M&A picks up on healthy backdrop

The chemicals M&A market will continue to strengthen in terms of the number and dollar volume of deals amid a shift to the US. High valuations will favour sellers

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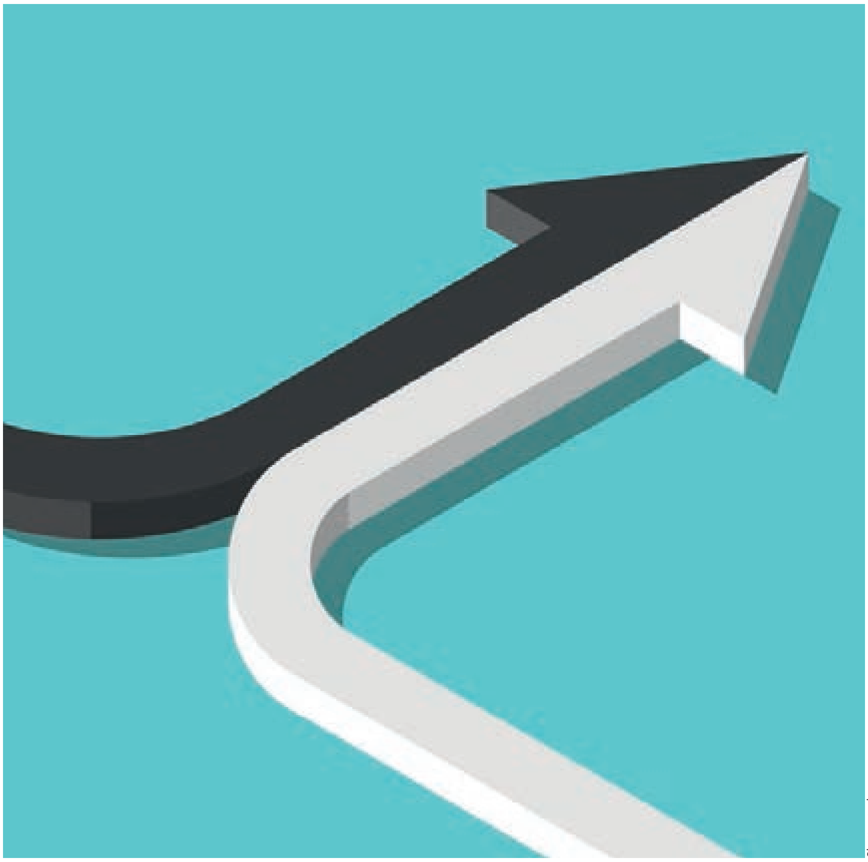

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The chemicals industry, like many global industries, has faced major changes, both positive and negative. On the mergers and acquisitions (M&A) front, activity is picking up and there is a healthy backlog of deals, along with a clear shift towards the US in terms of targets.

Global economic picture

The economic picture since the beginning of 2020 has been a challenge. After the plunge in economic activity that occurred after the onset of the pandemic in March and April, China recovered quickly, followed by a recovery in the US in Q3. Economic conditions in the rest of the world were far less positive, particularly in Europe.

More recently, there have been significant economic setbacks around the world for a host of reasons.

Shortages of semiconductors, severe disruptions in supply chains everywhere, rising inflation, shortages of labour, and the ongoing negative impact of the pandemic with the onset of the delta virus variant have dealt material blows to economic growth.

Much of the world is going through an energy crisis with high prices and shortages of oil, coal and natural gas.

58 deals were completed in the first three quarters of 2021 compared to 67 deals closed in all of 2020

China is going through its own very special setbacks with the Evergrande real estate crisis, high levels of corporate and government debt, severe shortages of electricity, high prices and a scarcity of oil/gas/coal, and government clampdowns on a host of industries.

The US economy has slowed, but it is not clear what the picture will look like going forward. Rising oil and gas prices, shortages of labour, rising inflation, disrupted supply chains, and shortages of semiconductors are plaguing the US along with the rest of the world.

We are facing a high degree of uncertainty with regard to the global economy.

Chemicals industry performance

On a relative basis, the chemicals industry has been in the middle of the pack in terms of industries that were affected by the pandemic. Profits have been strong since Q3 2020.

The impact of economic and the pandemic events on specific chemical companies has varied by markets served, supply chain configurations, nature of manufacturing and R&D, raw materials required, and oil and natural gas prices.

In addition, there have been pressures around plastics, sustainability, and carbon neutrality.

Equity market trends

During the first three quarters of 2021, global equity markets surged on the back of the continued flow of funds into Western equities, and the lack of other attractive investment market opportunities. The S&P 500 increased by 16.4% and the S&P Euro 350 by 13.2%.

The Young & Partners (Y&P) US/Canada Fertilizers index increased by 39.6% and our US Specialties index by 13.8%. But the Y&P US Basic Chemicals index rose by only 2.9% and our US Diversified Chemicals index by only 6.1%.

Our European indices also did not do well compared to the market. The Y&P European Basic Chemicals index increased by only 9.0%, our European Diversifieds index by only 7.9%, and our European Specialties index by only 10.3%.

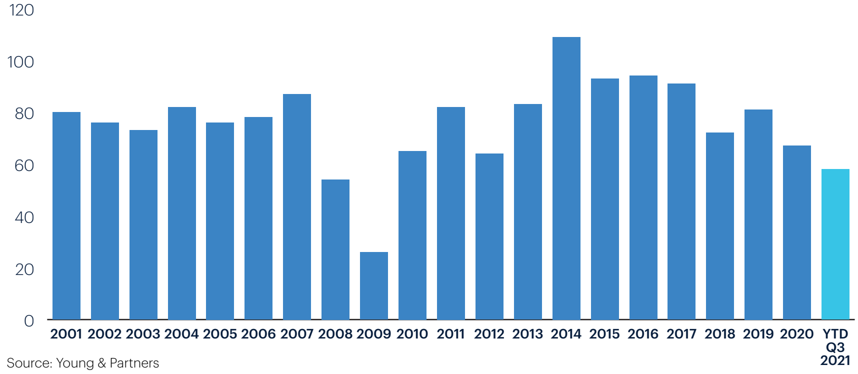
In terms of price/earnings (P/E) valuations, five of the seven Y&P Western chemicals indices were trading at a premium to the overall market indices at the end of the first three quarters of 2021.

On an EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) basis, four of the seven Western Y&P chemicals indices were trading at a premium to the market as of the end of the first three quarters of 2021.

These multiples are quite high relative to historical multiples for most of the chemicals industry sectors and high relative to the average chemicals M&A multiples.

Acquisitions of worldwide chemical companies – number of deals

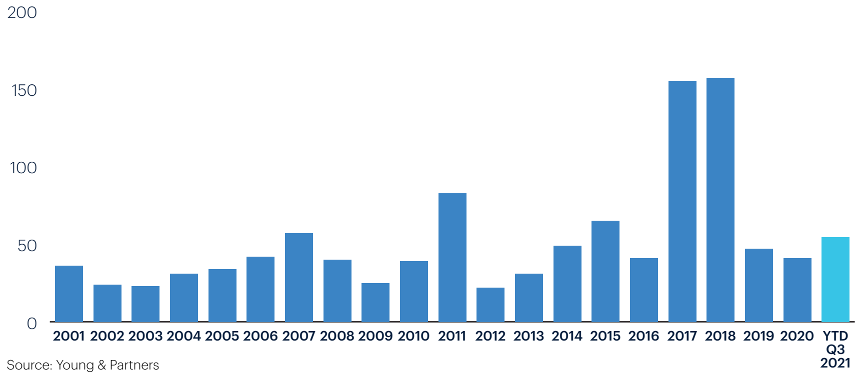
Total number of transactions over $25m in size



Source: Young & Partners

Acquisitions of worldwide chemical companies – equity value

$bn, disclosed deals over $25m in size



Source: Young & Partners

M&A trends

In the first three quarters of 2021, $54.4bn worth of chemicals deals closed. This compares to $41.3bn in all of 2020. IFF's merger with DuPont's Nutrition business alone was $17.7bn of the total.

58 deals were completed in the first three quarters of 2021 compared to 67 deals closed in all of 2020, so we are on a pace that will likely see a higher number of deals in 2021 versus 2020.

Valuations (EV/EBITDA) have been high in both specialties and commodities, averaging in the low teens.

Dollar volume and the number of deals were lacklustre in the first two quarters (with the exception of the one IFF deal) but surged in Q3.

The trends on a quarterly basis this year are particularly telling. 24 deals closed in Q3 versus 18 in Q2 and 16 in Q1. Dollar volume in Q3 was $17.8bn, up from $11.4bn in Q2 and $7.6bn in Q1 without the IFF deal and $25.3bn in Q1 with the IFF deal.

It is also important to look at a segmentation of the M&A market.

The number and share of commodities transactions in the first three quarters of 2021 accounted for only 39.7% of the total, down from 52% last year. Relative interest in commodity chemicals businesses is weakening.

Geographic shift to the US

The change in geographic mix has also changed dramatically. In terms of the location of M&A targets, Asia and rest of world (ROW) accounted for only 31.0%. The US surged to lead at 36.2% and Europe accounted for 32.8% of deals completed worldwide.

This is a significant departure from a more than six-year history when Asia and ROW was close to 50% of the total market. Starting in Q2, Asian deals slowed dramatically as economies turned down and consolidation activity slowed.

At the same time, the attractiveness of the western chemical markets, the stockpiles of cash held, the readily available low interest debt, and the desire for growth have all contributed to the surge in US and European chemicals M&A deals.

Private equity share rises

In the first three quarters of 2021, private equity increased its share of acquisitions to 10.3% of the number of acquisitions and 13.9% of the dollar volume. This is not high, but it is an uptick from the more recent miniscule shares. It is still well below private equity's long-term 20-25% market share of acquisitions.

Looking forward, the value of deals announced but not closed at the end of Q3 was a healthy $31.4bn (42 deals), which suggests a healthy volume going forward.

Depending on when the backlog of deals close, this year will end up well ahead of last year, but still well below previous years.

High M&A valuations will favour sellers. This is a good time to restructure business portfolios or to exit ownership

Debt financing trends

There was a dramatic reduction in non-bank debt financing in the first three quarters of 2021. This drop was not the result of lack of access. Rather it reflects a lower need for new debt by chemical companies. There was a surge in borrowing last year to assure liquidity and to take advantage of lower interest rates.

Global non-bank debt financing was only $23.0bn in the first three quarters of 2021 compared to $52.2bn for all of 2020.

Investment grade debt was $18.0bn of the total in the first three quarters of 2021 compared to $38.5bn in all of 2020, a dramatic decrease on an annualised basis.

Only $4.9bn of high yield debt was issued in the first three quarters of 2021, a fraction of the activity when compared to the $13.7bn issued in 2020.

There was a significant increase in equity issuance in the first three quarters - $15.3bn of equity was issued from 92 offerings. This compares to $14.1bn of equity issued from 80 offerings for all of 2020.

In terms of initial public offerings (IPOs), 45 IPOs were completed worth $6.2bn in the first three quarters of 2021 - the same number completed in all of 2020 worth $6.5bn.

Asian companies issuing in the Asian public markets continued their domination of both the IPO and secondary offering markets, as has been true for many years. Global equity issuance is heading for a record year in 2021.

Economic outlook

The global economic outlook is complex with positive and negative factors, but the net outlook is positive for the chemicals industry.

However, it depends on what sectors you are in and whether you are in commodity or specialty chemicals.

Headwinds include inflation, supply chain disruptions, shortages of semiconductors, geopolitical factors, prices of natural gas and oil, negative pressures on plastics, costs related to the push for carbon neutrality, ESG reporting and compliance increasing, and economic growth challenges in various parts of the world

Positives include relatively stable economic growth in the US and Europe, the importance of chemicals to most economies, and innovation in bio-based and circular chemicals.

The chemicals industry as a whole is doing well. We expect overall continued prosperity in terms of demand and profitability under the majority of COVID-19/economic scenarios.

M&A and financing outlook

The chemicals M&A market will continue to strengthen in terms of the number and dollar volume of deals going forward.

High M&A valuations will favour sellers. This is a good time to restructure business portfolios or to exit ownership.

Inevitably, these high valuations will increase the supply of businesses being sold by public and private chemical companies and private equity. Increases in supply will gradually weaken prices.

Prices have already shown slight signs of softening in commodity chemicals, although part of the slide in multiples has been increasing EBITDA that buyers are not confident are sustainable. And so they are unwilling to apply the same multiples to these earnings.

Relatively high public company valuations of specialty and diversified public companies will continue to make the cost of equity inexpensive. Public valuations for most pure-play commodity chemical companies are being compressed for the same reason that commodity chemical M&A multiples are softening.

Debt financing will continue to be readily available at low interest rates.

Equity offerings will continue at the current moderate, healthy pace, but involving a larger number of smaller offerings. There will be a small number of western chemical IPOs and renewable raw materials and circular chemistry company IPOs, and a large number of small Asian IPOs. ■

Peter Young is CEO of Young & Partners, an international investment banking and strategy consulting firm that focuses on the chemical and life science industries. The firm provides exceptional execution of corporate and financial strategy projects, M&A, private placements of debt and equity, and financial restructuring. Young & Partners has served a global client base of companies in Europe, North America, Latin America and Asia for the last 25 years.
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