Staying the Course

Despite a cloudy economic picture, M&A activity continues to grind forward.

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The M&A market is, by its very nature, unpredictable. Much like a surfer riding a wave, M&A activity can rise and fall and turn on a dime. Success as a buyer or seller is predicated on staying focused and balanced. While ebb and flow in markets is normal, the pace at which we've seen markets change in recent years has often felt more like whiplash. For example, 2020 began with high hopes and promise, but the rapid onset of COVID-19 was like a pin popping a balloon. Deal making got back on track later in 2020, and 2021 turned out to be a record year for transaction activity. While activity moderated a bit last year, the market generally kept its footing. Current opinions vary widely in terms of where M&A will head this year. Grace Matthews has remained busy, however, and we believe market fundamentals are solid. In fact, we are cautiously optimistic about how deal activity will play out over the balance of 2023, and we see potential for volume to build over the back half of this year. In this edition of M&A Corner, we'll take a look back at transaction activity over the past 16 months, discuss some of the key factors shaping the current M&A market, and offer our thoughts on the outlook.

A Look Back: Navigating Through the Turbulence

When we last shared our thoughts on the M&A markets in late 2021, dealmaking was firing on all cylinders. Following a COVID-induced lull during much of 2020, buyers and sellers had come back to the table in full force, fueled by abundant private equity capital, strong strategic buyer balance sheets, low interest rates, a surging global economy (fueled in part by government stimulus programs), and pent-up demand for deals. Fears about potential tax law changes brought many sellers to the table with a goal of closing a transaction by year end. Grace Matthews saw this firsthand, as we advised on 10 completed transactions during 2021, with five of those deals closing in November and December.

As we moved into 2022, it became increasingly clear that M&A activity, while still solid, was unlikely to match the prior-year's pace. For starters, the frenetic pace of deal closings in the fourth quarter of 2021 meant that deal pipelines were skinnier than we typically see in the early part of a year. In February, Russia's invasion of Ukraine set off shockwaves that affected energy markets, demand patterns, and general sentiment around the world. Supply chains across the broader chemicals industry quickly went from challenging to effectively broken, helping fuel inflation and adding significant uncertainty to the outlook. Many companies were put on allocation by suppliers and forced to make difficult production and pricing decisions. It was "all hands on deck" for a lot of companies, and most management teams were laser focused on just getting products out the door. All of this noise in the market made the path to closing an acquisition more opaque than usual.

Monetary policy in the United States and abroad also shaped the M&A market last year. Following a 7% increase in real GDP in Q4-2021, and with inflation continuing to run red-hot, the Fed stepped in and began raising interest rates in an effort to cool the U.S. economy. Beginning in March 2022, the Fed initiated a series of interest rate hikes that took the Federal Funds Rate from essentially zero to nearly 5% (as of March 2023). While these efforts appear to have stemmed the rate of inflation, with year-over-year inflation peaking in the second half of last year, the impact of higher interest rates reverberated across M&A markets and the broader global economy. The most immediate impact was felt in lending markets, with the cost of financing increasing rapidly and many banks implementing more conservative leveraged lending practices. These are the loans that directly support a buyer's acquisition of a business. Higher lending costs and less debt availability caused some buyers to reassess their appetite for acquisitions and the valuations they were willing to pay. This has been much more pronounced for larger deals (>$500 million in enterprise value) than for middle-market transactions, where lending generally remains available (albeit more expensive).

Higher interest rates also impacted consumer spending for housing and other big-ticket items. For example, the monthly mortgage payment for a $300,000, 30-year mortgage at 6% (where average 30-year rates are currently) is more than 40% higher than the same mortgage at a 3% interest rate, which was common during 2020-2021. As rates moved higher last year, U.S. housing starts fell swiftly from an annualized rate of around 1.8 million units in April 2022 to a rate of 1.3 million units in January 2023. Construction is a major end market for adhesives, sealants, and coatings, and a slowdown in new residential construction is impacting financial performance for many companies serving the construction industry. A company's underlying financial performance during a sale process is a significant factor in driving interest and value from buyers. Therefore, potential sellers that have meaningful exposure to construction markets (particularly new construction) may be faced with some difficult questions during due diligence if their business is underperforming. The good news is that the adhesives and sealants industry as a whole is not driven by a single end market, and many other end markets like packaging, aerospace, and infrastructure have continued to perform relatively well.

As a result of the factors discussed above, the number of reported transactions in the global chemicals industry (based on data from Chemical Week Research and S&P Global) declined by approximately 11% in 2022 compared to 2021, while aggregate transaction value was down by more than 30%. Given the high bar set in 2021, however, last year's decline in activity doesn't actually look that bad. For comparison purposes, the 280 chemical industry transactions reported in 2022 was only marginally below the 293 announced in 2019.

Adhesive & Sealant Majors Have Remained Active

While chemical industry M&A activity last year didn't reach the levels seen in 2021, deals did continue to get done, particularly among the adhesive and sealants "majors." For example, H.B. Fuller acquired five companies in 2022 for total consideration of around $250 million. All of these transactions were small or mid-sized "bolt-on" transactions such as Apollo, a UK manufacturer of adhesives and coatings primarily for construction markets, and ZKLT, a China-based producer of adhesives for the automotive industry. As we have discussed in the past, international growth remains a priority for many of the large adhesive and sealant companies like H.B. Fuller, and acquisitions can provide "plug and play" access to new geographies.

Henkel's Adhesive Technologies business unit made two acquisitions during the year, including the Thermal Management Materials business of Nanoramic Laboratories as well as NBD Nanotechnologies, which provides coatings technology that reduces fingerprint visibility and provides stain repellency on various substrates. Henkel also made several organic investments to bolster its production capabilities. One was the expansion of its manufacturing facility in North Carolina, adding its first large-scale UV hot melt production operation outside of Europe. The second was a new hot melt adhesives plant in Mexico to better serve customers in North, Central, and South America.

Following its purchase of Ashland's Performance Adhesives business, which was first announced in 2021, Arkema made several smaller bolt-on acquisitions, including Shanghai Zhiguan Polymer Materials, a manufacturer of hot melt adhesives for consumer electronics, and Permoseal, a South African manufacturer of adhesives for DIY, packaging, and construction applications.

We expect industry leaders in adhesives and sealants to remain on the hunt for acquisitions this year to continue growing market share, add new technologies, and expand geographic reach. On Henkel's fiscal 2022 earnings review call in early March, CFO Marco Swoboda noted that "M&A remains an integral part of our strategy." Although the cost of debt has increased, balance sheets for public companies in the adhesives and sealants and broader chemicals industry are strong and will continue to support bolt-on acquisitions. H.B. Fuller's net debt to EBITDA ratio was around 2.2x at the end of 2022, a reasonable level that will allow the company to continue executing its acquisition strategy. Arkema's ratio was even more conservative at 1.1x to end the year. Debt/EBITDA ratios below 2.5-3x are typically considered to be quite healthy and generally facilitate an active M&A strategy without meaningful restrictions.

Private Equity Getting in on the Action

Private equity firms also remained active in 2022, with several transactions announced in adhesives, sealants, and tapes. Matrix Adhesives Group, which was formed by Goldner Hawn in 2021 through the acquisition of Guy Chemical and Nuco, added Lohnpack in March 2022 and Adaseal in April 2022 and continues to execute a "roll-up" strategy with companies involved in formulating, filling, blending, and contract packaging for the adhesives and sealants market. Arsenal Capital Partners, a familiar investor in adhesives and sealants, sold its portfolio company Meridian Adhesives Group to American Securities in September 2022, capitalizing on its multi-year effort to build Meridian into a leading player in high-performance adhesives. Arsenal also entered the industrial tapes market through its acquisition of ATP Group earlier in the year. We find that some private company owners desire more of the "partnership" model that PE groups can offer (including the benefits of retained equity and incentive options for management teams) versus the "synergistic valuation" that often is the main lever available to large strategic buyers. The free cash flows and fragmented nature of the adhesives and sealants market are highly attractive to private equity buyers, and we expect PE groups to continue targeting the space.

A Balanced Outlook, with Corporate Divestitures Leading the Way

While the global economic picture is cloudy and pockets of weakness certainly exist, our near-term M&A outlook is balanced, and we see potential for deal volume to pick up as we head through the back half of the year. First, supply chains are starting to normalize, leading to greater availability of key raw materials and potentially easing prices for some products. For example, on Sherwin-Williams' most recent earnings call, management noted that the company's budget for 2023 assumes a mid-single-digit percentage decline in raw material costs as compared to 2022. For RPM's most recent fiscal quarter, overall raw material costs were down approximately 3% compared to the prior quarter. Why does this matter for M&A? For one, it increases executives' ability to forecast their own company's performance – a critical precursor to having the confidence to make acquisitions versus preserving "rainy day" capital. And two, it may help provide more stability in earnings performance for acquisition targets, making it easier for potential buyers to assess the outlook, value a business, and ultimately move ahead with an acquisition process.

While debt is likely to remain relatively expensive this year, most banks are still willing to provide financing for acquisitions in the middle market. We are seeing this firsthand through the lens of several sell-side projects we have in the market right now across various chemical sectors. It's worth noting that the current lending market, while incrementally tighter versus a year or two ago, is nowhere near as restrictive as what we saw during the Great Recession, when many banks effectively stopped lending money. Also, private equity funds have amassed a significant amount of "dry powder" (nearly $2 trillion as of the end of 2022) that is ready to be deployed. Our frequent conversations with the private equity community offer a clear indication that investors are highly focused on putting that capital to work despite a more expensive lending market and other general market uncertainty. In short, they want to do deals.

Most economists believe the Fed will stop raising interest rates at some point in 2023, but where rates peak and when that occurs remains a critical question. That said, the rapid pace of rate hikes seen in 2022 is most likely behind us, and the market may be starting to transition to a period of higher but more stable interest rates. A sense of stability amid a dynamic market can often improve the general psyche and sentiment of decision makers involved in M&A processes and support overall activity.

One area that we are particularly optimistic about is corporate divestitures. Over the past several years, executives and corporate boards have increasingly come around to the fact that carve-outs are not a sign of weakness. Rather, they see divestitures as an opportunity to accelerate value creation and free up resources and capital that can be reallocated towards acquisition opportunities, capital projects, or technology development in core segments of their business. Ashland's divestiture of its adhesives business to Arkema is a perfect example of this.

Executives at large specialty chemical companies like BASF, Sherwin-Williams, and Henkel have commented publicly in recent quarters about their ongoing efforts to divest non-core business as a way of enhancing long-term shareholder value. We can confirm that many other companies across the industry share this sentiment, as several of our current sell-side mandates are corporate divestiture projects.

As we noted above, we expect private equity firms to continue targeting the adhesives and sealants space given the fragmented nature of the industry, high free cash flow, and opportunities to extract synergies through follow-on acquisitions. In addition, the steady amount of M&A activity over the past 5-10 years has left many former business owners and executives looking for new opportunities before they sunset their careers, and many of these individuals are finding roles supporting PE firms as they look to acquire companies in this industry.

While the overall pace of M&A this year may be hampered by some of the macro concerns discussed earlier, high-quality companies that are performing well will continue to garner strong interest from buyers. And although public equity valuations (a directional indicator of transaction multiples) have dropped anywhere from 15-25% from their recent peak, the market is critically imbalanced when you compare the number of ready buyers to the supply of high-quality companies considering a sale. The result is a “seller’s market” for companies that offer some combination of proprietary products, strong market positions, above-average margins, and a clear, defensible growth outlook. Companies with these characteristics will continue to command high valuations, with double-digit multiples possible in some cases. Overall, we expect buyers to remain committed to identifying and executing on high-quality acquisitions, and sellers who fit this profile should have opportunities for a successful exit or partnership this year.