Rex Features

Deal-making rebounded in 2013 and conditions are lining up for more activity this year

Positive M&A to continue in 2014

The overall outlook on economic and chemical mergers and acquisitions activity is positive, but there are factors that could derail the upward trend

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We are cautiously optimistic about how 2014 will play out for the chemical industry from a strategic, business performance, stock market, M&A and financing point of view. It is our hope and expectation that 2014 will turn out to be as positive as 2013 was for the industry. However, we fully acknowledge that there are both upside and downside scenarios that have reasonable odds of happening, principally driven by world economic and financial factors that are difficult to predict and are outside the control of senior management.

2013 was a positive year for the chemical industry overall. The US survived a budget crisis, Europe showed some economic improvement, China continued its strong growth, and weakness in certain developing and emerging markets did not put a dent in the overall economic picture.

Earnings were solid except in specific regions, the stock market was kind to the industry, mergers and acquisitions (M&A) activity improved significantly and debt was relatively easy to raise with only modest increases in interest rates.

Only chemical industry equity financing was tepid, a chronic outcome for the industry, and high-yield financing in Europe was a challenge.

However, the start of 2014 has brought new challenges to the industry as the stock market has stumbled and emerging market countries are experiencing a downdraft. As the US Federal Reserve tapers its bond purchases, emerging market country exchange rates, capital inflows and economic activity have all suffered.

Coupled with renewed concerns about sustainability of growth in China, the US economic recovery, and the ongoing European economic struggles, the trajectory of the global economy in 2014 is uncertain. Will we see a net deterioration in the global economic and financial conditions, or will the rocky start to the year stabilise and see a stronger 2014 versus 2013? There are reasonable arguments for either scenario.

What will this mean for the chemical industry, its stock market performance, and the health of the M&A and financing markets?

2013 was generally favorable for the chemical industry in terms of profitability, cash flows and demand as the US continued its slow recovery and China continued to prosper. Europe was the most difficult region of size with regard to demand because of the weak economic conditions there, but there was significant improvement compared to 2012.

STOCK MARKET PERFORMANCE

Chemical industry equities performed exceptionally well in 2013 on an absolute and on a relative basis compared to the market indices. A portion of this positive performance was driven by the success of the overall stock market.

The US broader market as measured by the S&P 500 increased by 26.4% and the FTSE Euro Top 100 increased by 12.6%. Some of the increase was due to the market's positive perception of corporate earnings and the broader global economy, but a greater part has been capital trying to find a home where there are very few attractive alternatives, particularly in debt instruments.

But the chemical industry did even better. The Young & Partners (Y&P) US Basic Chemicals index increased by 34%, Y&P US Specialties index by 27% and the Y&P US Diversifieds index by 38%. Only the Y&P US/Canada Fertilizer chemical index underperformed on an absolute and relative basis with a loss of 9%.

In Europe, performance was not as strong but still very impressive, with the Y&P European Basic Chemicals index increasing 10%, Y&P European Diversifieds index increasing 26% and Y&P European Specialties index increasing 30%.

What has powered this strong performance? The chemical industry was swept up in an enthusiasm for industrial companies benefiting from the global economic recovery.

US chemical companies in particular did well because of the excitement associated with the benefits of shale oil and gas and the relative performance of the US economy. This strong stock market performance also drove up the valuations of chemical companies from both a price/earnings (P/E) and an enterprise value/EBITDA (EV/EBITDA) basis.

This was a boon to investors, but also had an indirect effect on the M&A market, making it more difficult to acquire public chemical companies. A handful of chemical companies, some private equity owned, were able to go public and achieve valuations that were comparable to M&A multiples.

ACTIVIST INVESTORS

The most notable new equity market event in 2013 was the flurry of shareholder activist activity aimed at chemical companies. Targets include American Pacific, Ferro, Air Products, Ashland, LSB Industries, DuPont, and Dow Chemical.

Case by case, the companies have had to deal with the activist and have reacted in a number of ways.

> **"The M&A rebound was really driven by a reduction in the number of macro uncertainties, the cyclical convergence of buyer and seller price expectations, and a growing movement of assets in Asia"**

American Pacific granted the activists seats on the board and recently announced a sale of the company to HIG Capital. Ferro cut costs, sold off smaller non-core businesses and fended off an offer from A. Schulman. Ashland increased its dividend and share repurchases and began to divest a number of businesses. Air Products announced the retirement of its CEO. DuPont announced that it will spin-off of its performance chemicals division that represents $7bn of its revenues. Dow has increased its stock dividend and share repurchase programme and indicated that it was pursuing its own "shareholder activist" programme.

In general, for shareholder activists making the argument that their target is undervalued on a trading basis, the argument is a hard one to make because chemical companies have been trading at very high valuations, making them less obvious targets as "undervalued" companies.

M&A PERFORMANCE

The M&A market experienced a significant rebound in 2013. On an equity value basis, $31bn of deals greater than $25m in value were completed globally in 2013. This dollar volume was about 41% greater than the $22bn total in 2012 which was a trough year.

In terms of numbers of transactions, there were 83 deals completed in 2013 compared to 64 deals completed in 2012. This was a 30% increase in the number of deals completed. M&A valuations also increased across both specialties and commodities.

What caused this rebound in the M&A market? As one would expect, there are a number of factors.

Some of the supportive factors helped, but were also in place during the trough year and did not drive the increase: low interest rates, solid cash flows, large cash stockpiles, a need to enhance corporate growth beyond organic growth, corporate restructuring activities, and ongoing private equity buying and selling of assets.

The rebound was really driven by a reduction in the number of macro uncertainties from a very high level to a more tolerable level, the cyclical convergence of buyer and seller price expectations after an M&A trough, and a growing movement of assets in Asia – a strategically important region for the industry.

This rebound was uplifting and consistent with our predictions that the market would improve significantly, but not yet return to the peak levels experienced in 2011.

The number of large deals was subdued due to residual CEO concerns about economic and financial uncertainties.

There were concerns about China, lingering problems in Europe, new concerns about the emerging markets, the anxiety over the US debt ceiling and budget crisis that was only temporarily solved on 30 September and rising interest rates. This explains why the number of deals above $1bn increased only modestly from 2012 to 2013.

DEBT FINANCING

The debt markets continue to be favourable overall and chemical industry debt financing remained elevated in 2013. This was achieved even as interest increased moderately.

Global non-bank debt financing was strong again, with $32.5bn issued in 2013 versus $33.8bn for 2012.

Investment grade debt totalled $23.1bn in 2013 compared to $17.9bn in 2012. Issuance in this category continues to be driven by how much the investment grade companies want to borrow, often to finance M&A activity.

High yield debt issuance dropped but remained healthy with $9.5bn issued in 2013. This compares to $15.8bn issued in 2012. Only the European high yield debt market was soft with the ongoing concerns about that region.

This healthy debt issuance market greatly benefited the chemical industry as a very favourable source of funding for growth, acquisitions, dividends and stock repurchases.

EQUITY FINANCING

In 2013 there were 20 equity offerings totalling $7.1bn by the chemical industry. This compares to 17 offerings totalling $6.3bn in 2012. »

This was a clear improvement, but on a chronically modest base.

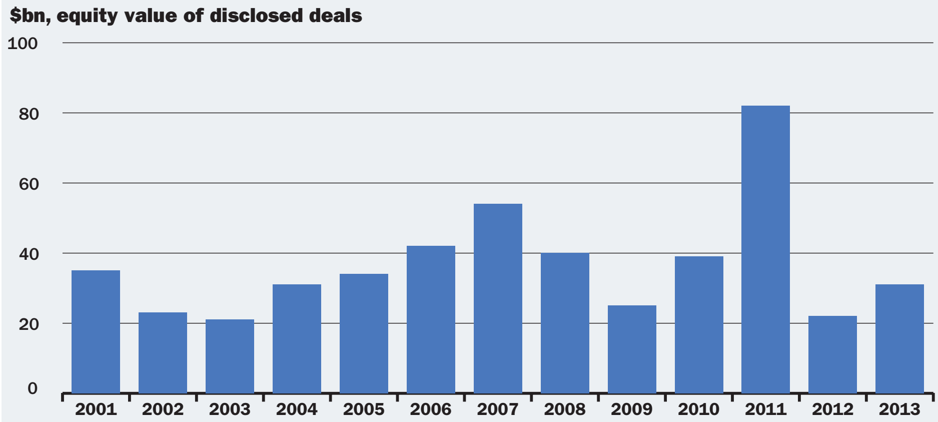
With strong cash flows, excess cash, access to low-cost debt financing and no large M&A deals requiring subsequent balance sheet adjustments through the issuance of equity, the chemical industry's need for public equity has always been limited and was limited last year.

However, it is also true that the equity markets have not been in love with the chemical industry. Even when valuations have been strong, interest in chemical industry new equity has been much weaker than many industries.

The overall initial public offering (IPO) market was very strong for much of 2013, allowing companies in many industry sectors to go public. Coupled with the positive equity market performance of chemicals, there was a modest increase in chemical IPO activity last year.

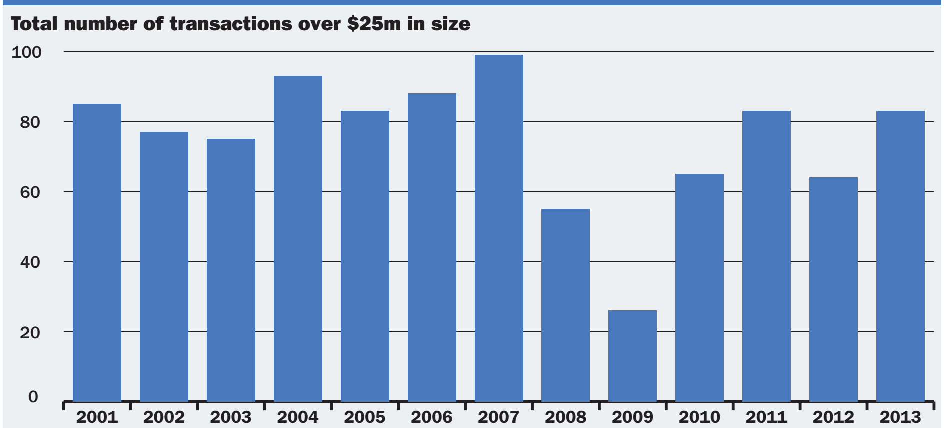
Five chemical company IPOs were completed in 2013: Taminco, BioAmber, Evonik, Marrone Bio Innovations, and OCI Partners. This is comparable to the six IPOs that were completed in 2012, but relatively low compared to previous peaks in chemical IPO activity.

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – DOLLAR VOLUME



SOURCE: YOUNG & PARTNERS

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – NUMBER OF DEALS



SOURCE: YOUNG & PARTNERS

WHAT WILL THE FUTURE BRING?

The start of 2014 has been rocky for the emerging markets with regard to their financial position; currency rates; capital flows; and stock market performance as the US Federal Reserve has tapered its bond purchasing programme; and an improving US economy has diverted the flow of capital.

In addition, the political turmoil in Turkey, Egypt, Thailand and other countries has contributed to uncertainty and the global capital market weakness.

There have also been recent concerns about the Chinese economy and some small signs of weaker than anticipated economic activity in the US. For these reasons, the economic outlook is unclear since it is not known if the emerging market problems will get worse or the extent to which it will spill over to the developed countries.

We believe that the most likely scenario is a recovery from the weak start to 2014. We will see a continued slow economic recovery in the US and Europe, another year of slightly lower but solid growth in China and a modest downward pull on the global economic growth as a result of ongoing emerging market country turmoil. This will be a good scenario for the chemical industry.

However, the probability of a downside scenario is greater than an upside scenario relative to our most likely case for the reasons articulated above.

Nonetheless, whichever scenario does prevail, the global economic performance this year will directly affect the capital markets and will be a principal driver of chemical industry profitability, stock market performance and M&A activity

The outlook for the stock market performance of the chemical industry will be heavily driven by the performance of the overall stock market and the general outlook for industrial companies who depend heavily on the performance of the global economies and the financial system.

The chemical industry is currently trading at a premium to the general market as a favoured industrial industry. Should global economic growth continue, we expect chemicals to continue to do well. However, in an era of sluggish growth or disruptions to the financial system, the industry will likely lose its aura along with other industrials and trade at a discount to the market in a declining overall equity market.

Young & Partners believes that the outlook for the chemical industry M&A market is very positive and we expect to see a solid 2014. Only an economic disruption in some combination of the larger economic regions of Europe, China and/or the US will create a significant negative economic disruption. This is possible, but not highly likely. Meltdowns in the smaller emerging market countries are unlikely to be large enough to have a broad effect unless the contagion spreads to the larger economies.

Equity financing volume will likely continue to be modest given the market's historic bias against the chemical sector and the chemical sector's limited need for equity capital. If the equity market revive from its slump at the start of this year and the IPO market overall picks up again, we will not be surprised to see 4 or 5 chemical IPOs in 2014, but they will be moderate in size.

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 volatile, but relatively strong in the US and more depressed in Europe due to the sovereign deficit and debt problems in the eurozone. ■

Peter Young is President of Young & Partners, an investment banking firm that serves the M&A and financing needs of the chemical and life science industries worldwide. Young & Partners is in its 19th year and serves a global client base of large and mid-sized companies.