Taming the bull: Uncertainty weighs on M&A

5:00 AM | April 04, 2022 | Vincent Valk

While 2021 saw one of the strongest chemical M&A markets in history, inflation, supply disruptions, and geopolitical risks are entering into M&A discussions. The outlook for this year remains positive, but the environment is more complex, and a repeat of last year may not be realistic.

Chemicals M&A has roared back from a pandemic-induced dip that can now probably best be described as merely a pause. In 2021, some 315 chemical M&A transactions were announced, totaling about $116.4 billion in value, according to CW data. This followed a strong rebound in the second half of 2020, which saw 138 transactions announced, totaling $45.0 billion in value.

Last year's roiling market brought big EBITDA multiples, as M&A valuations followed equity markets to new highs. In-demand specialties sectors—personal care, flavors and fragrances, pharmaceutical and life sciences—saw multiples routinely exceed 15 times (x), and sometimes even 20x. Even assets in commodities and intermediates often fetched multiples well into the double digits, above historical norms. "Last year was the strongest year we had since 2015–16, which were by far the most active years for industry M&A over the past two decades," Sean Murray, managing director with Goldman Sachs (New York, New York), said at a webcast sponsored by the Chemical Marketing and Economics (CM&E) Group in mid-March.

Uncertainty is, once again, on the rise. Russia's invasion of Ukraine has caused deal-makers in Europe to hit the pause button, as bankers and executives aim to evaluate exposure of assets to surging energy costs on the continent. In North America, the war has less of a direct impact, but it has exacerbated supply constraints and inflation in raw material, energy, and labor costs. "It's just aggravated what was already a difficult situation," says Anthony Giorgio, managing director/chemicals and materials with TM Capital (New York, New York), an investment bank. "Labor, inflation, raw material costs [are all rising rapidly]…so it just gets compounded into the system."

Tough forecast

The rationale and supportive conditions for M&A, including credit availability and cash reserves at private equity firms, remain in place, but forecasting business performance is more difficult given cost inflation and higher geopolitical risks. "The biggest hindrance to M&A activity is uncertainty and we are very much in a period of uncertainty," Murray said in March. "Companies are being mindful about capital allocation now that it's difficult to look ahead. We do see capital allocation strategies de-emphasizing M&A in light of this uncertainty…[including] the remaining supply disruptions, raw material inflation is notable."

Russia's invasion of Ukraine, and the impact of further disruption of supply chains and rising energy prices, has lowered growth forecasts. S&P Global Market Intelligence cut its global GDP forecast to 3.3% in 2022, compared with an expectation of 4.1% in February, but "the world economy has sufficient resilience to avert a recession," S&P Global Market Intelligence says.

The invasion "has triggered a global commodities shock that will further dislocate global supply chains, drive up prices, and slow economic growth—especially in Europe. Russia's economy will suffer permanent losses through sanctions, an exodus of foreign businesses, and a new emphasis on energy security," says Sara Johnson, executive director, global macroeconomics, S&P Global Market Intelligence.


YTTRE: Pent-up demand in the second half of 2022.

The impact will be felt more keenly the closer a business is to a barrel of oil, and the more exposure it has to Europe. "It will depend on the subsector," Murray said. "For some of the more downstream businesses, where they have the ability to pass costs on despite rising raw material prices and freight issues [it won't be as much of an impact]. The European upstream chemicals industry is going to struggle massively."

That has already reverberated to M&A. "We've seen processes put on pause if they have some sort of critical mass of exposure to energy prices in Europe," says Jared Mudge, managing director/chemicals at Piper Sandler (New York, New York), an investment bank. For companies in that position, "if you don't need to launch a process, you are not going to launch one right now," Mudge adds. "You are going to wait and see how things play out. It could take months or potentially longer."

Owners of chemical assets are also assessing the impact. "We are spending a lot of time trying to understand the impacts of the conflict and repercussions in different parts of our businesses, such as top line, supply chain, logistics, and energy costs," Roy Seroussi, investment partner with Arsenal Capital (New York, New York), a private equity firm with major investments in chemicals, said during the CM&E webcast in March. "We are realizing that it can take a while to understand…given that [the Ukraine conflict] can often be two or three steps removed from our businesses. But we are starting to see the impact."

Seroussi added that a fresh injection of uncertainty could easily impede M&A. "We haven't seen this level of uncertainty since COVID started," he said. "We feel like we are in a similar environment now where things are changing on a daily basis, and we are trying to stay close to our businesses, customers and suppliers."

The Ukraine invasion compounds an already-difficult situation for forecasting. With inflation in the US running at its highest level since the early 1980s, and a cascading series of supply chain challenges, buyers are looking to pick apart revenue and EBITDA growth forecasts. "The sustainability of the run rate [for EBITDA growth] is a relevant factor in this environment," says Kevin Yttre, president and managing director at Grace Matthews (Milwaukee, Wisconsin), an investment bank.

The resilience of high profit margins is also a relevant concern. “If you’re looking at a company that is able to pass on price increases above headline inflation numbers, how sustainable are those price increases, and what will that do to the business in the long-term [are important questions],” Mudge says. “In every M&A process we’re looking at now…we’re trying to understand what margins were like three years ago, what’s happened since then, what the projection is, and what a normalized pricing level looks like.”

Such considerations add complexity to deal processes, according to Giorgio. “In late 2020 or early 2021, the question was how do you normalize for COVID,” Giorgio says. “That was probably more straightforward, the business was either up or it was down. But now there’s this new paradigm with inflation, raw material costs, labor. It’s harder to parse what the individual effects are and what is and is not sustainable.” Looking into the components of revenue and profit numbers can be especially important. “Buyers need to pick apart the sales book and determine how much of that revenue is about taking advantage of market arbitrage, and how much is truly sustainable revenue growth,” he adds.

Interest rates are also on the radar, with the US Federal Reserve raising the base rate by 0.25% in March in an effort to curb inflation, the first of what is likely to be a series of rate hikes. The impact on M&A and leveraged loans has thus far been minimal, although that could as rates rise further. “Benchmark base rates have gone up on floating rate debt,” notes David Ruf, managing director and head of chemicals and materials with KeyBanc (New York, New York). “Those things are already happening…[but] the market doesn’t seem very afraid of it in the long term.” While inflation expectations over the next year are high, long-term inflation expectations remain at manageable levels. “Even with the Fed bump-ups, [interest rates] are still very livable,” Ruf says.

Despite the Fed increases, and a small ratcheting-up of expectations, “conditions continue to be supportive, and despite the volatility in the past six weeks it’s still pretty good,” Brett Durick, managing director with Goldman Sachs, said at the CM&E webinar in March. “Private equity and corporates still have fairly inexpensive access to capital and lots of different options [for financing], which should continue to support M&A.” The cost of capital has increased, if only slightly, according to Durick. “Financing is a little more expensive, but it’s definitely open,” he said.

Still running hot

While inflation, the supply crunch, and Russia-Ukraine have added considerable new uncertainties to the economic outlook, the demand outlook remains high and much of the industry remains focused on satisfying that demand. Yet another injection of uncertainty could slow down last year’s torrid M&A market, but a big shift is seen as unlikely. “On a macro basis…we are very much in an expansionary period,” Murray says.

GDP is still expected to grow at an above-trend pace despite forecast downgrades due to the conflict and the impact of sanctions. US GDP growth is expected to total 3.3% this year, down from a February forecast of 3.7%, mainly because of higher food and energy prices and weaker export markets. GDP is expected to increase 5.1% in mainland China, short of its 5.5% target, because of energy price inflation, slower growth in European exports, and the potential for new COVID-19 lockdowns.

With growth still going, the ingredients remain in place for a robust M&A market in chemicals, even if it is off a bit from last year’s pace. “There is still a big appetite for deals among strategic buyers and private equity firms, and that hasn’t for deals among strategic buyers and private equity firms, and that hasn't changed," Giorgio says.

Companies are still evaluating portfolios, with supply chain challenges added to the list of considerations. "There are plenty of corporates still looking at portfolio rationalization and realignment," Ruf says. Major chemical makers with assets on the selling block include DuPont, Huntsman, and DSM.

Money also continues to flood into private equity funds, and the chemical industry has become an ever-more-popular target for buyout firms, bankers say. "The private equity industry still has over $1 trillion in dry powder, meaning equity commitments they can use to invest," Durick said last month. "So even after spending a lot of money in 2021, there is still a lot of capital available."

"Uncertainty is never a great thing for M&A, but we aren't hearing anyone give us any input that their plans for M&A have changed," Yttre says. "Our outlook is still pretty bullish. It's still going to be pretty busy in the back-half of the year based on pent-up demand."

That pent up demand is, in part, a result of last year's white-hot M&A environment. The assets that flooded into the market in late 2020 and early 2021 quickly built up to a backlog—a sort of labor crunch within the M&A market itself, bankers say. "The market research and legal people were tied up on what they were executing in the third and fourth quarters [of last year]," Ruf says. "There wasn't a lot of ability to prepare for first-quarter launches."

The net result of this backlog is a slowdown in deal flow that many bankers expect to abate in the second and third quarters of this year, as the backlog is worked through. "The system was so flush with deals last year that we started to run into a bandwidth issue," Giorgio says. "So owners of businesses…started to pull back a bit on new deal launches, and we're now starting to see some assets coming back again."

Business performance has also remained strong, despite the operational challenges. "I think you will see more activity in the late second quarter and the third quarter," Yttre said at a panel discussion in early March. "A lot of companies did very well in 2021 and had a strong January and February. If that holds, you'll see more deals happen in the back half of this year. Right now I'm pretty bullish on the second half of 2022 and early 2023."

Another impact of the flood of assets hitting the market last year was a deliberate strategy—especially on the part of private equity firms—to aggressively pursue selected transactions. This 'triage' strategy has often meant a competitive M&A process and high valuations, even if the number of bidders is relatively small. "We started to triage last spring….that dynamic has meant that every process has become very narrow," said Bob Girton, partner with private equity firm Edgewater Capital Partners (Cleveland, Ohio) at a panel discussion in early March. "You figure out very early what to focus on."

While that strategy has long been a feature of strategic buyers, it is relatively new for private equity, according to Giorgio. "Strategics…know what they are looking for and will walk away from even a great deal if they have pipeline constraints," he says. "Private equity would previously at least take a look at most things and make a determination. But when the floodgates opened in late 2020, they realized they had limited bandwidth and only would spend time on those deal processes they have a good possibility of winning."

The aggressive stance of private equity buyers has been a factor in boosting multiples. "Private equity's view is that if they are going to spend the resources to get an asset, they'll lean in, and if that means [paying a little more] to secure it, get an asset, they'll lean in, and if that means [paying a little more] to secure it, then so be it," Giorgio says.

EBITDA multiples in chemicals M&A transactions have, of course, increased alongside asset valuations more generally. “Historically, you could get better value from strategic buyers,” Yttre said in early March. “They’d move slower, but they’d pay more. But now, private equity is willing to pay more, and strategic buyers are moving faster. It makes it harder to differentiate.”

Overall, the picture is complex. M&A activity in the industry seems unlikely to fall off a cliff—announced transactions through 28 March are about even with last year’s pace, according to CW data, and bankers say that unannounced deal flow is coming back after resource constraints put a lid on it earlier this year. Buyers, especially private equity firms, are aggressive. At the same time, inflation, and labor, raw material, and energy costs are clouding the outlook and making forecasting difficult; the impact of the Russia-Ukraine conflict is starting to be felt, especially in Europe; and COVID-19 could still snarl supply networks and reduce demand, especially in China. Financing markets are open, but interest rates are on the rise, albeit gradually.

Ultimately, although inflation and geopolitical concerns can weigh down M&A macroeconomic strength should serve as a highly effective counterweight and impacts will vary depending on exposure to energy costs and certain commodities. And while last year’s hot M&A market is undoubtedly a tough act to follow, it may be a bit of an unfair comparison and conditions for transactions are still broadly supportive. “We are…very much in an expansionary period,” Murray says. “There is uncertainty today, but I don’t think it is going to be as pronounced as the absolute shutdown of M&A markets we saw in the second-quarter of 2020.”

2022’s biggest M&A deals

Target	Acquirer	Seller	Deal size in USD millions	Target Sector
Mobility and materials segment	Celanese	DuPont	$11,000	Plastics
Renewable Energy Group	Chevron Corporation	Renewable Energy Group	3,150	Renewables
Environmental science business	Cinven	Bayer	2,600	Specialties
TES	SK Group	Navis Capital Parners	1,000	Services
Exelead	Merck KGaA	Exelead	780	Pharma/Fine

Notes: Largest M&A transactions by US dollar value announced in 2022.
Source: IHS Markit.