuations but IPOs will remain scarce. Debt is still available and investment grade financing has been increasing steadily

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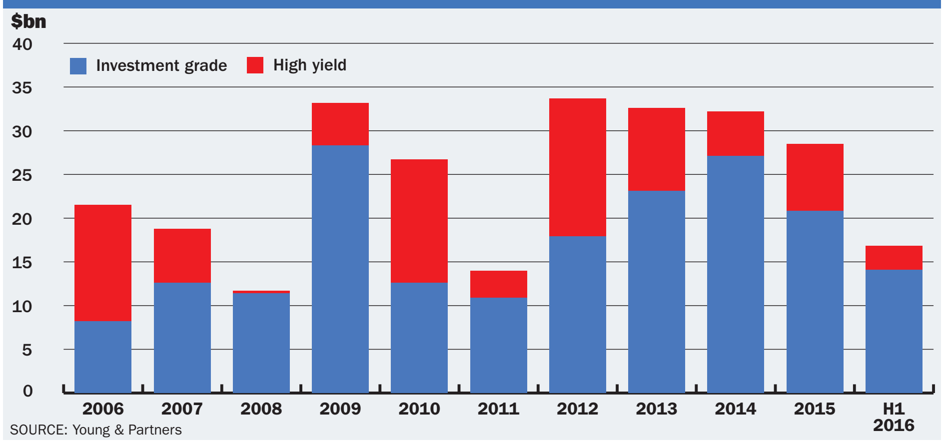
In our last article on capital markets, we pointed out that the chemical industry was not being treated in a consistent manner by the equity and debt markets. Although the stock market currently loves public companies in the sector and has been rewarding them with high valuations and easy access to the secondary equity issuance markets, they have been treated like lepers when it comes to initial public offerings (IPOs).

The only area where they have been treated in a consistent fashion has been in the debt markets, where the industry is very much favored.

WORLDWIDE CHEMICAL DEBT FINANCING



SOURCE: Young & Partners

EQUITY TRADING MARKETS

Global equity markets saw a drastic dip in the wake of the Brexit vote on 23 June, but quickly recovered. By the end of June, the S&P 500 had increased by 4.3%, while the FTSE Eurotop 100 increased by 6.7%.

In an environment of high economic stress and uncertainty, one can certainly understand why the markets dropped. Yet they have since regained all those losses. The important question is why.

Although the global equity markets have been and will continue to be volatile, we believe the macro flow of funds trend will continue to drive investors to the US and partially Europe as long as the alternatives continue to be unattractive.

How about interest rates? Interest rates on a global basis have continued to be low, with some countries issuing debt at negative rates. Although indications are that the US Federal Reserve might raise rates again before the end of the year, everyone realises that any increase will be extremely modest. Yet it would strengthen the US dollar.

The end result has been a relentless parking of funds in the safe haven 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 selected European equities, have been much less appealing to investors. High yield debt is going through its own challenges as desire for yield has clashed with investor concerns about default and other risks, especially as a large portion of the issuers are shale gas and other energy companies.

CHEMICAL STOCK PERFORMANCE

The stock market has been favouring the chemical industry due to the industry's strong earnings fundamentals.

With the exception of fertilizers, US chemical companies did well. The Young & Partners (Y&P) Basic Chemicals index increased by 1.7%, the Y&P US Diversified Chemicals index increased by 3.6%, the Y&P US/Canada Fertilizers index decreased by 9.0% and the Y&P US Specialties index increased by 14.1%.

Except for specialties, European chemical companies did not do well. Our Y&P European Basic Chemicals index decreased by 3.1%, the Y&P European Diversifieds index decreased by 7.0% and the Y&P European Specialties index increased by 3.1%.

How about valuations? Over the last few years, chemical valuations have been at a premium but with the mixed chemical industry performance in the first half, only three of the seven Young & Partners chemical indices were trading at a last 12 months (LTM) P/E (price/earnings) premium to the market. However, overall valuations are still very healthy.

One source of relief for chemical company CEOs is that there have been fewer firms in the sector targeted by shareholder activists. Given the high valuations, the fact that trading values are exceeding M&A values on average, and self-initiated restructuring activities of the companies themselves, the undervalued company argument has been harder to make.

DEBT AND EQUITY FINANCING

Similarly, the debt markets have been healthy, with the exception of sporadic choppiness in high-yield markets. Global non-bank debt financing was $16.8bn in the first half of 2016 versus $28.5bn for all of 2015, a modest increase on an annualised basis.

Investment grade debt was a major reason for the increase with $14.1bn issued in the first half of 2016 compared to $20.1bn for all of 2015. This offset the weaker high yield debt issuance of $2.7bn in the first half of 2016 – well off the pace of $7.7bn issued in 2015.

Equity issuance was modest at $6.1bn in the first half on 23 equity offerings but a significant increase in pace from the total $6.5bn issued in 2015.

CHEMICAL IPOS

Chemical businesses have had great difficulty going public. The number of chemical IPOs has been very limited for decades. Our data going back to 1980 show extremely low numbers of IPOs each year and dollar amounts that are almost rounding errors when compared to the debt and M&A markets.

The highest numbers were less than $5bn in 2006 and only 14 IPOs in 1995. For most of the years, the dollar volume was under $1bn and the number of IPOs between zero and three. This has continued this year where there were only four IPOs in the first half (all Asia companies) totalling just $300m.

Unfortunately, investment banks have regularly encouraged chemical companies to explore going public when the overall IPO market has been strong, but this advice has been flawed. Why then have banks pitched IPOs so aggressively? That is a question every private chemical company who has thought about going public or tried and failed should ask themselves.

TRADING VERSUS M&A VALUATIONS

The inversion of the average trading and M&A chemical values continued through the first half of 2016. The "flow of funds" explanation for the high Western equity valuations is part of the rationale. 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 make acquisitions 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 the "flow of funds" macro trend will continue to drive investors to the US and partially to the European equity markets as long as the alternatives continue to be unattractive. We also believe that the larger Asian equity markets such as Japan, China and India will hold up, but may have greater volatility.

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. But we do not expect that to happen.

DEBT AND EQUITY FINANCING OUTLOOK

Investment grade debt volume will be driven by issuer demand which continues to be favourable. M&A related financing will likely drive volume.

The high-yield debt market has improved but whether it can stay at this relatively stable issuance level for chemicals will depend heavily on whether the default rates in the energy sector surge and on the economic risk profile going forward.

Equity financing volume will continue to be modest and issuance will be dominated by Asian companies.

In IPOs, history will repeat itself and the numbers will be small. And, if the first half is an indication, activity will be concentrated in Asia.

We expect chemical public valuations to stay high for the moment and debt to be easily available. But IPOs will be few and far between and seemingly at odds with investors' love affair with existing public chemical companies. Investment grade debt issuance will continue to be strong and issuer driven, while high yield will be stable, but fragile. ■

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. The firm has served global clients for 21 years.