BlackJack3D, iStock / Getty Images Plus, via Getty Images

Unlocking Value: Corporate Divestitures in Chemicals and Materials M&A

Jon Glapa
March 3, 2023

Our first report of the year reflects on the chemicals and materials M&A market of 2022, as well as our outlook for the year ahead. Higher interest rates and credit costs, global economic uncertainty, political instability, and other factors contributed to M&A activity in 2022 declining from record levels in 2021, and these challenges linger into 2023. However, Grace Matthews expects M&A markets to remain resilient and steady as buyers and sellers establish a "normalized" level following the volatility of 2020 (COVID-19), 2021 (supply chain issues), and 2022.

Additionally, corporate divestitures are a segment of the M&A market that we expect to continue to remain active as large companies funnel capital to priority areas while divesting non-core businesses/segments whose value can be unlocked more quickly under different ownership.

Volatility of 2022 Positions 2023 for Resiliency and Opportunity

In retrospect, the step-down in M&A activity in 2022 should have been obvious. The drop-off from the record levels of 2021 to 2022 felt stark and tangible, particularly given 2021's activity was very second-half weighted. Interestingly, the M&A headwinds that emerged in 2022 were clear at start of the year: rising inflation, geopolitical instability, and a decade-long bull market in public equities inevitably due for a correction. While deal-makers were aware of these at the start of 2022, few anticipated the pace at which these challenges would unfold. For example:

- Rapidly rising interest rates quickly resulted in increased lending costs and, in some instances, temporarily reduced supply of debt financing as some lending institutions chose to remain on the sidelines for periods of 2022.
- Russia's invasion of Ukraine and the resulting war, which still has no conclusion in sight, has fostered enormous political instability and contributed to volatility in demand patterns, raw material costs, and energy prices on a global basis, with a particularly challenging impact in Europe.
- Public equities worldwide pulled back between ~10-30%,[1] and the general expectation in the equity markets is that levels will trend sideways for the near and medium-term.[2]

M&A in 2022 was hit by a variety of challenges, and while obstacles persist into 2023, we remain optimistic. On the interest rate front, further interest rate hikes are expected, but the rate of increases is already slowing. While debt will continue to be relatively expensive, the record amount of dry powder that private equity funds have amassed (nearly $2 trillion as of December 2022) remains ready to be deployed, particularly given the fact that many of these well-capitalized buyers sat on the sidelines throughout 2022.[3] Similarly, inflation in the U.S.

appears to have peaked in the second half of 2022, which should begin easing cost and price increases. Globally, while the Russia-Ukraine war continues, Europe is seeing energy prices gradually return to late 2021 levels, and Grace Matthews expects demand in Asia-Pacific to return closer to normalized levels via the gradual reopening of China.[4] Despite constant chatter of a looming recession throughout 2022 and beginning this year, U.S. GDP grew 3% in Q3 2022.[5] Moreover, within the North American chemicals industry, overall output managed to increase by nearly 4% throughout 2022.[6]

Through all the challenges of 2022, deal-making continued. Simply put, to borrow from IntraLinks and MergerMarket's 2023 Global M&A Dealmakers Sentiment Report, "Optimism persists," as they note that 62% of respondents "expect overall levels of M&A activity to increase over the year to come."[7]

Specific to the chemicals and materials industry, M&A activity expects to be driven by a focus on quality, fit, and geography.

1. Quality: Businesses that maintain a positive outlook for 2023 and performed well over 2020-2022 by managing through supply chain issues, inflation and raw material cost increases, and other headwinds will continue to command attention in M&A processes.

2. Fit: Strategic acquirers will continue to deploy capital towards inorganic growth should they see strong fit, alignment with core strategy, and/or synergy potential within their organization.

- "We remain confident in the quality of our portfolio and its growth potential, and we'll look to be opportunistic with select and targeted M&A moving forward," said Edward D. Breen, DuPont CEO and executive chairman during a DuPont Q3-22 earnings call.
- "We'll continue to invest materially in the coming years in the U.S., including if we have the opportunity on M&A," Thierry Le Henaff, Arkema chairman and CEO during an Arkema Q3-22 earnings call.

3. Geography: M&A in North America is likely better suited for a more active 2023, as the region has not been as exposed to the energy price shocks and demand uncertainty that Europe is currently facing. In the Asia-Pacific region, the re-emergence of China after altering its 'Zero-COVID' strategy will unfold over time, and this may give economic fits to the region similar to what the United States and Europe saw throughout 2021.

As previously mentioned, one segment expected to see strong activity is corporate divestitures, an area where Grace Matthews has substantial expertise.

The Rise of Corporate Divestitures in Chemicals and Materials M&A

The fundamental driver behind corporate divestitures (also referred to as carve-outs) is the premise that large corporations can achieve more value over time by selling a business segment and investing the proceeds into areas of higher return than continuing to own it. While carve-out transactions have unique complexities that the sale of standalone businesses may not have, such as post-closing transitional service or supply agreements, scope and structure challenges, and disentanglement from the parent organization, corporate divestitures create the opportunity for a win-win arrangement between seller and buyer. On the one hand, sellers can invest proceeds to accelerate long-term value creation — for example, sellers can re-deploy capital for M&A opportunities, capital projects, or technological advancements in high-priority segments sooner than they otherwise would have. On the other hand, strategic acquirers of carve-outs can bolster existing market positions and extract synergies, while private equity acquirers can create standalone businesses with lean, highly functional organizations focused solely on growing what is commonly referred to as the "corporate orphan."

Reasons for Corporate Divestitures and Expectations for Continued in Carve-Out Activity

While drivers behind corporate divestitures may vary, executives at these organizations have recognized that carve-outs can unlock value within an organization, and public equity data supports this. A recent *PwC* article noted that, over the past decade, the median public company announcing a divestiture saw its stock increase 3.8% relative to peers around the announcement date.[8] In a nod to the current M&A environment, *PwC* goes on to note, "a disciplined, strategic approach to divestitures can drive overall returns, even in a challenging environment." There can be a wide range of motivators to put a non-core business segment out to market. Grace Matthews focuses on carve-outs that fit one or more of the following criteria:

- Different financial profile than core business segments (e.g., margins, growth rates, capex requirements).
- Serving a market/industry with different growth rates or industry outlook than core businesses.
- Sustained underperformance of business segment relative to expectations.
- Misalignment with ESG (Environmental, Social, and Governance) initiatives of parent organization.
- Recent or upcoming capital expenditure requirements that exceed the parent company's desired capital allocation parameters.
- Sellers seeking liquidity.
- Minimal or no overlap with parent organization's core strengths or mission, creating an inability for parent company to leverage synergies that other organizations may have (see again the popular term, "corporate orphan").

Leaders of large corporations are constantly reviewing their businesses to gauge performance and understand if there is potential to create value through a divestment. When the time comes to act on such a decision, these executives recognize that carve-outs are not a sign of weakness but rather an opportunity to accelerate value creation and reinforce the core strategies of the parent organization.

Looking ahead within the chemicals and materials industry, Grace Matthews fully expects corporate divestiture activity to continue in line with broader M&A activity. This sentiment is echoed by executives throughout the industry and buyers, both strategists in the space as well as private equity funds making platform investments continue to have success in creating value with segments other companies deem non-core. The more challenging market conditions as of late have arguably heightened the need for executives to focus on near-term value creation for shareholders, and portfolio management, in the form of divestitures, allows companies to achieve this and funnel resources to higher priorities with their organizations.

Read Grace Matthews' entire Chemical Insights Winter 2023 newsletter here: https://gracematthews.com/news-insights/chemical-insights-newsletter/

References

1. S&P Global - U.S. Equities Market Attributes, December 2022
2. Fidelity Management & Research Company, December 2022
3. S&P Global - Global Private Equity Dry Powder Approaches $2 Trillion, December 2022
4. The New York Times - Natural Gas Prices in Europe Fall to Pre-Invasion Levels, January 2023
5. U.S. Bureau of Economic Analysis - GDP by Industry and Corporate Profits, Third Quarter 2022
6. ICIS - More Challenges in 2023 After Big Year for US Chems, December 2022
7. 2023 Global M&A Dealmakers Sentiment Report
8. PwC - US Deals 2023 Outlook

By **Jon Glapa**, Grace Matthews