In M&A, now you see it, now you don't

Despite talk of record deal activity in 2016 including mega deals, the dollar volume came in well short of the prior year with the number of deals just slightly ahead

Mergers and acquisition results are in a fragile envrionment right now

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In this article, we cover the mergers and acquisitions (M&A) results for 2016, the relevant economic and political environment, the chemical industry's performance, and our predictions for all three for 2017 and beyond. In addition, we will comment on the implications for management.

If one is going to have surgery, it is important to have a skilled surgeon. But the surgeon will fail if the information that he or she has is flawed or inaccurate, whether it is a flawed medical principle or an inaccurate MRI. The same is true for M&A and strategic/financial decisions by management, regardless of whether the execution is in-house or from an investment bank.

Virtually all the public statements from other investment bankers throughout 2016 indicated that M&A in 2016 was at a pace much greater than 2015 and was going to end up much higher.

Private equity firms were cited as being very active and visible players in the market. Comments about valuation almost always indicated that valuations were extremely high and were likely to stay there for a while.

Many senior management decisions that relied on those views resulted in failed transactions and disappointing results.

Here we share a portion of our analysis and reflect on what really happened and what you can expect going forward. We will also discuss what the implications are for management and private equity executives.

FRAGILE FINANCIAL ENVIRONMENT

There have been bright spots in the global economy such as the lower price of oil, the strength of the US economy, the continued growth in China, and signs of a revival of growth in India. However, there has also been a dramatic increase in negative global trends recently.

Economic growth has been weak in Japan, Europe, and many emerging markets such as Brazil. Terrorist activities and geopolitical turmoil involving a large number of countries such as China (South China Sea), Turkey (attempted coup), the Middle East, the UK (Brexit), Pakistan and North Korea have created an environment of uncertainty and risk.

Countries heavily dependent on oil revenues are under severe pressure in terms of budget deficits, capital outflows, economic performance and exchange rates.

There continue to be worries about the Chinese economy and the possibility of weaker growth and a bursting of the real estate and lending bubble.

The surprising outcome of the US presidential elections has created a whole new set of uncertainties associated with the likely policies and tactics of Donald Trump.

There is a great deal of speculation about what the net effect of a Trump presidency will be, but the current view is that it will be a net positive for businesses in the US given Trump's stated intention to cut corporate taxes and boost infrastructure spending. On the other hand, a trade war, if initiated, will have a negative impact for the US and the rest of the world.

The pace slowed considerably in 2016 such that only $41bn worth of deals were completed

But if one looks at the elections that are coming up in various parts of Europe and elsewhere, as well as the Brexit results from last year, it is apparent that Trump is just part of a move to populism and nationalism that has erupted around the world. This raises the risk of rising trade restrictions and other actions that will be disruptive to the global economy.

There a number of possible and reasonable scenarios for the future. In summary, we have been in a period of significant global political, economic and financial stress for some time and that stress is increasing.

THE CHEMICAL INDUSTRY

As a whole, the chemical industry has been doing well for a number of years. Earnings and cash flows have been positive and the dramatic drop in the price of oil has benefited the industry in terms of raw material and energy costs. However, there have been pockets of weakness, particularly in Europe, many emerging markets and sectors affected by the downturn in the energy sector.

Also, growth has been hard to come by and there are concerns that a further weakening of the global economy will damage overall chemical industry revenues and earnings.

The picture in the US for chemicals is clearly stronger with a stable US economy and the advantage of low cost shale gas/oil. Yet US companies have been negatively affected by the strength of the dollar.

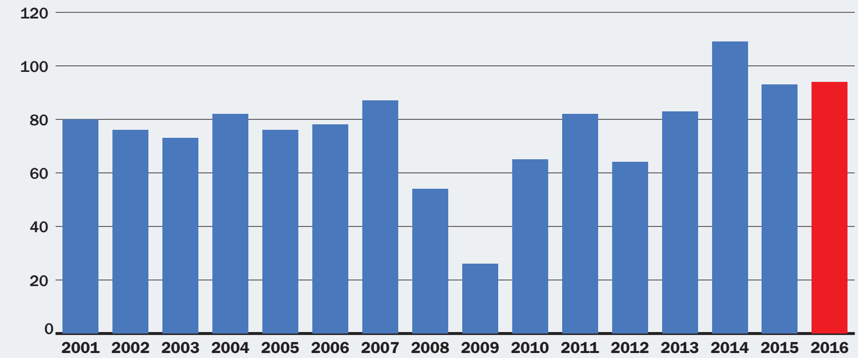
> **There continue to be worries about China's economy – the possibility of weaker growth and a bursting of the real estate and debt bubble**

Overall, chemical industry CEOs are cautiously optimistic, but they are concerned about the global economic and financial environment, the lack of global growth, the cratering of the energy sector markets, and the challenge they have been facing trying to achieve growth in revenues in the current environment.

A key issue for the industry going forward is whether the fragile global economic and financial conditions remain stable or are negatively disrupted. 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 dramatic drop in the price of oil has benefited the industry in terms of raw material and energy costs.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – NUMBER OF DEALS

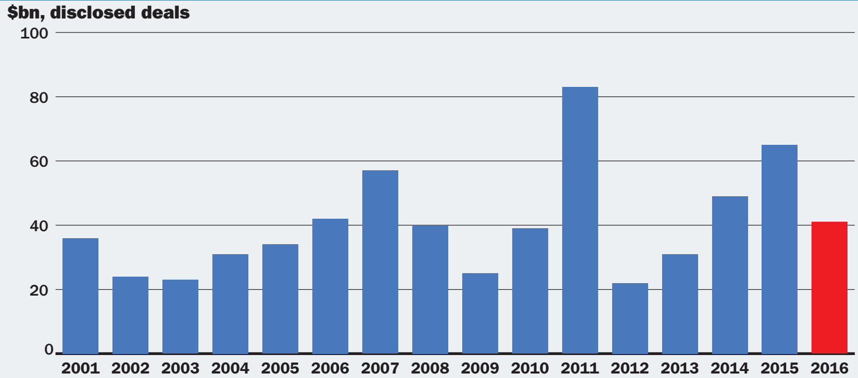
Total number of transactions over $25m in size



SOURCE: Young & Partners

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – EQUITY VALUE

$bn, disclosed deals



SOURCE: Young & Partners

GLOBAL CHEMICAL M&A ACTIVITY

So what actually happened in 2016? The M&A market in dollar terms had been increasing every year, rising in meaningful amounts each year off the trough of $22bn in 2012. Dollar volume rose to $31bn in 2013, $49bn in 2014, and $65bn in 2015. All of that changed in 2016. The pace slowed considerably in 2016 such that only $41bn worth of deals were completed. Only one large deal closed – the acquisition of Airgas by Air Liquide – and that carried an equity value of $10.3bn and an enterprise value of $13.3bn.

In terms of number of transactions, 94 deals were completed in 2016 versus 93 deals in 2015, but below the 109 in 2014.

In terms of the location of M&A targets, Asia/Rest of the World dominated in 2016, accounting for 52% of deals completed worldwide, slightly up from 51% in 2015.

Private equity firms receive a lot of publicity, but continue to lose market share in terms of acquisitions. They accounted for only 8% of the total number of deals completed in 2016, a startling loss of share compared to the historical norm of 20-25%. Even their share of the dollar volume was low at only 4.5% in 2016.

Commodity and specialty chemicals have been on very different M&A cycles, with commodity chemicals recovering from their 2015 trough and specialties falling off their 2015 peak.

Looking forward, the value of deals announced but not closed at the end of 2016 was massive at $274bn (55 deals). However, the list is dominated by just a few mega deals (greater than $5bn) such Dow/DuPont, Bayer/Monsanto, Praxair/Linde, ChemChina/Syngenta, PotashCorp/Agrium and Sherwin-Williams/Valspar. Only two had any hope of closing in 2016, but were heavily delayed by antitrust and other regulatory actions – Dow/DuPont and ChemChina/Syngenta. But given the heavy concentration of the ag chem industry and the flurry of announced deals, the likelihood of heavy regulatory scrutiny was high.

The rest of the mega deals that were announced in 2016 were already known to be 2017 deals at best in terms of their likely close dates (Sherwin-Williams/Valspar, Bayer/Monsanto, Praxair/Linde, and Potash/Agrium), but they all are in industries that are already heavily concentrated and threatening to be concentrated even further. One should note that the CF Industries/OCI NV North American transaction failed in 2016 for antitrust reasons.

Throughout 2016, we indicated every quarter that the number of deals and the dollar volume was coming in at lower numbers than in 2015. The only surprise to us was that there was a higher-than-expected number of small deals in Q4 2016 that resulted in the number of deals for the year being flat compared to the previous year.

So reality was dramatically different in 2016 from what others have been espousing. The number of deals was flat, not up. The dollar volume instead of being considerably higher, was substantially lower. Valuations were not at peak, but have been coming down in specialties and coming up for commodity chemicals.

The number of deals in the West has become very small as Asia has come to dominate the global M&A volume. And at only 8% of the market, private equity firms have become a marginal portion of the market as buyers – hardly the lions of the market that others touting "conventional wisdom" have indicat-