Chemicals M&A in 2020...

is this the tipping point?

Special feature from Grace Matthews

It is no secret that the chemicals M&A market has shown continued strength over the past several years. At the end of seemingly every year we are asked, “How much longer can this aggressive market continue?” As we move into 2020, the questions from sellers continue. We regularly hear concerns about the market being “late cycle” and inquiries regarding the potential for “compressed valuation multiples.” When coupled with global macroeconomic uncertainty and the upcoming presidential election, it obviously begs the question about 2020 and whether this year is finally the “tipping point” for the chemicals M&A market.

Before we provide our outlook on 2020, let’s first rewind to late 2018 and remind ourselves of the status of the chemicals market as we headed into 2019. As you recall, there was a broad year-end correction in the public equity markets during Q4 2018, which caught many by surprise and created a noticeable degree of market anxiety. During those three months, the S&P 500 declined by approximately 14 percent, and oil prices dropped by approximately 40 percent. Our view at the time was that while market volatility and uncertainty may steer 2019 towards being a “good, but not great” year, the fundamentals of the chemical industry and the broader U.S. economy were solid. Overall, we expected to see fewer mega-deals, but felt that the door remained open for middle market M&A activity in the chemical industry.

Fast-forward to today, and our prediction for 2019 was largely correct. There were a number of macroeconomic and political factors that jolted the financial system in 2019 (e.g., tariffs with China, ongoing Brexit disentanglement, attacks in the Middle East on petrochemical facilities, etc.). However, in general, the impact of these factors on middle market chemicals M&A remained short-lived – ultimately overshadowed by strong buyer interest and abundant capital. In a good year at Grace Matthews, we expect to close eight to 10 transactions, and this is exactly where

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we landed in 2019. Importantly, valuations have remained elevated – some of the Grace Matthews transactions that closed in 2019 were at the highest earnings multiples that we've seen since we first began advising clients in the chemical industry more than 20 years ago.

However, the global chemicals M&A market was not rosy across the board in 2019. With fundamentals weakening in select segments of the chemical industry, there were public instances of stalled transaction sales processes during the year. Typically, this occurs when financial performance for a business does not meet expectations during a sale process. Underperformance relative to projections complicates transaction dynamics, as the buyer may start to question the valuation it had initially agreed to. This issue is compounded in today's market where sellers' expectations have been based on sky high valuations. From an advisor's perspective, this dynamic reinforces the need for upfront preparation and realistic budgeting.

As we look out to 2020, our expectation for M&A is fairly consistent with 2019. While geopolitical uncertainty may be tempering global growth and one-off risks remain, we believe that middle market chemicals M&A will continue at a healthy pace, with valuations remaining at or near historically high levels. It's clear that select end markets have begun to experience softness amid growing headwinds. However, as of late 2019, we have not seen a pull-back in our project volume and, for the most part, our clients' businesses have remained resilient in this environment. We believe structural factors for both private equity funds and public chemical companies continue to support a robust M&A market. The growth rates assumed in today's public chemical company valuations require acquisitions to enhance modest GDP-level organic growth, and private equity has an enormous amount of capital to invest. As private equity has gotten more comfortable with, and more invested in, the chemical sector, we want to provide a refresher on these PE funds – who they are, what they do, and how to react if you are negotiating with them.

Continuing emergence of private equity in chemicals investments

First, a simple reminder that private equity is in the business of investing capital. These funds partner with owners and management teams to buy, grow, and ultimately

sell businesses. Typically, the goal for funds is to generate returns by investing in growth (organically or through add-on acquisitions), building out systems and infrastructure, and executing other operating initiatives. Today, a growing number of private equity funds continue to raise an increasing amount of capital – some sources estimate there is more than $1 trillion of equity capital available in North America. The true amount of available capital is actually greater, as private equity also utilizes debt capital from lenders to fund transactions and overall debt availability remains incredibly robust. As a result, the private equity industry, made up of thousands of funds in North America alone, is more competitive than ever.

Generally, investing in the chemical industry is like the "varsity" of the deal world for private equity. It is challenging for some private equity funds to diligence and

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get comfortable with complex issues frequently found in chemical transactions, including environmental concerns, regulatory risk, commodity exposure, and the general technical know-how of the businesses. Because of this, we usually joke that you never want a private equity fund learning the industry on "your" deal. As recently as 10 years ago, our view was that there were probably 20 - 30 private equity funds that were truly "chemicals capable." Five years ago, that number was more like 50 - 60 funds. Today, we believe there are more than 100 funds that have a strong appetite to invest in the space and the know-how to execute a chemical transaction. More credible buyers entering a space provides more options for a seller and ultimately better deal dynamics. This, combined with the influx of capital referenced earlier, is why most owners are getting emails and calls several times a week from buyers that are interested in their business – there are a lot of investors chasing deals!

If a seller is attracted to the benefits of partnering with a private equity fund, we would recommend they first do their homework. Clearly, a seller wants to find a partner that aligns with their vision for the business. Different funds have different objectives – the investment philosophy, criteria, and scope can differ substantially between each fund. Importantly, a well-run sell-side M&A process will allow owners ample opportunities to meet and interact with key personnel at private equity funds. Use these opportunities to better understand the fund's track record in the industry, its management style from prior investments, and how prior owners/management teams have enjoyed working with the fund – and ultimately, make sure you have the best partner for your desired outcome.

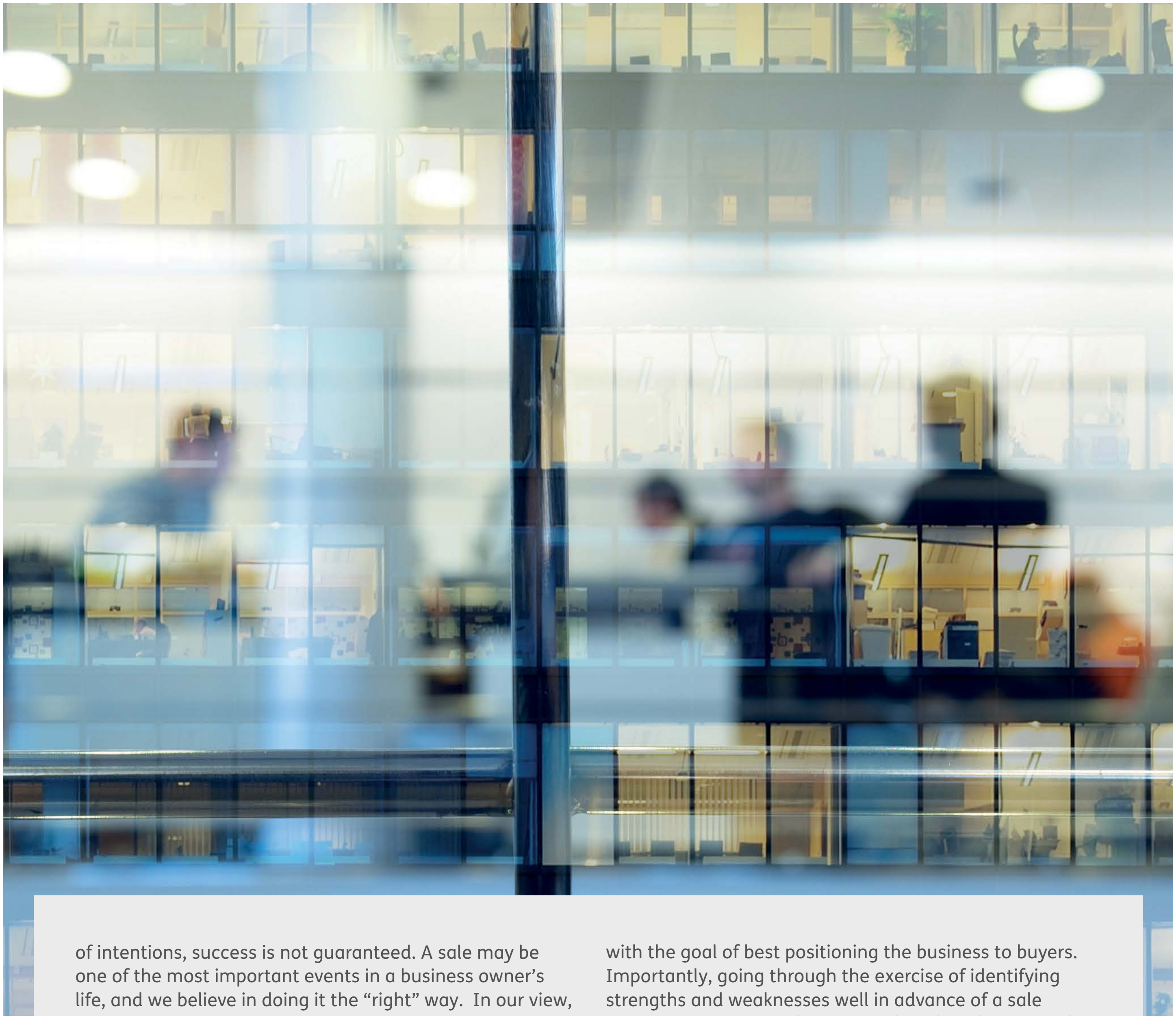
Ensure you have options

Increased attention from buyers may be great if you are a business owner considering a sale, but there are a number of things to keep in mind as you evaluate next steps. In order to create and maintain leverage, sellers want to have as many options as possible when they are considering some form of an exit. Understanding the market and preparing for a sale puts a seller in a better leverage position when they are ready to sell, regardless of whether the sale is to a strategic buyer, employee(s), private equity buyer, or minority partner.

We have a saying that "there are no rules in the M&A world," and while buyers and sellers can both have the best

While capital availability is a major driver of private equity buyers' increased competitiveness in the broader market, there are a number of specific factors driving the increased interest in the chemical industry. These include:

- **Funds increased use of operating partners (e.g., former chemical executives),**
- **Advances in environmental risk quantification and remediation efforts, and**
- **High-profile private equity success stories in the industry.**



of intentions, success is not guaranteed. A sale may be one of the most important events in a business owner's life, and we believe in doing it the "right" way. In our view, this means customizing the sale process to the particular situation. At Grace Matthews, we start by defining success (e.g., value, terms, transition dynamics, legacy, etc.), and then work backwards to engineer a sale process to meet those objectives. An owner's objectives will help dictate the appropriate process to utilize. We often find that most private sellers focus heavily on headline value, which is important, but legal terms, speed and certainty, and intangibles are also meaningful in ensuring that an owner is satisfied with a process outcome. In our view, the "market will speak" if the appropriate process is utilized and run well – the goal is to create multiple options and establish leverage. A question for sellers to keep in mind is "how do you know that you received a market clearing deal if you have not appropriately tested the market?"

Regardless of an owner's timeline to exit, we recommend taking time to understand the key factors, both positive and negative, that will influence buyer interest in a transaction well in advance of an exit. With that understanding, sellers can market the positives of the business and appropriately frame the potential risks, with the goal of best positioning the business to buyers. Importantly, going through the exercise of identifying strengths and weaknesses well in advance of a sale process gives owners the time to de-risk and improve the variables that a sophisticated buyer will consider when determining their valuation for a business.

Circling back to our original prediction for 2020, while it is fair to say that we may be in the "late cycle," without a crystal ball, our advice to business owners in this environment is to stay ahead of the curve and focus on the variables that you can control. Rather than try to time the market, we recommend owners start the exit-planning process well in advance. No two businesses are alike, and sellers can best position themselves if they can identify and properly articulate the positives of their business, and address or minimize the potential risks prior to considering a sale.

Kevin Yttre and Andrew Cardona are with Grace Matthews, an M&A advisory firm that focuses exclusively on the chemical and materials value chain.

M&A Advisory for the Chemical & Materials Value Chain

In chemical mergers & acquisitions, industry-specific expertise is invaluable in maximizing value and managing risk. Grace Matthews has that expertise, having successfully advised clients on over 150 specialty chemical M&A engagements over two decades. We represent owners of privately held businesses and private equity groups in business sales and recapitalizations, large multinational corporations in acquisitions and divestitures, and management teams in leveraged buy-out financing. We have transaction experience in a number of chemical sectors, including paints, coatings, inks, adhesives and sealants, plastics, polymers, resins, energy, oilfield chemicals, water treatment, food and agriculture, personal care and soaps, intermediate chemicals, and inorganics and catalysts. All inquiries held in confidence.

WST
has been acquired by
Italmatch Chemicals

EPOXIES ETC.
has been acquired by Arsenal Capital Partners' portfolio company
Meridian Adhesives Group

H.B. Fuller
has divested its surfactants, thickeners and dispersants business to
Tiarco, LLC
a subsidiary of
Textile Rubber & Chemical Co., Inc.

CABOT
has entered into a definitive agreement to sell its Specialty Fluids business to
SINOMINE

Chemours™
has sold its methylamines business to Belle Chemical Company, an affiliate of
Cornerstone Chemical Company

QUALICHEM
has entered into a strategic partnership with
Yushiro

MFG CHEMICAL LLC
BUILDING VALUABLE BONDS
has been recapitalized by
PLATTE RIVER EQUITY

ActiveMinerals INTERNATIONAL, LLC®
has been acquired by
GOLDEN GATE CAPITAL

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

GABRIEL
has acquired select assets of the Capcure business from
BASF
We create chemistry

Silbond®
has been acquired by
EVONIK INDUSTRIES

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