Chemical Week

High rates, slowing economy to dampen deals

8:56 AM | December 12, 2022 | Vincent Valk

Higher interest rates, in response to the highest inflation in decades in most developed economies, are poised to reset the chemicals M&A market, although a full halt in deal-making appears unlikely. The worsening economic outlook – partly a consequence of interest rate increases – and geopolitical uncertainty are also key headwinds for M&A, especially in Europe and, to a lesser extent, Asia.

S&P Global Market Intelligence is forecasting a recession in the coming months in the US and the eurozone, with a weak recovery taking hold in late 2023 or early 2024. US GDP is forecast to fall by 0.5% this year, and eurozone GDP is forecast to fall by 0.6%. “Global economic conditions continue to deteriorate as inflation remains uncomfortably high and financial market conditions tighten,” says Sara Johnson, executive director/global economics at S&P Global Market Intelligence. “The months ahead will likely bring recessions in Europe, the United States, Canada, and parts of Latin America. With moderate growth in Asia Pacific, the Middle East, and Africa, the world economy can avoid a downturn, but growth will be minimal.”

Meanwhile, the US Federal Reserve is widely expected to continue raising interest rates to get inflation under control, with S&P Global Market intelligence expecting the target federal funds rate to reach 4.50-4.75% by March 2023, and remain there for a year. Rates are also expected to increase in the eurozone until February 2023, albeit to a peak of 3.00%.

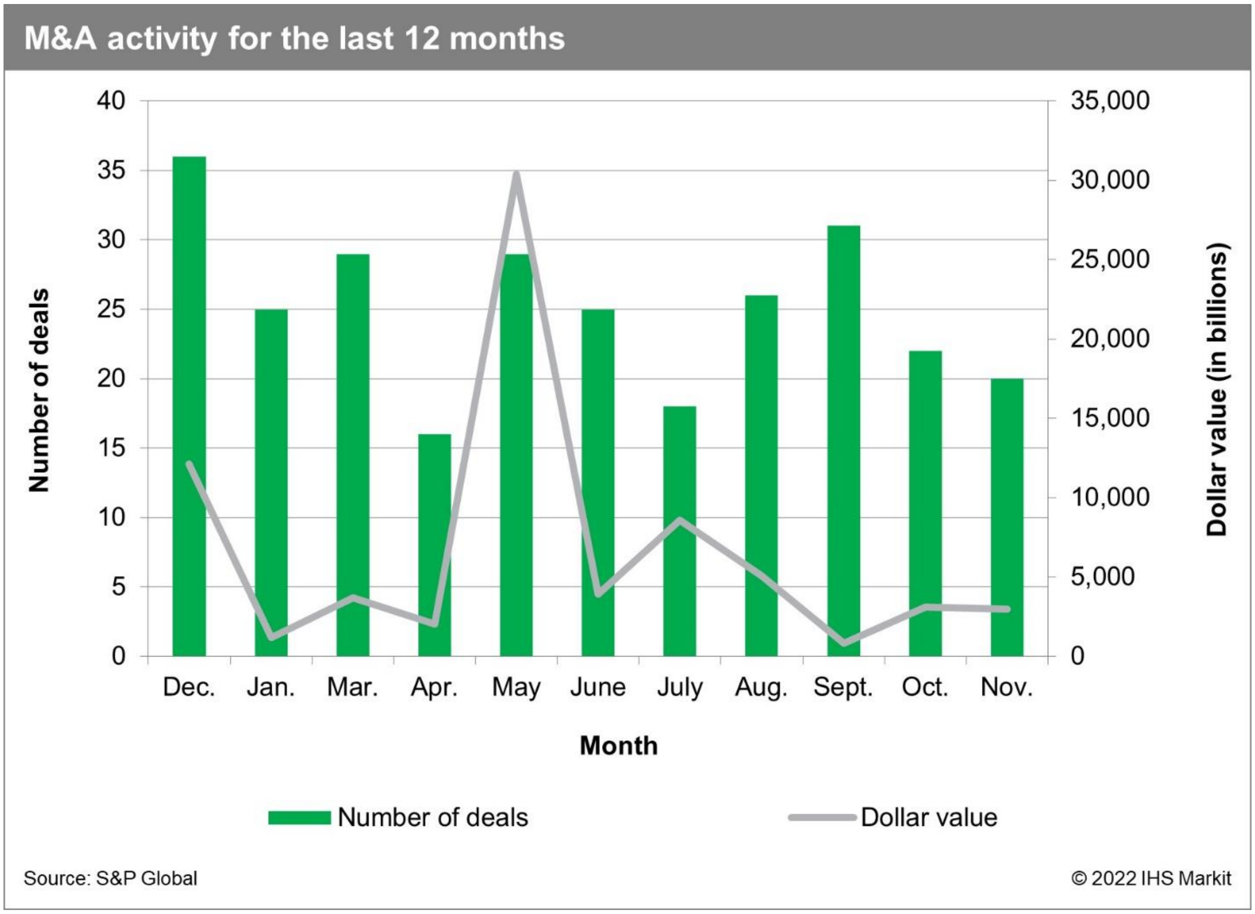
Participants in the M&A market will be keeping a close eye on growth and interest rate figures as the responses, and political events will largely determine the outlook in 2023,” says investment bank Piper Sandler (New York, New York).

Going down-market

The impact of higher interest rates and a weaker economic outlook will be most keenly felt in the market for larger transactions. “You’ll see the impact more for larger deals, north of $1 billion [in deal value],” says Ariel Levin, managing director with Piper Sandler. Transactions worth less than $500 million “can get done, and in the $500 million to $1 billion range there are ways to do it but it’s tricky,” he adds.

Business quality counts for a lot. “At the sub-$500 million range, people are still finding ways to get deals done, but the business has to be performing well,” says Kevin Yttre, managing director at M&A advisory firm Grace Matthews (Milwaukee, Wisconsin). “Everything is a bit harder, but you can still finance deals worth less than $500 million. It’s more expensive and harder to work though than a year ago, but it’s still active.”

Through the third-quarter of 2022, chemical M&A volumes were relatively steady. Some 74 transactions recorded in CW’s database for the third quarter of the year, up slightly from 69 in the second quarter. However, deal values have declined. The total value of all announced deals in CW’s database for September was $862 million, the lowest such figure for the previous 12 months. October saw just one billion-dollar-plus transaction announced – Lotte Chemical’s $1.8 billion acquisition of a majority stake in copper foil producer Iljin Materials.



A big part of the reason for the relative decline in larger transactions is weakening credit conditions, a situation that analysts expect to continue as rates rise further. Higher interest rates "have a dampening effect in general, because everything get more costly," notes Mukta Sharma, executive director/chemicals at S&P Global Commodity Insights.

The financing that is available is, generally, more suited to smaller deals. "Direct lending is available and deals are getting done that way," Levin says. "What that means, if you're a seller and you're bringing your business to market today, there is a much smaller pool of capital that your buyer universe can tap into. This market is not as large as the syndicated financing market." Syndicated financing, which tends to be how large deals are financing, "is currently pretty much closed," Levin adds.

Higher rates and relatively scarce credit have an especially significant impact on private equity firms, which rely on leverage to generate big returns for investors. "The most obvious impact for higher rates is on private equity's ability to complete deals," Levin says.

Private equity acquisition activity was somewhat low in October 2022, according to CW's M&A database. Just two of twenty deals announced in first three weeks of the month involved private equity on the buy-side, and neither was a straightforward acquisition. It's a small sample size, though, and different financial forces are pushing private equity firms in different directions.

The main force counteracting higher rates, from a private equity point of view, the amount of capital that firms have to deploy. Many potential buyers remain well-capitalized and eager to put money to work to acquire fundamentally strong and attractive businesses. "U.S. private equity 'dry powder' (committed capital) reached a record $1.0 trillion at the end of 2021, and lower middle market lenders have remained a bit more active than their larger commercial and institutional counterparts," according to Grace Matthews.

Strategic buyers, too, are sitting on strong balance sheets, a mitigating factor on the bottom falling out on the M&A market. "The average net-debt multiples for publicly traded companies are fairly low and balance sheets are very strong," Levin says. "That gives corporates some flexibility."