Chemical M&A moving in every direction, all at once

Never have so many parts of the chemical M&A and financial markets moved in totally opposite directions at the same time. What are the major implications?

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Making sense of today's multidirectional M&A market is a challenge

In our early December 2015 article in *ICIS Chemical Business* we indicated that the chemical mergers and acquisitions (M&A) market was very healthy, but highlighted signs that different segments were moving in different directions, that financial buyers were having increasing difficulty, and that Asia was not only in the lead in M&A but beginning to dominate. We predicted a strong increase in 2015 dollar volume, but a drop in the number of completed deals versus 2014.

In this article, we cover the M&A results for all of 2015, the underlying trends, and the uncertain outlook for 2016. An overall observation is that we have never had so many parts of the M&A and financial markets moving in totally opposite directions at the same time. Dollar volume is up, but the number of deals are down.

Valuations and deal volumes are both up and down in the M&A market, depending on what segment you are looking at. Asia M&A volume is up, but Europe and the US are down. Strategic buyers have become more aggressive, but financial buyers are struggling. Investment-grade debt is strong, but high-yield debt is suffering a collapse. Is it confusing? Yes. Do we understand why and what the implications are for chemical companies? The answer is also yes.

Some of the important questions we will address in this article include:

- What happened in 2015 and what is the outlook for 2016 and beyond?
- What are the factors that are driving the market activity?
- Will the current stock market meltdown increase or decrease the aggressiveness of shareholder activists?
- Are there differences by region, type of chemical, or type of buyer?
- How are private equity firms faring as buyers?
- Have valuations peaked?
- What are the implications for buyers and sellers of businesses?

GLOBAL ENVIRONMENT

M&A activity in the sector continues to be heavily influenced by the overall business and financial environment.

The global economic situation was difficult for all of 2015 and worsened towards the end of the year. Further signs of slowing economic growth in China; the negative effect of the drop in oil prices on energy companies and countries dependent on high oil prices (Russia, Iran, Venezuela, Saudi Arabia, and other OPEC countries); the economic and immigrant challenges in Europe; depressed demand for commodities that are affecting a host of commodities export dependent countries; and the increased threats from ISIS have all contributed to global economic and geopolitical turmoil.

The chemical industry performed solidly in 2015, but with significant pockets of weakness in various parts of the world and in certain sectors such as oilfield chemicals. But cash flows continued to be strong overall.

Separately, the equity markets have been volatile since major declines in August and September 2015. This impacted valuations of many chemical companies and has had an indirect effect on the M&A market. The meltdown in January 2016 damaged public chemical valuations and has heightened uncertainty about where public valuations will head.

GLOBAL CHEMICAL M&A ACTIVITY

The M&A market has been increasing in substantial steps each year from the trough of $22bn in 2012, the jump to $31bn in 2013 and then to $49bn in 2014.

2015 was a continuation of that steady increase in dollar volume. On an equity value basis, $65bn of deals greater than $25m in value were completed globally, including a huge $34bn surge in Q4.

Before one jumps to the conclusion that there was a huge increase in 2015, one must note that $17bn of that $34bn Q4 surge was from one deal – the seriously delayed completion of the Merck KGaA acquisition of Sigma-Aldrich that was first announced in September 2014.

Without that one deal, the total dollar volume for 2015 would have been $48bn, slightly less than the $49bn in 2014. Although the deal did close in 2015, its impact on the total dollar volume is not indicative of the overall M&A market.

In terms of numbers of transactions, 90 deals were completed versus 108 deals in 2014. Although 90 deals is a solid total compared to historic numbers, it is a significant drop from the previous year.

Was the market up or was it down? One of the primary reasons for the confusion is that the commodity chemical and specialty chemical markets were moving in opposite directions in 2015. There has been a splintering of the M&A market as the volume and valuation of commodity chemical deals fell dramatically starting at the beginning of the year, while specialty chemical volumes and valuations hit a peak – a trend Young & Partners first highlighted many months ago.

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

Asia/ROW dominated in 2015, accounting for 51% of deals completed worldwide. This was a record market share for Asia/ROW since we began tracking regional shares in 1986. The US and Europe followed with 26% and 23%, respectively.

Private equity firms accounted for only 9% of the total number of deals completed in 2015. This is a startling loss of share compared to the historical norm, which has been in the 20-25% range.

When financial buyers have pursued acquisitions that are not of interest to strategic buyers or bolt-on acquisitions for existing portfolio companies where they have synergies, they have been competitive. However, private equity firms have been at a significant disadvantage elsewhere. Private equity firms heavily favour specialty chemical deals, where valuations are at peak levels and strategic buyer interest has been high.

Relatively few private equity firms are comfortable dealing with cyclical commodity chemicals. Further, deals have heavily shifted to Asia where private equity firms are less comfortable investing. In addition, financing has become more difficult.

The high-yield market deteriorated in the second half of 2015 as interest rates increased and default risks accelerated. Banks have also put limits on total borrowing, as dictated by regulators, which has taken even more financial ammunition away from financial buyers.

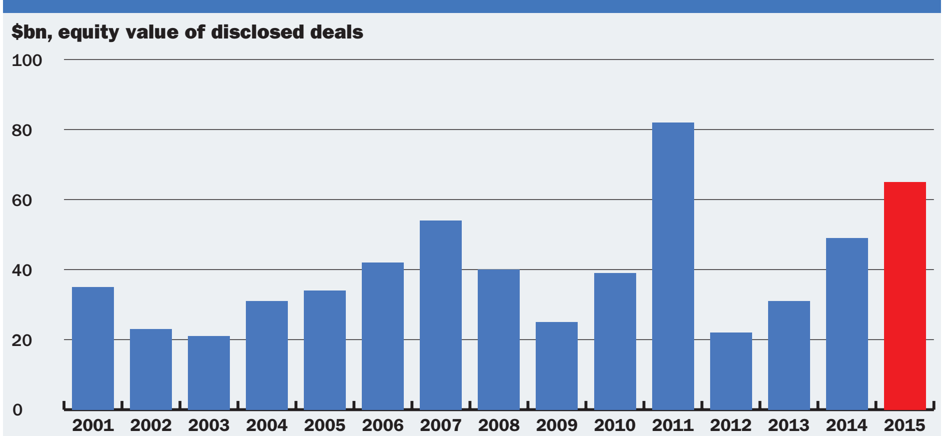
M&A OUTLOOK

The drivers of the M&A market will continue to be the same in 2016. Demand for growth in excess of what can be achieved organically, the need to use a build-up of cash, ongoing restructuring efforts, consolidation in agricultural chemicals, pressure from shareholder activists, and consolidation and industrial rationalisation in China will continue to be drivers of deal activity.

In addition, market share will continue to shift towards Asia.

Unused funds will continue to be drivers of deal demand for private equity firms, but the difficult debt markets and heavy competition from strategic buyers will continue to take their toll, except in cases where strategic buyers are not interested.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – EQUITY VALUE



SOURCE: Young & Partners

Other factors that will have a dampening effect on M&A include the unusually high level of global economic and political uncertainty; the weakened state of the shareholder activists, many of whom suffered major losses in the recent stock market turmoil; and the demand/pricing problems in certain chemical markets.

Looking forward, the value of deals announced but not closed as of the end of 2015 was $99bn (35 deals) compared to $36.8bn (34 deals) as of the end of Q3 2015, a sign that deal activity has escalated.

We expect 2016 dollar volume to be higher, but the key will be how many of the large marquee deals (Dow/DuPont, Air Liquide/Airgas, CF Industries/OCI's European and North American businesses, the pursuit of Syngenta) actually get done. There is considerable uncertainty around a number of these deals.

Either way, we expect the number of deals to stay at very strong levels of around 85 to 95 deals for the year.

SENIOR MANAGEMENT

First and foremost, the decision on whether this is still a good time for chemical companies to sell non-strategic assets and for private equity firms to sell mature portfolio companies 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, but not across the board. 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, but getting the right advice is important.

From the buyer's point of view, as the chemical M&A market moves further through and past this ageing peak, buyers should either pursue commodity chemicals, wait for prices to drop if they are targeting specialty chemicals, or find clever ways to take advantage of inefficiencies in the M&A market that favour buyers.

In a period when there have never been so many parts of the M&A and financial markets moving in totally opposite directions at the same time, it becomes important to know precisely where the parts are moving and why, and to use that knowledge to pursue opportunities that create significant value in an unconventional market. In these times, following advice that is either not supported by an accurate understanding of the markets or is based on "conventional wisdom" is very likely to lead to an unhappy result. ■

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