Private equity to compete in chems

Private equity firms have been active sellers of chemical assets, but on the buy side, they have been hindered by a volatile high-yield debt market

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Private equity firms will have a permanent and important role in the chemical sector, acquiring businesses that need adjustments to their cost structure, capital structure, strategy or level of industry fragmentation.

These financial buyers make a market for businesses that otherwise would go unsold or that are in need of restructuring to make them viable. Private equity firms also have substantial capital available to acquire, recapitalize, or do build-ups in various chemical industry sectors.

This would normally result in a great deal of mergers and acquisitions (M&A) activity by private equity firms. However, private equity firms will continue to be at the mercy of the health of the high-yield debt market and the level of aggressiveness of strategic buyers.

With the economic and financial challenges in Europe, access to high-yield debt will continue to be volatile. On the positive side, although in theory there should be strong competition from strategic buyers that are healthy and sitting on large amounts of cash, many of these companies have decided to be more cautious, providing a window of opportunity for private equity firms to compete.

And on the sell side, private equity firms have been divesting their chemical assets at record levels in the past two years, contrary to what other investment bankers have said publicly.

BIRTH OF LBOS AFTER WWII

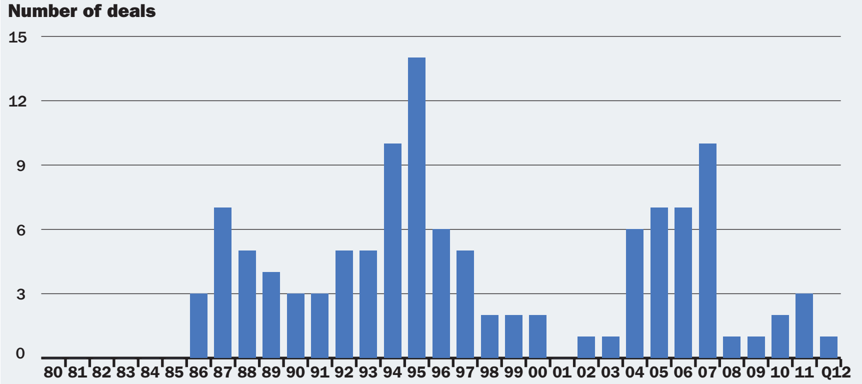
Leveraged buyouts (LBOs) were first conceived after World War II, but became popular in the 1970s and 1980s. They generally involved businesses with some combination of the following: steady cash flows; significant profit improvement potential through cost-cutting and other means; the potential for follow-on consolidation acquisitions; break-up values in excess of the purchase value; and multiple exit options (sale, IPO, recapitalization).

Although the first LBO may have been the purchase of a US government chemical plant by J.H. Whitney & Co. in the late 1940s, the chemical industry was not the target of the majority of the financial buyers in the early years.

This was due to the greater complexity of the industry, the need to understand environmental issues, the cyclicity of commodity chemicals, the high prices of specialty chemical businesses, and the poor public image of the industry.

In private equity, investment managers

WORLDWIDE CHEMICAL IPOS



SOURCE: Young & Partners

control investments in operating companies from a pool of equity capital that the company has raised.

When investing in a leveraged buyout, the goal is to maximize the return on the investment from operational improvements, deleveraging, and capital structure adjustments in order to ultimately achieve a capital gain upon the sale of the business.

Private equity companies typically hold an investment for three to five years, while targeting returns of 20–30%/year.

The total private equity capital and number of funds with over $1bn (€773m) has changed dramatically over the past 20 years. In 1994, there were 10 funds with over $1bn and the total private equity capital was around $40bn. By 2006, there were over 100 funds with more than $1bn. Today, the estimated total private equity capital is over $2 trillion.

CHEMICAL LBO FACTORS

The early pioneers of chemical industry LBOs were Gordon Cain and George Harris, among others. But the number of chemical LBO transactions completed each year was low and the competition for deals was very limited.

The main factors that favored early chemical industry LBOs was the long history of easy access to the debt markets; the regular supply of high-overhead, orphaned and diversified businesses from large companies; and the attractive values available during the trough periods of the chemical M&A cycle.

Private equity companies are often willing to take on tasks that strategic and industrial buyers usually avoid, such as implementing unpopular cost-reduction measures and buying diverse portfolios. They are able to act as a "market maker" during the cyclical peaks and troughs of the chemical industry.

Private equity often seeks to consolidate fragmented industries with embedded structural and financial inefficiencies. Depending on market conditions, private equity firms may at times have a lower cost of capital than strategic or industrial competitors.

Private equity buyers have been particularly successful where the industrial buyers have either retreated or are legally unable to compete. Prime targets include diversified businesses where industrial buyers have business fit problems, and pure-play targets where antitrust considerations prohibit the major industry players from bidding.

MYTHICAL ROLE

It is a commonly held belief that LBOs have been numerous in the chemical industry for years. But the reality is that private equity buyers have only been highly active since 2000. Prior to that time, industrial buyers generally outbid the financial buyers and financial buyer interest in chemicals was modest.

As the chemical M&A market peaked in mid-1999 and industrial buyers began to retreat, the financial buyers stepped in.

Private equity buyers were the successful buyers of only 4–8% of all chemical deals each year from 1996–1999. But then this figure jumped from 20–28% from 2000–2005. It has fallen to around 15% since then.

Private equity buyers lost significant share in 2006 to more aggressive industrial buyers bidding for available businesses.

The trend reversed again in the first half of 2007 with extraordinarily friendly debt issuance market conditions that favored the financial buyer.

Private equity buyer volume fell dramatically in 2011 as industrial buyers became more aggressive and high-yield debt financing became more difficult, particularly in Europe.

Financial buyers have generally paid significantly lower multiples for businesses compared to industrial buyers. From 2000–2011, for specialty chemical businesses, financial buyers paid on average 7.1 times earnings before interest, tax, depreciation and amortization (EBITDA) on a 12-month trailing basis, while industrial buyers paid 9.5 times EBITDA.

The gap was not as large in commodity chemicals for the same time period, where financial buyers paid 6.9 times EBITDA and industrial buyers paid 7.5 times EBITDA.

FINDING THE EXIT

Ultimately, private equity owners of chemical businesses have to exit, either through a sale or an initial public offering (IPO).

Unfortunately, the IPO track record has been poor. This is not the fault of the private equity owners.

The IPO market window for chemicals is usually closed and only opens when both the overall IPO market is strong and there is a positive view of one or more segments of the chemical industry.

Recently, the segments that are viewed favorably have been emerging markets and fertilizers. Therefore, the burden has fallen on divestitures as the primary exit method, where the buyer is either strategic or financial. ■

Rex Features

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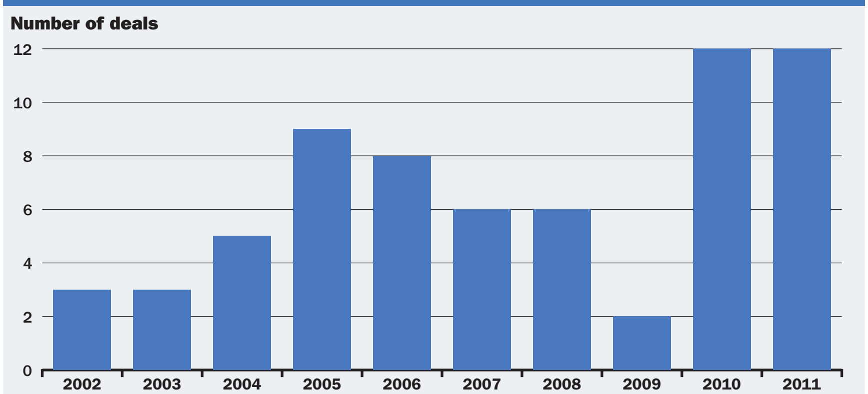
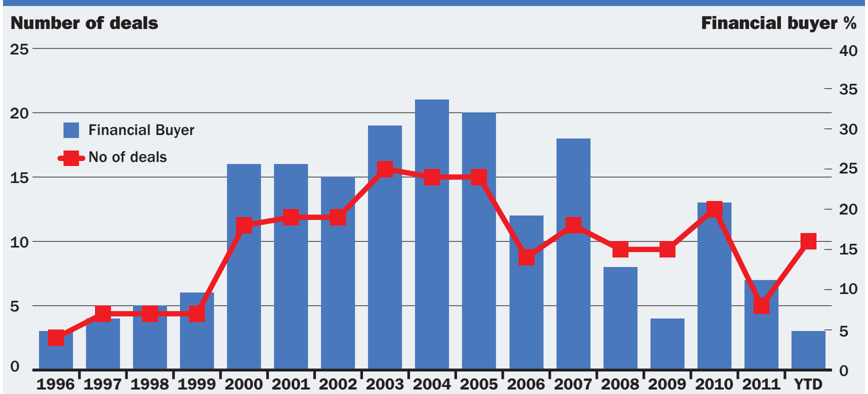
PRIVATE EQUITY SALES OF CHEMICAL ASSETS



SOURCE: Young & Partners

PRIVATE EQUITY ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES



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