Equity and debt markets split

The financial markets are taking a split view of chemical stocks and debt securities. The outlook for financing is robust on the debt side, but IPOs will be limited

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Rex Features

Chemical equity and debt markets share a diametric relationship

Usually an industry is either loved or hated by either the equity markets or the debt markets in some rational way. At most, there might be a difference in the way the equity and debt of an industry is viewed.

What is extraordinary about the chemical industry is that there are extremes in the market's view between and within individual categories of securities. More often than not, the debt markets love chemicals, but the equity markets do not. Even more puzzling is why the equity markets can love chemicals, as they do now, but chronically shun initial public offerings (IPOs).

OVERALL EQUITY AND DEBT MARKETS

Through the first three quarters of 2014, the equity and debt markets generally performed well. The S&P 500 increased by 6.7% and the STOXX Europe 600 by 4.5% – a solid, but not spectacular performance. There was volatility in October, but the equity markets have recovered strongly through the end of November.

Similarly, the debt markets for the most part have been healthy with the exception of high yield debt where investors have been withdrawing funds due to concerns about geopolitical issues, interest rates and economic risks.

This is all in the context of the seemingly contrasting actions of the US Federal Reserve versus the European, Japanese and Chinese central banks. The US Fed tapered off its quantitative easing and has hinted at interest rate increases in 2015, while the European, Japanese and Chinese central banks have instituted interest rate cuts and implemented quantitative easing activities on concerns about a slowdown in economic activity and fears of deflation.

The end result has been a further increase in equity values, particularly in the "safe haven" US, and reluctance on the part of investors to invest heavily into certain fixed income markets. The equity market is getting a disproportionate amount of capital as investors desperately look for returns. As a result, there appears to be an overvaluing of certain assets, such as equities and real estate, and lacklustre demand for certain debt instruments.

STOCK MARKET PERFORMANCE

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

How about this year? The chemical industry performed well during the first half of 2014 on an absolute and relative basis, but then lost some ground in Q3. When compared to the S&P 500 (6.7% increase) and the STOXX Europe 600 (4.5% increase) benchmark indices, two Young & Partners (Y&P) chemical indices performed better, two about the same, and three underperformed through Q3. This compares to the first half of 2014 when six of the seven Y&P chemical indices outperformed the market.

Through the end of Q3, chemical equity valuations continued to exceed that of the general market indices by a considerable margin. Trailing price/earnings ratios of our Y&P chemical indices ranged from 23.7x to 32.3x, versus 19.4x for the S&P 500. Does this mean that chemical companies are worth that much? Not on a sustained basis and not relative to their expected revenues and earnings growth.

In addition, specialty chemical companies as a group are not trading at a premium to commodity chemical companies or, for that matter, diversified chemical companies.

Last, shareholder activists continue 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 mergers and acquisitions (M&A) values on average, the undervalued company argument is hard to understand.

CHEMICAL DEBT/EQUITY FINANCING

Chemical industry debt financing slowed moderately in the first three quarters of 2014, primarily due to a decrease in high yield issuance. Global non-bank debt financing was \$22.3bn through Q3 2014 versus \$27.4bn in the year-ago period.

Investment grade debt was steady at $19.0bn through Q3 2014 compared to $17.9bn in the year-ago period. Only $3.3bn of high yield debt was issued versus $9.5bn in the same periods. This was driven by investors withdrawing from high yield funds with the US Fed's tapering of bond purchases and the surge in geopolitical problems.

With regard to equity financing, through Q3 2014 only $3.8bn of equity was issued as a result of 16 offerings by chemical firms. Although this is a very small dollar amount, the explanation has less to do with the interest of investors in the chemical industry, which was very positive as reflected in the public valuations, and more with the fact that companies have strong cash flows, easy access to the debt markets, and a limited need for public equity.

CHEMICAL IPOS

The odd, seemingly contradictory phenomenon, however, is 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 show 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 were less than $5bn in 2006 and only 14 IPOs in 1995. For most of the years, the dollar volume was under $1bn and the number of IPOs between zero and three. These are astonishingly low numbers.

In addition, the number of attempted IPOs that did not go through is significant and includes some very well-known chemical names. Last year there were only five IPOs for a total dollar volume of only $979m. In contrast, there were 38 biotech IPOs last year and 58 biotech IPOs through Q3 2014.

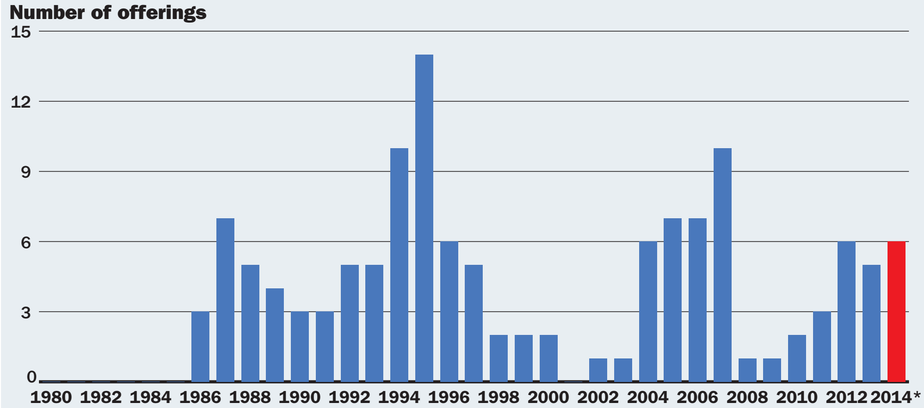
The odd, seemingly contradictory phenomenon, however, is the fact that private chemical companies have had so much difficulty going public

Granted, the stock market has disliked chemical companies generally for six or seven years out of 10, but how can the current situation exist where chemical stock prices and valuations are high, the general IPO market is strong, and yet chemical IPO activity is moribund?

Only six IPOs were completed in the first three quarters of 2014, raising only $1.5bn. Since the end of Q3, one more IPO was completed, by Axalta ($975m).

There are a host of reasons why there have been so few IPOs. First, commodity chemical companies that try to go public are perceived as risky if they are at the peak of their cycle, descending from the peak, or at the trough. The window seems to be the narrow period of time when earnings are cycling up and no one can clearly see where the peak is.

WORLDWIDE CHEMICAL COMPANY IPOS



*Year to date Q3 2014 SOURCE: Young & Partners

Second, there is a perception of much greater risk associated with the financials of a private chemical company, even though 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 five to 10 years have been fertilizers, emerging markets, and high margin niche businesses. 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 firms seeking to go public.

Is this diametrically opposed treatment of public companies versus private ones trying to go public fair or rationale? Absolutely not. But given that it has lasted for at least a couple of decades, it would be foolish to bet that this phenomenon will change.

Why then have investment banks pitched IPOs so aggressively for the last number of years? That is a question that every private chemical company who has thought about going public or tried and failed should ask itself.

STOCK MARKET OUTLOOK

The US and European chemical industries are currently trading at a valuation premium to the general market. 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 2014 of a severe equity market retreat due to political upheaval in various countries, the situations in the Ukraine, Iraq, and Israel/Palestine, and emerging market economic and financial stress. This erupted into a volatile and weak stock market in October, 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.

FINANCING OUTLOOK

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

High yield debt issuance will continue to be volatile and depressed in Europe and partially elsewhere.

The current high yield weakness that we have experienced through Q3 2014 will continue through the rest of the year.

Equity financing volume will likely continue to be modest given the market's historic bias against the chemical sector and the sector's limited need for equity capital.

For IPOs, our prediction for this year was seven, and there have been seven thus far. The final number will be very modest for 2014 and e do not see conditions changing in 2015.

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. ■

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. Young & Partners has served a global client base of companies in Europe, North America, Latin America and Asia for the last 18 years.