Private equity diversifies the portfolio

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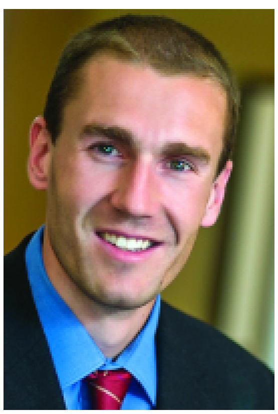
Private equity investors in chemicals are growing more numerous, and more sophisticated. In 2018, about 23% of chemicals M&A volume and 34% of M&A value was in deals in which private equity firms were involved, either as buyers or sellers of assets, according to CW data. This represents a big increase from 2017, when the figures were 12% and 9%, respectively; and 2016, when they were 14% and 7%.

“Chemicals have become a more popular area of investment for private equity, period,” says Chris Hogan, managing director/chemicals, M&A group, at KeyBanc Capital Markets (Cleveland). “If you went back ten years or so the number of private equity funds that were dedicated to chemicals or seriously pursuing chemicals investments were fairly limited. You had a handful of funds that knew the space well … but over the past decade you have seen chemicals become viewed as an attractive area for investment. It’s a place to get good cash flow, and private equity likes that.”



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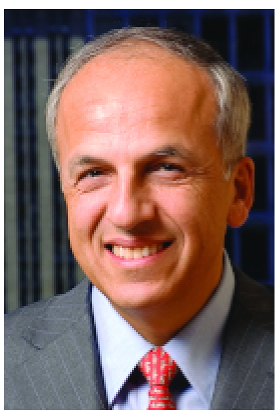
YTTRE: Many firms partner with industry executives.



TELEVANTOS: Investing in carve-outs is attractive.

Apollo Management (New York), a longtime private equity investor in chemicals, agrees. “The amount of private equity activity and the number of firms focusing on this sector has increased dramatically,” says Sam Feinstein, partner with Apollo.

Private equity has had some notable successes in the sector. Axalta, the former performance coatings business of DuPont, was acquired by private equity firm The Carlyle Group (Washington, DC), in 2013 for $4.9 billion. Less than two years later, Caryle sold a 24% stake in the company in an IPO, raising $975 million. The firm sold down its stake over the course of two years, raising billions with a series of public share offerings. Carlyle exited Axalta in 2016, raising an additional $1.2 billion by selling about 42.6 million shares.

Royal Adhesives & Sealants, which was acquired by H.B. Fuller for $1.6 billion in 2017, is another private equity investment that paid off. Arsenal Capital (New York) acquired the company, then a small specialty adhesives maker, in 2010, combined with another specialty adhesives firm and grew it via a string of acquisitions. When Arsenal sold Royal to American Securities (New York), another private equity firm, for around $1 billion in 2015, the company had about $600 million/year in sales and generated $115 million/year in EBITDA. Royal grew further under American Securities, reaching $138 million/year in EBITDA when it was acquired by H.B. Fuller.

Perhaps the highest-profile private equity investment in chemicals, however, has been Apollo Management’s stake in LyondellBasell. Apollo bought up LyondellBasell debt on the secondary market as the economy crashed in 2008 and 2009, putting it in position to take a big equity stake during the company's bankruptcy restructuring. When LyondellBasell emerged from bankruptcy in mid-2010, Apollo was the company's largest shareholder. Apollo sold down its stake in LyondellBasell over several years, raising billions after buying in for pennies on the dollar.

These three transactions represent, in their differences, a salient fact about private equity investment in chemicals—that no two deals are precisely the same, and that firms often employ different strategies. Arsenal Capital, which has a particular focus on chemicals, has employed buy-and-build acquisition strategies similar to the Royal Adhesives path with other investments, most recently Accella Performance Materials (Maryland Heights, Missouri), a polyurethane foams maker. SK Capital (New York), another firm with a focus on chemicals, often holds businesses for an unusually long time—it acquired Ascend Performance Materials from Solutia in 2009, and appears to be in no rush to sell. Larger, more generalist firms such as Carlyle and Apollo often take big chunks out of publicly traded companies and are more likely to pursue an IPO on exit. On the other side of the spectrum, smaller private equity firms such as Edgewater Capital Partners (Cleveland) trade in industry expertise, with a focus on smaller corporate carve-outs, and family owned businesses.

Know thy market

Operating partners with industry experience are often attractive to private equity firms. "Funds will partner with former industry executives … and try to bring a different set of lenses and strategic vision to a company," says Kevin Yttre, managing director with Grace Matthews (Milwaukee).

This is often true of smaller and medium-sized private equity firms, but even larger ones see value in industry operational experience. Advent International (Boston), which was founded in 1984 and has about $39 billion in assets under management, works with over 80 operating partners, who serve on boards and help advise management teams, according to the firm's annual report.

Advent has also brought industry experience in-house, including in chemicals. Ronald Ayles, who heads chemicals investments as Advent's managing partner/global chemicals and materials, worked in a variety of management roles with Degussa for a decade before joining private equity in the early 2000s. "When Advent first invested in Europe, it acquired a fund that was mainly focused on the chemicals industry," Ayles says. Advent began investing in chemicals in the 1990s, he notes. "The heritage is strong."

Advent isn't afraid to invest in lower-growth markets. "Corporates tend to want to invest in areas with secular growth trends," Ayles says. "That is a real opportunity for us because you can invest to grow and consolidate in other markets." In a business with growth rates near GDP, "you can debottleneck a little, it's less capital intense but the cash flows can still be good," he adds. The firm sees opportunities in buying these kinds of businesses, investing in them, and building them out. "In high-growth businesses, it's hard to compete with strategic buyers," Ayles says.

As an example, Ayles cites Allnex, the former Cytec coating resins business, which Advent acquired in 2013 for $1.15 billion. "We've grown revenue by a factor of two by consolidating, investing in new sites, and going into markets where the business wasn't present before," such as China, Ayles says. In 2016, Advent-backed Allnex acquired Nuplex Industries, a New Zealand-based maker of polymer resins.

"I've learned to differentiate between a good company and a good investment," Ayles says. "A good company isn't automatically a good investment, because for a good investment you have to make something better. The better a company is, the tougher it is to improve it."

Corporate carve-outs, of which Allnex was one, are widely seen as major opportunities by private equity investors. “The biggest source of opportunities comes from either private companies that need to exit due to succession planning issues, or carve-outs from public companies,” says John Televantos, partner with Arsenal Capital (New York). “These are assets that corporates want to monetize to fund their own strategies.”

Funds of different sizes and industry orientations pay attention to carve-outs. “Carve-outs are an area that we think is particularly fertile for investment,” says Martin Sumner, managing director at The Carlyle Group. “We have expertise in that area so we go after it pretty hard.” Edgewater Capital, a specialist in chemicals and life sciences that focuses on small-to-midsized transactions, also views corporate carve-outs as an opportunity. About two-thirds of Edgewater’s transactions are carve-outs, and the rest mostly involve private owners, according to Bob Girton, partner with Edgewater. “There are particular niches in certain chemistries that we are experienced in and that we like,” Girton adds.

High-profile corporate divestitures and carve-outs often wind up going to private equity buyers. In the largest announced chemicals transaction of 2018, Carlyle acquired Nouryon, the former chemicals business of AkzoNobel, for $12.6 billion. That deal was “the largest equity check Carlyle has ever written” without partnering with another firm, according to Sumner. GIC, a Singaporean sovereign wealth fund, was a co-investor on the Nouryon deal but has a much smaller stake in the company. More recently, Advent in March agreed to acquire Evonik’s methacrylates business for $3.4 billion.

Many private equity investors view carve-outs as a way to grow a business that may have lacked resources, attention and investment. “Big companies are usually not giving them capital or personnel priority, they are giving them less resources,” Televantos says. “Often in carve-outs we want to bring in new senior leadership that really understands the pace of private equity,” Sumner says. For example, Charles Shaver, the current CEO of Nouryon, was brought on board last year from Axalta—which he joined when it was owned by Carlyle. “It doesn’t have to be someone we’ve worked with before, but it does have to be someone who understands private equity and buys into the plan,” Sumner adds.

Buyers in private equity should have ample opportunity to pick up more divestitures and carve-outs in the coming years. BASF is currently exploring a sale for both its pigments and construction chemicals businesses. Clariant is also planning to divest its’ pigments business. DuPont has said that, after becoming independent in June, it will divest about 10% of its $22.6 billion in annual revenue. Private equity firms say that they are closely watching such portfolio reshuffling and, if the past is any guide, some of these businesses are likely to wind up in private equity’s hands.

Shareholder activism, which has often played a role in such reshuffling, can also get the attention of private equity firms. “We keep an eye on activism,” Sumner says. “Activists have caused the pace of change to heighten in chemicals.” Carlyle followed Elliot Advisors’ (New York) activist campaign against AkzoNobel, as the hedge fund agitated for a merger with rival PPG before the deal was stymied by Dutch authorities and Nouryon was put on the selling block.

Capital gains

Private equity funds of all kinds have, in recent years, raised significant amounts of capital. While figures can vary, the amount of dry powder—capital available for deployment —at private equity firms surpassed $2 trillion in 2018, according to some reports. Firms with a track record in chemicals also have substantial amounts of capital. Apollo Management’s private equity arm has about $36 billion in dry powder, according to a February investor presentation. SK Capital closed its’ fifth fund in February, raising $2.1 billion, the firm’s largest fund to date.

This means there is a lot of private equity capital chasing acquisitions, which helps support EBITDA multiples for M&A deals, including in chemicals. “There is a lot of money out there,” Hogan says. “There is very much an impetus to put capital to work.” Average EBITDA multiples for chemicals transactions have remained above 10 times (x) for most of the past three years, although there was dip below that level in the second half of 2018, according to CW data.

High multiples, and more competition from rivals, often mean that private equity firms are forced to use novel approaches in acquisitions. It helps to have a clear angle, and a clear investment thesis. “Given the increased private equity competition investing in the sector, we have to focus on opportunities where we can differentiate in some way,” Feinstein says.

Most private equity investors are considering creative strategies and methods of improving the value of their investments beyond simple cost-cutting. There exists a wide variety of tactics. Apollo, for example, often pursues complex transactions, such as the 2015 acquisition of OM Group for $1.03 billion, which entailed selling some divisions of the company to Platform Specialty Products (now Element Solutions). Apollo later sold off pieces of OM Group to other private equity firms. The buy-and-build strategy, which Arsenal Capital has pursued successfully, is quite common in the chemical distribution business—distributor Azelis, owned by EQT Partners (London), was among them most acquisitive chemical companies in 2018, according to CW data. Advent often looks at a target’s geographic focus. “Our strategy is to consolidate markets, look at growth in Asia,” Ayles says. Edgewater tries to leverage the intersection of technology and commercial impact. “If we are evaluating an investment, we ideally try to talk to the technical people an the customers,” Girton says. “Our companies when we invest are typically very technically competent, then we need to invest in the commercial side.”

Meanwhile, the stock market correction in late 2018 hasn’t really stopped M&A, although there are some signs of increasing caution. “It was not widespread panic” when the market fell late last year, according to Mario Toukan, managing director with SK Capital Partners. “I think the correction … served as a catalyst for sellers that may have had a wide gap in expectations in comparison to buyers,” he adds. This dynamic applies to private equity owners, too. “If you have an asset and you’ve realized value in it and you are ready to exit, moving faster rather than slower is probably prudent,” Feinstein says.

Private equity partners do view it as a good time to sell right now, as valuations are high and the macroeconomic environment looks uncertain, at least for the next few years. But with plenty of available capital, acquisitions are likely to continue, as well. “The private equity industry is awash with cash,” Ayles says. “Many firms look at everything that comes through the door.”

Top private equity transactions

(Deal value in USD millions)

Target	*Acquirer*	*Seller*	*Deal value*	*Target Sector*	*Private equity role*
AkzoNobel chemicals business	Carlyle Group; GIC	AkzoNobel	$12,600	Diversified	Buyer
Capsugel	Lonza	Kohlberg Kravis Roberts	5,500	Pharma/Fine	Seller
Evonik’s methacrylates business	Advent International	Evonik	3,400	Basics	Buyer

Linde businesses in the Americas	Messer; CVC Capital Partners	Linde	3,300	Industrial Gases	Partner
Atotech	Carlyle Group	Total	3,200	Specialties	Buyer
Momentive Peformance Materials	SJL Partners; KCC Corporation; Wonik QnC	Apollo Management; Oaktree Capital	3,100	Specialties	Partner; Seller
Parex	Sika	CVC Capital Parnters	2,550	Specialties	Seller
Azelis	EQT	Apax Partners	2,300	Distribution	Buyer; Seller
Nexeo Solutions Holdings	WL Ross Holding	TPG Capital	1,670	Distribution	Seller
Royal Adhesives & Sealants	H.B. Fuller	American Securities	1,575	Specialties	Seller

Notes: Top chemicals M&A transactions involving by private equity by deal value, since 1 January 2016. Source: Chemical Week research. © 2019 IHS Markit