

Creating value in a challenging market

There's a difference between conventional wisdom and data-driven reality. Here we outline major chemical M&A trends, the outlook and implications for management

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In the second and third quarters, almost all public comments and quotes from investment bankers and certain industry articles and interviews have indicated that the mergers and acquisitions (M&A) volume in dollar terms and number of deals is higher this year so far and that the full year's figures will be significantly higher than last year.

According to one publication at the end of July: "A high level of M&A activity has occurred this year. [We have] counted 177 M&A transactions in the chemical industry and adjacent services, such as distribution and logistics, so far in 2016, with the total deal value approaching \$80bn – both figures are higher than last year."

In that same article and others, a number of investment bankers expressed the same point of view. One said, "The second half [of this year] should be fairly strong like the first half, and that will likely continue into 2017."

Another said: "I think you have the private equity community willing to accept lower returns, strategic buyers willing to accept lower returns, and these translate into higher valuations and a longer market peak."

All the investment bankers indicated that valuations have been high and will only gradually soften. "I think the market has peaked from a valuation perspective," one said. "I think... the landing is going to be soft and prolonged."

VOLUME WILL BE LOWER

Throughout the year, we have indicated every quarter that the number of deals and the dollar volume were decreasing from last year. It has been consistently our view that the number of deals will be lower for the full year versus 2015 and that the dollar volume will be higher, but only if one or more of the announced mega deals (Dow/DuPont and ChemChina/Syngenta) closes this year.

We noted, however, that both deals had regulatory uncertainties, primarily antitrust. We also explicitly ignored a number of announced deals where, at the time of announcement, the parties involved declared that the deal that



Reeling in a big value-creating deal requires a thorough understanding of the market

would not close until 2017, and even those face regulatory scrutiny.

One deal, the CF Industries/OCI NV North American transaction, failed earlier this year for antitrust reasons.

So what is actually happening? The number of deals and the dollar volume of M&A through Q3 continue to be well below last year's numbers on an annualised basis. The two mega deals that could have closed this year are now clearly delayed into 2017, and at least one may not happen at all.

Further, valuations are falling dramatically in half of the chemical sector and climbing out of a trough in the other half. It is hard to call that a valuation peak covering the entire market that will go through a "soft and prolonged landing."

GLOBAL CHEMICAL M&A ACTIVITY

The M&A market in dollar terms increased in substantial steps each year starting from the trough of \$22bn in 2012, to \$31bn in 2013, \$49bn in 2014, and \$65bn in 2015.

The pace has slowed considerably this

year. On an equity basis, only \$6bn of deals were completed in Q1, \$18bn in Q2 when the Air Liquide/Airgas deal closed (\$10.3bn equity value) and \$7bn in Q3.

That totals \$31bn of deals greater than \$25m in value through Q3, well below last year's pace. Just to tie with last year's \$65bn would require closing \$34bn of deals in Q4. Only the completion by year end of either the Dow/DuPont deal or the ChemChina/Syngenta deal could have bridged that gap.

In terms of number of transactions, 61 deals were completed through three quarters versus 91 deals for all of 2015. Again, on an annualised basis, we are on a slower pace compared to last year. Even last year showed a slowdown in volume from the 109 deals in 2014.

The industry would have to close 30 deals in Q4 to match last year, a near impossible outcome. Here, the two mega deals would not help, even if they closed, since adding just two deals would only bridge less than 7% of the gap.

Looking forward, the value of deals announced but not closed as of 20 September 2016 was \$227bn (59 deals). However, the list is dominated in dollar terms by just a few mega deals (greater than \$15bn) such as Dow/DuPont, Bayer/Monsanto, ChemChina/Syngenta, PotashCorp/Agrium, and Sherwin-Williams/Valspar. None of these will close in 2016. Some may not close at all.

GEOGRAPHIC MIX

In terms of location of M&A targets, the Asia/Rest of the World (ROW) category is now massively dominant, for reasons ranging from the attractiveness of the growth in Asia to the gradual maturing and consolidation of the Asian companies.

Through Q3 2016, Asian deals rose to 52% of all transactions globally. This was a record market share for Asia/ROW since we began tracking regional shares in 1986.

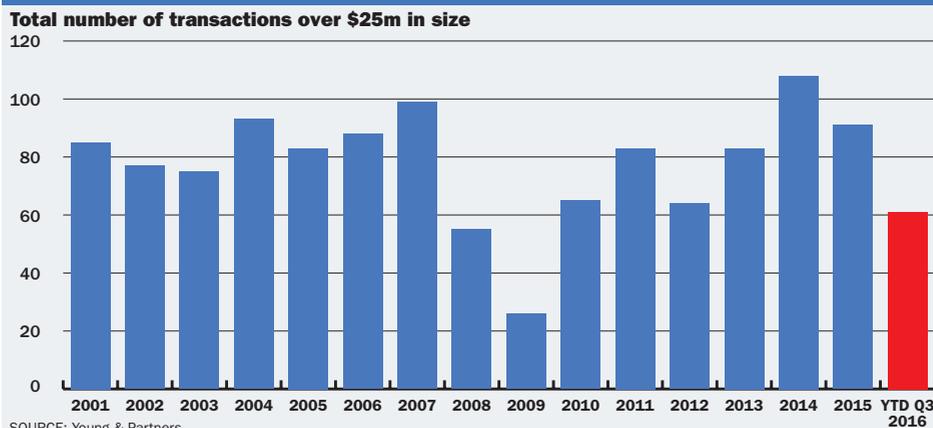
Private equity firms receive a lot of publicity, but continue to lose market share in terms of acquisitions. They accounted for only 7% of the total number of deals completed through Q3 2016, a startling loss of share compared to the historical norm of 20-25% and a drop from their 9% share through the first half.

Even their share of the dollar volume was low at only 3% of the total through Q3 2016, down from 4% in the first half. Private equity firms have been at a significant disadvantage as buyers recently, with some disadvantages self imposed. Private equity firms shun commodity chemicals and Asia and heavily favor specialty chemical deals, where valuations and strategic buyer interest have been high.

M&A OUTLOOK

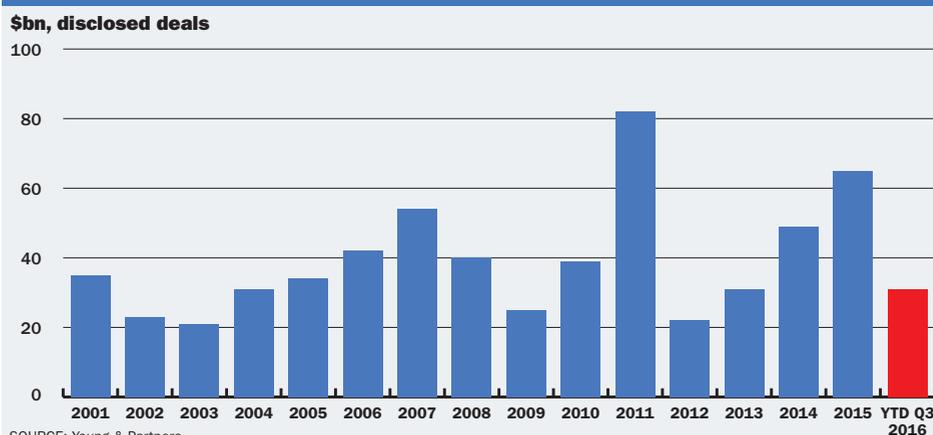
The drivers of the M&A market will continue to be the same for the rest of 2016 as they have been – demand for growth in excess of what

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES - NUMBER OF DEALS



SOURCE: Young & Partners

ACQUISITIONS OF WORLDWIDE CHEMICAL COMPANIES - EQUITY VALUE



SOURCE: Young & Partners

We expect a modest decrease in the number of transactions in 2016 versus 2015

can be achieved organically, the need to use built-up cash, ongoing restructuring efforts as companies focus on their core businesses and exit non-core and weaker businesses, consolidation in various sectors such as agricultural chemicals/fertilizers and coatings, pressure from shareholder activists, and consolidation and industrial rationalisation in China.

However, the unusually high level of global economic and political uncertainty, significant antitrust scrutiny in a number of sectors, the weakened state of shareholder activists, and demand/pricing problems in certain chemical markets will dampen overall M&A volume.

It is important to note that almost all of the large and mega deals are in sectors where the antitrust hurdle is high – agchem, fertilizers and coatings. The added loss of any tax inversion possibilities by US buyers has put a further brake on mega deals.

We expect a modest decrease in the number of transactions in 2016 versus 2015, with around 80-85 deals closing and a dollar volume of \$45bn-55bn or less, which would also be less than last year's total.

IMPLICATIONS FOR MANAGEMENT

Because there have never been so many parts of the M&A and financial markets moving in opposite directions at the same time, it is important to know precisely where the parts are moving and why, and to use that knowledge to pursue opportunities that create significant value in this unconventional market.

In these times, following advice that either is not supported by an accurate understanding of the markets or is based on “conventional wisdom” will very likely lead to an unhappy result.

Expert advice combined with sound and accurate knowledge of the markets and the industry is a minimum requirement. ■



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