The normal and abnormal in equity

There is a disconnect between the high interest in and high valuations of already public chemical stocks, and the weak market for chemical IPOs

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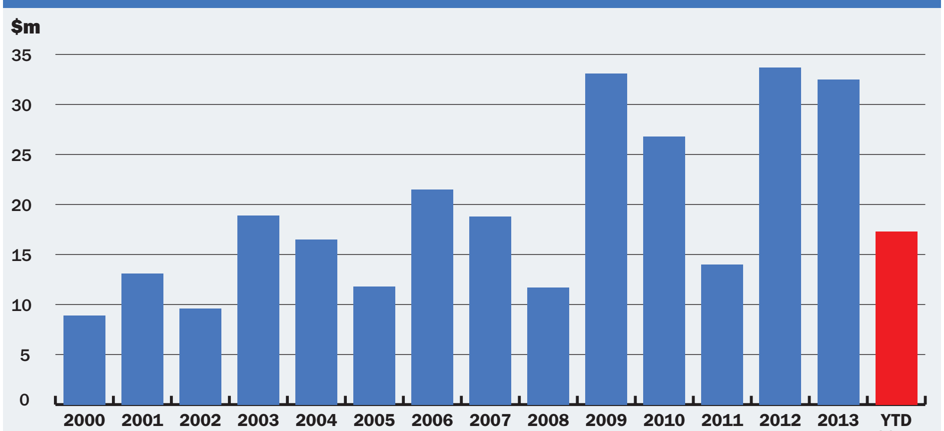
Sometimes the equity and debt markets behave in ways that are unusual. Although some aspects are continuing their normal path, others are not following conventional wisdom or logic. We will share what is happening now and what we expect in the future with regard to chemical industry stock market performance, issuance of equity and debt, and initial public offering (IPO) activity.

The normal trends that have been happening are the strong performance of the stock market; easy availability of debt overall; and low interest rates.

But the unusual trends are the stock market not reacting to a rash of global geopolitical and military crises; stock market valuations equal to or higher than mergers and acquisitions (M&A) values in a peak M&A market; and lacklustre chemical IPOs at a time when stock market valuations are high and the general IPO market is very strong.

CHEMICAL DEBT FINANCING



SOURCE: Young & Partners

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STOCK MARKET

The history of the relationship between the stock market and the chemical industry has always been a difficult one, with the industry severely undervalued for long periods of time, followed by shorter periods when it is overvalued.

Through the first half of 2014, the overall market did well, with the S&P 500 increasing by 6.1% and the FTSE Euro Top 100 by 3.7%. Capital continues to look for returns, and with very little return in the debt markets with exceptionally low interest rates and other asset categories looking to be at high values, the equity market continues to see strong capital inflows.

But the chemical industry did even better. Six of the seven Young & Partners chemical stock price indices significantly outperformed the overall market. As a result, chemical equity valuations are well above general market valuations. Trailing price/earnings (P/E) ratios of our chemical indices range from 27.3x to 32.3x, versus 19.4x for the S&P 500.

Chemical companies that once traded at 6x EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) just two years ago are now at 11x or higher.

Does this mean that chemical companies are worth that much? Not on a sustained basis and not relative to their expected revenues and earnings growth. So what is going on? First and foremost, we are in a period when the equity market is getting a disproportionate amount of capital as investors desperately look for returns where the alternatives are unattractive.

But with the inevitable increase in interest rates that economists expect at the latest in mid-2015 and the potential for a major disappointment such as a slowdown in the Chinese economy, some correction in the equity markets is expected and inevitable.

The US Federal Reserve is even thinking of raising interest rates earlier than mid-2015 over concerns about inflation and the asset bubbles that have been created from ultra-low interest rates.

Second, the market is particularly in love with industrial companies that are benefiting from the economic recovery in the US and, with more caution, the recovery in Europe. This will last for awhile, but cannot last forever.

GEOPOLITICAL TURMOIL

What about the non-reaction of chemical stocks and the stock market generally to the geopolitical turmoil?

There was speculation earlier this year that there might be an equity market retreat due to the problems in emerging market countries and the rash of geopolitical turmoil. Many developing market countries are either in political and/or military turmoil (Egypt, Thailand, Ukraine, Turkey, Syria, Iraq, Israel/Gaza) or under severe pressure in terms of capital flows, economic performance and exchange rates (Argentina, Brazil, Vietnam, Cambodia, India).

There are at least three reasons why the equity markets have not shown much concern. First, the flood of liquidity provided by the US Fed and the European Central Bank (ECB) has pushed down market risk and supported investment in higher risk securities.

Second, investors perceive that the countries undergoing turmoil are small relative to the global economy.

Third, Middle East oil is less important today given the massive increase in oil and gas production in the US and Canada. The fact that the price of oil has dropped below \$100/bbl while violence has erupted in multiple parts of the Middle East is clear evidence that this is true.

PUBLIC VALUES ABOVE M&A VALUES

The fact that trading values are equal or higher than M&A values today is particularly unusual. To cite just one example, the average specialty chemical M&A EV/EBITDA multiple currently is 9.3x. The average trading EV/EBITDA for the Young & Partners US Specialty Chemical Index is 11.7x and for the Young & Partners European Specialty Chemical Index is 12.3x.

It is more typical that trading values, which do not include any synergies or premiums associated with taking control of a company, are materially lower than M&A values. Note that we are at a peak in the M&A cycle for chemicals, so we are not comparing trading values to trough M&A values.

The plain and simple explanation is that the stock market has become overvalued and the stock market values of companies do not reflect the value of the company to an industrial buyer buying it as a business.

Ultimately the stock market will go through a correction. In the meantime, however, public companies will be able to use their shares as very valuable acquisition currency, potential buyers of public companies will either have to overpay or forego these acquisitions, and private companies that cannot go public will seek to merge with existing public companies to "go public" without doing an IPO.

NON-BANK DEBT SLOWS MODERATELY

Chemical debt financing slowed moderately in the first half of 2014, primarily due to a decrease in high yield issuance. Global non-bank debt financing was \$17.3bn in H1 2014 versus \$23.5bn for H1 2013. Interest rates continue to be exceptionally low and attractive for issuers.

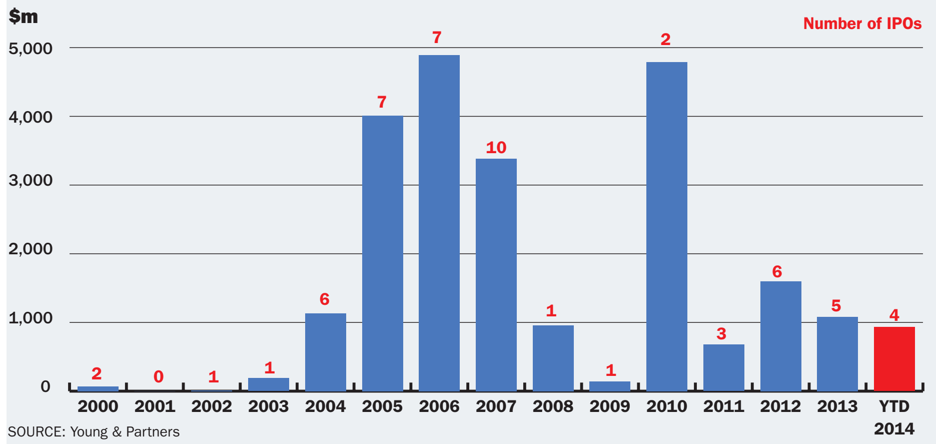
Investment grade debt was steady at \$15.4bn in H1 2014 compared to \$15.7bn for H1 2013. Investors continue to flock to strong investment grade chemical companies with volume only limited by the amount of financing the companies need.

On the other hand, high yield debt issuance fell, with only \$1.9bn issued in H1 2014 compared to \$9.5bn for all of 2013. Investors withdrew from high yield funds with the tapering of US Fed bond purchases and the surge in geopolitical problems. This lull did not last for long as the market reconsidered those events and continued its quest for yield.

EQUITY FINANCING, IPOS STILL MODEST

Global chemical equity issuance has historically been very modest. The industry, with its strong cash flows, excess cash, access to low cost debt financing, and no large M&A deals requiring balance sheet adjustments through the issuance of equity, has had limited need for public equity. In H1 2014, only \$2.7bn of equity was issued in 11 offerings.

CHEMICAL INDUSTRY IPOS



SOURCE: Young & Partners

STAGNANT CHEMICAL IPO ACTIVITY

Chemical IPO activity has been very modest for the last couple of years, with just five in 2013 and six in 2012. Of the few chemical IPOs that have succeeded in the last five years, the themes have been fertilizers, emerging markets, alternative materials, and high margin products.

Investment banks have been encouraging chemical companies to explore going public, citing the very active general IPO market and high trading valuations. However, only four IPOs were completed in H1 2014, raising only \$932m.

The four IPOs were Green Seal Holding (\$63m), PCC Rokita (\$32m), Trinseo (\$190m), and Tianhe Chemicals Group (\$646m). With the exception of US-based styrene producer Trinseo, the IPOs were by emerging market companies.

The IPO of Orion Engineered Carbons has been completed since then, but below the original price range. PQ Corp filed for an IPO while conducting a "dual track" sale, but settled for a sale of 47% of the company to CCMP Capital Advisors.

The general message is that investors apply a very different and higher standard across a variety of issues when they accept or reject chemical firms trying to go public.

They are not accepting weaker, lower margin, and most commodity chemical companies today. Is it fair? Absolutely not. Is it going to change anytime soon? Absolutely not.

STOCK MARKET OUTLOOK

The stock market has been modestly favouring the chemical industry due to the its strong earnings fundamentals and restrained capacity increases.

The US and European chemical sectors are trading at a premium to the general market. It is unclear where the industry valuation is heading given the overall uncertainty and recent volatility in economic and financial markets.

Should global economic growth continue to revive overall, we would expect chemicals to outperform the market. In an era of sluggish or no growth and financial uncertainty, the industry is likely to suffer more and trade at a discount.

Chemical stock performance will be heavily driven by macro trends, but we believe that, independent of the possibility of an overall stock market correction, chemicals should continue to do well in 2014.

DEBT AND EQUITY FINANCING OUTLOOK

Equity financing volume will likely continue to be modest given the market's historic bias against the chemical sector, the sector's limited need for equity capital, as well as general IPO market conditions.

Even if general IPO market continues to be healthy, we expect only a modest number of chemical IPOs through the end of 2014 and they will be modest in size. There have only been five thus far, and we would be surprised to see more than one more IPO by the end of 2014.

Investment grade debt volume will be driven by issuer demand as opposed to investor demand. M&A related financing will drive volume. We expect investor demand to stay strong. High yield debt issuance will continue to be available, but relatively strong in the US and more volatile in Europe due to the latter's economic problems.

In summary, we expect chemical public valuations to stay high for now and debt to be easily available. But IPOs will be few and far between. And the high chemical trading values will be both a curse and a blessing, depending on who you are and what you are trying to do. ■

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. Young & Partners has served a global client base of companies in Europe, North America, Latin America and Asia for the last 18 years.