No slowdown in chemicals M&A activity as structural realignment, low growth and strong profits continue to underpin the market.

Companies are optimizing M&A through additional cost synergies, scale benefits and enhanced revenue growth.

Transaction valuations are robust as demand for quality businesses remains resilient – “is 15x the new 10x?”

These and other key topics will be debated at The Valence Group Chemicals M&A conference in New York on September 14th.
Introduction

This year has shown that despite the slowdown in acquisition activity across some sectors, chemicals M&A continues unabated. Undeniably, M&A activity across chemicals has accelerated, valuations have remained healthy, average deal size has increased and we have witnessed some of the largest chemical transactions in history. It seems nothing can derail chemical companies’ willingness to acquire.

Until recently it was generally assumed that the supply of capital and historically low interest rates were almost solely responsible for the exuberant stock market valuations and related M&A activity. Although this is undoubtedly a factor for most industries and across the globe, it underestimates some of the specific structural and financial factors contributing to chemicals M&A. The convergence of factors such as raw material feedstock supply, increased profitability, low growth, changing cost competitiveness, Chinese-led investment and the huge oversupply in intermediates are all combining to drive the chemicals M&A market to its eventual conclusion of a changed chemical industry landscape. In our view, until this scenario has finally played out, only major macroeconomic impacts could divert chemicals M&A activity from its current elevated trajectory. Activity and valuations will remain strong for the foreseeable future.

Drivers of Chemicals M&A

As depicted graphically in Figure 1, there are a multitude of elements driving chemicals M&A. Each on their own is sufficient to help support the market but the confluence of so many drivers has led to the current situation of an almost frantic need to acquire. Of course, each company has specific strategic imperatives that will steer the need for M&A, but we believe that the key reasons, as we discuss below, of lack of growth, declining supply of higher quality targets, a unique financial environment and a once-in-a-generation structural change will continue to propel the market further.

Figure 1 Mid-Term Chemicals M&A Drivers

“FOR”
- Lack of growth
- Structural change to more downstream
- Limited supply of quality targets
- Chinese competition
- Adverse weather
- Increased volatility in extracting energy
- Lower cost financing
- Strong cash flows
- Limited cash investment options
- Less efficient product development
- Declining productivity growth

“AGAINST”
- Uncertainty in macroeconomic outlook
- Better organic investment options (e.g. R&D)

The Need for Growth

Whether you believe the world is going through a period of “secular stagnation”\(^1\), or simply still readjusting after near collapse in 2008/9, undeniably economic growth has been at best lacklustre, and for some European countries close to zero, in the past five years. Apart from the US and China, both of which have been boosted by shale and government intervention respectively, growth has been a key issue for many more mature countries and companies. Furthermore, many developing economies such as Brazil, have seen a reversal of previous high growth rates.

Against this economic backdrop, growth in the chemical industry (shown in Figure 2) has been positive with average nominal growth in US and European chemicals companies at near 4% p.a. over the last 10 years (averaging over the cycle). However, this includes M&A and when this is stripped out we estimate growth is actually close to 3-3.5% p.a., which is not far from the level of inflation, suggesting almost zero real growth. Consequently it is unsurprising that the chemical industry has had to resort to M&A to boost growth.

\(^1\) The Age of Secular Stagnation, L.Summers, February 2016
The alternatives of product development and productivity gains have proved to be much harder for many parts of the chemical industry. New product introductions are often hampered by regulatory requirements or increasing development costs. Productivity gains have been exhausted across much of the mature parts of the industry as process technology is already significantly advanced. Although these avenues are far from complete, we are reaching a point of diminishing returns.

This points to further M&A growth with companies seeking to:

- Boost growth in sectors where volumes or revenues are increasing (e.g., electronic chemicals, food ingredients and personal care ingredients), and which have seen more acquisitions and increased valuations
- Increase productivity growth and profitability through consolidation (e.g., gases, agrochemicals and coatings)
- Expand into growth geographies (e.g., Asia)

Unless global economies revert to higher growth soon, senior management in the chemical industry will ultimately have to rely on expansion through M&A.

**Structural Change**

This topic has been reviewed at length in previous newsletters. Simply, as Chinese companies continue to expand in commodities and intermediates, Middle Eastern companies use their feedstock advantages and the US reaps the benefits of shale, companies will need to substantially realign their portfolios. Already we have seen previously highly profitable intermediate products being increasingly dominated by Chinese companies. Products such as caprolactam, BDO, adipic acid, acrylic acid, MDI & MEG have seen the most competition and/or value destruction. The result has been major forward moves down the value chain as European and US companies vie to acquire better protected downstream businesses.

The majority of M&A in the last few years has followed this trend as companies such as Solvay, FMC, DSM, Arkema, BASF and DuPont have all divested upstream businesses while investing heavily in more specialty chemicals. This trend has accelerated appreciably in the last 5-6 years.

**Supply & Demand**

As the rate of M&A has increased in the last few years, the availability of suitable assets has not kept pace. Competition for higher quality businesses has risen as more companies are under pressure to grow and realign. Additionally, the last few years has seen the emergence of Asian (predominantly Chinese) companies wanting to acquire larger specialty...
chemical businesses. Unfortunately, the availability and supply of higher quality businesses has fallen, with the predictable conclusion being more companies chasing fewer targets and the inevitable rise in valuations.

Some speciality chemicals sectors have witnessed so many transactions that some sectors are now highly consolidated (see Figure 3). Further acquisitions in these and related areas are now only possible through larger “mega” deals at valuation levels that some executive and governing boards are initially reluctant to fund.

More than 80% of chemicals deals are now in specialty chemicals and there are now almost ten $1bn+ strategic speciality chemicals transactions per year (Figure 4). This can clearly only last for a finite time but in the next c. 5-10 years the demand for downstream chemicals businesses will remain and valuations will be underpinned by the tight M&A supply/demand situation.

Profitability
It is worth remembering that the chemical industry has done remarkably well in terms of profitability in the last 10-20 years. The industry has reformed from being capacity and utilisation driven to being more profit centred. Despite the advance of China adopting a more volume-linked expansion philosophy, chemical companies have embraced a more disciplined expansion strategy. Profitability has therefore expanded without as many cyclical highs and lows as seen in the 1980s and 90s.
Overall profitability in the chemical industry (as shown in Figure 5) has been resilient with the last five years in particular being boosted by M&A and associated synergies. This has created strong balance sheets and confidence that the cash flow can be used to fund acquisitions. With the build-up of cash, companies have either reverted to stock buy-backs, increased dividends or, where possible, organic growth through higher investment. This has started to reach a limit and the focus has been cash flow re-directed towards M&A.

A more careful inspection of profits across chemicals sectors reveals that specialty chemicals have benefitted disproportionally (Figure 6).

Consolidation, growth and geographic expansion have enabled specialty chemicals to outperform, with the trend most apparent in recent years. Companies have also become more adept at maximising benefits, such that typical synergies of 7% of target revenue is now regarded as the norm with many transactions creating even greater value. This additional profit growth has further increased valuations in the sector as companies are willing to pay for the added profit. Valuations / EBITDA multiples have advanced accordingly.

Financial Environment
It would be naïve to ignore the impact of low interest rates and the abundant availability of debt. Certainly, the lack of investment opportunities for cash has driven markets higher and quantitative easing has found its way into several asset classes. This has driven up public valuations in general, while also limiting external cash investment opportunities. An option has been M&A, either through debt financing or...
stronger balance sheets. Although this is not a fundamental driver for chemicals M&A, it has certainly provided fuel to the market and has helped financial investors.

Private equity companies, despite not being a major part of chemicals M&A, have remained key acquirors as portfolio realignment has thrown up orphan or niche businesses. Indirectly this has provided further support to both volumes and valuations in the market.

**Outlook**
Each one of the above key factors would be sufficient to support the chemicals M&A market but the convergence of low growth, high profitability and structural change have combined to create a highly competitive market dynamic. The unavoidable outcome has been increased valuations and activity. Barring larger macroeconomic impacts, it is difficult to see why this should change in the mid-term.

**Chemicals M&A – Valuations**

Predictably with the high level of deal activity, valuation levels have risen in the last few years with limited appreciable decline in 2016. Trading and transaction multiples remain in the 10-11x EBITDA range (Figure 7). Announced transactions, such as the recent Evonik and BASF acquisitions of Air Products Performance Materials and Chemetall, respectively, have been at much higher levels (c. 15x EBITDA), indicating substantial synergy and growth potential.

These latter two transactions also serve to highlight the diverging valuations for higher end specialty chemicals (as defined earlier) and the mid tier specialities. Post 2009, with a push to move into shale-based chemicals and broader specialty chemicals, sectors such as food ingredients and electronic chemicals briefly lost some of their shine.

However, as the pendulum has now swung more distinctly towards building resilient downstream specialty chemicals portfolios, the focus has again been on more protected market sectors. Consequently, the higher end specialty chemicals companies now trade at an average premium of three turns (3x EBITDA multiple higher) than the broader specialty chemicals businesses and the overall chemicals market (Figure 8, over).

As analysed earlier, our view is that with further demand to acquire high quality businesses and a dwindling supply of these assets, this difference in valuation levels will likely be preserved. This will particularly be the case if we continue to see large sector consolidation transactions where synergies and growth forecasts justify valuations.
It almost goes without saying that transaction volumes have also been buoyant (Figure 9). Monthly volumes continue to remain healthy and large deals continue to be announced.

In conclusion, increased M&A activity in chemicals is an upshot of wider structural changes, shifting regional dynamics and macroeconomic trends all combining to push the chemical industry to undergo a period of major acquisition and divestment. The Dow-DuPont, Bayer- Monsanto, ChemChina-Syngenta deals are the most obvious examples that highlight the scale and breadth of the industry restructuring. Until these changes have fully played out, we expect the chemical industry to continue portfolio optimisation, predominantly and increasingly through M&A.

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