Activist premise on Dow spin-off is false

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By Joseph Chang

NEW YORK (ICIS)--Activist investor Dan Loeb’s premise that the commodity chemicals businesses of US-based Dow Chemical can be spun off to create greater shareholder value is wrong, an investment banker said on Monday.

The high-profile activist investor, through his hedge fund Third Point, announced recently a $1.3bn stake in Dow Chemical, estimated to represent around 2.5% of shares outstanding, and pushed for the company to spin-off its commodity petrochemicals business.

“We believe Dow should apply the intelligent logic of its recently announced chlor-alkali separation to the entirety of its petrochemical businesses by creating a standalone company housing Dow’s commodity petrochemical segments,” said Loeb in a letter to Third Point’s investors on January 21.

But Peter Young, president of investment bank Young & Partners, disagrees with that assertion.

“Overall, we believe that his premise is false,” Young said.

“If Dow were to spin off commodities and end up as two public companies – one commodity and the other specialty – the resulting independent companies would trade at multiples that would produce valuations for the two that would not add up to a number higher than what Dow is trading at today,” he said.

Dow is trading at around 9.7 times LTM (last 12 months) EBITDA today – close to the 10.0 times EBITDA for specialty chemical companies and 7.7 times EBITDA for commodity chemical companies, Young noted.

“The resulting math is straightforward,” he said.

“One driver to this conclusion is that Dow is trading at a reasonable multiple today with no penalty for being diversified,” said Young.

“If anything, for the last five years, diversified chemical companies have enjoyed a noticeable premium from an earnings multiple basis, with the only exception being 2010 when diversifieds were at a premium to specialties, but a discount to commodities,” the banker pointed out.

A second key driver is that US specialty chemical companies as a group do not trade at a material premium to commodities, he said.

“This has been true for some time. This is separate from the fact that stronger companies trade at higher multiples than weaker companies, and that diversified chemical companies have been trading at a premium to pure plays,” said Young.

“This is also separate from the fact that in the M&A [mergers and acquisitions] market, specialty chemical businesses trade on average at a 1.5 times EV/EBITDA (enterprise value/EBITDA) multiple premium through the M&A cycle. Third Point, at any rate, is proposing a spin-off – not a sale,” he added.

Wall Street analysts conducting sum-of-the-parts analyses on Dow have come to different valuations, but some to similar conclusions. The analysts use estimated forward 12-months EBITDA versus the last 12-months EBITDA Young uses in his calculations.

“Applying a nine times multiple on expected 2014 specialty EBITDA and seven times multiple on expected 2014 commodity EBITDA derives a $45 current combined share price – essentially in-line with the current share price,” said Wells Fargo analyst Frank Mitch on 21 January.

UBS analyst John Roberts arrived at a $50/share valuation for Dow, using a 10.0 times estimated forward EBITDA multiple for specialties and 7.5 times EBITDA for commodities.

Cowen & Co analyst Charles Neivert projects Dow’s break-up value to be $64/share. However, his analysis is not a traditional sum-of-the-parts analysis, but one based on Dow retaining its commodity chemical businesses and selling specialties.

Shares of Dow closed on 24 January at $43.41, down $1.31, or 2.9%, amid a global stock market rout. The broader US market as measured by the S&P 500 fell 2.1%.

“Unless Third Point has a different line of reasoning or suggested plan, its premise about increasing Dow's trading value by spinning off their commodity business is not correct,” said Young.

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