Markets strong but with a twist

2018 should be another strong year for chemical equity valuations and debt financing. There is scope for more spin-offs but IPOs for western companies are challenging

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PETER YOUNG YOUNG & PARTNERS

Overall, 2017 was a great year for the chemical industry in terms of stock market prices, valuations and the availability of debt and equity financing. However, overall activity, although healthy, did go down compared to 2016. In other areas, the activity was high, but there were dramatic differences in who could finance and why. 2017 turned out to be very different in a number of ways.

This report is based on the proprietary Young & Partners (Y&P) data through the end of 2017 and provides the outlook for 2018 and beyond.

EV/EBITDA public trading values are equal to or higher than the prevailing M&A valuations for both commodity and specialty chemicals

There are three objectives for this article. First, we will report on how the stock market, equity financing and debt financing markets behaved in 2017 for both the broader market and for the chemical industry. Second, we will explain why debt financing was flat and equity financing volume weakened, while also commenting on some unconventional trends by type of company and geographic region. Third, we will share our predictions for the chemical equity and debt markets, and financings going forward and what we see as the implications for industry executives.

During 2017, the global equity markets performed well. In the US, the S&P 500 increased by 19.4% and in Europe, the UK's FTSE 100 increased by 7.1%. The positive performance was fuelled by overall economic growth in many parts of the globe, strong corporate earnings, confidence that China and India will continue to keep their economies from faltering in the medium term, hope that certain legislative and other changes in the US will fuel growth and investment (such as the new tax laws that were enacted in December), and the absence of alternative places to invest. This positive performance was in spite of the geopolitical turmoil that has increased across the globe.

Interest rates increased very modestly at the end of last year, and have continued to be very low. As a result, the economic stimulus from low cost debt continued and the relative returns of fixed income securities remained low.

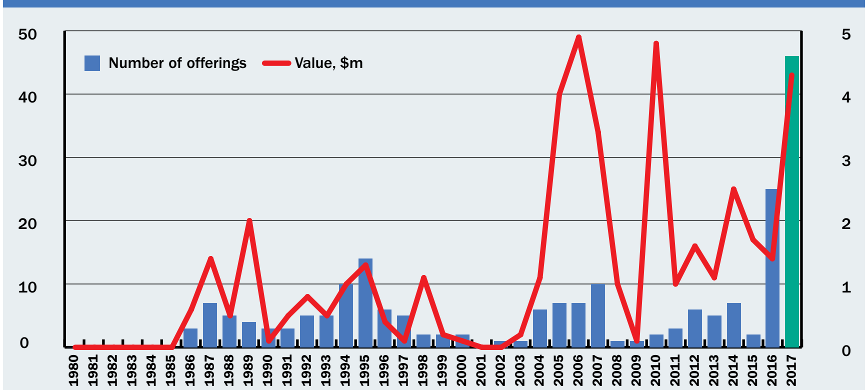
Overall, the stable global economy and the flow of funds driver of investment dollars will continue to drive a relentless parking of funds in the safe haven US, Japanese and selected European equity markets.

CHEMICAL STOCK PERFORMANCE

The chemical industry continues to be a darling of the stock market due to its strong earnings and cash flow fundamentals. The industry has been trading at valuation multiples that are either close to or above the overall market for some time now.

All of the Y&P chemical indices performed exceptionally well in 2017. The Y&P US Basic Chemicals index increased 25.6%, the Y&P

WORLDWIDE CHEMICAL COMPANY IPOS



SOURCE: Young & Partners

US Diversified Chemicals index rose 22.6%, the Y&P US/Canada Fertilizers index gained 13.2% and the Y&P US Specialties index jumped 37.5%. Fertilizers had performed badly in 2016, but staged a modest recovery in 2017. The Y&P European Basic Chemicals index increased 28.8%, the Y&P European Diversifieds index rose 23.7% and the Y&P European Specialties index surged 46.2%.

These are huge percentage increases that were well above the already robust overall market performance. In terms of valuations, by the end of 2017, the average trading valuations of the Y&P chemical index companies were at high levels.

Interestingly, EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) public trading values are equal to or higher than the prevailing M&A valuations for both commodity and specialty chemicals – a relationship that is quite unusual since it is usually the opposite.

As a result, the number of spin-offs and equity carve-outs has increased since the beginning of 2016, with five completed in 2016 and one in 2017. The only interesting question is why there was only one spin-off in 2017.

CHEMICAL DEBT FINANCING

Chemical industry debt issuance activity in 2017 was slightly higher than 2016, driven by a combination of mergers and acquisitions (M&A) financing and funding of growth initiatives.

Global non-bank debt financing was $47.2bn in 2017 compared to $45.9bn for 2016. The behaviour of investment grade versus high yield was not very different. Investment grade debt in 2017 was $40.4bn compared to $38.0bn in 2016. High yield debt issuance was stronger at $8.6bn in 2017 versus $8.0bn for 2016. Essentially, we have a steady debt issuance market that has benefited both strategic and private equity players.

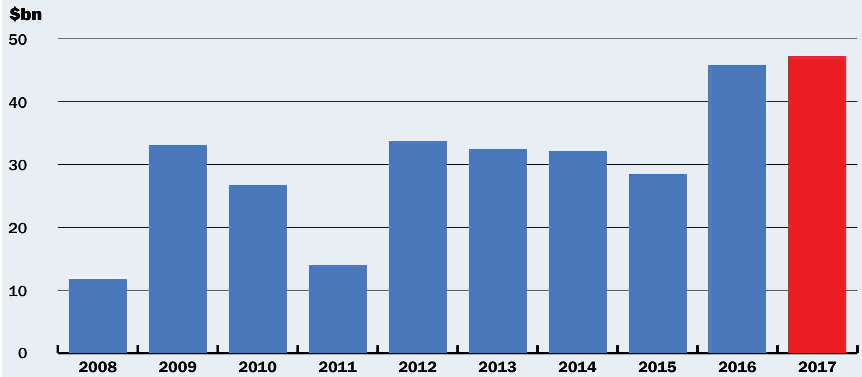
CHEMICAL EQUITY FINANCING

The picture for equity financing was somewhat different. Chemical equity issuance market was fairly weak in dollar terms in 2017 versus 2016, but very strong in terms of numbers of offerings. In other words, a busy market, but smaller offerings in terms of dollars. To illustrate, in 2017 $15.7bn of equity was issued from 93 offerings compared to $23.8bn of equity issued in 2016 from 71 equity offerings.

In addition, the totals continue to be dominated by Asian companies issuing in the Asian public markets for both the initial public offering (IPO) and secondary offering markets.

This was particularly dramatic in the IPO market. IPO volume historically is very low in the chemical industry. Up until 2016, the highest number of IPOs going back to 1980 was 14 in 1994. In 2016 the industry broke that record when 25 IPOs were completed and in 2017 the record was broken again when a mind boggling 46 IPOs were completed.

GLOBAL CHEMICAL INDUSTRY DEBT FINANCING



SOURCE: Young & Partners

However, western chemical companies have not been part of this surge. Of the 25 IPOs completed in 2016, all were by Asian companies. Of the 46 IPOs completed in 2017, only two were by western companies. All of the rest were by Asian companies, mostly Chinese. In any case, the IPOs over the last two years have generally been very small. As a result, the total dollar volume in 2017, for example, was only $4.3bn.

The two western chemical company IPOs last year were completed by PQ and Venator Materials. Both were challenging to execute. Prior to that, the last western chemical IPO was the Covestro IPO in 2015 that was also difficult.

STOCK MARKET OUTLOOK

We believe the overall global economy will continue to see steady growth and, on a global equity basis, the flow of funds macro trends will continue to drive investors to the US and partially European equity markets as long as the alternatives continue to be unattractive.

The stock market has been favouring the chemical industry due to strong earnings fundamentals. If there is no major geopolitical or economic disruption, we expect the strong stock market performance of the chemical industry to continue as long as the western equity markets continue to be safe havens for funds.

If there is a significant downturn in global economic and financial conditions and/or major increases in interest rates, neither of which anyone expects, we would expect earnings and the valuations of industrial companies, including chemicals, to suffer.

DEBT AND EQUITY FINANCING OUTLOOK

Investor demand for investment grade debt has been very strong and will continue to be strong. Volume will be driven heavily by issuer needs such as M&A rather than investor demand. The likely solid to high level of M&A by strategics in 2018 will fuel investment grade financing.

High yield debt issuance will continue to be healthy, but more modest. Equity issuance, both secondary and IPO related, will continue to be dominated by Asian issuers. There has been a recent weakening of the Chinese stock market, which will moderately lower the number of Chinese secondary and IPO equity offerings. Western IPOs will continue to be dormant.

Therefore, overall we expect strong, but slightly fewer equity offerings. They will be almost entirely Asian and very small.

IMPLICATIONS FOR MANAGEMENT

For those companies already public, we expect valuations and share prices to continue to be strong, which will be a positive for shareholders. 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 private companies, unless you are an Asian chemical company, the IPO market is virtually shut.

Although interest rates increased very slightly last year and there may be some further increases in interest rates this year, there is no sign of any end to the easy availability of low interest debt. This is certainly true for investment grade companies, allowing them to finance acquisitions and major capital expenditures with low cost debt.

High yield will continue to be healthy, but more volatile. However, it will be healthy enough to support the M&A and recapitalisation activities of these 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. The firm has extensive industry knowledge, contacts, technical expertise and an absence of conflicts of interest. Young & Partners has served a global client base of companies in Europe, North America, Latin America and Asia for the last 22 years. Peter Young can be reached at *pyoung@youngandpartners.com*. The Young & Partners website is *www.youngandpartners.com*