Chemical financing markets improve, but there are still some clouds

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The chemical financing market has made great strides in 2010 and remains buoyant. But some storm clouds loom on the horizon. What is the outlook for 2011?

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The year 2010 has been a period of mostly good news for the chemical industry on the earnings and debt-financing sides, and mixed news on the equity front. The industry went through the depths of the economic and financial crisis in late 2008 and the early part of 2009, but there was a recovery in earnings and in debt financing that started in 2009 and that has continued thus far through 2010.

As the market came to realize that the global economy was not entering a depression, the financial markets began to stabilize, interest rates were driven down to very low levels, and investors faced a dilemma with regard to where to find returns and where to invest.

As chemical earnings rebounded, bond investors sought safe places to invest with any kind of yield, moving first into **investment-grade debt** and then into **high-yield debt**. Banks also started lending, although cautiously. The flood of bankruptcies in the chemical industry stopped at the end of the fourth quarter (Q4) of 2009, as earnings improved and troubled companies were able to refinance and extend maturities.

The equity side has been more of a rollercoaster as the stock market plunged in the first half of 2009, recovered from that dive, plunged again earlier this year, and then powered to 52-week highs through mid-November. The equity financing side for chemicals, unfortunately, has been weak all along, particularly with regard to **initial public offerings (IPOs)**. There has only been one chemical IPO in each year since 2008.

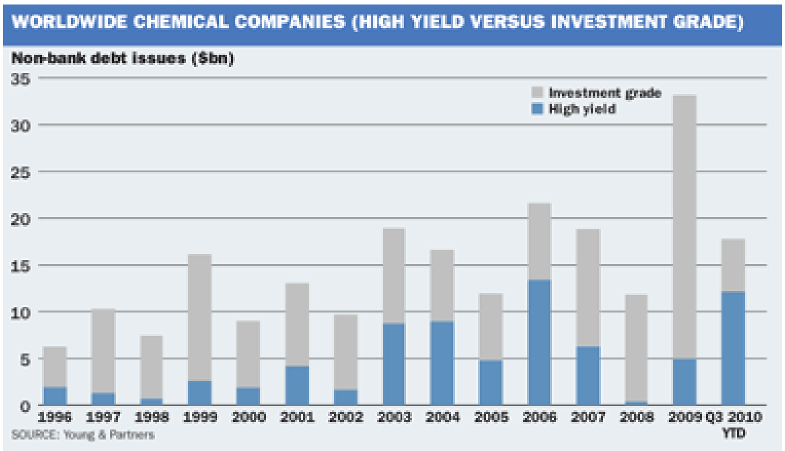
Although the global economy is clearly in better shape, chemical earnings are very strong, fears of a double-dip recession have receded, and most parts of the financing system are now functioning, the skies are still partly cloudy.

There is a distinct possibility that any number of forces could materially turn negative. Some of these forces include an escalating sovereign debt financial crisis in Europe - the latest being focused on Ireland, a slowing of the US and European economies that may stumble further with the end of government stimulus programs and a stalled restructuring of the mortgage market, looming commercial real-estate loan defaults, and the possible bursting of the Chinese real estate and bank lending bubble.

It is highly unlikely that all of these negative forces will exert themselves. But the probability that a few will is reasonably high. Which ones are hit will determine whether the skies stay partly cloudy or turn decidedly stormy.

STOCK MARKET PERFORMANCE
After a reasonable Q1 this year, the performance of the Young & Partners chemical indexes was poor in Q2, along with the overall stock market. But Q3 was kind to the chemical industry as the general stock market surged upward and chemicals did even better.

As a result, as of the end of Q3, the seven Young & Partners chemical indexes had recovered and were trading anywhere from 16.3 times to 25.3 times trailing price to earnings (P/E), with the S&P 500 trading at 21.3 times.



HIGH-YIELD NONBANK DEBT SURGES
Global chemical nonbank debt financing completed in the first three quarters of 2010 was $17.7bn (€13.2bn), compared with $33.1bn for all of 2009. Although the annualized rate is lower than last year's total, last year was an exceptionally high year.

High-yield debt issuance through Q3 2010 was $12.1bn of the total $17.7bn in debt issuance. This was more than the high-yield issuance for all of 2009, which was $4.9bn. The key difference, if one compares three quarters of 2010 to the totals last year, was the shift to high-yield versus investment-grade debt. However, investment-grade debt issuance fell primarily because issuer demand for debt went down - not from a lack of investor interest.

BANK LENDING REMAINS TIGHT
In contrast to the strength of non-bank lending, bank lenders have been lending, but more cautiously than the bond investors.

The reasons are straightforward. Many banks are facing their own worries with regard to ongoing mortgage woes, strained commercial real estate and sovereign loans on their balance sheets, and the maturities of their loans to companies in general. Even with government pressure to lend, banks are concerned about their existing portfolio of loans and their need to keep powder dry.

EQUITY FINANCING
Global chemical equity issuance in dollars has historically been very modest each year as a result of low chemical company valuations and the limited equity finance needs of chemical companies. This has been compounded this year and the previous two years by weak valuations and a difficult general equity issuance market.

To illustrate, there were no public equity offerings completed globally during Q1, $1.4bn in Q2, and $200m in Q3 - for a total of only $1.6bn in the first three quarters. This paltry amount compares to the equally modest sum of $3.2bn for all of 2009 and $3.1bn for all of 2008.

There have been many attempts to carry out IPOs this year, but none succeeded in the first three quarters of the year, including failed attempts by Belgium-based amines producer Taminco and Russian fertilizer firm Uralchem. US-based pine chemicals company Arizona Chemical filed an IPO registration, but was sold instead to private equity firm American Securities on November 19.

However, in mid-November, one IPO was completed. PETRONAS Chemicals Group raised $4.1bn in an IPO that was heavily oversubscribed. PETRONAS, a Malaysian chemical company, manufactures chemical compounds and fertilizers, as well as industrial and specialty chemicals.

What drove this offering was PETRONAS being an emerging markets growth play and, at the same time, a large company with a robust earnings outlook.

It is not clear whether the enthusiasm for this IPO will carry over to chemical companies that do not have the emerging markets theme or that are smaller in size.

WHAT WILL THE FUTURE BRING?
Except for unique emerging market situations, chemical equity financings will be modest, given the poor condition of the equity markets, the negative bias towards the chemical industry, and the chemical industry's limited need for equity capital.

There are small signs that the general equity issuance market is strengthening, but we do not expect it to reach the levels necessary to create a strong chemical IPO market.

We expect continued strength in the debt financing markets through the end of 2010 and well into 2011 as long as the global economic and financial trends continue to be stable. Although we expect some bumps in the road in 2011, we do not expect any severe disruptions.

For chemical companies needing debt financing either to refinance existing debt or to finance acquisitions, the future looks workable, as long as the economic and financial disruptions are not severe or numerous.

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