

Chemical Week

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Searching for adjacencies

Coatings consolidation enters a new phase amid demand declines

by Vincent Valk

Major coatings producers continue to look towards acquisitions to boost growth, even as the number of targets shrinks. Meanwhile, a softening economy has reduced end-market demand for paints just as raw material cost inflation lets up.

Consolidation has been a constant in coatings for some time. Major producers have figured among the most acquisitive companies in the broader chemical industry for years, with industry leaders such as PPG Industries and Axalta regularly on the hunt. Consolidation in coatings has been “a noteworthy trend... especially among the largest producers,” according to IHS Markit.

That consolidation has, in broad strokes, taken two forms. The first and most visible has been large-scale consolidation to build and maintain scale among the largest companies, as well as to gain strong positions in new regions. The most prominent example of high-level consolidation in coatings in recent years was Sherwin-Williams’ (SW) 2017 acquisition of Valspar, a \$13.4-billion deal that gave SW, which was traditionally focused on architectural coatings, a big presence in the industrial coatings market. Smaller, but still significant, was Nippon Paint’s \$2.7-billion acquisition of Australia’s DuluxGroup in April of this year. That deal was just the most recent major example of a Japanese firm looking to expand beyond its home market, a trend that extends beyond the coatings sector.

Some big deals have been rumored, or come close to fruition without panning out. In 2017, PPG’s \$29.5-billion hostile bid for AkzoNobel grabbed headlines before the Dutch paint-maker spurned its rival and spun off its chemicals business. Later that year, Axalta disclosed merger discussions with both AkzoNobel and Nippon Paint. More recently, in June of this year Axalta announced a strategic review, which could result in a sale of the company. Private equity firms are rumored to be looking at Axalta—which was owned by The Carlyle Group (Washington, DC) from early 2013 to late 2014—along with coatings majors such as PPG and AkzoNobel.

The outcome of Axalta’s review process, however, remains unclear.

While big deals, or rumors of big deals, have received attention, it’s possible to argue that the real action in coatings M&A has been in smaller transactions. PPG and RPM International—which also has a major business in construction materials—have regularly ranked among the industry’s most acquisitive companies, according to CW data. In a sector with a handful of very large, global players, and a long tail of small companies with niche products or strictly regional markets, it’s perhaps inevitable that M&A activity would disproportionately see large companies buying up much smaller rivals.

Buying new business

Coatings watchers say there is a dearth of mid-sized companies in the industry that would serve as natural targets for majors such as PPG, SW, and AkzoNobel. “It’s hard to find many independent mid-sized producers that will move the needle for the really large companies,” says Eric Linak, director/resins and coatings at IHS Markit. “Coatings producers are broadening their portfolios by acquiring companies that don’t really produce coatings... because they [producers] have good cash flows and are looking for ways to spend.” PPG’s acquisitions of aerospace surface treatments maker Dexmet last month, and its acquisition of coatings application equipment maker Metakote in 2016, are examples of this trend, Linak adds.

It’s a trend that seems likely to continue. “We’ve seen companies expanding their reach into areas beyond their traditional core,” says Lee Harrs, managing director and head of chemicals with Houlihan Lokey (New York, New York), an investment bank. “You’ll see it for a number of the big companies going forward.” In the absence of targets in markets like architectural or automotive coatings,

paint makers are looking to add “formulated products that serve the same markets and use similar or overlapping chemistries” to their portfolios, Harrs says.

The specifics of this strategy can vary depending on the market. In architectural

coatings, for example, “a coatings manufacturer can move into building envelope products,” says Andrew Hinz, managing director with Grace Matthews (Milwaukee, Wisconsin), an investment bank. Such products could include waterproofing or soundproofing materials, roofing materials, fire protection materials, caulks, or adhesives and sealants. “It’s other kinds of liquid, formulated chemicals that contractors are applying at [construction] job sites,” Hinz says.

In automotive coatings, applicators such as Metakote can make for attractive targets. “These companies were buying paint from PPG and spray applying it” to cars, Hinz says. “So PPG just took over the whole operation, and now they can provide the entire service.” Adhesives and sealants, which are chemically similar to paints, is a logical sector into which coatings manufacturers can extend their footprints, with

growing applications in the automotive and aerospace markets. “You can provide a solution with a bundle of different services” for a particular market such as aerospace or construction, Harrs says. “These are areas that are natural adjacencies [for coatings makers].”

To the extent that acquisition candidates do exist among manufacturers of actual coatings, the industrial and specialty coatings businesses seem to offer the most possibilities. “Where there is still fragmentation, it’s certainly more on the industrial side,” Hinz says. PPG and Axalta have bought up numerous companies in industrial coatings over the past several years. “A lot of the



MORALES: Expecting momentum in margin recovery.



HINZ: Acquisitions aim to bundle services.

Cover story

companies that PPG and Axalta have acquired are industrial or specialty industrial types of businesses," Hinz adds. "They operate in niches and they're pretty focused." PPG, for example, acquired Whitford Worldwide (Elverson, Pennsylvania), a maker of low-friction fluoropolymer and ceramic coatings in December 2018. Whitford's products are used in the automotive, aerospace, energy and construction industries, as well as in small appliances and cookware.

Axalta, for its part, has clearly focused M&A on industrial and specialty coatings. The company, the former automotive coatings business of DuPont, has pursued a deliberate strategy of acquiring businesses to grow in industrial coatings. Axalta doubled its industrial coatings sales from 2013 to 2017, to about \$1.0 billion, chiefly through acquisitions. "That is their adjacency," Harrs notes.

Acquisitions in coatings remain expensive, despite some weakening financial results. "A downturn in results will affect M&A values, because EBITDA will be lower," Harrs says. "But we don't see a downturn yet in multiples." Leverage remains available, and major coatings producers have both the means to pursue acquisitions and a strong interest in deals, lending support to valuations despite some end-market weakness, he adds.

The broader competitive landscape in coatings almost forces a strategy of looking at adjacencies or niche players if the big producers want to expand via M&A. "There aren't very many mid-sized consolidation candidates out there," Harrs says. "It's consolidated and the fragmentation that remains is mostly among companies that are pretty small."

Coatings M&A, big or small, overall looks set to continue even as the industry faces soft demand. In fact, it may continue because the industry faces soft demand. "If the overall macro environment is slow ... a company might need to go out and buy things to grow," Hinz says. Stock prices for large, publicly-traded coatings companies continue to price in an expectation of growth, pushing management teams to look towards M&A as a way to outpace a sluggish market, he adds.

Price up, demand down

Indeed, the operating environment for coatings producers has been challenged for

some time, although the reasons behind that are shifting. Last year, rising raw material prices put pressure on margins. This year, raw material cost inflation has cooled, and selling price increases have begun to take hold, but demand growth has often been tepid, at best.



HARRS: Mid-sized acquisition targets few and far between.

Demand is especially weak in the automotive end market. PPG, Axalta, and AkzoNobel all flagged weakness in automotive coatings demand, especially in China, in their second-quarter results. This weakness has hit other chemical manufacturers, as well (p. 7).

The downturn in the automotive market is expected to continue in the second half. "We expect the third-quarter to look like the second-quarter for the automotive original equipment manufacturer (OEM) business, with overall global automotive new builds down for the third quarter and down a mid-single digit percentage for the full-year 2019," says Vincent Morales, president and CFO at PPG.

General industrial markets aren't faring much better than automotive, and indicators point to continued sluggish industrial

Nearly all major coatings makers view M&A as a strategic priority.

production in most major economies. PPG is "not anticipating any notable change in industrial demand in North America," Morales says. "In China, we are forecasting industry demand in the third quarter to be similar to the weakened levels we experienced in the second quarter. Industrial growth rates in Europe remain uneven by country and end-market, but generally lower overall. We have seen better year-over-year growth trends in South America."

Emerging markets are still expected to have stronger demand growth than developed markets in the coming years, simply because demand growth in coatings hews rather closely to the broader economy. Demand growth for coatings is forecast to average 2%/year in the US during 2018–2023, and 1.5%/year in Western Europe during the same timeframe, according to IHS Markit. In China and India, however, demand growth is expected to exceed 5%/year, IHS Markit says. "Coatings in general

grow in tandem with economic activity," Linak notes.

While the Chinese economy has cooled of late, most coatings firms still see the country as a key growth market. "In the longer-term, we continue to be optimistic about China's growth," Morales says.

On the flip side, coatings makers have managed to raise selling prices, and raw material cost inflation is abating. "We think prices for raw materials have moderated after some run-ups in 2018," Linak says. "Most coatings producers are projecting price inflation of about 3% or so in 2019." Some minor raw materials with production concentrated in China, such as certain organic pigments and photoinitiators for radiation curable coatings and inks, are exceptions to this, Linak adds. In second-quarter earnings announcements, coatings makers have generally said that raw material cost inflation has been manageable this year, and is expected to moderate further as the year progresses.

PPG is optimistic on margins, despite the demand weakness. "In the second-quarter, raw material cost inflation moderated compared to the prior year," Morales says. "We expect the momentum of our margin recovery to continue." PPG, AkzoNobel, Axalta, and SW all said selling prices increased during the second quarter, although volumes declined for PPG and Axalta.

Regardless of demand and prices, PPG, like its peers at the top of the industry, is aiming for acquisitions. M&A "remains one of our preferred cash deployment options," PPG chairman and CEO Michael McGarry said during the company's most recent quarterly earnings call. "Currently, our pipeline remains solid."

SW, which has been relatively quiet on the M&A front since acquiring Valspar, also appears likely to get back into the game. "As far as M&A goes, I would say we are very, very active," John Morikis, chairman and CEO of SW, said during the company's most recent quarterly earnings call. We're pleased with the progress we have made on a number of projects." Axalta and AkzoNobel also say M&A remains a strategic priority, despite Axalta's undertaking a strategic review.

The runway for consolidation in coatings might be following a more divergent path than in the past, but it hasn't run out of room. ■