ASI ADHESIVES & SEALANTS INDUSTRY

M&A Corner

Looking Ahead: M&A Primed for Liftoff?

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December 23, 2020

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The cover of a recent issue of *Time* magazine dubbed 2020 "The Worst Year Ever." From the COVID-19 pandemic and subsequent global economic fallout to a tumultuous U.S. presidential election and the loss of icons like Kobe Bryant, Ruth Bader Ginsburg, and Alex Trebek, 2020 certainly has been a year for the books. Suffice to say, we're all eager to turn the page to 2021. With COVID-19 vaccines starting to roll out and economic recovery underway, a palpable sense of optimism is beginning to emerge like the first rays of sunlight after a dark night.

Over the last few months, Grace Matthews has noticed a comparable sense of hope and optimism within the M&A community in adhesives and sealants and across the broader chemicals value chain. What began as a slow drumbeat of activity as we moved into the second half of 2020 has steadily evolved into an almost frenetic pace. Many have asked if we expect a return to “pre-pandemic” M&A levels in 2021. We think it’s certainly possible; we’re already seeing a strong uptick in activity as we close out the year.

Confidence in the outlook is critical to getting M&A transactions closed. When the outlook is uncertain, as we saw earlier in 2020, buyers have a much harder time committing to an acquisition, and valuations are impacted as well. Therefore, one of the key questions on the minds of M&A decision makers has been, “When will the world get back to ‘normal’?”

COVID-19 vaccines have already been administered across the U.S. As a result, the outlook appears much more favorable than it was even six months ago. In our opinion, continued positive developments on the vaccine front could serve as a catalyst to M&A, as buyers gain confidence in a return to sustainable economic growth. A rebounding global economy will be particularly critical to reviving dealmaking in some of the harder-hit end markets like automotive, aerospace, and oil and gas.

Strategic Buyers Seeking Scale

Within adhesives and sealants and across the chemicals industry, scale provides a distinct set of competitive advantages. Brand strength, more efficient raw material purchasing, and a lower cost of capital are among the benefits that a larger company can have over a smaller player.

The pandemic has brought to light a unique set of challenges that scale can help mitigate. For example, regulatory costs, including costs of adhering to more stringent health and safety protocols for employees and contractors, are less burdensome when spread across a much larger organization. Back-office virtualization, maintaining continuity of production operations and supply chains, and managing uncertainty in general are all typically done more efficiently and cost-effectively by larger companies. Further, ongoing consolidation among raw material suppliers and distributors, as well as in retail channels, puts pressure on manufacturers from all sides. As a result, we believe the quest for scale is becoming as important as ever, leading to a heightened sense of urgency for the big to get bigger.

Abundant Capital and Pressure to Grow

Another factor that we expect to drive dealmaking in 2021 is the strong availability of capital and the ever-pressing demand for public companies to show growth. For the most part, balance sheets for public companies across the specialty chemicals industry remain quite strong.

Many of the largest coatings and adhesives companies, including PPG, RPM, Sherwin-Williams, and Arkema (Bostik), have net debt/EBITDA ratios (a common measure of balance sheet health) of less than 3x, and meaningfully lower than that in some cases. Companies in this situation are well-positioned to take on incremental debt to fund acquisitions without putting their balance sheets in jeopardy. In addition, many public coatings and adhesives companies' stock prices are trading at growth multiples—low-to-mid teens (or higher!) when measured by enterprise value/EBITDA. While it sounds obvious, demonstrating growth is crucial to maintaining a growth multiple in the public markets. Combine these two factors (strong balance sheets and the need to show growth in what has been a relatively low-growth environment) and you essentially have a coiled spring primed to release.

Grace Matthews' conversations with CEOs and corporate development leaders at many of the larger specialty chemical companies support this view. Many companies are taking a more proactive approach to M&A and are courting their highest-priority targets directly instead of waiting for deals to come to them. Some sellers are finding themselves in a situation of leverage that is more typically seen during peak M&A years—not one that you might expect during a global pandemic. We've had a few sell-side projects this year with outcomes so favorable they made even the most optimistic clients blush. We predict this situation will continue into next year as competition for the highest-quality acquisition targets intensifies.

As we've talked about in the past, we're seeing companies focus more intensely than ever on maintaining and growing their core business. Acquisitions are a tool commonly used to strengthen and expand a company's core business, and divestitures are being utilized to offload businesses that detract from a company's main strategy—in many ways, emulating aspects of Jim Collins' Hedgehog Concept.

We saw several examples of this in 2020, including Momentive divesting its Consumer Sealants division to Henkel, and Huntsman recently announcing its intent to acquire Gabriel Performance Products, which directly aligns with Huntsman's goal of broadening its Advanced Materials division. In our view, new business risks introduced by the pandemic are driving companies to double down on their efforts to streamline and focus, and much of this will be accomplished through M&A.

De-Risking in a Newly Risky Environment

From a seller's perspective, we also see a number of dynamics that have the potential to drive healthy M&A activity. Earlier, we discussed some of the key benefits of scale enjoyed by larger players in the industry. Competing effectively without the luxury of scale is becoming increasingly difficult, and it's a situation that some private companies find themselves in. By no means is it impossible; we have had many highly successful sell-side projects involving relatively smaller companies possessing significant advantages through differentiated technology, nimbleness, and unparalleled leadership and execution.

All else equal, however, scale does tend to help. The COVID-19 pandemic has rewritten many of the rules and introduced several systemic headwinds that some entrepreneurs are finding harder to navigate. We believe many business owners may ultimately conclude that de-risking in a newly risky environment—whether that involves an outright sale of their company or by utilizing private equity to take some "chips off the table"—may be the best course of action for their families, their legacies, and themselves.

Many entrepreneurs have also found that being forced to stay home under lockdown or quarantine was actually better than expected. Reevaluating personal and professional priorities may lead some business owners to decisions they may not have considered even a year or two ago. When answering the "Why sell now?" question, some private company owners are simply saying, "It's just time." We are seeing this situation play out with some of our current clients, and it's likely to continue.

Strong valuations are another consideration that should benefit M&A in the year ahead. After dipping to almost a 10-year low in March, average public company valuations across the chemicals industry have roared back and are currently hovering near a 10-year high. While public company valuations do not always correspond directly to M&A valuations, they represent one of the driving forces. Many of the factors we've already discussed, including a strong buyer appetite, abundant availability of capital (and low interest rates), and a scarcity of high-quality targets, are all supporting strong valuations. This can serve as a strong tailwind as business owners contemplate a potential sale of their business.

Looking Ahead

Wrapping up this rather rosy outlook for M&A, I'd be remiss if I didn't mention a few caveats. For one, due diligence on an M&A transaction is as difficult as it's ever been. Zoom and Teams are great tools, but most buyers are unwilling to close a transaction without eventually having face-to-face meetings and site tours. However, progress with vaccines should help open up travel and facilitate more face-to-face meetings over the course of the year. In addition, new trade deals can help or hurt, supply chains are in flux, the regulatory environment is uncertain, and some decision makers are simply being more conservative in their approach to risk taking.

The pandemic's impact on individual companies is unique, and "outperformers" (those experiencing a COVID-induced tailwind) and "rebounders" (those that are or will soon be "back to normal" following initial setbacks) are much better positioned structurally for M&A than the "underperformers" that continue to experience a meaningful setback. The M&A equation today admittedly involves more variables than ever, but Grace Matthews firmly believes that the path of least resistance is upward, and we would not be surprised to see activity breaking out as we head through 2021.

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