Good, bad news for chemical financing

Financing activity has been relatively healthy amid favourable business conditions, but headwinds from trade and interest rates are getting stronger

PETER YOUNG YOUNG & PARTNERS

Overall, 2018 through the third quarter was good to the chemical industry in terms of stock market prices, valuations and the availability of debt and equity financing.

However, overall activity, although healthy, shows some weakening around valuations and equity financing. In other areas such as debt financing – both investment grade and high yield – the activity was strong through the third quarter. But everything has turned more negative since the beginning of October.

This report and outlook highlights key trends in the financing market with implications for senior executives, and is based on proprietary Young & Partners data through the third quarter of 2018.

BUSINESS AND FINANCIAL MARKETS

As a whole, the chemical industry has been doing well for a number of years. Earnings and cash flows have been positive overall and the drop in the price of oil a few years ago benefited the industry in terms of raw material and energy costs. US chemical companies have been the beneficiary of the shale gas/oil supply and the massive tax cuts that were implemented late last year.

However, there have been clouds developing as concerns about global growth, geopolitical uncertainty, and the tariff wars are dampening enthusiasm and beginning to damage chemical industry revenues and earnings.

Companies that are investment grade will have easy access to the debt markets at slightly higher interest rates, but high-yield financing has become more expensive and volatile

The overall stock market performance globally has been decidedly mixed. During the first three quarters of 2018, the US equity markets were robust, with the S&P 500 increasing by 8.1%, but European markets were tepid, with the FTSE 100 decreasing by 1.8%.

Outside the West, the picture was quite bleak, with the Japanese stock market slightly negative and the Chinese stock market down by almost 30% since the start of the year.

As we all know, the stock market took a decidedly downward path in early October in all parts of the world as the concerns about trade wars, the slowing Chinese economy, higher interest rates, Brexit, challenges in certain European countries such as Italy and rising geopolitical tensions took their toll.

There was a partial recovery, but the downward trend continued through the end of October.

The bond market and the market for the issuance of new debt were reasonably solid for most of this year, with a few bumps in February and April. High yield had a slump during the summer, independent of investment grade debt. In general, the bond market has traded independently of the stock market.

However, this has changed recently, with concerns about higher interest rates and the global economy. This has driven a repricing of debt in the market and is also having an impact on lower rated debt issuance.

CHEMICAL STOCK PERFORMANCE

The overall picture for chemical company shares was mixed through the first three quarters. There was no clear pattern across the various industry segments.

The Young & Partners (Y&P) US Basic Chemicals index decreased by 1.5%, the US Diversified Chemicals index increased by 6.5%, the US/Canada Fertilizers index increased by 12.7% and the US Specialties index increased by 3.2%.

The Y&P European Basic Chemicals index increased by 0.5%, the European Diversifieds index decreased by 15.7% and the European Specialties index increased by 15.0%.

In terms of price/earnings (P/E) valuations, by the end of the third quarter 2018, six of the seven Young & Partners Western chemical indices were trading at a premium to the already high overall market indices.

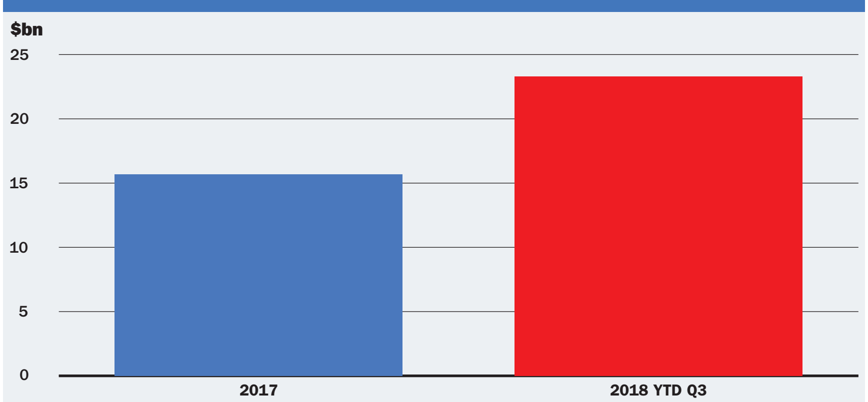
In Asia, the Young & Partners Chinese chemical indices show extraordinarily high multiples for both specialties and commodities, even with the recent steep drop in the Chinese stock market.

The Young & Partners Japanese specialty chemical index also has high multiples, but the commodity and diversified sectors are trading much lower.

CHEMICAL DEBT FINANCING

Chemical industry debt issuance activity in the first three quarters of 2018 was very strong and significantly higher on an annualised

CHEMICAL INDUSTRY EQUITY ISSUANCE



SOURCE: Young & Partners

basis than in 2017, driven by a combination of mergers and acquisitions (M&A) financing, refinancing and a surge in high-yield debt.

Global non-bank debt financing was $40.6bn in the first three quarters of 2018 compared to $47.2bn for all of 2017.

The investment grade debt part of that total in the first three quarters of 2018 was $29.8bn, compared to all of 2017 when $40.4bn was issued. There was $10.8bn of high yield debt issued in the first three quarters of 2018 compared to $8.6bn in all of 2017.

Essentially, we have had a steady debt issuance market that has benefited both strategic and private equity players.

CHEMICAL EQUITY FINANCING

The chemical equity issuance market was stronger in dollar terms through the first three quarters on an annualised basis compared to 2017. However, the number of offerings was down significantly.

Around $23.3bn of equity was issued from 49 offerings in the first three quarters of 2018. This compares to $15.7bn of equity issued for the entire year of 2017 from 93 equity offerings.

We have had a steady debt issuance market that has benefited both strategic and private equity players

The pace of the number of initial public offerings (IPOs) slowed dramatically in the first three quarters, with only 12 IPOs completed worth $2.0bn. This compares to 46 IPOs raising $4.3bn for all of last year.

In 2016 and 2017, Asian companies issuing in the Asian public markets dominated both the IPO and secondary offering markets. In the first three quarters of 2018, Asian companies continued to dominate, with only one non-Asian IPO completed. However, there was a dramatic slowdown in Asian IPOs as the Chinese stock market has fallen.

INDUSTRY BUSINESS OUTLOOK

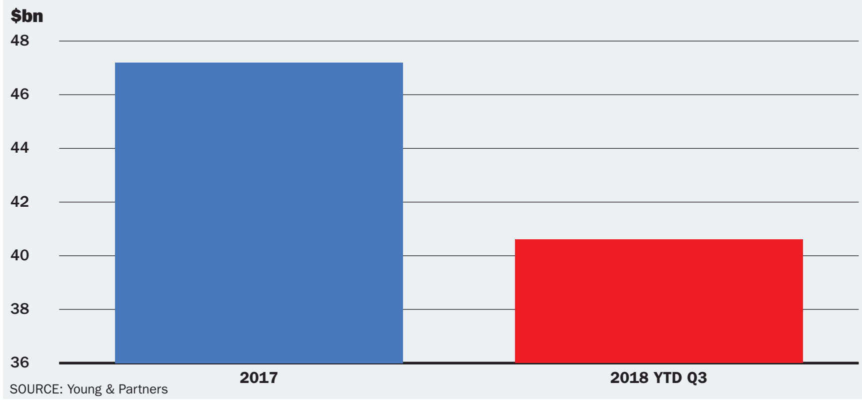
The future economic picture is very uncertain. Although overall global growth is reasonable, there is weakening growth in China, Europe and many of the emerging market countries.

In addition, we expect the trade dispute between the US and China to be prolonged and result in a period of tariff wars that will hurt both countries as well as other global economies.

The US deficit and debt are increasing and may at some point, along with rising interest rates and higher oil prices, create a negative tipping point for the US economy.

None of these developments are good for the chemical industry.

CHEMICAL INDUSTRY NON-BANK DEBT FINANCING



SOURCE: Young & Partners

The near-term earnings environment for chemical companies will be positive in the West and overall demand and capacity utilisation will be steady.

However, the negative forces cited will gradually erode chemical industry earnings in the US, Europe and China.

Growth will continue to be hard to come by and certain specific markets will continue to suffer.

STOCK MARKET OUTLOOK

The stock market has been favouring the chemical industry due to its strong earnings fundamentals. As a result, the industry has been trading at a premium to the overall market. However, its relative valuation has weakened recently.

It is unclear where the industry's valuation is heading given the overall uncertainty and volatility in economies and financial markets. The recent fall-off in the global equity markets impacted the chemical industry, but not in proportion to the overall market indices.

In the near term, the global equity markets will continue to be unpredictable, driven by a long list of economic, financial and geopolitical stresses.

DEBT AND FINANCING OUTLOOK

Investor demand for investment grade debt has been very strong and will continue to be strong. But volume will be driven heavily by issuer needs rather than investor demand, with M&A related financing driving volume. The announced mega deals that use debt will help to offset the slowdown in refinancing-driven volume.

High-yield debt issuance has been healthy. Higher interest rates, however, are having an effect on high-yield debt pricing and funds flowing into high-yield investment funds.

The recent surge in equity issuance has been driven by Asian issuers. Without Asian issuers, equity financing volume would have been modest given the market's historic bias against the chemical sector in the West and the chemical sector's limited need for equity capital.

Equity issuance going forward, both secondary and IPO related, will be moderate and will continue to be dominated by Asian issuers. Western IPOs will continue to be dormant. We predict a continuation of the slowdown in Asian IPOs given the weaker Chinese economy and the drop in Chinese stock market values.

IMPLICATIONS FOR MANAGEMENT

For those companies already public, we expect valuations and share prices to still be attractive overall and compared to historical levels, but there will be slippage and volatility driven by the overall weakening and volatility of the equity markets.

As long as public values remain high, public chemical companies that are exiting non-core businesses should consider spin-offs as an effective way to exit from a valuation point of view.

For those companies that are private, unless you are an Asian chemical company, the IPO market is virtually shut for companies in the US, European and many other non-Asian countries.

Although interest rates have increased slightly last year and this year, and there will be further increases in interest rates this year, debt availability will continue and interest rates will still be low on a historical basis. Companies that are investment grade will have easy access to the debt markets at slightly higher interest rates, but high-yield financing has become more expensive and volatile – a challenge for a smaller subset of chemical companies and for private equity investors. ■

Peter Young is president and managing director of Young & Partners, which is completing its 23rd year as a focused chemical and life science industry investment banking firm.