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Chemical M&A – below the surface

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Many M&A mistakes made are the result of not looking deeply enough under the surface

Nuances in the mergers and acquisitions market matter, especially when evaluating portfolio moves. 2018 looks to be another strong year but be aware of the differences

PETER YOUNG YOUNG & PARTNERS

If one reads the comments in chemical publications about M&A, it is increasingly true that one can be misled. Some of these pronouncements are based on having the wrong facts, but many are the result of not looking deeply enough beneath the surface. Unfortunately, advice and decisions based on these views can lead to unsuccessful actions and strategies.

The following are some examples of views widely held and expressed by investment bankers, consultants and industry experts:

- The M&A market has hit historic highs on all fronts in terms of the numbers of deals and their dollar volume.
- It is a seller's M&A market and valuations are exceptionally high across the board, making it a good time to sell and paramount to bid high in order to win.
- Private equity firms are well funded and are major players in the M&A market as buyers.
- Public valuations of chemical companies have escalated as shares have performed well, which is having an effect on the M&A market.

And then there is Young & Partners' view:

- The M&A market was strong last year, but the number of deals completed was flat to down compared with 2016 and 2015.
- The closing of just a few mega deals drove the total dollar amount to historic highs. Without these deals however, the dollar volume was solid, but slightly down and definitely not spectacular.
- The chemical M&A market is not at high valuations across the board. In fact, it is really a collection of many market segments moving in different directions. It is a seller's market in specialty chemicals, with high valuations and volumes, but quite the opposite in commodity chemicals.
- The Asian market has become dominant in terms of its share of businesses sold. It is following a different drum beat, with unusually high levels of activity and heavy consolidation.
- Private equity firms are well funded and can still borrow at low interest rates, but are struggling to complete M&A deals. Reluctant to acquire Asian or commodity chemical companies, they are forced to compete in the specialty chemical market in the West against strategics.
- On the sell side, private equity firms are having no problems selling pure play specialty businesses for high prices, but are struggling to sell commodity and combination businesses. Many divestitures by private equity firms are to other private equity firms.
- The higher public valuations are inhibiting the acquisition of public chemical companies and encouraging spin-offs, but only in a limited way.
- On the other hand, high public valuations are giving public chemical companies a valuable equity currency to do deals financed partially by high value equity either via secondary offerings or the use of shares in the transaction.

THE HARD NUMBERS

Young & Partners recently completed its analysis of chemical M&A trends for 2017 and the outlook for 2018. The following are the results and observations.

The M&A market in dollar terms increased steadily from the 2012 trough of \$22bn, to \$31bn in 2013, \$49bn in 2014 and \$65bn in 2015. This steady increase changed in 2016 when the pace slowed considerably and only \$42bn worth of deals were completed.

Last year, this changed dramatically when a record \$154.6bn worth of deals closed. The surge was driven by three mega deals – Dow/DuPont, ChemChina/Syngenta, and Sherwin-Williams/Valspar. So the view that the total dollar volume last year was enormous is correct. Looking past the headlines, however, the picture can look quite different.

In reality, without the three mega deals, the dollar volume and number of deals actually fell compared to 2016. The three deals alone totalled \$113.6bn. Without them, the total would have been \$41.0bn. In terms of number of deals, 2017 was down slightly, with 89 deals completed compared with 95 in 2016.

In terms of location for M&A targets, Asia/Rest of the World dominated in 2017, accounting for 47.2% of deals worldwide. This dominance has been true for the last few years. It is impossible to find anyone who has pointed this out other than Young & Partners. Many Asian deals were consolidation transactions in China as the government encouraged mergers to reduce the number of competitors. Interestingly, as Asian targets made up 47.2% of the market, that means all of the rest of the world was squeezed into the remaining 52.8%.

Because of private equity's bias against Asian deals and commodity chemicals, its low market share of acquisitions continued. In 2017, they were the buyers for only 9.0% of the number of acquisitions and 3.0% of the dollar volume.

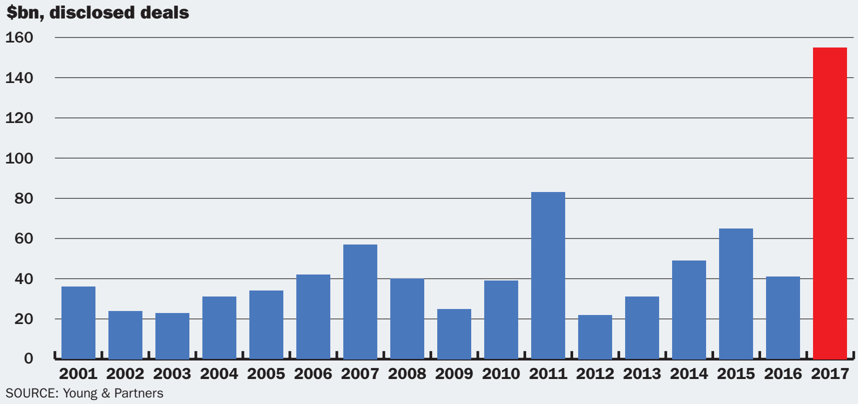
Private equity was moderately more active on the divestiture side, but not as high as you would think. In 2017, they sold $7bn worth of chemical assets or 4.5% of the total market. In terms of divestitures, they had a 13.5% share of the total number of the deals in 2017. So, they are divesting, but not at a high pace and the deals are not that large.

The chemical M&A market is not at high valuations across the board. In fact, it is really a collection of many market segments moving in different directions

In addition, the ratio of commodity to specialty deals has shifted, with specialties accounting for 58% of the deals. The two are on very different M&A cycles. Specialties are hot and commodities are not in terms of both valuations and M&A volumes.

Although high public valuations should have encouraged more spin-offs, only one was completed in 2017, down from three in 2016. This is surprising because high public valuations and tax laws make spin-offs attractive relative to divestitures. However, there are many factors that go into deciding whether a spin-off is viable that can offset the valuation and tax benefits.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES - EQUITY VALUE



SOURCE: Young & Partners

OUTLOOK FOR 2018 AND BEYOND

We expect 2018 will be a strong year in terms of M&A dollar volumes. Assuming the likely stability of the global economic/financial environment, Young & Partners believes the number of deals in 2018 will be similar to 2017, but the dollar volume will depend heavily on which mega deals close.

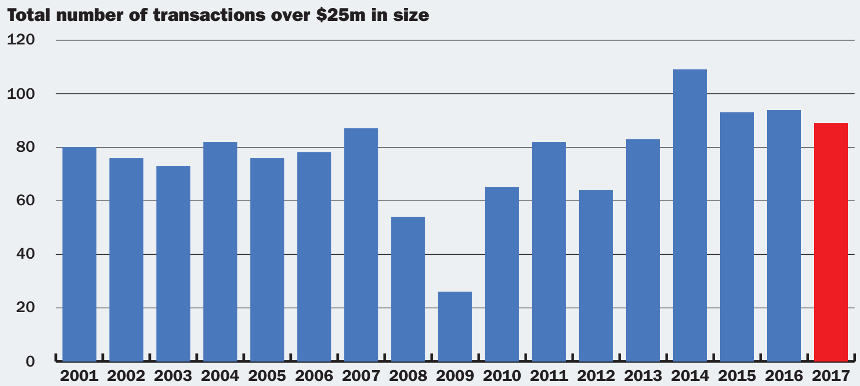
This is supported by the year-end pipeline of deals. The value of deals announced but not closed as of 31 December 2017 was huge at $144.1bn (77 deals). Most of this was driven by Bayer/Monsanto, Praxair/Linde and Potash/Agrium. Postash/Agrium closed on January 1, 2018. The others are moving forward, but are under heavy antitrust review.

Asia will continue to dominate with regard to the location of businesses sold.

In specialty chemicals, valuations and deal volumes peaked in 2015 and fell in 2016 as the M&A market cycle moved past the peak. Valuations and deal volume came back strongly in 2017 and will likely stay high in 2018. Commodity chemical M&A valuations and deal volumes fell to trough levels in 2015, surged in 2016, and fell again in 2017. We believe that commodity chemical M&A valuations and deal volumes will remain weak in 2018.

Private equity firms will not materially increase their share of the market as the valuations of specialty chemical companies stay high and their reluctance to acquire Asian and commodity chemical companies will keep their share of the market low.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES - NUMBER OF DEALS



SOURCE: Young & Partners

IMPLICATIONS FOR MANAGEMENT

It is critical that senior management looks below the surface when it seeks the right information to make decisions. Managers should challenge what investment bankers say about M&A, and be suspicious of advice that would create more investment banking activity and fees.

Since various parts of the market are moving in very different directions, it it vital to buy or sell a business based on the specific dynamics of the relevant market and what the real valuations are.

Only sell to a private equity firm if it can produce the best value for you. Be wary of investment banks that have a large "financial sponsors" group and the potential conflicts of interest when it comes to their priorities.

Expect Asian companies to continue to dominate the Asian M&A market, but do not worry about it unless your company wants to participate in the Asian M&A market.

Try to leverage the high public chemical company values to work in your favour, and not vice versa. ■

Peter Young is president and managing director of Young & Partners a focused chemical and life science industry investment bank serving clients in North America, Europe, Asia and South America. Its focus is on providing in-depth industry expertise, technical investment banking skills and senior management. Visit www.youngandpartners.com. Peter Young can be reached at *pyoung@youngandpartners.com*