ASI ADHESIVES & SEALANTS INDUSTRY

M&A Corner

Adhesives and Sealants M&A: Reaching Cruising Altitude

The level of merger and acquisition activity in 2021 has by almost any measure exceeded expectations.

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Andy Hinz

What a difference a year makes. In our last "M&A Corner" column, published December 2020, we talked about the sense of "hope and optimism" we were starting to see in the M&A community following a challenging year for everyone. At that time, deal activity across the adhesives and sealants and broader chemicals industry was starting to pick up. On the horizon, we saw the underpinnings for a "perfect storm" of M&A activity.

With most of 2021 now in the rearview mirror, we can confirm that these trends did in fact play out. Put simply, it's been busy. The rebound itself obviously wasn't a surprise, but the level of activity and the valuations we've been seeing have by almost any measure exceeded our expectations entering the year.

According to data from S&P, year-to-date global M&A transaction volume through the third quarter of 2021 was up 34% compared to the first nine months of 2020 and 14% over the same period in 2019. The average reported transaction value in 2021 is 29% higher than in 2020 and up 19% over 2019. What is driving this activity? Well, it's a few things:

- The threat of higher capital gains tax rates is pressuring some sellers, particularly owners of private and family-held businesses, to consider a sale now to avoid potentially paying more taxes in the future.
- Capital is abundant, and private equity firms are back in the market after being more internally focused in 2020.
- Large multi-nationals are as active as ever and are using M&A as a strategic tool, constantly reviewing their portfolio for divestiture opportunities and leveraging their balance sheets to fund acquisitions that support their longer-term strategy.
- Market disruptions (from COVID-19, labor and supply chain challenges, and other factors) have also caused buyers to use M&A more creatively to enhance their competitiveness.
- Valuation metrics remain at historically high levels, enhancing the economics of a potential sale for sellers currently on the sidelines.

Tax Issues

First, let's talk about taxes. A variety of tax increases were part of the original proposal for the American Families Plan issued by the Biden Administration last April, including instituting a tax rate of 39.6% on capital gains for high-income earners. This got the attention of many business owners, who would see their tax rate on capital gains essentially double in the event of the sale of their company.

Owners of some private and family-held companies, many of whom had already been considering a sale, used this proposed legislation as an impetus to begin a sale process in 2021 rather than waiting a year or two. In fact, several of our recent sell-side clients were emphatic about closing a transaction in 2021 for this very reason.

The Build Back Better Act, a bill that contains some of the tax provisions originally proposed by the American Families Plan, was ultimately passed by the U.S. House of Representatives in November (though still under debate by the Senate as we publish this) without any proposed changes to capital gains tax rates. While this was a relief to many business owners, the threat of future tax legislation remains high and will continue to factor into potential sellers' thoughts about the timing of a sale.

Private Equity

The private equity community has been extremely active this year and showed its continued commitment to investing in the adhesives and sealants industry. In April, Arsenal Capital Partners announced it had acquired Applied Adhesives, a provider of custom adhesive solutions for the packaging, paper converting, assembly, and other industries, from Goldner Hawn, LP. Many participants in the adhesives and sealants industry know Arsenal through its ownership of another adhesives platform company, Meridian Adhesives Group, and additional investments around the chemicals and materials industry.

Since its acquisition by Arsenal, Applied Adhesives has already announced five acquisitions (Adhezion, Inc.; Adhesive Systems Technology Corp.; American Chemical; ADQ, Inc.; and Bird Song Adhesives, Inc.), an impressive run in a short period of time. Meridian Adhesives was similarly busy during 2021, with seven announced acquisitions, including the adhesives division of Tri-Tex Co. Inc., which produces hot-melt, water-based, pressure-sensitive, and general-purpose adhesives. Completed this month, the Tri-Tex acquisition is Meridian's 16th deal since forming in mid-2018.

ICP Group, backed by Audax Private Equity, also got in on the action with its acquisition of Choice Adhesives, a provider of adhesive technologies for roofing and other markets. As we've discussed in the past, the adhesives and sealants market remains highly fragmented, supporting the "buy and build" strategy that many private equity firms employ. Overall, the private equity community was somewhat less active in 2020 as it focused more on navigating existing portfolio companies through the impacts of COVID-19. This changed significantly in 2021, as private equity firms stepped out into the market more aggressively, putting to work the significant amount of capital they raised in recent years.

Large Multi-Nationals

Deals in the adhesives and sealants industry in 2021 were not limited to private equity buyers by any means. In fact, some of the most notable transactions involved large "blue chip" adhesive and sealant companies that are active on a global scale.

One of the more talked-about deals was Ashland's sale of its Performance Adhesives business to Arkema for $1.65 billion. Ashland reported the valuation to be approximately 20x EBITDA, or 15x EBITDA after considering the tax benefits (estimated at more than $200 million) linked to the structure of the transaction. Arkema pointed to the growth and margin profile (> 25% pro forma EBITDA margins) of the business as justification for the valuation multiple and also noted the significant level of anticipated synergies ($45 million pre-tax) from the deal. In fact, after considering Arkema's estimate of transaction synergies over the next five years, the reported pro forma valuation multiple is a more modest 8.7x EBITDA.

We were not surprised to see Arkema emerge as the buyer given its strong, strategic fit with the business, financial wherewithal, and ongoing commitment to becoming a pure-play specialty materials company. While most of the deals we have seen (and expect to see) in the adhesives and sealants industry are more of the "bolt-on" variety, an acquisition of this size is truly a needle-mover and undoubtedly got a lot of attention from buyers in the market.

On the Ashland side, the deal also made a lot of strategic sense. On the heels of Ashland's decade-long transformation into a focused additives and specialty ingredients company (largely through acquisitions and divestitures), the Performance Adhesives business was essentially the last remaining piece of "legacy Ashland" and was not strongly aligned with the company's longer-term strategy. Speculation around the potential sale of Performance Adhesives had percolated in the market for several years, and some of the market dynamics we discuss in this column likely contributed to Ashland's decision to divest.

Another company that has been extremely active in adhesives and sealants M&A over the past year—at times under the radar—is Sika. Sika announced eight acquisitions in 2021, including: DriTac, a U.S.-based floor covering adhesives manufacturer; Hamatite, the adhesives business of The Yokohama Rubber Co.; and others deals in the U.S., Brazil, Russia, Mexico, and China. In November, Sika made a splash by announcing its intent to acquire MBCC Group (formerly BASF Construction Chemicals) as a means of accelerating growth and helping drive the sustainability transformation of the construction industry.

The transaction's enterprise value of CHF 5.5 billion (approximately $6 billion) represents approximately 11.5x pro forma 2022E EBITDA (8.5x after expected synergies). In its acquisition announcement, Sika presented its view of the highly complementary fit with MBCC across a variety of countries, regions, and product ranges. As part of this, Sika also highlighted its corporate goal of generating 80% of sales from products that have a positive effect on sustainability, adding that more than 35% of MBCC Group's products today are "sustainably advanced." ESG goals are very much in vogue today across the broader chemicals industry, and we're seeing this topic mentioned more and more often as part of broader M&A and strategy discussions among industry participants.

Other Considerations

With all of this discussion about strong M&A activity and high valuations, one may conclude that it's been relatively easy to get a deal done in this market. We would argue that it's actually been quite the opposite. While buyer demand has clearly exceeded the supply of deals from willing sellers, we're not necessarily seeing that translate into faster, more efficient deal processes.

For one, valuations remain historically high, with public chemical companies trading around 10-20% above 10-year averages for most of the past year. This is attractive to sellers, obviously, but also can lead to more scrutiny during the buyer's diligence process.

In addition, many companies still have a lot of "noise" in their financials, either resulting from COVID-driven swings in end market demand, or from supply chain challenges, or from labor shortages—you get the point. We're seeing buyers take their time to make sure they truly understand what they are buying, particularly when underwriting a premium valuation.

Portions of a buyer's due diligence process are typically supported by third parties like accountants, lawyers, and environmental consultants, and those third parties also have been extremely busy in this environment. In addition, COVID-related travel restrictions have impacted some companies' ability (or desire) to travel, leading much of the due diligence and deal negotiation process to be conducted virtually. In many cases, these factors are contributing to a longer (and often more stressful) diligence process. Deals are obviously still getting done, but they just feel like they've been taking longer and been more challenging than in years past.

As the saying goes, "An ounce of prevention is worth a pound of cure." This is why we encourage sellers to start working with an advisor long before they intend to kick off a sale process. The importance of preparation cannot be overstated in today's market.

2022 Expectations

Given all of these influencing factors, what does our crystal ball portend for 2022? Will the Milwaukee Bucks repeat as NBA champions? We certainly think so, and the city of Milwaukee is ready to support another deep playoff run.

Similarly, we're optimistic that the M&A train will continue to roll in 2022, building on the strong finish we're seeing for this year. Large strategic buyers continue to be on the prowl for acquisitions, and we can look at our own pipeline of sell-side engagements as an indication that interest from sellers doesn't appear to be subsiding.

Our current project backlog has a mix of private company owners, private equity firms intending to sell a portfolio holding, and large corporates planning a divestiture process. Each of these groups of sellers will continue to step up to the plate and evaluate their options.

We expect valuations to remain high, particularly if interest rates stay low, cash remains readily available, and the overall business environment remains strong. Private equity fundraising kicked off in earnest again during 2021 following a brief respite in 2020. That fresh capital—combined with a vast amount of "dry powder" already on the sidelines—needs to be put to work. And although it looks like near-term tax legislation may not be as onerous as initially predicted, the environment remains uncertain at best, and many believe that tax rates will only go up over time.

While this "perfect storm" may not pack quite as much punch as it did when it first arrived in 2021, it is undoubtedly still here and should stay with us for some time. With appropriate planning and advice, buyers and sellers can capitalize on this healthy M&A market to harvest what they have built or make a strategic move that puts their company in a stronger position for the future.

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Andy Hinz is a managing director with Grace Matthews, Inc. He can be reached at ahinz@gracematthews.com or www.gracematthews.com.