SPOTLIGHT ON... THE CHEMICALS SECTOR

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Kevin Yttre, Managing Director of Grace Matthews, Inc.

The chemicals sector consists of a wide range of organisations; from high volume bulk chemical companies to small scale, specialty businesses. The market dynamics facing these businesses can have a significant impact on the potential profits that they are able to earn. Grace Matthews' Kevin Yttre spoke to Finance Monthly to highlight the sectors changing structure along with some of the key challenges it is facing.

Q What more can you tell us about Grace Matthews?

Grace Matthews is a middle-market investment banking firm with a chemical and materials industry practice that is known globally for its expertise in providing strategic M&A advisory services. We have a somewhat different approach than most banks, which is what attracted me to Grace Matthews versus high volume M&A factories in the first place. While our backgrounds are similar to other bankers – high end finance MBA's, smart and interesting people, hard workers – our philosophy centers on driving value by understanding operations and business fit rather than financial engineering. In other words, we don't worship at the altar of auctions!

We advise clients on strategies and tactics to create value in mergers, acquisitions, business sales, and other strategic alternatives. Our clients include owners of privately held businesses, private equity groups, and large multinational corporations. We also offer strategic guidance in distressed situations, workouts, and portfolio management. With roots dating back to the early 1990s, our 13 professionals have over 175 years of chemical experience, and have completed over 100 transactions in the chemicals and materials industries worldwide.

Q What is your professional background and how did you come to join Grace Matthews?

Investment banking is a second profession for me – first and foremost, I am a chemical engineer, and unlike some of my engineering classmates who went straight to banking, I wore steel toe boots and a hard hat working in manufacturing for ICI for a few years first!

Grace Matthews recruited me after graduate school in 2008, and today I am a Managing Director in our chemicals practice, where we are pretty well known around the world for middle-market M&A advisory services. Prior to that, I held a number of engineering and management positions in ICI's Uniqema specialty chemicals businesses in the U.S. and the Netherlands. While at Uniqema, I helped design, build, and operate a manufacturing facility and did some chemicals marketing in Europe. My education includes an M.B.A. from Harvard Business School and a Bachelors of Science in Chemical Engineering from the University of Wisconsin-Madison.

While at Grace Matthews, I have worked on deals ranging from $20 million to $500 million in transaction value, and in a variety of chemical sectors including specialty chemicals, biomaterials, commodity chemicals, coatings, fine chemicals, plastics and polymers, and electronic materials.

Q Can you give us an overview of the chemicals sector at present? How has it developed in recent years?

The industry is bookended by low-tech commodity chemicals on one end and highly specialized formulated chemicals on the other. All companies fall somewhere on the spectrum between these two poles. Commodity chemicals, just like all other commodities, are high-volume and low-margin. Specialty chemicals are the opposite: low-volume, high margin, and with market differentiation based on product performance and service.

All other things being equal, a chemical manufacturer would prefer to be in specialties, especially with a superior product for a growing market with few competitors. The problem is that those situations are few, and when you do find them, they are very difficult to sustain. Over time, the trend is for specialty chemicals to migrate towards the commodity end of the spectrum: products lose patent protection, process know-how spreads through the industry, and more competitors enter the market. To be successful in specialties, you have to be constantly innovative and nimble – and few companies can maintain that over the long term unless it's deeply embedded in the company culture.

Q How is the structure of the industry changing?

The revival of the North American petrochemical industry through hydrofracking and shale gas is a game changer for the chemical industry. We now know that lower energy costs are ultimately going to benefit all industries – within a few years, the U.S. will probably become energy independent, and our manufactured products are going to be more competitive in the global marketplace. But remember that chemicals are at the very beginning of the economy's supply chain, and they are going to experience an increase in demand well before manufacturers positioned further downstream. Also, chemicals are doubly advantaged in respect to other industries: lower oil and gas prices means both lower manufacturing costs (because chemicals are an energy-intensive industry) and lower raw material costs (because so many chemicals are petroleum-based).

Because of this, many companies are making major commitments to manufacturing chemicals in North America, when just a few years ago they would have been building new plants overseas.

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Q What are the main transaction-issues facing the chemicals sector?

Relative to deals in most industries, chemical transactions are challenging. Environmental issues have always been a focal point of transactions and can be difficult to navigate. More recently, uncertainty around trade compliance issues and the Foreign Corrupt Practices Act (FCPA) are common.

Q How can these be mitigated or overcome?

No surprises! It is critical for a seller to be prepared. From an operational standpoint, owners should focus on internal processes and systems. From a transaction standpoint, owners need to work with experienced advisors. This is especially true in preparing to market the business. Marketing materials need to accurately articulate and frame the issues. If they do not, it can lead to false positives in term of buyer interest in the project or can result in late surprises in diligence. Both of these are bad for a seller, as they can lead to no sale, lack of leverage in negotiation, and/or value erosion. Again, it is all about preparation.

Q What predictions do you have for the future?

As we discussed earlier, shale gas is going to positively impact the North American chemical value chain in ways that are just beginning to be understood. Now is a great time to invest in North American chemical assets, and we expect to see continued strong M&A interest for domestic companies. The ethylene chain, oil and gas process chemicals, heavy duty coatings and water treatment are all areas that should do very well in a shale gas driven chemical industry.

Interestingly, we see environmental regulation as being more of an opportunity in one specific sector – the convergence of shale gas hydrofracking operations and water treatment. The general consensus is that large scale hydrofracking in North America will occur, but only after lengthy political negotiations surrounding environmental protection. New, stringent and specific wastewater regulation is likely. Water usage is enormous in fracking – millions of gallons per well – and the treatment of wastewater will be highly regulated. Further, each well has a different "cocktail" of process chemicals down hole, and will require engineered water treatment solutions. This new, growth market will reward those with the best water treatment technologies.

The chemical industry is global, and rewards both scale and high service. It has a barbell structure – large global players like BASF and Dow who are both the low cost producers and technology leaders, as well as smaller specialty players providing a service bureau model of chemical selection and delivery for a customer process. We see this continuing.

Q Is there anything else you would like to add?

In our experience, the majority of successful chemicals transactions include significant synergy potential - cases where truly the whole is greater than the sum of the parts. Whether it be manufacturing, raw material, channel, or other synergies, it is critical that a buyer understand what they are acquiring and how it fits into their existing business. Great outcomes occur when the right buyer acquires the right business. Too often we see firms use an identical evaluation methodology for all projects they review. As a result, they come up short on targets where they should have stretched and succeed in acquiring businesses where they should have passed. Chemicals transactions are complex, and to be successful, buyers need a disciplined, but flexible, approach that evaluates each project within the context of the buyer's overall strategic goals.

It is also important for sellers to understand the value of synergies. The highest values result when the buyer understands how the acquired business is going to improve the buyer's competitive position in the marketplace. For this to happen, the sale process must focus on the best buyers: that is, those that have the most to gain from acquiring the seller's business. It is easy for sellers to fall into the trap of running a "broad" auction, which we believe is appropriate in only a minority of projects. A targeted approach is much more likely to result in a less stressful process and an optimal value.

Finally, the chemical industry is currently rewarding scale – global brands, sophisticated supply chain, leverage of administration, purchasing, regulatory compliance – all favor the big over the small. Combining this with strong balance sheets and public market growth pressure for large chemical companies create a seller's market at present. Put bluntly, most mid-size chemical companies are worth more to large global players than they are as standalones. The challenge is capturing the value gap!

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