QUARTERLY UPDATE
MERGERS & ACQUISITIONS

The first half of this year has seen a sharp rise in the number and value of deals

Rex Features

M&A strong amid nervous prosperity

Chemical mergers and acquisitions activity hits peak levels, but global macro factors are cause for concern, so there is much to look out for in the coming months

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The strength of any mergers and acquisitions (M&A) market is heavily driven by the presence of strong economic and financial conditions. When earnings and cash flows are strong and predictable, when financing is available on attractive terms and when sellers are willing to sell for financial and strategic reasons, M&A volume is usually high, with valuations to match.

These conditions have been present in the global chemical industry for 18 months. Public-company executives have also been stockpiling cash and are under intense pressure to grow in excess of their ability to grow organically, fueling the drive to make acquisitions.

The first half of 2011 was particularly active. In equity value, $40bn (€28bn) of deals were completed, up from $39bn for the whole of 2010 and a continuation of the surge in volume that started at the beginning of that year.

Even more significant is that the number of these deals worth more than $25m jumped to 45 in the first half of 2011 from 32 during the first half of 2010 and 33 in the second half.

The value of deals in progress on June 30, 2011 was $34bn, a clear sign of a strong M&A market. M&A valuations also have increased dramatically since the late 2009 trough.

Young & Partners believes the chemical M&A market has reached peak levels in terms of both activity and valuations. But there are some differences among certain segments of the industry. For example, basic chemical activity has been particularly strong in volume terms and financial buyers have lost significant market share. Nonetheless, the overall market is clearly at a peak.

Financial buyers have lost share as strategic buyers have become increasingly aggressive and public market valuations have surged. In the first half of 2011, financial buyers accounted for only 7% of the number of deals, down from 21% in 2010. This decline is in line with our prediction at the end of last year that financial buyers would begin to lose share against industrial buyers as valuations escalated.

After the worldwide financial crisis in 2008-2009, the global economy stabilized and credit became available. Governments around the world lowered interest rates, provided massive stimulus programs, pumped extensive liquidity into their economies and provided rescue loans for countries in financial trouble.

Economic growth, however, has been uneven. Emerging markets have experienced relatively robust performance but there has been slower growth in the US, Europe and Japan.

Much of the global growth has been fueled by unsustainable government stimulus programs and spending, even in a number of the emerging markets.

STORM CLOUDS IN THE SKY?

Although the recovery has been a blessing, there are negative signs all around us.

The housing market in the US and Europe shows no sign of a recovery. High unemployment persists in the Western countries. Signs of credit and construction bubbles are visible in various emerging markets.

In addition, national, state and local government deficits and debt levels are extremely high around the world, coupled with consumer debt that is still high. Debt rating downgrades and negative outlook warnings are escalating, particularly in Europe.

Unfortunately, in order to deal with deficits and high debt levels, spending cuts and tax increases have been adopted by many governments and will slow economic growth.

The chemical industry picture has been bright for at least two years as prices, volumes and margins have been strong for much of the industry. Numerous positive factors, many long-term in nature, are benefiting the industry. The surge in natural gas supplies in North America pushed down natural gas prices in the US in a manner that is benefiting local chemical operations.

Supplies of chemicals from the Middle East are not increasing as rapidly as expected. Strong export-driven demand in Asia and an economic recovery in the West, albeit fragile, have also favored chemicals.

In addition, chemical companies have mothballed plants and have been reluctant to add capacity during the downturn, creating a period of tight capacity that will last until new capacity inevitably comes on-stream. For the commodity chemical companies, which take longer to add significant capacity, tight capacity will either be a medium-term boon or help soften the impact of an economic downturn.

If there is no severe financial downturn, Young & Partners expects M&A volume until early 2012 to be strong

A caveat is that downstream companies buying feedstocks and intermediates have faced major price increases due to higher oil prices and tight upstream capacity utilization. These downstream companies are concerned about their ability to continue to raise prices to cover raw-material cost increases.

Although Young & Partners believes that the mostly likely scenario is a fragile but stable economic and financial picture, there are several potential wild cards, the effects of which could disrupt the weak global economy and finances. These wild cards include:

- Escalating inflation in food, energy, oil and other commodity prices
- The impact of reduced fiscal stimulus spending worldwide
- Withdrawal of the unprecedented liquidity measures in the US
- Escalating governmental (sovereign, state or local) debt crises, particularly in Europe and Japan and concerns about US debt
- Persistently high long-term unemployment and consumer debt in the US and Europe
- The Japanese earthquake disaster
- A bursting of the lending and construction bubble in markets such as China as governments tighten credit and raise interest rates
- Disruptions from the political uprisings in the Middle East and North Africa

The crises surrounding sovereign debt in Europe, concerns about US debt, and rising unemployment and weak housing markets in the West illustrate the global economic fragility. If the wild cards' negative effects are limited, the impact will still be noticeable but not disastrous. But if the wild cards fall in large numbers with each producing a high level of severity, we will suffer a significant economic and financial downturn.

The key issue for the chemical industry is whether the fragile global conditions remain stable or become severely disrupted, which would negatively affect the industry.

OUTLOOK FOR CHEMICAL M&A

If there is no severe financial and economic downturn, Young & Partners expects M&A volume for the rest of 2011 and early 2012 to be strong, with a positive outlook due to a number of factors:

- A strong supply of divestitures from restructuring chemical companies and the sale of private equity owned businesses
- A fragile but stable global economy supporting buyer confidence in their own earnings and the earnings of acquisition targets
- The ready availability of debt financing at low interest rates
- The need to use a growing cash stockpile that chemical companies have been amassing
- Pressure on chemical companies to grow in excess of organic growth and to achieve strategic goals that only M&A can satisfy

The financial buyers, with higher M&A multiples and public-trading values that are no longer at a discount to the market, will continue to lose market share to strategic buyers.

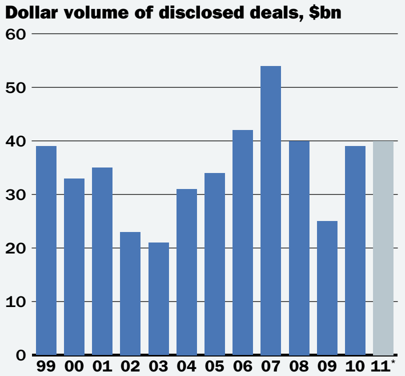
M&A activity in the Asia/rest-of-the-world areas will remain on par with the other global regions in terms of the target assets.

The long list of deals announced but not yet closed supports our prediction of a strong second half in 2011.

Some of the announced chemical industry deals include US-based Ashland's acquisition of US-based International Specialty Products, Belgium-based Solvay's acquisition of France's Rhodia, US holding company Berkshire Hathaway's acquisition of US-based Lubrizol, Switzerland-based Lonza's acquisition of US-based Arch Chemicals, and US-based Ecolab's acquisition of US-based Nalco. ■

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – EQUITY VALUE

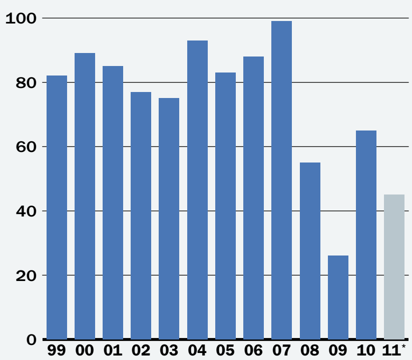
Dollar volume of disclosed deals, $bn



NOTE: *first-half figure SOURCE: Young & Partners

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES – DEALS

Total number of transactions over $25m



NOTE: *first-half figure SOURCE: Young & Partners

Peter Young is president and managing director of Young & Partners with more than 25 years of experience in the field. Young & Partners is a leading investment bank serving the chemical and life sciences industries worldwide.