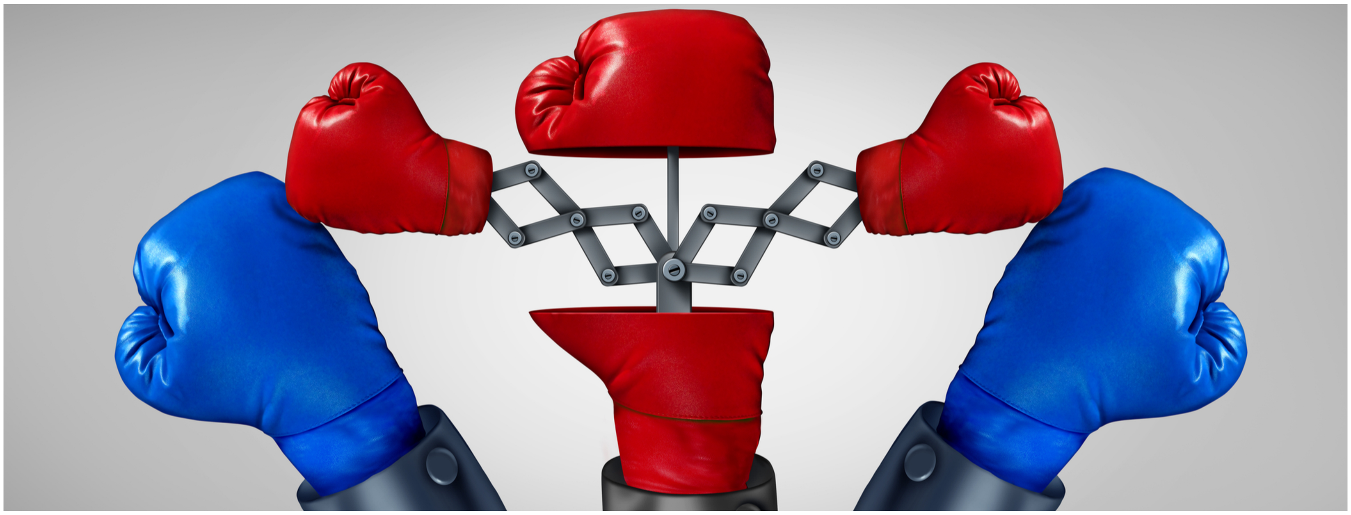
CHEMICAL INSIGHTS



Emergence of Private Equity in Chemicals M&A

Part II - How do strategic buyers successfully compete with private equity in chemicals M&A?

In Grace Matthews' Fall 2017 newsletter, we described the increased competitiveness of private equity in chemicals M&A and the various drivers behind this emergence. As we detailed, this change is being driven by both market dynamics as well as by "softer" explanations such as positioning and process management, where private equity has developed compelling tactical strategies. In Part II, we discuss ways in which we believe strategic buyers can develop counter strategies and practices to increase their own competitiveness in M&A. Clearly strategic buyers continue to be a force in M&A, but there seems to be a growing disparity between those groups with sophisticated M&A practices and those that struggle to consistently emerge successfully in competitive M&A processes.

Additionally, in late 2017, the tax reform bill – the "Tax Cuts and Jobs Act" – was signed into law. The bill has far reaching effects for the business community and, ultimately, M&A activity. We examine a few key takeaways from the bill and their potential impact on chemicals M&A.

Competing with Private Equity

Given increased competition in chemicals M&A, we are frequently asked by both small and large strategic organizations how they can best succeed in an acquisition process. The old "Golden Rule" that many less experienced purchasers believed ("whoever has the gold, rules!") doesn't apply in competitive environments like today where capital has become a commodity. Instead, minimizing perceived "deal risk" for both the seller and the seller's banker (e.g., price erosion or withdrawing from the transaction completely) is the key factor for success. The advice we commonly provide to strategic buyers is that to maximize competitiveness, strategic buyers need to focus on a few things: 1) Be willing to share the value created by synergies, 2) Centralize M&A review and streamline decision-making (and make this transparent to the seller's team!), 3) Do your homework in advance of an M&A process and 4) Make a compelling case as to why you are the best home for the business.

Show me the money! And synergies too, please.

The simple and obvious answer to ensure competitiveness is to pay more. The willingness to pay a full valuation is obviously dependent on strategic fit and the availability of hard, quantifiable synergies. If there are real synergies available, there is no reason that a strategic buyer should lose to a private equity buyer if the strategic is willing to share a portion of the value of synergies with the seller. We will repeat and simplify this statement: if a strategic buyer is willing to share a portion of its synergies, it should prevail over private equity in an M&A auction process.

The amount of synergies and willingness to share can vary by buyer, but the reason that the largest chemical deals in the industry are being completed at record multiples is that buyers are acknowledging the substantial synergies to be realized and that they can afford to share a portion with the sellers (i.e., pay more). When the Sherwin-Williams – Valspar transaction was announced in 2016, the industry was shocked to see the ~15.0x EBITDA multiple that was paid. However, this multiple is considerably lower when considering the >$250 million in synergies that were expected at announcement. Our advice to strategics is to be diligent about quantifying potential synergies – both top-line revenue enhancements and cost savings, and consider the amount that they are willing to share in formulating an offer.

Synergistic Valuation Example

	Announced	Assumed Synergies	Post-Close
Revenue	$600mm		$600mm
EBITDA	$70mm	$20mm (3% sales)	$90mm
Purchase Price	$840mm		$840mm
Multiple	**12.0x**		**9.3x**

The valuation gap between strategics and financial sponsors has narrowed over the past few years with the emergence and availability of cheap capital – both in the form of equity and debt. With this in mind, strategics are being pushed to find other ways to maintain competitiveness. One dynamic that frequently undermines strategics in competitive processes is that private equity professionals often have a greater incentive to complete a deal versus their strategic counterparts. It is important to remember that private equity is in the business of buying and selling companies, and in many ways is incentivized to invest capital. Put simply, for many funds, a 50-50 bet is better than no bet at all. Rather than wait for the perfect buying opportunity, financial sponsors take a dynamic and unique approach to each opportunity, and will work to structure and price risk accordingly. That may mean acquiring a business that has issues that need to be managed prior to exit, such as customer concentration or environmental remediation.

Centralize M&A Review and Streamline Decision-Making

Whereas sponsors are constantly evolving and developing new ways to structure around or get comfortable with deal challenges, some strategics are less nimble. In Grace Matthews' view, the internal decision-making structure is a key factor differentiating strategics that are repeatedly successful in M&A vs. those that struggle. It is not uncommon for some strategic buyers to establish a decision-making structure that works against its own M&A interests and results in a disproportionate number of deals that fail to receive internal approval. For example, functional areas that may not be involved in M&A discussions with high frequency are often afforded outsized input on a decision to proceed with a project. These areas might include I.T., EH&S, tax, risk management, operations - often these groups are disincentivized to support acquisitions at a large strategic company. These groups are likely to get no credit for a successful transaction, but will be held accountable if there is a major oversight in diligence. Instances where individuals are asked to weigh-in on a topic that only relates to downside risk typically results in a “safe” decision that ultimately may lead to a strategic exiting a sale process. Conflicts created by inefficient decision-making structures inhibit the flexibility of a strategic, and ultimately make it difficult to succeed in M&A.

Avoiding this “play it safe” dynamic within an organization begins by establishing a system to efficiently review M&A opportunities that is led by a centralized decision-making group. Once buyers have determined that an acquisition target is in-line with its strategic criteria, then we would encourage the involvement of multiple departments to aggressively identify, quantify and search for potential solutions to issues raised in diligence - importantly, though, the review process can't stop when an issue arises. A centralized group should be capable of taking feedback from these functional areas and focusing diligence efforts on the most important items to the organization. This group should have clear definition around what is important to the organization during a diligence process, and most importantly, should be empowered with the decision-making authority to move forward. This separates the personal interests of the business unit from the overall benefit of a potential transaction to the organization. Buyers should be transparent with the seller and seller's advising team about this process - this helps to reduce perceived deal risk, improving the seller's (and banker's) confidence to move forward with a buyer. A centralized group with clear lines of communication and approval will help to maintain pace in a process and ensure that the strategic is in the best possible position to be successful in an M&A process.

Furthermore, many private equity firms and strategics are differentiating themselves in competitive processes through the use of buy-side bankers. While large, experienced chemical companies certainly understand the nuts and bolts of buying businesses, in certain cases the credibility and arm's length view added by a buy-side advisor is invaluable. At Grace Matthews, when a prospective buyer of one of our sell-side clients engages a buy-side advisor, our confidence in the buyer increases exponentially. This is especially true where there are significant cultural or language issues - Asian, Latin American and Middle Eastern buyers in particular benefit from having a buy-side advocate.

Don't be surprised by an opportunity

If the first time that a buyer is analyzing a business is when that business is for sale, the buyer is already at a disadvantage. Keep a list of targets and analyze these businesses prior to the targets being brought to market – this will ensure that you can hit the ground running during a process launch. Financial sponsors will typically meet every Monday morning to discuss new business opportunities and can move quickly in a process as they outsource diligence to third parties and streamline decision making to a deal lead and his/her investment committee. There are obvious reasons why a strategic buyer cannot replicate this exact approach (nor would they want to), but it is important to understand best practices that may be borrowed and benchmarked against.

Emphasize Why You are the Right Home for the Business

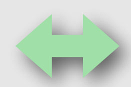
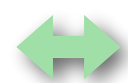
The last and potentially easiest way to maintain competitiveness in a process is to ensure that you make the case why your organization is the best home for the business. Providing a good home will likely not help overcome an inability to meet a clearing valuation, but if you are competitive on value it clearly differentiates your organization and defines why a transaction with your organization is optimal for all parties. This has become an area where sponsors have increasingly focused their attention, often "selling" their organization's fit with the target more than the seller "selling" the target. It is common practice for sponsors to prepare customized presentations with thought and data explaining the rationale for the acquisition and why they are an ideal fit. This is particularly true for transactions involving family-owned businesses where a sale may represent the conclusion of multiple generations of ownership and where the family may be more interested in finding the best steward for their organization. As a strategic buyer, your connection with the target is much more direct and obvious than any financial buyer. It is important to highlight this link, but also to explain why your organization is the right home for the business – this may come in the form of a discussion around the background and founding of your organization, and how its values and culture mirror that of the target. A strategic's involvement in a process often includes personnel from multiple business units, which may make it very easy to overlook the simplicity of discussing your core beliefs, culture, and what has made your organization what it is today.

Concluding Thoughts

The continued innovation and best practices utilized by private equity have reshaped the image of a private equity buyer from a seller's point of view. The Hollywood image of a corporate raider looking to buy at a discount, cut costs, withhold investment, and sell to the highest bidder is a thing of the past. To the extent that they can be competitive on value, financial sponsors have become a highly desirable alternative to traditional strategic buyers and can be viewed as a good home for businesses. It is important that strategics recognize this and understand how they can best compete.

Death and Tax Relief - an M&A Tax Reform Bill Primer

The dust has hardly settled on the U.S. tax reform bill passage (Tax Cuts and Jobs Act), but advisors are already commenting on the bill's far reaching effects for the business community and, ultimately, M&A activity. The reform bill is comprehensive, complex, and if you aren't a tax accountant – potentially intimidating. There are a variety of takeaways from the bill, all that can vary substantially based on the particulars of your company – e.g., geographic footprint, manufacturing presence, capital intensity, and leverage profile. While the net impact to your business may yet to be determined, an ***important takeaway from Grace Matthews' view is that the tax bill could have a positive near-term impact on valuations in M&A processes***. Although few changes are explicitly linked to M&A, nearly every change relating to business taxation will have an impact on the valuation of a company and the structuring of a transaction. Included below is a simple outline of a few key takeaways from the bill and how it will impact M&A processes. Note, this is not meant to be a comprehensive overview on the tax bill – consult a tax accountant or attorney for a full analysis on the potential impact to your business.

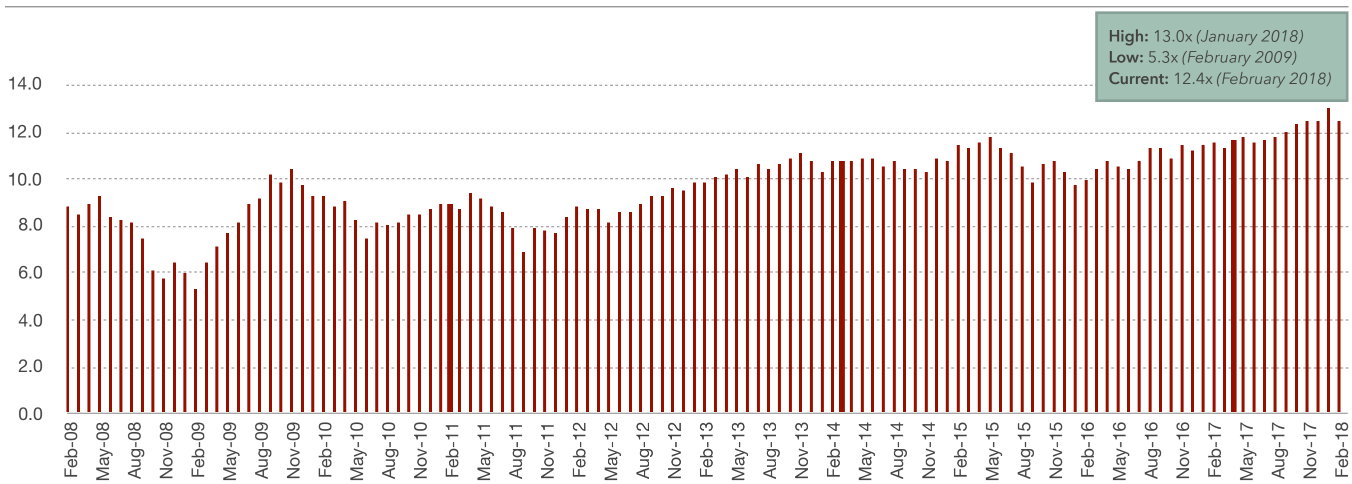
Category	Action	What does this mean?	M&A Impact
Corporate Tax Rate	Federal corporate income tax rates have been reduced from 35% to 21%.	Most corporations will be paying a lower tax rate, which increases cash flow. This will increase liquidity for corporations that can be used on M&A and will increase after-tax cash flow of potential targets (which should drive valuations).	
Capital Expenditures	Select types of capital investments can immediately be fully expensed vs. being capitalized and depreciated over time. Importantly, this provision includes assets acquired in an asset sale.	This provision impacts valuation and M&A in two very different ways: - This provides a tax shield for businesses, increasing liquidity that can be used on M&A and increasing cash flow of potential targets (which should drive valuations). - From an M&A perspective, if a transaction is structured as an asset sale (both real or elected), some or all of the purchase price that has been allocated to non-goodwill items can be deducted in the first year following an acquisition. This provision is applicable to whomever owns the business, regardless of when the asset was placed into service. Depending on purchase price allocation, this provision can allow a purchaser to immediately deduct a significant component of the purchase price.	
Repatriation of Capital	Earnings of U.S. companies that have been generated and held overseas can now be repatriated back to the U.S. at improved tax rates.	Existing earnings will receive a one-time reduced tax rate. On a go-forward basis, the move from a world-wide taxing system to a territorial taxing system will result in a more complicated, but reduced tax on foreign earnings. Ultimately, the repatriation of capital will increase liquidity for U.S.-based companies. How these companies utilize the increased capital will vary, but M&A is a possible outlet.	
Carried Interest Holding Period Requirement	Investment firms are now required to hold capital assets for three years before being eligible to qualify for long-term capital gains. Previously, firms would receive this benefit after holding an investment for only one year.	Average holding periods for financial sponsors are generally above three years, so this may not have a material impact on M&A.	
Deductibility of Interest Expense	The ability to deduct net interest expense when calculating taxable income has been capped at 30% of EBITDA over the next few years. Previously, this deduction was uncapped.	All other variables held constant, this provision could impact cash flow of leveraged businesses, increasing taxes paid and reducing after-tax cash flow. Given the current financing environment with historically low interest rates, over the near term this may only materially impact highly levered, underperforming companies. As interest rates increase and/or the economy slows, this could have a negative impact on the cash flow of levered companies and/or the amount of leverage used in LBOs.	

Select Recent Chemical Transactions

Announced Date	Acquirer / Target	Enterprise Value	EV / Sales*	EV / EBITDA*
Feb-18	Saint Gobain / HyComp			
Feb-18	ACG Materials (HIG Capital) / Kelly Limestone			
Feb-18	Polymer Solutions (Arsenal Capital Partners) / Phoenix Chemical			
Feb-18	LyondellBasell / A. Schulman	$3,045	1.2x	15.5x
Feb-18	Sensient Colors / Globenatural (natural color business)			
Jan-18	Sierra Corporation (Tonka Bay Equity) / Burke Industrial Coatings			
Jan-18	2M Holdings / Franken-Chemie			
Jan-18	ICP Group (Audax) / Arizona Polymer Flooring			
Jan-18	MPD Chemicals (Addison Capital Partners) / Norquay Technologies			
Jan-18	High Road Capital Partners / U-C Coatings			
Jan-18	Valentus Specialty Chemicals (Huron Capital) / US Coatings			
Jan-18	Chase Corporation / Stewart Superabsorbents	$71	3.0x	
Jan-18	Ecolab / Cascade Water Services			
Jan-18	PolyOne / IQAP Masterbatch			
Jan-18	PPG / Procoatings			
Dec-17	Ravago (AMCO Polymers) / Polymer Technology & Services			
Dec-17	Umicore / Materia (metathesis catalyst business)	$27		
Dec-17	Henry Company / Fortifiber			
Dec-17	WR Grace / Albemarle (polyolefin catalysts business)	$416		12.8x
Dec-17	SK Capital / Israel Chemicals (Fire Safety and Oil Additives businesses)	$1,000	3.4x	
Nov-17	Borchers (The Jordan Company) / Owensboro Specialty Polymers			
Nov-17	Innophos / NutraGenesis	$28	2.3x	
Nov-17	Bostik / XL Brands	$205		11.0x
Nov-17	Aakash Chemicals (CenterOak Partners) / Calico Food Ingredients			
Oct-17	Sika / Butterfield Color			
Oct-17	Italmatch Chemicals (Ardian) / Sudamfos do Brasil			
Oct-17	BASF / Bayer (select Crop Science businesses)	$6,986	4.5x	15.3x
Oct-17	SK Global Chemical / DowDuPont (polyvinylidene chloride resins business)	$75		
Oct-17	Buckman Laboratories / CiDRA Chemical Management			
Oct-17	Carlisle Companies / Accella Performance Materials (Arsenal Capital)	$670	1.6x	11.5x

** EV = Enterprise Value in USD millions (equity value, plus funded debt, minority interests and preferred shares; less cash and cash equivalents)*

Grace Matthews Chemicals Index: Enterprise Value / EBITDA (Last 10 Years)



Source: Grace Matthews & Capital IQ

The GM Chemicals Index tracks the Enterprise Value / EBITDA ratios of 98 publicly-traded chemical companies that span multiple markets and geographies. The index aggregates the latest reported financial data and stock prices, and tracks valuation trends and operating metrics. The index averages are equally weighted, as opposed to weighting by market capitalization, in order to avoid having the valuations and financial performance of the largest companies determine index values.

Grace Matthews: Select Chemicals and Materials Transactions

BASF The Chemical Company
has sold its global Polyolefin Catalysts business to
GRACE

3M
has sold its pressurized polyurethane foam adhesives business to
ICP

CiDRA
has sold its subsidiary CiDRA Chemical Management Inc. (CCMI) to
Buckman

MFG Chemical, Inc.
"Building Valuable Bonds"
has been recapitalized by
Platte River Equity

RANBAR
has been acquired by
GABRIEL

Owensboro Specialty Polymers, Inc.
has been acquired by The Jordan Company's portfolio company
borchers

Henry
has been acquired by
American Securities

United Paint
has sold its global automotive interior rigid thermoplastics coatings business to
AXALTA

APPLIED adhesives
has been acquired by
GHJ&M Goldner Hawn Johnson Morrison

AAKASH CHEMICALS
THE SKY IS THE LIMIT
has been recapitalized by
CenterOak Partners

Ennis-Flint
has been acquired by
Olympus Partners

Bacon Adhesives
a division of
Cass Polymers
has been acquired by
Royal Adhesives & Sealants

TPC Group
has sold its Baytown Operations to
SI Group The Substance Inside

Buckman
has sold select Canadian assets to
TRIWATER HOLDINGS

americhem
has acquired
Vi-Chem Corporation

DELOS CAPITAL
sold its portfolio company
California Products Corporation
to
Audax Group

Silbond
has been acquired by
EVONIK INDUSTRIES

Compass Chemical International
has been acquired by
ONE ROCK CAPITAL PARTNERS

TAYLOR
Innovative Science. Applied Technology.
has been acquired by
Dominus Capital

ChemQuest Chemicals
has been acquired by
EDGEWATER CAPITAL PARTNERS

Grace Matthews Clients Listed First

Grace Matthews Overview

Grace Matthews is recognized globally as a leader in transaction advisory services for manufacturers and distributors throughout the chemical value chain. Grace Matthews' clients include privately held businesses, private equity funds, and large, multinational corporations.

Grace Matthews' practice is global in scope, and focuses on several areas: sell-side transactions and divestitures for private companies, private equity holdings, and multi-national corporations; buy-side work for large public companies, major multi-nationals, and sponsor-backed chemical platforms; leveraged transactions and recapitalizations, strategic advisory analysis, and transaction fairness opinions. Areas of expertise include:

- Adhesives, Sealants, Tapes
- Catalysts, Petrochemicals
- Construction Chemicals, Building Products
- Contract Manufacturing, Custom Synthesis
- Distribution, Equipment, Infrastructure
- Food Ingredients, Flavors, Fragrances
- High Purity, Electronic Chemicals
- Industrial Minerals, Inorganic Chemicals
- Intermediates, Industrial Chemicals
- Lubricants, Lube Additives
- Oilfield & Water Treatment Chemicals
- Paints, Coatings, Inks
- Personal Care, Soaps, Medical Materials
- Plastics, Colorants, Additives
- Tolling, Private Label Products
- Additional Chemical Sectors

Grace Matthews is a privately held investment bank with successful chemical industry transactions dating back to the early 1990s. Grace Matthews principals have completed over 100 transactions involving global corporations such as AkzoNobel, 3M, Lubrizol, BASF, DuPont, Sherwin-Williams, PPG Industries, Ashland, Ceradyne, DSM, ICI, Borregaard, Air Products, Landec Corporation, The Home Depot, Hexion Specialty Chemicals, ITW, PolyOne, Weatherford, and Evonik, to name a few.

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Grace Matthews

Grace Matthews, Inc. (www.gracematthews.com) is an investment banking group providing merger, acquisition, and corporate finance advisory services for chemical companies both in the U.S. and internationally. Grace Matthews is global in scope and well known for its strong track record of success dating back to the early 1990s.