

Consolidation: More runway ahead

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A flurry of consolidation activity has taken hold across the chemical industry over the past few years, and bankers say the trend has not played itself out. While some sectors, notably industrial gases and agchemicals, are approaching a level of concentration that makes substantial further consolidation unlikely, many others have not. Executives are still under pressure to both grow their businesses and justify their corporate portfolios, and market conditions are expected to remain benign in 2018 despite a gradual ramp-up in interest rates.

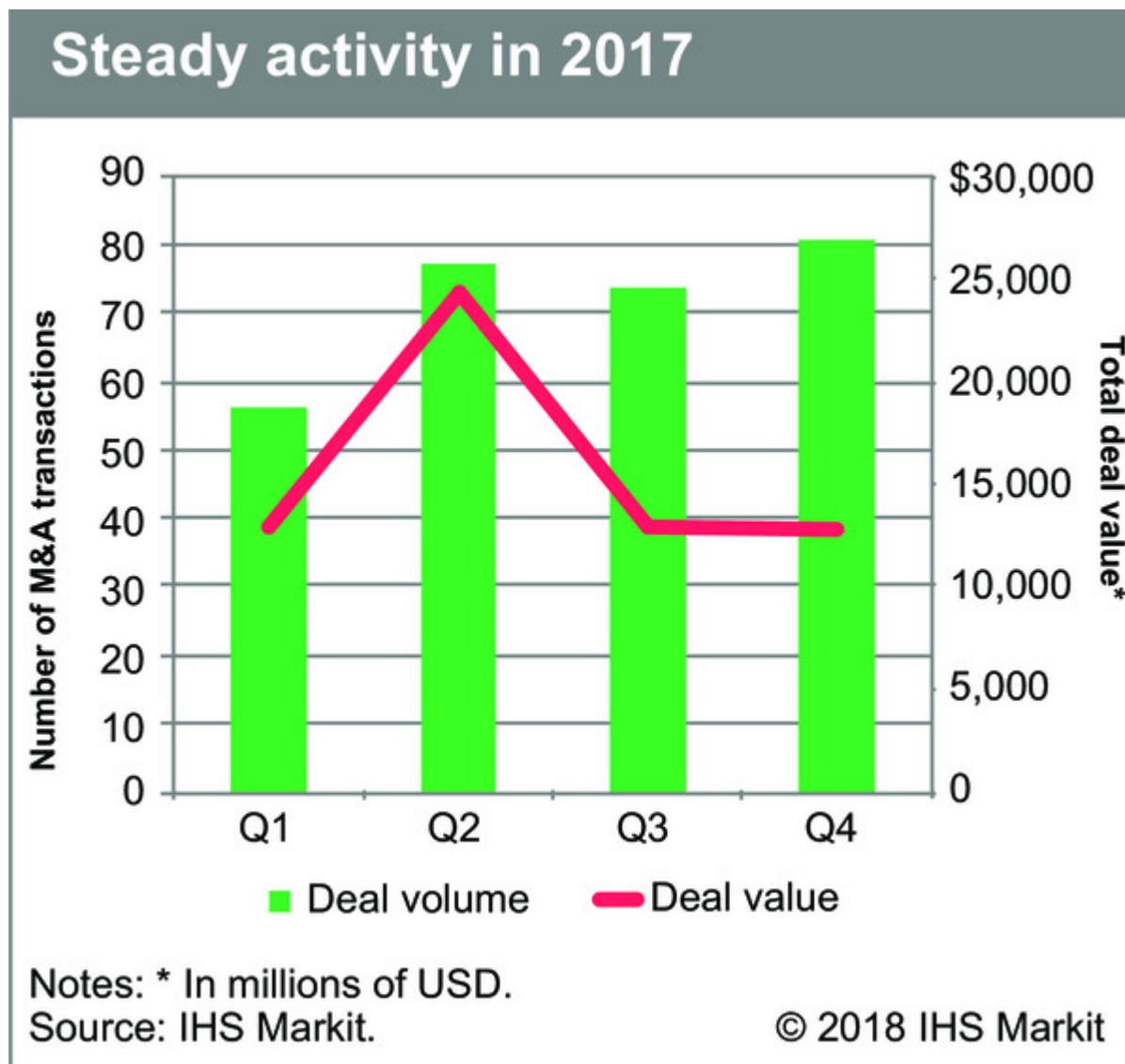
Chemical M&A watchers largely agree that the sector to watch in terms of consolidation at the moment is paints and coatings. The \$135-billion industry is much less concentrated than industrial gases, and slightly less concentrated than agchemicals (table), but at a point where major megadeals could still occur. While Sherwin-Williams' (SW) acquisition of Valspar closed in 2017, the past year in coatings M&A has amounted to much ado about very little—PPG's pursuit of AkzoNobel was derailed by opposition from Akzo's management and board in the spring, and a burst of activity around Axalta in late November petered out with no transaction in place. But this status quo appears likely to be temporary.

The SW-Valspar merger has likely "increased pressure on other players in the coatings sector," says Mukta Sharma, managing director/chemicals with IHS Markit. The battles and rumors among PPG, AkzoNobel, Axalta, and Nippon Paint would seem to provide evidence of this. "Clearly, what you see going on with the big coatings players ... they are positioning themselves to do something," says Ben Scharff, managing director with Grace Matthews (Milwaukee). While a PPG-AkzoNobel merger appears off the table for now, next-tier players such as Axalta, Nippon Paint, or RPM International could be targets, or could bulk up significantly. Axalta and RPM have both made bolt-on acquisitions a crucial part of their strategies, although sources say RPM has evinced little interest in large-scale M&A. PPG, as well, maintains a strong pipeline of acquisition candidates, according to company executives.

While the coatings sector is at a stage where megadeals look like realistic possibilities, other chemicals sectors are undergoing consolidation as well. The adhesives sector remains fragmented, with the top five players accounting for less than 40% of market share. "There are many, many small companies or businesses that are divisions within larger companies," says Jim Owens, president and CEO of H.B. Fuller. "Many consolidation opportunities still exist." Fuller took a big step toward consolidation in 2017, acquiring rival Royal Adhesives and Sealants for \$1.58 billion, and the company does actively scout out acquisitions, albeit usually smaller ones. However, the nature of the sector means that relatively small-bore consolidation is likely to be the dominant mode for the foreseeable future, according to Owens. "It's a diverse set of end markets and chemistries and customers," he says. "Consolidation has to happen in a strategic and thoughtful way ... it is a little slower than some other areas because of the degree of complexity."

Such complexity could lessen the advantages of scale, and scale is perhaps the major benefit of consolidation. "Segments where market scale and access are more important, and where there are

established players, have consolidated most quickly," says Telly



Zachariades, partner with The Valence Group (New York). "Others, where market scale provides less competitive advantage, have been slowest to consolidate." Slower-consolidating sectors include fine chemicals and food ingredients, he adds. The adhesives and sealants sector is somewhere in the middle.

Consolidation is also happening among smaller companies. "Smaller private companies are finding this period of high valuations and good earnings to be a good time to exit," says John Televantos, partner with Arsenal Capital (New York). "They're making themselves available to consolidate in situations where they otherwise would have held onto the company." Arsenal, a private equity firm that focuses on chemicals, has rode this trend, including at Royal Adhesives—a portfolio company of Arsenal until 2015—and at IGM resins, which is still owned by the firm. "IGM started as a distributor, but now it's the only company that does research on photoinitiators for UV curable coatings," Televantos says. "Some of the bigger companies in that space exited, and we bought two Chinese firms and put them together."

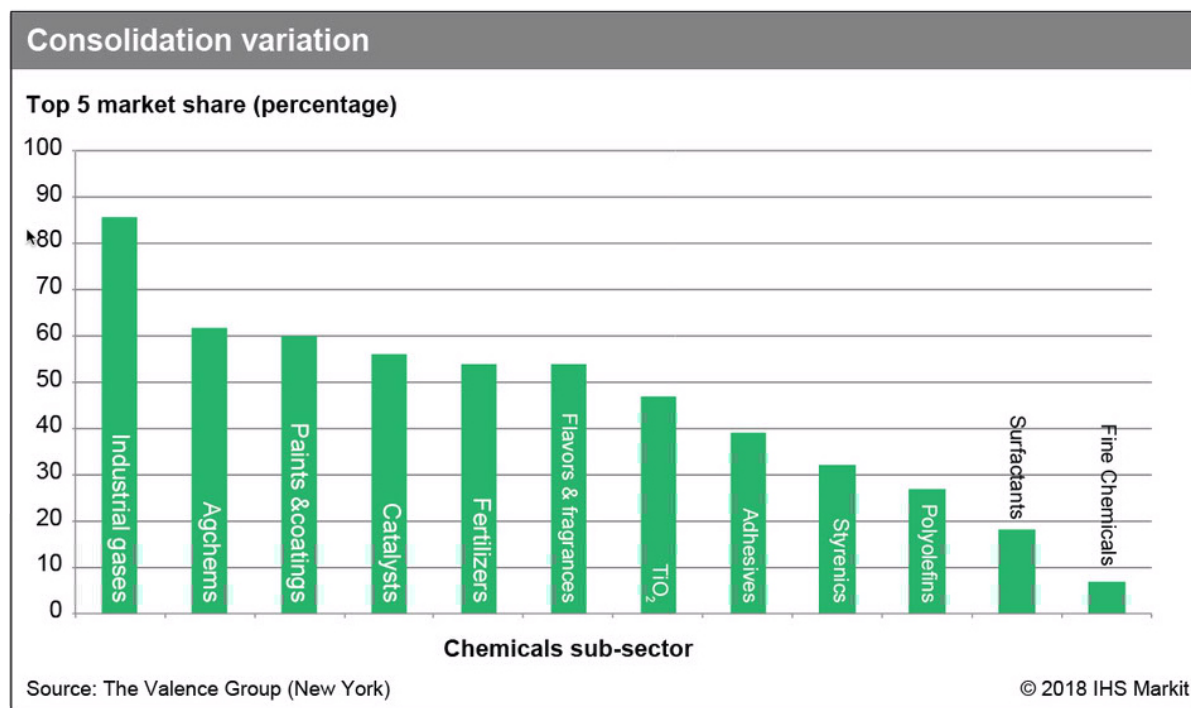
Private equity in general views it as a good time to exit investments—but is not rushing to the exit as quickly as one might think, given valuations. "Private equity firms are waiting to exit until they feel an investment has run its course," says Lee Harrs, managing director and head of chemicals with

Houlihan Lokey (New York). “I don’t see a lot of market timing. People know it’s a good time to sell, but that’s not the first consideration. And one implication is they think the market will remain robust.”

Cycles of selling and buying

Beyond consolidation, there is a clear trend for companies to focus on core businesses. Executives talk about M&A in terms of the core and adjacencies, and some investors—particularly activists—typically take a dim view of chemical conglomerates. “It’s been an awfully long time since I’ve heard any company say, ‘We need to diversify,’” Harrs says. The prevailing view among investors is that they can diversify themselves, while companies should focus on the businesses they know best and where they have top positions. “There’s a lot of challenge to being diversified just for the sake of it,” Sharma says. “It’s not an easy life, and you have to justify everything that’s in the portfolio.”

Activist investors, who have often pushed for companies to simplify their portfolios, have pushed this trend forward. Activists at Dow and DuPont helped drive thinking around that deal, and played a part in negotiating it. At companies as diverse as AkzoNobel, Ashland, FMC, and Ferro, activists have driven strategic moves, either directly or as a matter of preemption. In nearly all of these cases, the direction was toward simplification—FMC is now nearly a pure-play agchems maker; Ashland has honed its focus on specialty ingredients.



Indeed, the activist playbook in chemicals is by now well-known. “It’s pretty straightforward,” Zachariades says. Portfolio management and capital allocation are typically the biggest activist concerns. This includes questions like “are you focused, are there better owners for some of your businesses, are you spread too thin,” Zachariades says. “Is your balance sheet appropriate, neither too conservative nor too levered.” Executives have learned from this, and many are applying similar types of scrutiny to their own companies. The connection between this mindset and some recent high-profile corporate repositionings—whether or not activists were involved—is pretty clear. “Smarter management teams will try to defend themselves against an activist, even if they don’t have one,” Zachariades says.

Diversified manufacturers remain obvious activist targets, and there are more of them in Europe. Some of 2017's highest-profile activist cases in chemicals involved European companies, including AkzoNobel and Clariant. "Europe is generally behind the US in restructuring," Harris says. "What is happening in Europe happened in the US three or five years ago." However, differing conceptions of the role of the corporation in society mean that European restructuring is unlikely to have quite same outcome as US restructuring, bankers say.

In the longer-term, many bankers say the current round of consolidation is really just another cycle. Diversification is currently out of fashion with investors, and there is no reason to believe that this will change in 2018. Consolidation and portfolio reshuffling is likely to continue, and medium-sized diversified chemical makers will be caught in the crosshairs. But this particular cycle will not last forever. "I'd be surprised if this was the endgame," Zachariades says. "I wouldn't call this the end of the conglomerate, or the diversified chemical manufacturer, but it is the direction of things at the moment."