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MILWAUKEE—Merger and acquisition activity remained strong in the rubber and plastics chemicals market in 2018, and that momentum probably will carry into the new year, said Ben Scharff, managing director at Grace Matthews Inc.

Looking at the number of transactions compared to 2017, market activity was consistent for 2018, he said.

"It remains incredibly strong, and there's a lot of reasons for that," Scharff said.

The economy is still robust and there's a significant amount of capital out in the market chasing deals, he said. Also, debt is still relatively inexpensive, though the Federal Reserve increased interest rates in 2018.

"You have fairly strong growth rates right now in the dominant end markets here for rubber and plastics," Scharff said. "Then I'd also say an important thing is the regulatory environment right now. It definitely benefits companies of scale."

As the economy continues to remain durable at this level, Scharff said he "feels like we sound like a broken record sometimes when we sit down with private owners and say the market can't get any stronger, values are high, a lot of deals are happening. It's been that way for probably 4-5 years now."

Aside from building products, plastics and rubber markets likely saw the second highest amount of deal activity in 2018, Scharff said. Though rubber and plastics have traded a little bit lower from a perspective of multiples over the last year compared to specialty chemicals, relatively speaking the values have remained strong.

"We've seen a couple eye-popping valuations, which isn't too dissimilar to other industries in chemicals right now," Scharff said.

He pointed to LyondellBasell's activity as some of the most important in 2018. The materials company completed a $2.25 billion acquisition of A. Schulman Inc. in August, a supplier of plastics compounds, composites and powders. The acquisition more than doubled LyondellBasell's existing compounding business, according to company officials.

"I think the A. Schulman acquisition is one I'd tag as being significant this year," he said. "By everyone's measure, they paid a pretty healthy price, a healthy multiple for that transaction. But certainly, I think there was a strong rationale in doing it."

LyondellBasell also has been pursuing an acquisition of Braskem, a petrochemical company based in Latin America, through the end of 2018, with negotiations continuing into the new year.

Market optimism

Though different subsectors of the market have different dynamics, the effect of oil pricing adds an interesting twist to the rubber and plastics market, Scharff said.

"We've seen across numerous end markets the impact that oil pricing has had on raw material inputs, and a lot of folks in the middle, in this case compounders, plastic producers and others, having margins squeezed a bit," he said.

As the price of oil has dropped significantly, some optimism in the marketplace has built as some in the industry are looking at opportunities to experience margin expansion in the new year, Scharff said. Within the last year, companies have pushed price increases through to customers, but are at a point where they feel they might be able to hold those prices for a while, giving a chance for those expanded margins.

"On the flip side, you have, what's the impact of tariffs going to be? What's the impact of the increased Fed rate? And I don't know that there's a great answer there, because it seems to change from day to day," Scharff said. "It's not just rubber and plastics, right? It's other metals and whatnot that are sitting on the same product with them that are being imported and exported."

But even after several years of continuously consolidating markets, there are still many smaller independent, midsize compounders available, and "I think you're going to continue to see those being aggressively consolidated," Scharff said.

"Debt's cheap, a lot of these companies have pretty healthy balance sheets. A lot of them sit in close to GDP growth industries," he said. "I would say absent the last three months of the market (in 2018), a lot of them were trading at pretty healthy multiples and inherently had growth already built into the stock price."

As stock prices fell toward the end of the year, it created another interesting dynamic, giving companies pressure to grow, "and any way they can leverage their balance sheet to do that, they're going to, if it's a good acquisition for them," he said.

Major trends

Strategic buyers aggressively looking for bolt-on acquisitions was one of the bigger trends of 2018, Scharff said. But a growing current trend is increased attention and activity from private equity in the rubber and plastics market, covering at least a third of the transactions in the space overall. Strategic buyers should be able to be more competitive in acquisitions, by being able to do things like quote costs out and consolidate production, which should enable them to pay higher prices.

"But especially when you look at the compounding market, I think just given the large number of potential targets out there and the amount of private equity dollars out there chasing deals, I think it's a great buy-and-build scenario for private equity," Scharff said.

One notable example was Norwest Equity Partners selling Minnesota Rubber & Plastics to global investment firm KKR & Co. L.P. for an undisclosed amount that closed in November, he said.

"That was a big deal, and I would have to believe that they're going to be out there trying to aggressively grow that," Scharff said.

The multiples private equity firms pay can leave some scratching their heads at times, but part of the justification is that the firm will go and find add-on acquisitions to hopefully buy at a more reasonable multiple, Scharff said. Failing that, the firms will try to drive synergies to bring that effective multiple down.

"But similar to the big strategics, they just have such pressure to place capital," he said. "I think that will certainly continue going forward."

The "perfect situation" for private equity is a company poised to see growth, either through aggressive growth rates in the end markets or through a large number of potential acquisition opportunities, he said.

"And I think there are some healthy growth rates projected over the next 5-10 years," Scharff said. "Probably not as healthy as some other markets, but when you think of chemicals, they are fairly healthy."

And the current market is full of possible acquisition opportunities, he said. Private equity firms can buy a platform and then go to work looking for deals pursuing other acquisitions to make the initial platform even more attractive.

Return thresholds also have come down for private equity because of their competitive environment, which allows them to stretch on value, he said.

"And from a private seller standpoint, valuations are so high in the market that private sellers can get a very strong value from private equity," Scharff said.

Working with private equity also gives the seller some options, such as retaining some equity in the business, and seeing that the management team gets equity in the company going forward, he said. That makes it more of a "feel-good story" for sellers, who are able to look at their management team and say that they're staying on as an equity holder and investor, and that there are opportunities ahead to grow alongside the business.

That isn't to say that working with a strategic buyer doesn't provide opportunities, though, he said.

"Some strategics are great homes for private businesses, and they become a platform for folks within the company to be able to grow within a larger organization, so I don't want to paint it as a one-size-fits-all," Scharff said.

Looking forward

Going into 2019, values will continue to remain strong, independent of interest rates ticking upward, he said.

"The growth drivers are still there for rubber and plastics, so I think that will continue to spur interest in the space. All the dynamics are still there in terms of relatively healthy balance sheets and immense pools of private equity dollars," Scharff said. "I do think you'll see some margin expansion with these businesses, which is always good to be selling off of."

The market also is positioned to be favorable to sellers, and strong seller dynamics tend to drive the overall market, he said. The industry will continue to see a high level of deal activity as private equity firms will want to grow and develop their platforms.

"You're going to see just aggression from these funds and their portfolio companies just going out trying to roll up the industry," he said. "There's not a company that we go to meet with that the owner's got a drawer in the top right of his desk that he opens, and he's got 100 private equity letters for folks wanting to buy. I don't see that letting up."

The market might see some headwinds in the form of tariffs and political uncertainty, or increased interest rates, he said. There are enough levers within the market that could cause some to sit on their hands because of uncertainty as to what the market looks like going forward. Sellers also could be feeling just a little more cautious for the same reasons. Though the number of deals will remain high, Scharff's instinct is that it won't go higher than the market has seen during the last two years.

Strategic buyers will continue to do more deals, despite the raised attention of private equity firms, he said. But in terms of valuation, those private equity firms will continue to be aggressive in looking for more opportunities.

"I don't think their appetite will lessen," he said. "With more private equity in there, I think it'll continue to push values at or maybe even a little higher than they're at right now. People are chasing deals to put money to work."

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