Highs, lows and the unexpected

The investment grade debt market is wide open for chemical companies seeking to raise funds. Equity issuance dominated by smaller Asia offerings

Many of the chemical IPOs have taken place in China

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A lot has happened since our last report on the stock market and financing in ICIS Chemical Business in February. Last year the stock market treatment of the chemical industry was positive and there was a record level of debt and equity financing on all fronts. Although some of the trends are the same this year, 2017 is turning out to be very different in a number of ways.

During the first half of 2017, the western global equity markets performed modestly well with the US S&P 500 increasing 7.3% and the UK's FTSE 100 rising 1.9%. Performance in other countries and regions varied considerably.

The positive performance was fueled by overall economic growth in major parts of the globe, strong earnings from the major companies, confidence that China and India would continue to keep their economies from faltering in the medium term, hope that certain legislative and other changes in the US would fuel growth and investment, and the absence of alternative places to invest. This positive performance was in spite of the geopolitical turmoil that has increased due to Trump, North Korea, events in the Middle East, etc. There was some stumbling of the markets in August due to concerns about the US debt ceiling and budget issues that need to be resolved.

Interest rates increased very modestly at the end of last year, but have continued to be very low. Overall, 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, real estate and safe haven debt such as US, Japanese, German and Swiss government and corporate investment grade debt.

The stock market continues to favor the chemical industry for its strong earnings and cash flow fundamentals. The industry has been trading at valuation multiples close to the overall market. There has been a moderate weakening of chemical company valuations recently, but they are still trading close to the overall market valuation multiples.

The four Young & Partners (Y&P) US chemical indices did well, with the exception of fertilizers where there has been a meltdown due to poor conditions in the farming industry.

The Y&P US Basic Chemicals index increased by 4.3%, the US Diversified Chemicals index was up by 9.6%, the US/Canada Fertilizers index decreased by 12.9% and the US Specialties index jumped 18.4%. The chemical indices in Europe did even better. The Y&P European Basic Chemicals index increased by 13.9%, the European Diversified index gained 15.4% and the European Specialties index jumped 19.2%. These were exceptional results.

In terms of valuations, as of the end of first half of 2017, three of the seven Y&P chemical indices were trading at an EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) premium to the already high overall market indices. On a P/E (price-earnings) basis, by the end of first half of 2017, four of the seven Y&P chemical indices were trading at a P/E premium versus already very high overall market multiples.

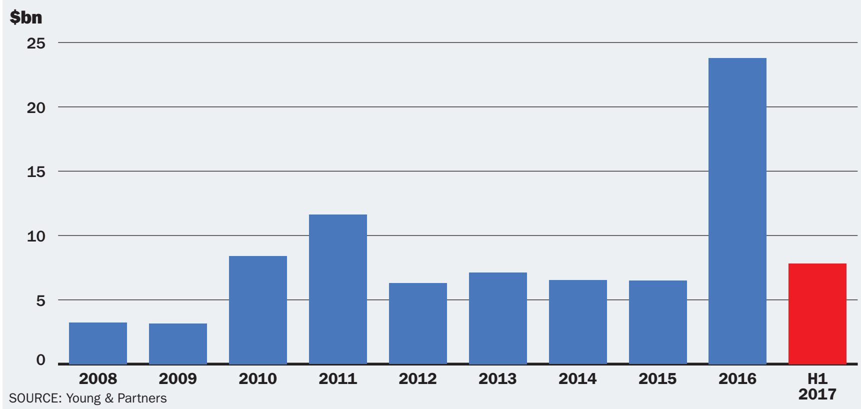
The message is that the overall western equity markets are at very high valuations and the western chemical public companies, with the exception of fertilizer companies, are also trading at high valuations. If there is no major geopolitical or economic disruptions, we expect this to continue as long as the western equity markets continue to be safe havens for funds and industrial companies such as chemicals continue to perform well financially.

CHEMICAL DEBT FINANCING

Chemical industry debt issuance activity in the first half of 2017 was about the same as 2016. Global non-bank debt financing was \$23.5bn in the first half (\$47bn on an annualised basis) compared to \$45.9bn for all of 2016.

Investment grade debt issuance was $22.2bn, a higher pace compared to 2016 when $38bn was issued. Investment grade companies have virtually unlimited access to the debt markets and have used the debt markets to fund mergers and acquisitions (M&A) and to refinance. High yield debt issuance, however, was weaker at $2.2bn compared to $8bn for all of 2016. This is a reflection of a modest pullback in the high yield market as a whole this year.

GLOBAL CHEMICAL INDUSTRY EQUITY FINANCING



SOURCE: Young & Partners

CHEMICAL EQUITY FINANCING

Overall chemical equity issuance was spectacularly strong in 2016, but, unlike the debt markets, dollar volume has fallen considerably even as the number of offerings has increased.

In the first half of 2017, $7.8bn in equity was issued from 46 offerings. This compares to $23.8bn in equity issued in 2016 from 71 equity offerings. The need for equity by the larger companies has fallen and the initial public offerings (IPOs) have been very modest in size.

Interestingly, the totals for both IPOs and secondary offerings have been dominated by Asian companies issuing in the Asian public markets. Focusing on IPOs over the last 30 years, the highest IPO dollar amount was $5bn in 2006 and the highest number was 14 in 1995. For most years, the dollar volume was under $1bn and the number of IPOs was between zero and three. These are astonishingly low numbers and indicate how limited the IPO market for chemicals has been for a very long time.

Much of that changed in 2016 at least in terms of the number of IPOs when 25 IPOs were completed for a total of $2bn. The $2bn dollar amount was in line with history, but the number of IPOs as a stunner. However, all of those IPOs were completed in Asia and almost all were by Chinese companies.

The pattern in the first half of 2017 was even more pronounced as 25 IPOs were completed for a total of $1.9bn. All 25 were by Asian companies and almost all by Chinese companies. Sadly, non-Asian IPOs have been non-existent. If the current trend continues, we will almost certainly set another record for the number of IPOs and possibly match or exceed the record for dollar volume. There is no question that Asian companies dominate the equity issuance market. But private chemical businesses and divisions of larger companies in the west have been locked out of the IPO market for some time now. The last western chemical IPO was Covestro in 2015.

However, investors will continue to have a strong appetite for existing public chemical shares of western chemical companies.

STOCK MARKET OUTLOOK

The stock market has been favouring the chemical industry due to the overall steady global economic picture in the major countries and the industry's strong earnings fundamentals. As a result, the industry has been trading at valuations that are at or slightly below the overall market. We believe that on a global equity basis, the flow of funds macro trend will continue to drive investors to the US and partially the European equity markets as long as the alternative investments continue to be unattractive. We also believe that the chemical industry will do well given the earnings strength of the industry.

However, if there is a significant downturn in global economic and financial conditions or a major geopolitical crisis, we would expect the stock market to falter and chemical company shares to suffer. Depending on the nature of the economic downturn or geopolitical crisis, earnings and the valuations of chemical companies could also suffer.

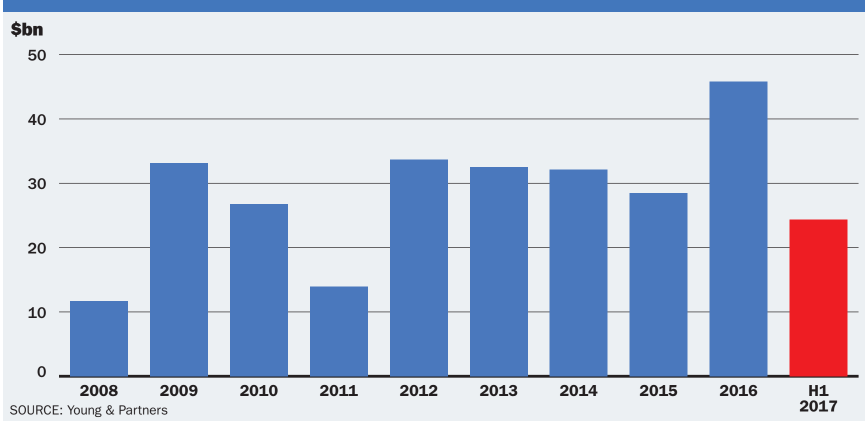
DEBT, EQUITY FINANCING OUTLOOK

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 may help to offset the loss of last year's refinancing driven volume. High yield debt issuance will continue to be healthy, but modest. Higher interest rates are having an effect on bond fund returns.Equity issuance has been and will continue to be dominated by Asian issuers. Chinese and other Asian companies will continue seeking liquidity and funding on the Asian stock market exchanges.

IMPLICATIONS FOR MANAGEMENT

For companies who are already public, we expect share prices and valuations to continue to be strong which will be a positive for shareholder value and as a source of funding when companies need funds beyond what they can borrow from the very attractive debt markets. For companies who are private, unless you are an Asian chemical company, the IPO market is virtually shut for companies in the US, Europe and many other non-Asian countries. ■

GLOBAL CHEMICAL INDUSTRY DEBT FINANCING



SOURCE: Young & Partners

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