M&A: Top of the cycle?

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Bankers and industry watchers are increasingly looking at the chemicals M&A market and seeing a peak. While there are no signs of a let-up right now, few observers believe the upcycle can go on forever.

With M&A valuations still very high and most economic indicators looking up, there is a strong consensus from industry bankers and analysts that the market is at or near a cyclical peak. While some assets are fetching particularly high valuations, and some regions and sectors are more active than others, activity is mostly robust across the board.

By CW's count, some 56 M&A transactions were announced this year through 26 March. Year-to-date (YTD) deal value stood at $6.4 billion on the same date, but it very nearly tripled the next day as AkzoNobel announced the long-awaited sale of its chemicals business for $12.6 billion. The deal values the business at 10 times its 2017 EBITDA. AkzoNobel's chemicals business is being sold to private-equity firm The Carlyle Group (Washington, DC) and GIC (Singapore), an investment firm.

That YTD deal values jumped so much on the back of just one transaction illustrates that the number of deals is arguably a better measure of the market. While deal values have fluctuated over the past few years, the number of chemical M&A deals has remained remarkably consistent since 2016. Through 26 March 2018, announced deal volumes—the number of transactions—are up 8% YOY from 2017. In all of 2017, 304 deals were announced, compared with 301 in 2016, an imperceptible shift.

Based on those numbers, the peak has been going on for some time and valuations remain on the high side for most businesses. "Everyone knows they are overpaying and multiples are too high," says Bob Girton, principal with private-equity firm Edgewater Capital Partners (Cleveland, Ohio). "[Multiples] will come down over some period of time, but I can't tell you when or what will drive it." Girton adds that fine chemical businesses are attracting particularly high valuation multiples.

"It's hard for me to imagine that we are not at the top," says Paul Colone, managing director with Alantra (Madrid). "Public markets are still strong, cost and availability of debt remains favorable, private equity has lots of dry powder [cash to invest]. It's hard to see how conditions get better from here. Now, what I don't know is how long it is going to last."

Robust outlook

At the start of 2018, bankers expected that the chemical M&A market would be strong this year and similar to 2017. So far, that has played out.

"You still have chemical companies with underutilized balance sheets," says Kevin Yttre, president and managing director with Grace Matthews (Milwaukee, Wisconsin), an investment bank. "Global public [chemical] companies are trading at growth multiples and still in a GDP-growth sector so in our simple view the math says using the balance sheet to make acquisitions can justify the growth

TELEVANTOS: Markets still strong, outlook remains good.

multiple." Yttre adds that shareholder activists are still pushing for portfolio reshaping and streamlining, although they have been relatively quiet in recent months.

"It's not precisely predictable, but the steady stream of medium-sized deals continues to be strong," says John Televantos, partner with Arsenal Capital Partners (New York), a private equity firm. "Markets are still strong and the outlook is good."

Most demand indicators for chemical makers are positive. At the IHS Markit World Petrochemical Conference (WPC), held during the week of 19 March, IHS Markit senior vice president of energy & chemicals, Dave Witte, said that the industry's current upcycle is likely to continue for several more years (p. 7). He noted that capacity additions have not kept pace with worldwide demand.

ACC's chemical activity barometer, meanwhile, is up 3.8% YOY on a three-month moving average (3MMA) basis, and The Conference Board's index of leading economic indicators (LEI) was up 0.6% in February and 0.8% in March. Eight of the 10 leading indicators expanded in February in what ACC calls "a very positive sign for the economy."

Capital and equity markets showed some volatility in early February, but have since stabilized. As of 27 March, the CW75 index is down 10.6% from its 2018 peak on 23 January, and the S&P500 is down 8.4% from its 30 January 2018 peak, but the indices have been mostly stable since mid-February and remain near historic highs. "Public share prices are still strong," Colone says. "They've pulled back a bit but they're still strong."

Debt financing remains cheap despite some small interest rate increases. Analysts at credit ratings agency Moody's Investors Service (New York) say that companies are often able to issue debt with very few covenants. Private-equity firms are also raising lots of capital to invest. Low interest rates are good for corporate borrowers, but drive big investors to higher-yield assets such as private equity. "You can make 8% [return] on a company you are buying," Televantos says. "Private equity is still a good place to make money."

There is, however, some caution around interest rates. "Rates are going to be a downward pressure for sure," says Ryan Meany, managing partner with Edgewater Capital Partners. However, bankers are quick to note that interest-rate increases have thus far been modest and appear likely to remain so. "There's nothing that has been done or talked about or forecasted as far as interest-rate increases are concerned that would be enough for anyone to tap the brakes [on the market] just yet," Colone says. Investors seem to agree, as debt financing has not been an impediment for M&A.

Indeed, as rates increase, the assets flowing through to debt markets could push lenders to cut the costs of debt packages in other ways. "Creditors are…adjusting their all-in rates to be competitive," Meany says. "As the Federal Reserve raises rates, you are going to see lenders on these deals become more aggressive with their packages so that for the deal itself the overall pricing doesn't

change much. The lender may make a little less money overall…but as more assets have moved into leveraged loans you have a more competitive marketplace."

It all adds up to a situation where M&A looks like a strong option, for sellers as well as buyers, in many circumstances. "There is just a significant amount of capital looking for businesses and therefore more demand than supply of good assets," Colone says. "That just hasn't changed. There is a real supply-demand imbalance that is fueling things as far as M&A is concerned."

A time to sell

While some potential economic issues have cropped up in the first few months of 2018—market volatility and US tariffs chief among them, together with rising interest rates—M&A watchers say that these factors have yet to dampen market enthusiasm. "If you look at the indicators out there, they are still pointing in a very positive direction," Girton says. Solid growth rates, especially in North America, are likely offsetting any potential difficulties, according to Yttre. Many bankers note that it is still very early to predict the outcome of the Trump administration's recent noises about trade, and industry leaders at the WPC echoed this sentiment.

So, all in all, CEO confidence remains strong. "There hasn't been any true change in sentiment" among CEOs looking to buy assets, according to Colone. Bankers say that CEOs generally remain upbeat despite some clouds on the horizon.

Market volatility, however, has shifted perceptions among a certain set of sellers: owners of private businesses. "It's not that they're seeing a change in their business or in the economy," Colone says. "But it's [market volatility] a reminder that we are at a top…and you don't know what's going to get things moving in the other direction. It could be a singular issue or it could be a compounding effect of multiple things."

Whatever the cause for a future shift, private-company owners who are considering a sale, perhaps due to succession issues, are actively moving on this, according to Colone. "Everyone realizes we are at a really elevated level…[business owners] who want to sell are thinking of doing something sooner rather than later," he says. "If the possibility of selling my business is on my mind over the next few years, I'm probably going to want to think about doing it now, because I wonder how long the window will be open." Some small business owners may not have had the state of the M&A market on their radars a year or two ago, but by now the generally favorable conditions are common knowledge, Colone adds.

Yttre agrees that those who are looking to exit are seeing a window of opportunity. "It's a sellers' market," he says. "Everyone recognizes valuations are healthy."

Despite the sellers' market, companies are under pressure to make acquisitions. Part of the reason is investors looking for growth, but part of it is also perceptions. "There is a chessboard being played out, and if you take your pieces and move to the side there is a concern that you could miss an opportunity," Meany says. A good time to sell can mean that good assets are for sale, even if not quite enough to meet demand. "Large corporations can't miss opportunities because it's too important to their strategy," Meany adds. It can be hard to know when the right asset is going to come onto the market and many buyers, especially corporate buyers, are willing to pounce.

This does not mean that private-equity firms are sitting on the sidelines. Some bankers say that increased interest in the leveraged loan market is making it easier for private equity to compete as

buyers, despite high valuation multiples. In either case, private-equity firms certainly have cash, and they are obligated to put it to work, which usually means buying companies. An analysis last summer by financial researcher Preqin (London) found that private-equity firms had about $963 billion in cash raised but not invested," according to a Bloomberg report. This figure has likely increased since then as investors flock to alternative asset classes amid low savings rates and bond yields, and instability in equity markets.

To give one example, by far the biggest chemicals deal to date in 2018 involved a private-equity buyer: Carlyle and GIC's acquisition of AkzoNobel's chemicals business.

Private-equity firms have also grown more comfortable with chemicals investments, a trend that has accelerated in the past five years. Many firms, such as Carlyle and Apollo Management (New York), have built up considerable expertise in chemicals. This group also includes firms focused on middle-market transactions, such as Arsenal, Edgewater, and SK Capital (New York). Market participants say that the size of the universe of private-equity buyers for chemical assets is increasing.

"Private-equity groups that were not necessarily focused on chemicals in the past now have enough industry advisors and operating partners…to compete for chemical businesses," Colone says.

Yttre notes that due diligence has become more sophisticated, enabling private-equity investors to understand complex issues such as regulatory or cyclical risk. "Recently…there are significantly more private-equity funds in the chemicals space…that have developed a competency," Yttre says. "There are more [private-equity funds] investing in chemicals than even five years ago."

Still, bankers note that the more-established firms tend to have the upper hand. "We say, 'you don't want an equity fund to learn chemicals on your deal,'" Yttre says.

YTTRE: Chemical companies have cash to put to work.

Colone notes that sellers are often more comfortable with established firms that are conversant in the sector and have a long track record. "That knowledge and experience allows them to be a bit differentiated when they speak to business owners," he says. "If you're choosing between two private-equity buyers, you have a greater confidence that the deal will close with the one that has had a historic focus on chemicals."

Specialty chemicals remain the main point of focus for private-equity firms, since there are lots of niche opportunities and the business model is usually closer to typical industrial manufacturing than that of an upstream petrochemical maker. "Private-equity firms have considerable interest in specialty chemicals, which have a good fit in terms of size and potential for efficiency improvements and bolt-ons," says Mukta Sharma, managing director of chemicals with IHS Markit. This "roll-up" strategy has often paid dividends for private-equity investors, especially those that know the chemical industry well. Firms often tend to look for fragmented sectors so that they can build value from buying up and combining

smaller companies, and are willing to pay a premium for assets that can enable this strategy, bankers say.

Looking for a fall

While valuations are high, bankers say that a higher-priced but strong asset is most likely a better bet for a buyer than a lower-priced but mediocre one. “If you are buying a good business that has some competitive advantages, with attractive cash flows and margins…that should always be a good outcome,” Colone says. While it is impossible to predict if valuation multiples will be as high in several years as they are today, a strong business will ultimately perform well and make profits for the owner, and it should be able to find a buyer even if the market has cooled. “For a good business, there’s always a buyer, there’s always a market,” Colone says. This makes such assets lower-risk investments even when they can command premiums, he adds.

But, the sense of optimism that comes with today’s strong market also comes with knowledge of a downside. While there’s a general consensus that the next downturn is unlikely to be as sharp or painful as the last one, the Great Recession has left scars. Bankers and CEOs are keenly aware of the cyclical nature of M&A markets, as well as of the chemical industry and the broader economy, and will readily admit that good times cannot last forever. “Everyone knows we are late in the cycle,” Girton says.

The implications of this are clear. “We are at a top,” Colone says. “It’s now a question of how long it will last, not how much better it will get from here.” No serious signs of a slowdown have emerged as of yet, but it is bound to happen eventually.

Big deals, so far*

(deal size in millions of USD)

Target	*Acquirer*	*Seller*	*Deal size*	*Target region*	*Target Sector*
AkzoNobel chemicals business	Carlyle Group; GIC	AkzoNobel	12,600	Europe	Diversified
25% stake in Clariant	SABIC	Clariant	2,500	Europe	Diversified
A. Schulman	LyondellBasell	A. Schulman	2,250	North America	Basics
TenCate Advanced Composites	Toray Industries	Koninklijke Ten Cate	1,100	Europe	Specialties
EP Minerals	U.S. Silica	EP Minerals	750	North America	Specialties
30% stake in Rafineri Holding	Petkim	Undisclosed	720	Middle East	Basics
Stake in Israel Chemicals	Undisclosed	Nutrien	700	Middle East	Diversified
Naturex	Givaudan	Naturex	649	Europe	Specialties
Century Portfolio	Nufarm	Adama	490	Middle East	Ag/Fertilizers
Terra Nitrogen Company L.P.	CF Industries	Terra L.P. unitholders	390	North America	Ag/Fertilizers

**Ten largest M&A transactions announced in 2018, by deal size. Source: Chemical Week research.*