Chemical M&A rapidly shifting

The market is splintering, with commodity deals already past the peak while specialty transactions flourish. Expect a buyer's market ahead

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The M&A market has shifted heavily and is moving towards a buyer's market

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In a September 2015 article in *ICIS Chemical Business* we indicated that the chemical mergers and acquisitions (M&A) market was very healthy, but there were signs that it was peaking, with different segments moving in different directions.

This view was based on our work with clients, our historical data on deals up to the end of Q2, and the pipeline of deals at the time. In this article, we will share the M&A market results to the end of Q3 2015, the underlying trends, and the outlook. Some of the important questions we will address include:

- What happened in the first three quarters and what is the outlook for the rest of the year and 2016?
- What factors are driving the market activity?
- Are there differences by region, type of chemical, or type of buyer?
- How are financial buyers faring as buyers?
- Have valuations peaked?
- What are the implications for buyers and sellers of businesses?

GLOBAL ENVIRONMENT

M&A activity continues to be heavily influenced by the overall business and financial environment. The global economic situation remains difficult in most of the major countries except in the US, China, Germany and India.

This has been true even with the benefits of the lower price of oil and substantial monetary stimulus by the central banks in Europe, Japan and China. A global economic recovery has been elusive. Plus the Chinese economy continues to slow and the lower price of oil is damaging the economies and financial positions of countries dependent on high oil prices (Russia, Iran, Venezuela, Saudi Arabia, and many other OPEC countries).

The chemical industry continues to perform solidly, but there have been pockets of demand weakness in various parts of the world. In certain sectors, such as chemicals serving the oil and natural gas drilling industries, demand has plunged. But cash flows continue to be strong overall and chemical companies are continuing to look for ways to grow.

On another front, the stock market fell in August and September and has been volatile ever since. This did not affect chemical company earnings and cash flows, but it has had an impact on the valuations of many chemical companies and a direct effect on the M&A market.

GLOBAL CHEMICAL M&A ACTIVITY

Prior to this year, the M&A market has been increasing in substantial steps. From the trough of $22bn in 2012, the market jumped by $9bn to $31bn in 2013, and by another $18bn to $49bn in 2014.

That has not been the case this year. On an equity value basis, $31bn of deals greater than $25m in value were completed globally in the first three quarters of 2015 ($17bn in Q1, $7bn in Q2, $9bn in Q3). This is equal to the $31bn completed in the first three quarters of 2014, so we are at the same place as we were at the same point last year from a dollar point of view. On an annualised basis, the number for 2015 would be $41bn, well off the $49bn total in 2014.

In terms of numbers of transactions, in the first three quarters of 2015 there were 70 deals completed versus 64 deals completed in the first three quarters of 2014, putting the market at a slightly higher pace through three quarters.

However, the number of commodity chemicals deals has slowed and the number of specialty chemical deals has surged. In addition, since there was a massive surge in deals completed in Q4 2014, it is not a given that we will match the full 2014 total of 108 deals.

In a nutshell, we are not going to have a large increase in dollar volume this year and we almost certainly will not match last year's number of deals.

The impact on chemical companies will vary dramatically depending on whether they are a buyer or a seller and what part of the market they are participating in

Although the value of deals announced but not closed as of 30 September 2015 was $36.8bn comprising 34 deals compared to $22.8bn (27 deals) as of 30 June 2015, only $18.5bn worth of deals have closed or are expected to close in Q4.

Any increase in the dollar volume is likely to depend heavily on the long delayed $17bn close of the acquisition of Sigma-Aldrich by Merck KGaA.

The Asia/Rest of the World (ROW) category has been in the lead for M&A for the past seven years for a number of obvious reasons, ranging from the attractiveness of the growth in Asia to the gradual maturing of Asian companies.

Asia/ROW's lead widened in the first three quarters of 2015 in terms of where deals were completed. That region accounted for a record 54% of deals completed worldwide. The US and Europe were tied for a distant second place with 23% each.

PRIVATE EQUITY

Financial buyers accounted for 13% of the total number of deals completed in the first three quarters of 2015. This is a loss of share compared to the historical norm. However, at 23% on a dollar volume basis, financial buyers, on average, appear to be doing larger deals than the industry average.

When financial buyers have pursued acquisitions not of interest to strategic buyers or bolt-on acquisitions for existing portfolio companies where there are synergies, they have been competitive. However, the financial buyers have been at a disadvantage elsewhere. Deals have shifted to Asia, where financial buyers are less comfortable investing.

The recent increases in borrowing costs and limits on total borrowing have taken some of the ammunition away from financial buyers. High-yield interest rates have now increased in Q4 for many borrowers, regardless of their size.

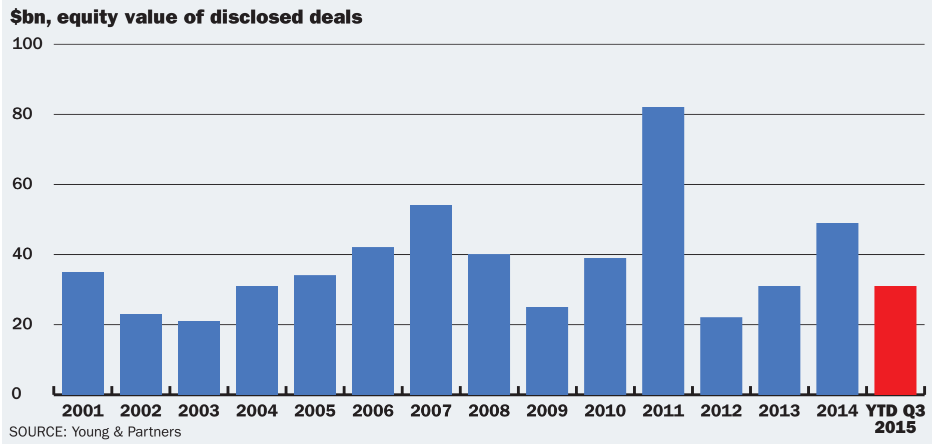
Even if they pursue acquisition targets that the strategic buyers are not interested in, they are still facing heavy competition from other financial buyers.

VALUATIONS

Valuations escalated last year, benefiting sellers. This was driven by greater demand than supply, the cyclical peak in the M&A market, and the unusually high prices being paid by financial buyers who were able to borrow at high multiples of earnings before interest, tax, depreciation and amortisation (EBITDA) and very low interest rates.

Through the first three quarters of 2015, the valuations overall continued to be high, but the market is splintering, with valuations still high in specialty chemicals, but well below last year's valuations for commodity chemicals. The impact on chemical companies will vary dramatically depending on whether they are a buyer or a seller and what part of the market they are participating in.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – EQUITY VALUE



SOURCE: Young & Partners

M&A OUTLOOK

We expect dollar volume for all of 2015 to be healthy and exceed last year's total, but by \$5bn-\$10bn, well off the \$19bn increase from 2013 to 2014. The number of deals completed in 2015 will also be very healthy, but will not reach the record 108 deals completed in 2014.

Next year will likely be flat compared to this year. Demand for growth and the build-up of cash will continue to be drivers of deal demand by strategic buyers. Unused funds will continue to be the driver of deal demand for financial buyers, but higher interest rates and heavy competition from strategic buyers will continue to take their toll except where strategic buyers are not interested. In addition, the market has slowed in the US and Europe as the M&A market has shifted heavily and will continue to shift towards Asia.

Global uncertainties will continue to hold down the number of very large deals, except in a few instances where there is a strategic imperative to reposition the acquiring company, as in the case with the Merck KGaA acquisition of Sigma-Aldrich.

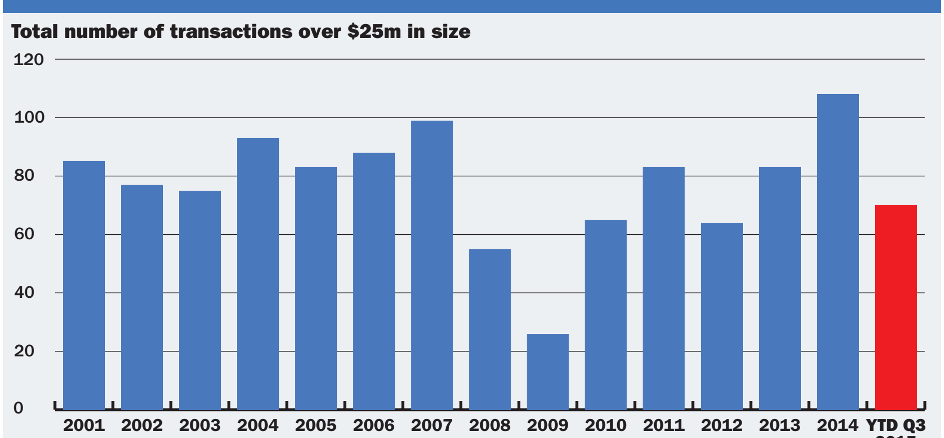
IMPLICATIONS FOR MANAGEMENT

First and foremost, the decision whether this is still a good time for chemical companies to sell non-strategic assets and for private equity firms to sell portfolio companies that they believe are mature from an ownership point of view will depend heavily on what business one is thinking of selling, where it is located, and when one starts the sale process.

The peak continues to hold in specialty chemicals. In commodity chemicals, we are already past the peak. In a variety of specific markets and situations there is still time to sell before valuations fall. It is particularly important to know if it is the right time to sell and to get advice that is not just "conventional wisdom".

As the chemical M&A market moves further through and past this ageing peak, it will be increasingly easy to buy at more attractive prices, and the market will favour buyers. ■

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – NUMBER OF DEALS



SOURCE: Young & Partners

Peter Young is president and managing director of Young & Partners. Young & Partners is currently in its 20th year and is 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 attention to every transaction, without conflicts of interest. It has successfully completed a large number of investment banking projects for companies around the world.
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