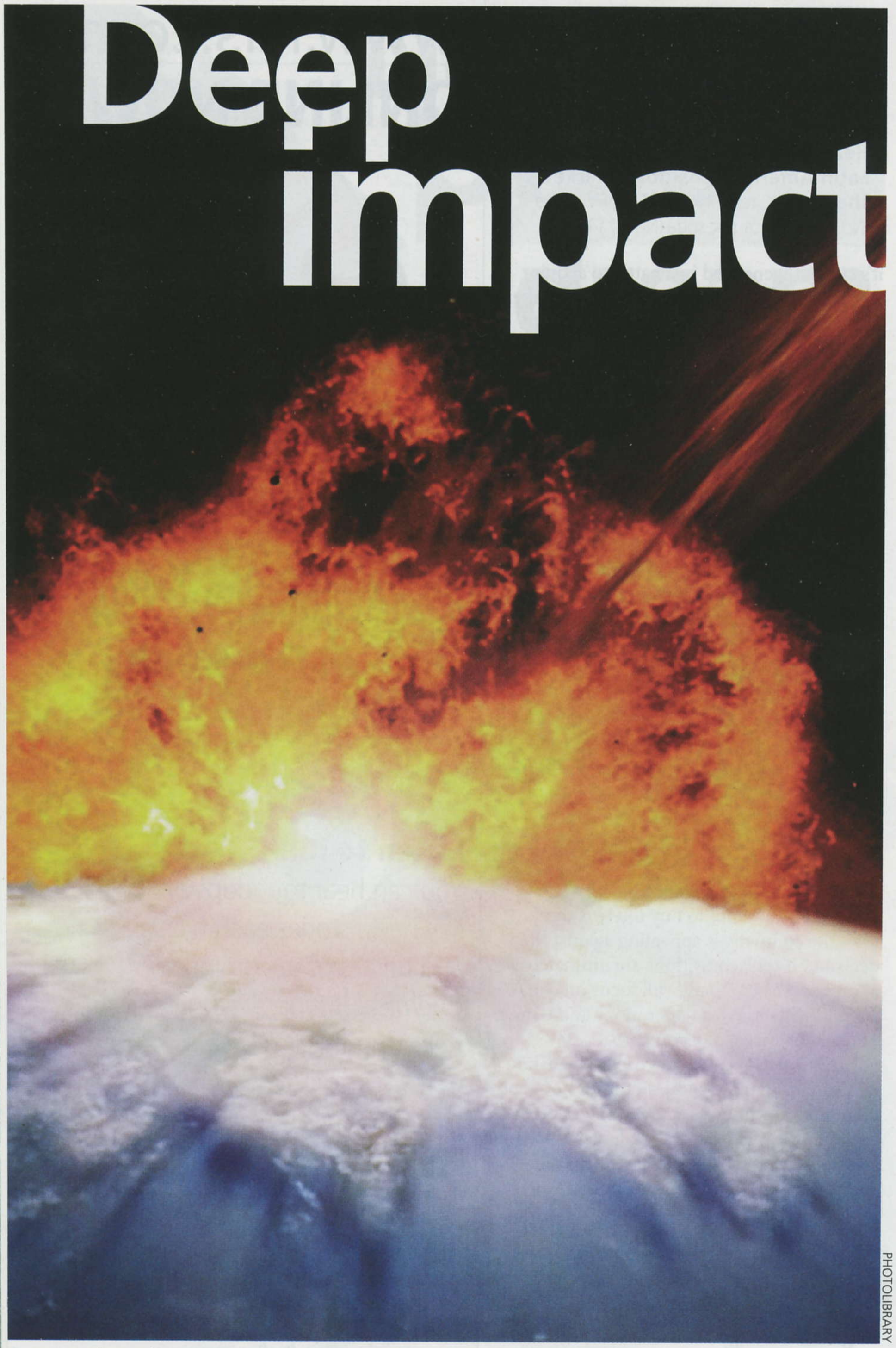
Deep impact



PHOTOLIBRARY

The financial and economic crisis has shaken up the chemical industry worldwide. What's coming next could surprise you

Guest columnist

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THE CRISIS that started in the autumn of 2008 has gripped the world, but the dynamics going forward and the impact on the chemical industry are not necessarily what you read in the newspapers.

The global financial and economic crisis started with the collapse of the housing securities and mortgage markets, causing a significant global recession.

The downturn has hit nearly all industries (service as well as manufacturing), the housing market remains quite weak, and the high level of unemployment has stressed consumption, as well as the mortgage and credit card systems.

Credit became virtually unavailable on almost all fronts, as lenders and fixed-income investors either could not or would not lend. The lack of credit severely handicapped many companies' ability to finance inventories and operations, as well as consumers' abilities to finance home and car purchases.

MIXED EFFECTS FROM STIMULUS

Governments around the world stepped in and initiated fiscal and monetary steps to try to stimulate their economies and stabilize the financial system. The benefits of these actions have been mixed.

On the positive side, many parts of the credit markets are now working – commercial paper and investment-grade debt, are cases in point.

Investment-grade debt issuance in chemicals surged in the second quarter to $13.6bn (€9.5bn) for a total of $19.8bn in the first half of 2009, compared with $11.1bn in all of 2008. The surge was heavily dominated by US-based Dow Chemical and Germany's BASF.

Although a collapse of the financial system has been avoided thus far, credit is still heavily constrained for all but the highest-rated investment-grade borrowers. Access to debt capital for non-investment-grade companies remains sporadic.

In addition, equity financing has been moribund as the stock market fell and most investors were no longer willing to partake.

Although $2.4bn of equity was raised in the first half of 2009, $1.9bn of that amount was issued by Dow as part of its effort to repair its balance sheet.

Most economic stimulus programs have

a significantly delayed effect in terms of job creation, but provide an important positive psychological impact in the short term.

Many economists are projecting a prolonged recession that may show the beginnings of positive growth at the end of 2009, but with a very slow, years-long recovery.

The domino effect that has been moving from one financial segment to another continues. The mortgage and leveraged loan markets were hit early on, but additional loan defaults in commercial real estate, Eastern Europe, and credit cards are looming.

IMPACT ON THE CHEMICAL INDUSTRY

This deep global recession has had a severely negative effect on the chemical industry.

There was a nearly unprecedented decline in demand because of inventory destocking throughout the chain and a lack of available credit to companies and their customers.

The impact on any individual company depended on which industry sectors it serves, whether its products are more specialty or commodity-focused, and on the amount and structure of its debt. Highly leveraged commodity chemical firms serving the housing, automotive and durable goods sectors have been hit the hardest.

However, it appears that destocking has ended and that declines in demand may have bottomed out. What seemed like an economic freefall now looks like the trough of the downturn, with small signs that the economy is beginning to stabilize. But the recovery will be very slow, with no clear engine for a strong recovery in any of the Western economies.

FINANCIAL STRESS

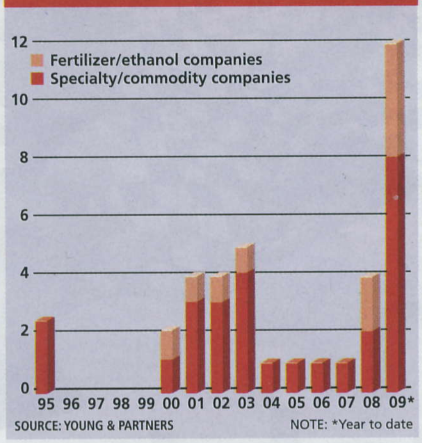
As a result of the crisis, a large number of chemical companies are under financial stress due to combinations of depressed earnings and cash flows, high levels of debt, or the inability to refinance maturing debt.

Many chemical companies are struggling to refinance, restructure or renegotiate the terms of their debts, as credit and equity continue to be scarce.

Netherlands-based LyondellBasell Industries, Canada's Arclin, and US-based firms Chemtura and Tronox (among others) have filed for bankruptcy. Canada's NOVA Chemicals narrowly avoided bankruptcy by selling itself at a distressed price.

Others working to restructure and avoid calamity include US-based chemical firms Georgia Gulf, Momentive Performance Materials and Hexion Specialty Chemicals.

CHEMICAL INDUSTRY BANKRUPTCIES



SOURCE: YOUNG & PARTNERS   NOTE: *Year to date

An indication of the problem is the rising number of bankruptcies (see graph above).

In addition, a large number of chemical companies that have not defaulted thus far have been forced to seek covenant relief or are on the verge of violating covenants, including UK-based INEOS, Momentive, Huntsman, and Ferro, all US.

Unfortunately, the current environment is more challenging than during previous downturns because of the reluctance of commercial banks to lend, the lack of non-investment-grade debt on reasonable terms, the scarcity and expense of Debtor-in-Possession (DIP) financing, the ownership of distressed debt by hedge funds, rather than banks or institutional investors, and the lack of traditional sources of equity capital.

> **"Most are better at looking in the rearview mirror than seeing the road ahead**

WHAT DOES THE FUTURE BRING?

We are cautiously optimistic that the global economy will show clear signs of stability and that, barring any further financial crisis, will return to very modest growth by the end of the year. The recovery, however, will be very slow and take a number of years.

In previous recessions, modest or severe, there was always some engine that drove the recovery. Where this driver appeared early on, the recovery was faster and we experienced what economists call a V-shaped recovery.

Usually these drivers have been consumer spending or a new war. No-one believes that consumer spending in the US or Europe is going to be robust any time soon. An economic recovery will clearly happen in Asia and other parts of the world first.

For some chemical companies, a slow recovery will be painful, but sufficient to return to an even keel. For others, particularly those that are highly leveraged, a slow recovery will not be enough.

Without access to new equity capital or credit, they will face the prospect of severe debt restructuring and, in some cases, bankruptcy or administration.

Unfortunately, the massive spending on the part of most governments and the high levels of government borrowings raises the real threat of inflation and the reality of high government deficits.

THE WILD CARD

The wild card, however, is the looming massive defaults that we see coming in the commercial real estate debt market, the Eastern European sector, in credit cards, and, to a lesser extent, in the leveraged loan market.

These debt markets are massive and total in the trillions of dollars. In the commercial real estate market, for example, the defaults have been limited thus far but are going to escalate.

With the massive layoffs in industry and the financial sectors, and the failures and retreats of large portions of the retail sector, the amount of empty office and retail space is staggering. Many of these properties are highly leveraged and were purchased at the height of the commercial real estate bubble.

As the loan defaults hit, the financial institutions will face huge losses that will be on the same scale as the mortgage write-downs.

It is our expectation that, if these loan sectors suffer major defaults, the financial institutions involved will be severely impaired and another round of rescues may be required. At a minimum, it will further constrain their ability to lend.

It is our hope that some set of events softens this wild card, but very few have focused on this potential problem until recently. Sadly, most are better at looking in the rearview mirror than clearly seeing the road ahead. ■

» Peter Young is president of New York, US-headquartered investment banking firm Young & Partners and has more than 20 years of experience in chemical and life science investment banking.