Contradictions in capital markets

Conventional wisdom does not always apply to chemical debt and equity markets. Public trading valuations continue to top those for M&A, while IPOs remain scarce

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The number of chemical IPOs has been very limited for decades

Usually the capital markets treat any specific industry in a consistent way. If they love the public companies in the sector, they reward them with high valuations and they let them access the equity markets easily, whether it is through an initial public offering (IPO) or secondary offering.

Similarly, if the industry has strong players that are attractive to potential strategic buyers, the M&A value is usually much higher than the trading value. And last, if the industry has strong cash flows and earnings, the debt markets love to lend to the industry, whether in the form of senior loans, senior corporate bonds or high yield debt.

What is extraordinary about the chemical industry is that two of the three statements above do not apply to the industry.

The only one that is true and consistently true is that the debt markets love chemicals.

But in an environment where chemical share valuations are equal or higher than the market indices and IPO activity has been strong overall, very few chemical companies have been able to go public – only two globally this year.

Further, for most of this year the Young & Partners seven chemical company indices have all traded at higher EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) multiples than M&A valuations. This has contributed to the modest number of acquisitions of public chemical companies and has led to an unusually high number of spin-offs.

There are two objectives of this article. First, we will report on how the stock market, and equity financing and debt financing markets have behaved through Q3 2015 for both the overall market and the chemical industry. Second, we will shed some light on the two seemingly illogical capital markets phenomenona that appear to be true for chemicals today.

OVERALL EQUITY TRADING MARKETS

In the first three quarters of 2015, the US S&P 500 decreased by 7.7%, while the STOXX Euro 600 increased by 1.5%. The weakness was heavily driven by the drop in the equity market in August, which has been partially recovered. However, the trailing price/earnings (P/E) multiple of the S&P 500 was 20.1x as of the end of September, well above historical norms.

In a weak global economic environment and amid concerns about the slowdown in the China economy, one would think stock market valuations would go down and stay down. Although they did go down in August and September, they have since regained much of the loss. The important question is why.

How about interest rates? The threat of higher interest rates in the US has occupied the news, with all eyes on the Federal Reserve's decisions on interest rates. However, if there is any increase, everyone realises it will be extremely modest. In addition, the fact is that global interest rates are being held down by central banks in Europe, Japan, China and elsewhere. Even negative yield government bonds are being issued for the first time in Switzerland and other European countries.

The end result has been a further pushing up of values in the equity markets, particularly in the "safe haven" US equity markets and other asset classes, and reluctance on the part of investors to invest heavily into certain fixed income markets.

It is not because the market believes the current valuations are fair. The equity market is getting a disproportionate amount of capital as investors desperately try to find a safe home for their money and look for returns in a low interest world. This is a "flow of funds" phenomenon, not a testimony to valuation.

As a result, there appears to be an overvaluing of certain assets, such as equities in the West and real estate in selected regions of the world, and lacklustre demand for certain debt instruments and emerging market equities.

CHEMICAL STOCK PERFORMANCE

The US chemical industry has underperformed the S&P 500 and the European chemical industry has underperformed the STOXX Euro 600 in the first three quarters of 2015, with the exception of European specialties, which slightly outperformed. There was a period of volatility in August and September, but the equity markets have recovered strongly through the beginning of November.

The history of the relationship of the stock market to the chemical industry has always been a difficult one. Typically, the industry will spend six or seven years out of 10 undervalued by the public markets (in the dog house) and only three or four out of every 10 overvalued (in the penthouse). Over the last few years chemical equity share prices and valuations have been at a premium.

This has not stopped shareholder activists from continuing to target chemical companies relentlessly, although it is not clear why versus other industries. Given the high valuations of chemical companies and the fact that trading values are exceeding M&A values on average, the undervalued company argument is hard to understand in general for the chemical industry.

CHEMICAL DEBT AND EQUITY FINANCING

Similarly, the debt markets for the most part have been healthy, with the exception of sporadic choppiness in high yield debt due to concerns about rising interest rates, the health of the global economy, and the potential for rising defaults.

Global non-bank debt financing was $23.4bn in the first three quarters of 2015, a slight increase versus $22.3bn in the year-ago period.

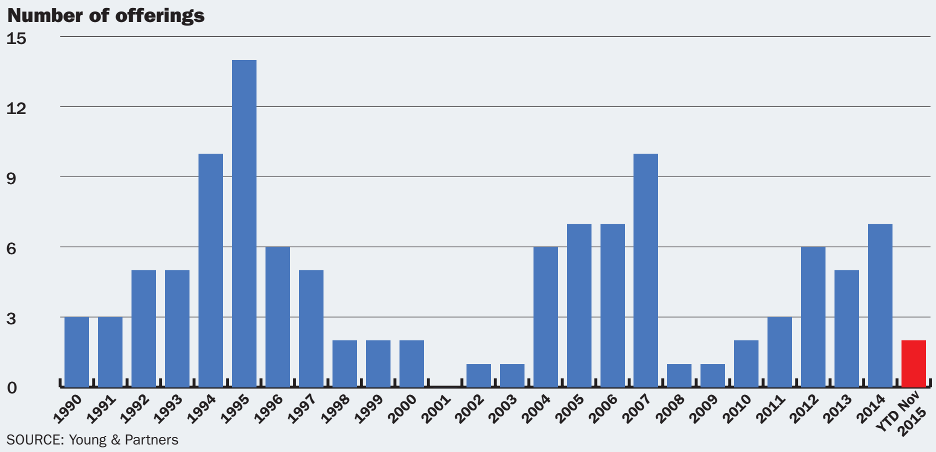
However, investment-grade debt totalled $16bn in the first three quarters of 2015, compared to $19bn in the year-ago period. Why the drop? This was not a reflection of any reduced interest on the part of investors, but rather a reflection of investment grade companies having lower borrowing needs.

High yield debt issuance was $7.1bn in the first three quarters of 2015 versus $3.3bn in the year-ago period, and is already higher than the $5.1bn issued for all of 2014.

However, after three quarters of strong performance, the overall high yield market has become more challenging again in Q4 with concerns about defaults in the shale gas and oil sector, a significant percentage of the high yield market.

With regard to equity financing, in the first three quarters of 2015, only $2.7bn of equity was issued in 7 offerings. Although this equity issuance is a very small dollar amount, the explanation has less to do with the interest of investors in the chemical industry, which is very positive as reflected in the public valuations, and more with the fact that chemical companies have strong cash flows, easy access to the debt markets, and very limited need for public equity.

WORLDWIDE CHEMICAL COMPANY IPOS



SOURCE: Young & Partners

CHEMICAL IPOS

The odd, seemingly contradictory phenomenon, however, is the fact that private chemical companies have had so much difficulty going public. The number of chemical IPOs has been very limited for decades. Our data going back to 1980 shows 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 over that 34-year period were less than $5bn in proceeds in 2006 and 14 IPOs in 1995. For most of the years, the dollar volume was under $1bn and the number of IPOs was between zero and three. These are astonishingly low numbers.

The odd phenomenon is the fact that private chemical companies have had so much difficulty going public

Through Q3 2015 there was only one IPO for a miniscule $65m. From the end of Q3 to early November there has been only one additional IPO, that of Covestro, the former Bayer MaterialScience. This offering was a difficult one, done well below the indicated pricing range, and the amount raised was €1bn less than the amount targeted.

In addition, the number of attempted IPOs that did not go through in the last couple of years is significant and includes some very well known chemical names.

How can the current situation exist where chemical stock prices and valuations are high and the general IPO market is strong, but chemical IPO activity is moribund? There are a host of reasons, but the following are some of the factors.

First, the commodity chemical companies that try to go public, rightly or wrongly, are perceived as risky if they are either at the peak of the commodity chemical cycle, descending from the peak, or at the trough. The window is the narrow period of time when earnings are cycling up the commodity chemical cycle and no one can clearly see where the peak is.

Second, there is a perception of much greater risk associated with the financials of a private chemical company, even though the securities filings contain at least three years of audited financials, versus a "mature" already publicly traded chemical company.

Third, the equity markets pick favoured themes and fads that change at different periods of time. Some of the themes and fads over the last 5-10 years have been fertilizers, emerging markets, high-margin niche businesses, etc. If you do not match the current fad, you are out of luck.

Threading the needle through these unfair and erratic biases is not only challenging, but often impossible to manoeuvre through for private chemical companies and subsidiaries of larger companies seeking to go public.

Why then have investment banks pitched IPOs so aggressively to private chemical companies for the last number of years? 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 has developed for the "flow of funds" rationale explained earlier in this article. Today, money has to find a home and is driving up public company valuations. »

US and European equities, and particularly industrials, have been a relative "safe haven" for investors. But it also makes sense that the investors in a public chemical company look at valuation and invest for reasons very different from corporate acquirers buying an entire company.

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 acquire private chemical companies and has increased the number of corporate spin-offs. Unfortunately, not all spin-offs have done well.

STOCK MARKET OUTLOOK

If the current weakness in global economic growth continues, we would expect industrial companies, including chemicals, to suffer.

There were signs in the first three quarters of 2015 of a severe equity market retreat due to political upheaval in various countries, the situations in Ukraine, Iraq, and Israel/Palestine, and emerging market economic and financial stress. This erupted into a volatile and weak stock market in August and September, followed by a rebound.

Since chemical industry stock market performance is heavily driven by macro trends, the future performance of chemicals will depend on the global economic/financial picture and whether there is a shift of equity capital into other securities or "safe" assets in a flight to safety or a major increase in interest rates. Neither seems likely in 2016.

DEBT AND EQUITY FINANCING OUTLOOK

Investment-grade debt volume will be driven by issuer demand, which continues to be favourable. M&A-related financing is likely to drive volume. We expect investor demand for investment grade debt to stay strong.

High-yield debt issuance will be volatile and partially depressed due to default concerns. The current high yield weakness that we have experienced since the end of the first three quarters of the year will continue through the rest of 2015 and beyond. Equity financing volume is likely to continue to be modest, given the market's historic bias against the chemical sector and the chemical sector's limited need for equity capital.

Our prediction for no more than three IPOs this year appears to be on target. We do not see conditions changing in 2016

We expected no more than three IPOs this year and our prediction appears to be on target. We do not see conditions changing in 2016 for chemical IPOs.

In summary, 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, and high yield will be volatile. With some M&A values beginning to erode, we will see a preservation the inversion of average trading and M&A valuations that we see today. ■

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. It has served a global client base of companies for the last 18 years.