Chemical Week

Private equity aims for creativity amid difficult M&A environment

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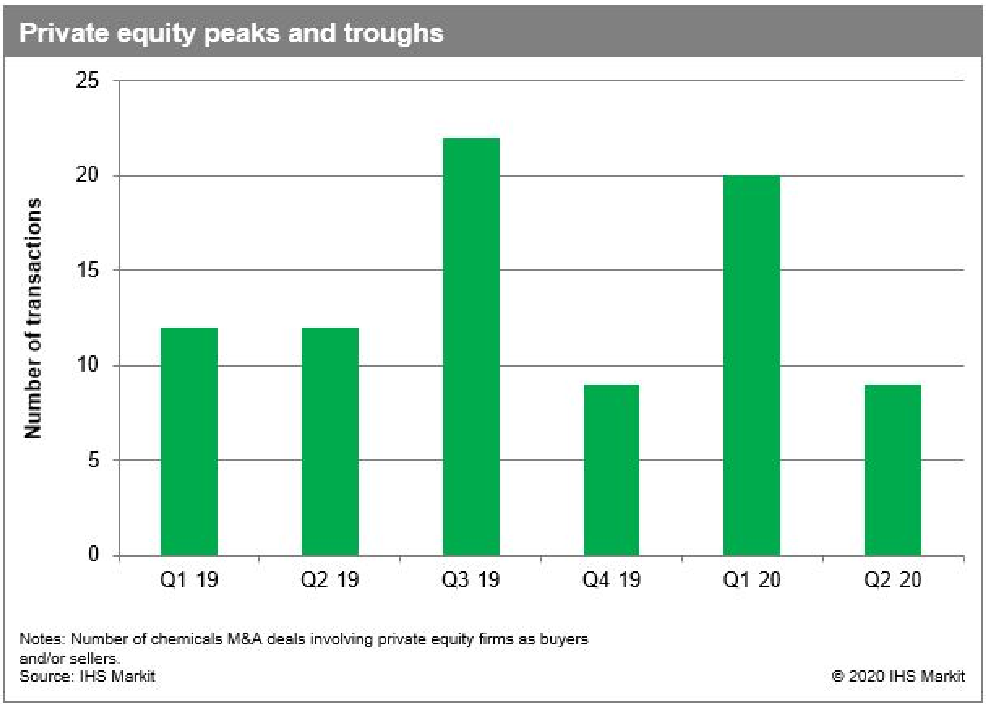

Private equity investors in the chemical industry are reaching for new strategies to complete acquisitions amid the uncertainty and market slowdowns caused by the COVID-19 pandemic. Firms are tapping relationship networks, putting more equity in deals, and looking at bolt-ons for existing portfolio companies, among other strategies.

The current environment presents a challenge to private equity firms because leveraged loans, while not completely shut off, are not readily available—but firms still have significant amounts of cash, which must be invested. At the same time, deal flow has slowed to a trickle as companies have focused on operating through the pandemic and related shutdowns and demand declines. “[Private equity] funds [have] indicated that inbound deal flow has effectively declined to zero…and securing financing for new platforms has become increasingly challenging,” says Grace Matthews (Milwaukee, Wisconsin), an investment bank.

Deals that were in process when the pandemic hit, however, were generally seen through to the close. This is especially the case with transactions that were nearing a final agreement, bankers say. This trend is visible in CW’s data, which shows a decline in private equity M&A activity for the second quarter, but not to unprecedented lows.

A new normal, for now

When the pandemic first broke out earlier this year, private equity firms in many cases behaved similarly to corporates, with a focus on the operations of portfolio companies. “They made sure their companies could manage through this,” says Ben Scharff, managing director with Grace Matthews. “Everyone pumped the brakes at first, and focused inward. In April and May, that’s where a lot of effort was focused.”

With restrictions easing, and some economic rebound evident, “over the past two or three weeks people have popped their heads out and looked around,” Scharff says. “There is clearly a desire to put capital to work and they’re trying to do what they can.”

That is likely to entail doing business in a new way, at least until the pandemic meaningfully subsides and the economy rebounds more strongly. Firms are reaching out to potential acquisition targets that they had preexisting relationships with, and focusing more on small bolt-ons for portfolio companies. “Private equity is not participating in a lot of broad processes, and I think processes in general are going to be narrower,” and include fewer participants, Scharff says.

“Many [private equity] funds and their portfolio companies have indicated ongoing conversations with potential add-on acquisitions for existing platforms,” according to Grace Matthews. There is “a preference for add-on acquisitions that are relatively smaller in size,” Grace Matthews adds.

With lenders more reluctant to fund deals, private equity buyers are also looking at using more equity in transactions. “Clearly, there’s a need to over-equitize given the financing markets,” Scharff says. “Banks are cautious and will continue to be cautious given the current risk profile for most deals.”

H.I.G Capital (Miami, Florida), which acquired aluminum chemicals maker USALCO (Baltimore, Maryland) in a deal that unfolded as the pandemic broke out, put more equity on the deal than was originally anticipated. “We eventually got there, but with a lower quantum of debt than we initially discussed,” says Keval Patel, managing director at H.I.G Capital. “But it was still workable.”

While new transactions are hard to come by, H.I.G. thinks corporate carve-outs can present opportunities. “We’re seeing more activity from the corporate side selling noncore divisions, and I’d expect that to continue,” Patel says. “In a recessionary environment, companies tend to stick to the core and sell noncore assets for cash.”

Getting it done

USALCO’s business, which is focused on the water treatment and catalysts markets, was viewed as relatively resilient, which helped the parties to the deal, and the lenders, feel comfortable moving forward as COVID-19 took hold. “We felt that this business, in particular, would be very resilient even in the face of the COVID-19 downturn given its end markets,” Patel says.

The USALCO transaction, which closed on 2 June, went through much of the process during the depths of the pandemic, and provides a good example of the sort of transaction that can be completed in this environment. “We had the deal signed up and the broad structure set up in February,” says John Talvacchia, member with law firm Eckert Seamens, which worked on the deal. The COVID-19 pandemic started to have a big impact in the US just after the letter of intent was signed, according to Telvacchia and Patel.

Beyond adding more equity, some changes were made to deal structure giving USALCO’s owners a larger stake in the business after the close than was originally anticipated. “The owners retained a significant ownership stake, which shows that they believe in the future of the company,” Patel says. “This will allow them to make just as much money, or more, on the back-end of the deal.” H.I.G Capital has declined to disclose the exact size of the transaction.

Leaving a rollover stake in the hands of existing management lessened the cash commitment from H.I.G at a time when financing markets tightened suddenly. “H.I.G. was putting in less cash at closing,” Telvacchia says. “So, for the seller, instead of getting a bit chunk of cash for one-hundred percent of the company, you get a smaller chunk of cash for a lesser amount. If a seller has time, you can play with that." The rollover stake could, of course, grow in value as the company grows. USALCO's existing management, including CEO Peter Askew, is continuing with senior roles in the company.

Along with confidence in the business's outlook, a commitment from both parties to see the deal through allowed for some flexibility. "We could do it because there was flexibility from the buyer and the seller to change the amount of cash at closing," Telvacchia says. Patel agrees, noting that both sides "were motivated to get it done."