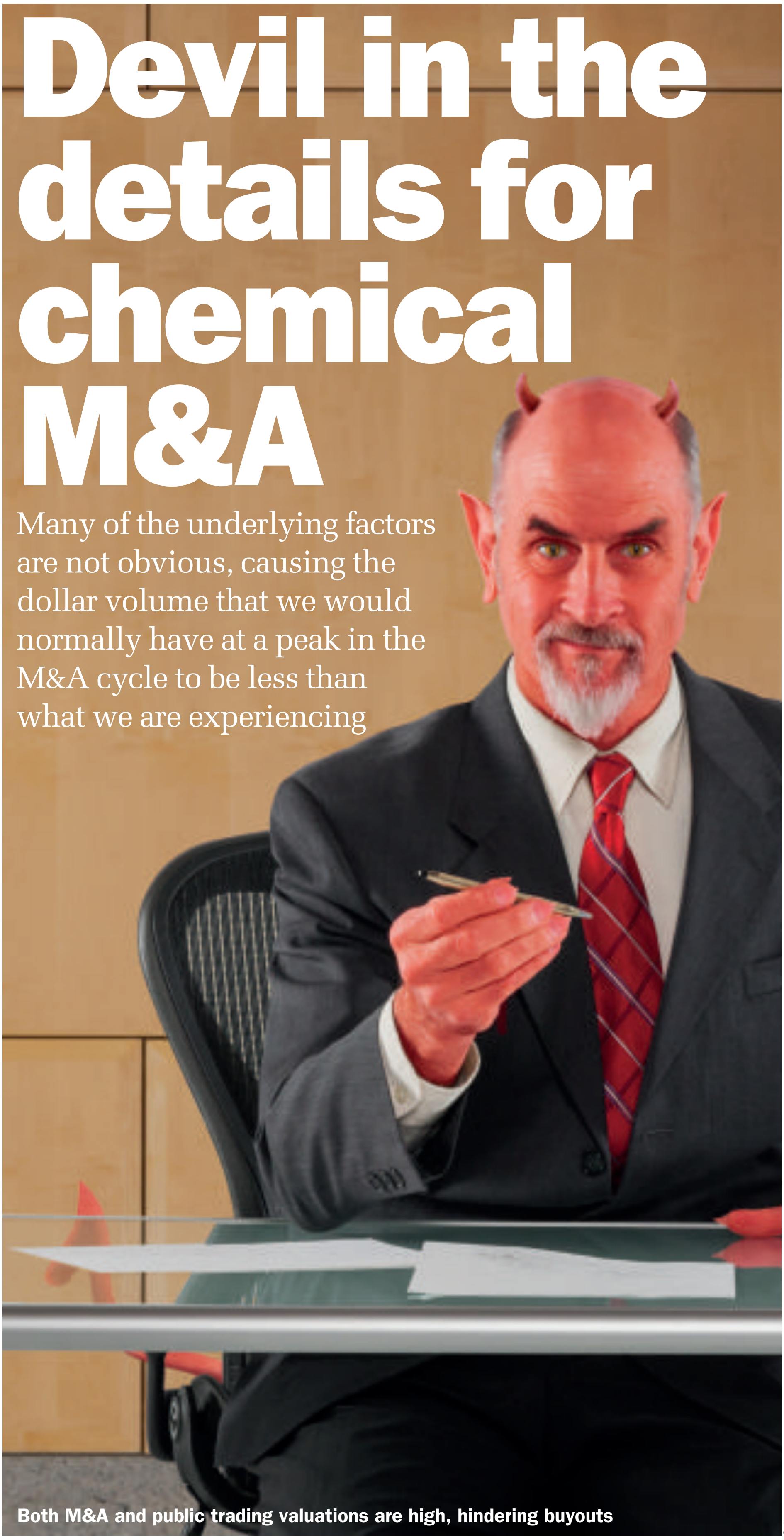
Devil in the details for chemical M&A



Many of the underlying factors are not obvious, causing the dollar volume that we would normally have at a peak in the M&A cycle to be less than what we are experiencing

Both M&A and public trading valuations are high, hindering buyouts

Getty

PETER YOUNG YOUNG & PARTNERS

The chemical mergers and acquisitions (M&A) market recovered in 2013 with $31bn in completed deals, which was 41% greater than the $22bn total in 2012. There was also a similar rebound in the number of transactions with 83 deals completed in 2013, a 30% increase from the previous year.

The pace of M&A deals has continued through the first quarter with $8bn of completed transactions.

Most of the drivers are conventional – strategic changes that are driving portfolio changes, low interest rates and easy availability of M&A financing, strong cash flows, and a strong desire to grow faster than organic growth among chemical companies which hold substantial amounts of excess cash.

But the devil is in the details as many of the underlying factors are not what you would think and the natural dollar volume that we would normally have at a peak in the M&A cycle is greater than what we are experiencing.

What are these unusual underlying factors and what are the implications for strategic and financial buyers and sellers? What can we expect for the rest of this year and beyond?

M&A AND TRADING VALUATIONS HIGH

Normally when M&A market valuations reach peak levels, where they are now, an enticing gap opens up and the number of public company acquisitions increases.

However, with the valuation of public chemical companies at very high levels that are comparable to M&A multiples, it has become difficult for acquirers to offer any premium to the trading values of targeted companies. Hence the scarcity of public chemical company acquisitions.

You would think that this would lead to more acquisitions using public shares as the acquisition currency, but that has not happened because sellers are demanding cash because they are not sure whether the current high trading valuations will continue.

SHAREHOLDER ACTIVISTS

The chemical industry has become a favoured target of shareholder activists. The list of chemical companies over the past two years includes Sensient Technologies, Calgon Carbon, American Pacific, Ferro, Air Products, Ashland, LSB Industries, DuPont, and Dow Chemical. No industry has as long a list of shareholders pushing for various changes by the companies and their management teams.

In general, shareholder activists make the argument that their target is not properly managed, should return cash to the shareholders, should sell off non-core businesses, or are undervalued on a trading basis.

The last argument is a hard one to make today because chemical companies have been trading at very high valuations and at a premium to the market, making them less obvious targets as "undervalued" companies.

As a result, only a handful of M&A transactions have arisen that would not have otherwise happened if the shareholder activists had not shown up.

Divestitures by Ashland and Dow were being contemplated before the shareholder activists showed up and, at best, activists may have accelerated the timetable of their divestitures.

In addition, some of the companies have opted for spin-offs rather than M&A transactions to exit from businesses, such as DuPont's announced spin-off of its Performance Chemicals division.

So predictions of a large number of M&A transactions stemming from the shareholder activist activities have fallen far short of investment bankers' forecasts.

WHERE ARE THE LARGE DEALS?

Normally during the peak of the chemical M&A cycle there are many large, billion dollar-plus transactions. But last year only nine deals over $1bn were completed and it's been a slow start to 2014 with only two deals over $1bn in the first quarter.

Why is that? The principal reason has been residual CEO concerns about economic and financial uncertainties. There are concerns about the slowdown in growth and structural problems in China, lingering problems in Europe, political turmoil in many countries (Egypt, Thailand, Turkey, and Indonesia), emerging market country challenges in terms of capital flows, economic performance and exchange rates, and the volatile situation in Ukraine.

The number of private equity firms competing in each auction of a chemical business has mushroomed

While the severity and number of the uncertainties in the global economic and financial environment is less than in 2008 and 2009, they are sufficiently high to suppress the number of large deals that CEOs are willing to pursue.

This does not mean that the M&A market is unhealthy – only that the activity has been concentrated in the sub $1bn market.

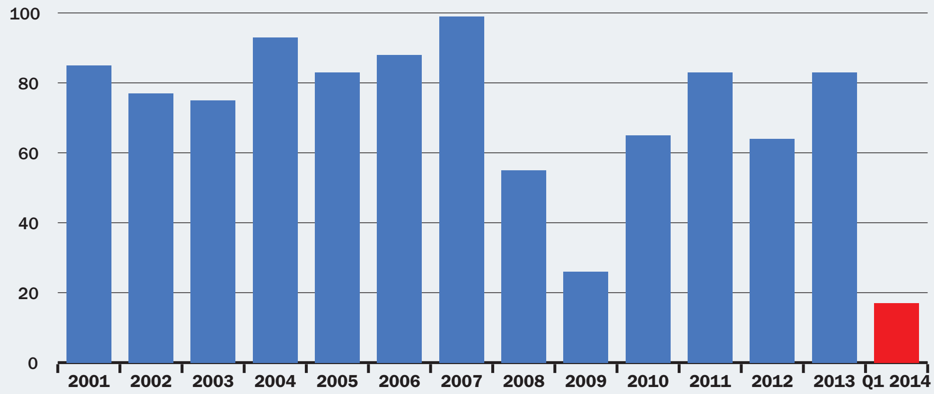
STRATEGIC BUYERS PICKY

Often when there is a frothy M&A market, strategic buyers are willing to be more flexible about whether the target is a pure play with a close fit with one of their core businesses.

It is now clear that, except for companies that cannot acquire more in their core businesses because their market share is already quite high and are adding businesses in adjacent markets, companies are not buying businesses that are clearly not a strong fit or that are not pure-play fits.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – NUMBER OF DEALS

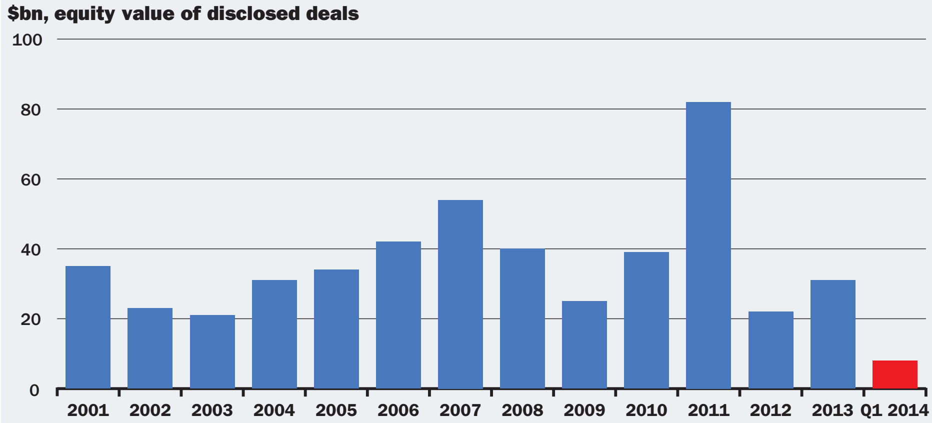
Total number of transactions over $25m in size



SOURCE: Young & Partners

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES

$bn, equity value of disclosed deals



SOURCE: Young & Partners

What does that mean for buyers and sellers of chemical businesses? First, it has presented an opportunity for financial buyers to buy businesses that otherwise would have gone to a strategic buyer in the past.

Second, it has caused many sellers to misjudge strategic buyer appetite for the business that they sold with the result that they either had to take a lower, financial buyer valuation or have had to withdraw the sale altogether.

TOO MUCH PE MONEY CHASING DEALS

If the strategic buyers are being more picky, one would think that this would create a wonderful opportunity for financial buyers. Unfortunately, there are other factors at play, so not all is rosy for financial buyers.

The primary issue is that chemicals has become a popular industry to target by the large number of private equity firms at the small, medium and large deal size.

The sheer amount of equity that is held by the private equity firms and the number of firms that have designated chemicals as an area of focus is enormous. As a result, the number of private equity firms competing in each auction of a chemical business has mushroomed.

WHAT WILL THE FUTURE BRING?

Young & Partners believes that the outlook for the chemical industry M&A market is positive and we expect to see a solid 2014 and beyond. But we do not expect a return to a higher number of very large transactions..

For sellers, this will be a very positive year, except if the business being sold has significant flaws or is distinctly not a pure play with a good fit with a number of strategic buyers.

For buyers, this will be a more challenging year to buy at an attractive price. But taking advantage of the inefficiencies in the market will clearly be important. ■

Peter Young is president and managing director of Young & Partners, an investment banking firm that serves the M&A and financing needs of the chemical and life sciences industries worldwide. Young & Partners is in its 19th year and serves a global client base of large and mid-sized companies.