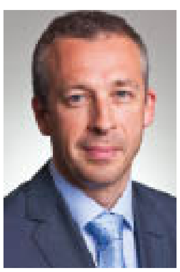
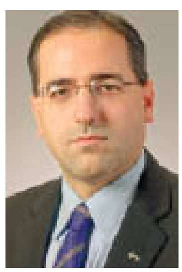
M&A: The old new normal

Deal activity in the chemical sector has settled into a groove, driven by cheap financing, large asset divestitures, and healthy valuations.

Mergers and acquisitions (M&A) activity in chemicals had a solid year in 2013, with a stronger second half offsetting a weak first half, bankers and industry executives say. That robust pace has continued in 2014. “The last quarter of 2013 and the first quarter of this year so far are pretty strong,” says Mario Toukan, managing director and head/chemicals at KeyBanc Capital Markets (Cleveland). “Momentum is strong, and I think it will continue this year.” Toukan notes that a disproportionate number of 2013 deals happened in the fourth quarter and that the pace has picked up since then.

Industry executives echo the sentiment. “The outlook remains relatively stable,” says Paul Graves, president and CFO at FMC. Two trends in particular underpin the current market. The first is inexpensive deal financing. Some bankers say deal financing is slightly more expensive than it was last year—when it was historically cheap—while others say it is slightly cheaper. In either case, it bodes well that the financing market is comparable to 2013. “I don’t see anything on the horizon that will cause a major disruption to the financing market,” says Paul Smith, head of the Chemical practice at Citi. “Geo-political risk is always difficult to predict, but it is probably the greatest downside risk, as fundamentals are quite strong.” Interest rates are still low, bankers say.


Graves: Investors pushing for simplicity.


Toukan: Activity strong in last two quarters.


Beagle: Ebitda multiples vary, but are mostly high.

Another trend driving deals is asset divestitures. Whether it is Ashland’s water treatment business, Dow’s planned $4.5-6 billion carve-out, Rockwood shedding titanium dioxide (TiO_2), or big spin-offs planned by DuPont and FMC, much of the larger deal activity of late is being driven by chemical makers shedding noncore assets. Often this is investor-driven, as investors favor chemical companies with a simple structure and a clear mission. “Slimming down and getting a clear story seems to trump concern about getting too small,” Graves says. FMC, which spun off its minerals business in response to investor feedback, is following such a strategy. While FMC did not have an activist investor—although rumors have surfaced that the company spun off minerals partly to fend off activists—activists are driving, or at least accelerating, dealmaking. “Clearly activists are pushing some companies to streamline their asset portfolios,” says David Bradley, global head/chemicals investment banking at Jefferies (New York).

Asset shedding: Not just activists

While activist investors, or perhaps the fear of activist investors, are helping drive some asset divestitures, even regular investors are increasingly frowning upon large, complex chemical entities. “I think the [asset divestitures] are driven by investors wanting a simple, clear thesis,” says Phil Kassin, senior managing director with Evercore (New York).

Of course, activist investors are the ones loudly advocating for divestitures, and bankers say their increased interest in chemicals is unlikely to abate. “I think as a result of hedge funds taking active positions and challenging management … [we will see] accelerated strategic thinking around noncore assets,” Bradley says. Activist investors have taken stakes in Dow Chemical, DuPont, and Ashland, all of whom have launched divestiture processes. Activists have also taken stakes in Air Products, Sensient Technologies, and Ferro, helping drive restructuring at the latter two companies, and smaller divestitures at Ferro.

Institutional investors also prefer streamlined companies, even if they are less vocal about it than activists. “Many companies are realizing that investors would prefer a pure-play story, and the backdrop of activists is pushing in the same direction,” Smith says.

While FMC has not publicly stated that its minerals division was sold to fend off activists, the company has said that investor preferences played a crucial role in the decision. “I think anybody who is selling assets is probably doing so to respond to investor concerns, whether or not they are activists,” Graves says. He adds that investors, activist or not, are increasingly asking why seemingly disparate businesses might have a common owner. JP Morgan (New York) upgraded Monsanto shares last week because of “a reasonable possibility of an activist appearance,” analyst Jeffrey Zekauskas says.

Private equity: Scooping up orphans

When asset divestitures do happen, the assets in question often land in the hands of private equity firms. Some larger divestitures, such as Rockwood’s TiO_2 unit, which was sold to Huntsman, wind up going to strategic buyers, but such deals are the exception. Most—Ashland’s water-treatment business, FMC’s hydrogen peroxide unit, DuPont’s automotive coatings business—are bought by private equity firms, or else they are spun off.

That is not a coincidence, bankers say. Investors’ preference for a simple, clear thesis means that a company that adds the proverbial third- or fourth-leg is likely to be penalized by shareholders. “Having five or seven segments that are all unrelated is not a smart strategy,” Toukan says. In situations with a lot of obvious overlap, such as the TiO_2 businesses of Huntmsan and Rockwood, strategic buyers will pounce, but such situations are unusual. “I think at the end of the day, you are not spinning off or selling the crown jewels,” Bradley says. Assets that are up for sale, even large ones with strong profitability metrics, often have something that investors don’t like, such as cyclicality, a difficult customer base, commoditization, or low growth rates.

A greater focus on core businesses also means that auction processes often have fewer bidders. Given that companies are unwilling to reach far outside their cores, “the number of buyers for any given asset is going to be small,” Graves says. “You will get one or two strategic buyers for any given asset, and then private equity. And what you find quickly is it is one or the other. I have not seen a lot of assets that make sense for strategic buyers or private equity.”

Private equity firms have the resources to buy such assets. “Debt markets have never been better,” says John Televantos, partner with private equity firm Arsenal Capital (New York). “Credit spreads are quite attractive and terms... are quite good,” says George Dugan, managing director at RBS (Greenwich, CT). “Many deals are coming out oversubscribed.” Private equity also has a better handle on environmental liabilities, which have scared them off from chemicals in the past. “There is a lot more experience in valuing liabilities, and there are insurance vehicles that didn’t exist 20 years ago that... protect you within certain limits” from environmental liabilities, Televantos says.

Valuations: Bring on the bulls

The flood of money in the debt market is not the only thing driving up M&A valuations. The bull market in equities is driving valuations up across the board. “When you do valuation work on publicly traded companies, the multiples are usually ahead of where M&A multiples are,” according to Telly Zachariades, partner with the Valence Group (New York).

“Valuations are a bit frothy,” Kassin says. “I think that goes in line with the rest of the US stock market.” With returns low on bonds, coupled with persistent economic uncertainty in Europe and more moderate growth in emerging markets, money has flooded into North American equities. The rising tide in equities has lifted many boats, including publicly traded chemical companies. Chemical stocks have risen faster than the average of the S&P 500 since the market’s nadir in 2009. Still, other sectors, such as technology, have risen even faster during that time, Bradley says. The S&P 500 has more than doubled in the past five years.

Some factors are driving the bull market in chemicals independent of the overall bull market, bankers say. “The biggest theme is the shale gas advantage, which has helped petrochemical companies in particular,” Smith says. Two other groups of companies— specialties firms with consistent, predictable earnings, and paint companies in a position to benefit from the US housing rebound—have also done well in the equity market, he adds.

Another driver of high-equity valuations is the industry’s operating improvements during the recession in 2008 and 2009. “The industry’s rationalization over the past five or six years gives [the industry] a healthy profitability and cash-flow profile,” says John Beagle, managing director with Grace Matthews (Milwaukee).

High-equity valuations are a mixed blessing for the M&A market. For sellers, the news is positive. “Sellers understandably have high price expectations and if those expectations are not met they have shown a willingness to hang on to the business,” Zachariades says.

For buyers, high-equity valuations mean, of course, higher price tags. It is difficult to buy a business at low multiple when public equity markets are trading high, bankers say. “It’s a sellers’ market, and to be successful you need to bid up,” Beagle says. “We are seeing 8 to 11 times (x) Ebitda” valuations for specialty chemical assets, he adds. Bankers, including Beagle, also add that valuation multiples vary widely depending on subsector. Lower-growth businesses in less-attractive sectors are selling for 6x-7x Ebitda, while higher-growth businesses in more-attractive sectors are going for 10x-11x Ebitda, according to Zachariades.

High-valuation multiples can scare off strategic buyers, especially considering investor pressure to justify large deals and conservatism around cash deployment. “Paying a high multiple for a $300-million business is a reasonable bet,” Beagle says. “Paying a high multiple for a $5-billion company is a bet-the-ranch move for a buyer.” It is also difficult to justify paying acquisition premiums to investors when public companies are trading at 12x Ebitda, he adds.

With easy access to financing, private equity is more willing to pay high multiples for large businesses. Private equity firms do not have to justify their actions to public markets, and loading on leverage can help ensure a return even if the purchase price is high, bankers say.

IPOs: Renewed enthusiasm?

Another response to high public-market equity valuations has been a new spate—at least relative to normal activity in chemicals—of initial public offering (IPO) filings and spin-offs. Apart from a flurry of fertilizer IPOs, chemical offerings have been rare in recent years. Spin-offs, most notably, include FMC’s minerals unit and DuPont’s $7.2-billion performance chemicals unit. IPOs include Trinseo, previously known as Styron, which refiled for a $200-million IPO last month after withdrawing last year, and PQ Corp, which filed for a $450-million IPO in February. Private equity firm Carlyle Group (New York), which took PQ private in a $1.7-billion deal in 2007, is pursuing a dual-track process in which IPO and sale are possible outcomes, bankers say.

Regardless of the outcome of the PQ process, equity markets are robust and owners of chemical assets are looking to tap into them. “I think we are going to see a pretty active IPO market because of the attractiveness of public multiples,” Bradley says. Tax leakage concerns—which were behind FMC’s decision to spin off, rather than sell, minerals—also play a part in the process. “When businesses are taken public, it is usually some combination of high public trading multiples, absolute size, a diverse portfolio that may not all appeal to strategic buyers, and possibly tax leakage issues,” Zachariades says.

The high multiples may represent a shift, driven by shale gas and the industry’s improved cost structure, some bankers say. Many bankers note that financing is unlikely to remain as cheap as it has been recently, and that public markets will likely deflate some, at least in the medium-to-long term. Nevertheless, shale gas will still be fracked, operating improvements are mostly here to stay, and investors continue to push management to get leaner. “We are out of the crazy business environment of the past six years,” Beagle says. M&A “is just normal, good management of your business.”