Chemical M&A hit by uncertainty

The evidence points to a slowing chemical M&A market as uncertainty prevails. What are the implications for buyers and sellers?

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Although some investment bankers recently described the chemical mergers and acquisitions (M&A) market as "healthy" and "robust" and said there is "no indication of valuations slipping yet," our observations and data show otherwise, as a number of the core drivers of a strong M&A market have weakened.

Worldwide chemical M&A in dollar terms was down by 76% in the first half of 2012 to \$9.6bn (€7.8bn) compared with \$40bn in the first half of 2011. On an annualized basis, M&A activity in 2012 is \$19bn, lower than the last trough and well off last year's total of \$82bn. This is a reflection of both a lower number of deals and very few large deals.

In terms of the number of transactions, in the first half of 2012 there were 35 deals completed valued at \$25m or more, compared with 47 deals completed in the first half of 2011 – a 26% reduction. There were only two deals over \$1bn in value completed in the first half, compared with 17 for all of 2011.

The other tangible evidence of where the market has been heading is the fact that the number and dollar volume of deals announced, but not closed – the best measure of the M&A pipeline – has gone down almost every quarter since the end of the second quarter of 2011.

BACKLOG OF DEALS

The backlog of deals has fallen from \$34bn at the end of June 2011 to only \$8.9bn at the end of June 2012. Note that only three deals over \$1bn have either closed or been announced since the end of June.

Further evidence of the slowdown is the fact that activity in the second quarter of 2012 was lower than in the first quarter – both in terms of the number of deals over \$25m completed (16 versus 19) and their dollar value (\$3.6bn versus \$6.0bn). This was a continuation of the quarter-to-quarter slowdown that started last autumn.

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In terms of valuations, the average EBITDA (earnings before interest, tax, depreciation and amortization) multiple for commodity chemicals has dropped by 36%, and for specialty chemicals, 22% since last year. It is worth noting, however, that the valuations for high-quality businesses that have sold recently have held up more than those for weaker businesses.

The primary reasons for the M&A slowdown are the high level of uncertainty perceived by senior management and the impact of the European crisis on the earnings expectations of many companies.

Although strategic buyers are under pressure to grow and have substantial financial reserves, they are very concerned about the global economy, the crisis in Europe, the US fiscal cliff and their own ability to predict their earnings and the earnings of target businesses. Because of these concerns and the »

high level of uncertainty, CEOs prefer to wait rather than make large acquisitions at a time when they cannot tell if the global economy will suffer a major downturn. The fact that the below-$1bn M&A market is still active is a reflection of this sentiment.

A secondary reason is the normal movement through the M&A cycle, which inevitably falls after passing through the peak.

There are also a number of other observations we can make about the M&A market. First, the Asia and the rest-of-the-world category is now by far the most active area where deals are closing – an astonishing difference compared with a number of years ago, when Asia was primarily a new construction region.

In addition, commodity chemical transactions have been much more prevalent than those in specialty chemicals, comprising 69% of all deals completed in the first half of 2012, up from their usual 45–50% of the market.

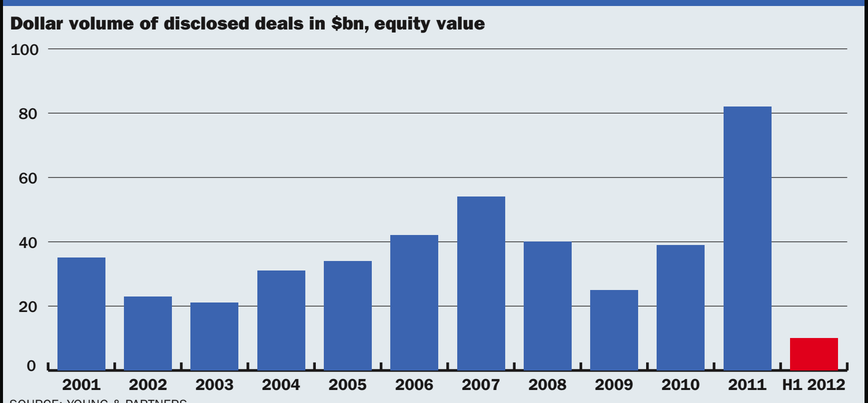
How about the financial buyers? They revived modestly, accounting for 11% of the number of deals and 24% of the dollar volume in the first half of 2012.

Although this is less than their 20–25% share of the number of deals for most of the last 10 years, it is an uptick from the 8.0% share of deals in 2011, when the high-yield market collapsed in August.

On the other side of the ledger, financial buyers have been heavy sellers of chemical businesses for the past three years, and this selling activity continued in the first half of 2012. Financial buyers sold a record number, and dollar value, of chemical businesses in 2010 and 2011.

So what are the implications for chemical executives and private equity investors?

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES SLOW



SOURCE: YOUNG & PARTNERS

First, the below-$1bn M&A market has slowed, but is still very active – a plus for both buyers and sellers. Buyers are more comfortable doing mid-size deals versus large deals. Both sellers and buyers will be more successful completing mid-size deals in the current environment.

For sellers, the news is positive if the business being sold is of high quality, because valuations are holding up for quality assets. Although the market is still open for weaker businesses, the valuations are lower and will be disappointing for sellers. In many cases, the deals will not go through at all.

NEXT REVIVAL

For these situations, sellers face the decision whether to sell now at a lower valuation or to wait for the next revival of the M&A market, which could take some time to develop.

For buyers, the valuations are better, but not necessarily for the highest-quality businesses. This could change if the M&A market continues to weaken.

For private equity buyers, this is still an attractive time to exit if the quality of the chemical business they own is high. It is a tougher time to buy, even with weaker strategic buyer interest in larger deals, and even if they are comfortable with the uncertainties in the economic and financial landscape. ■

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