Global M&A slows but spotlight on Europe

Activity is off to a slow start in 2015, but bankers expect a rebound in the second half. Europe targets are becoming more attractive while in the US, RMT deals are being explored

JOSEPH CHANG NEW YORK

Global chemical mergers and acquisitions (M&A) activity has been off to a slow start in 2015, but could pick up in the second half as drivers of deal activity remain intact and discussions move forward. European targets could be thrown in the spotlight on the weak euro and prospects for economic improvement.

"First-quarter activity has slowed. Valuations are still strong, appetites are robust with strategics focused on growth, and there's plenty of cash and liquidity. It could just be a function of Q4 2014 ending so strong," said Mario Toukan, managing director and head of chemicals investment banking at KeyBanc Capital Markets.

"2015 will be a good year but we can't predict if it will be better than 2014," he added.

"The drivers of M&A have not changed and we're not witnessing any slowdown directly, but there seems to be a consensus developing that the market may be taking a bit of a breather. Some buyers are complaining that there's not as much deal flow – assets available for sale," said Telly Zachariades, partner at investment bank The Valence Group.

"Private equity firms in particular have observed that the sheer volume of information memos hitting their desks has slowed," he added.

After more than two years of strong M&A activity and valuations, companies have already sold off noncore businesses, and private equity firms have also done their fair share of exits, he noted.

"Conditions remain strong for sellers, and challenging for buyers. Prices are at historical highs while there's a shortage of quality assets on the market," said Leland Harrs, managing director and head of chemicals at investment bank Houlihan Lokey.

"While the current deal flow and activity appears slow, there is a significant amount of activity in discussion that will lead to more deals in the next several quarters," he added.

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> **MARIO TOUKAN**
> Managing director, KeyBanc Capital Markets

Players seeking to divest may find it hard to top today's seller's market, and the window for robust exits won't be open forever, the banker noted.

"Conditions suggest the M&A market is at or near the top in terms of valuations. There's a short supply of assets and an excess supply of capital," Harrs said.

"If a seller is choosing not to sell now, it may believe the opportunity to improve EBITDA [earnings before interest, tax, depreciation and amortisation] outweighs the attractiveness of the current market," he added.

"2015 will be a strong year for chemical M&A. Several significant transactions have been announced to date and there were \$39.6bn of specialty and commodity chemical transactions announced in 2014 that are expected to close in 2015," said Allan Benton, vice chairman and the head of the chemical practice at investment bank Scott-Macon.

This includes Germany-based Merck KGaA's \$17bn deal to buy US-based Sigma-Aldrich (life science research chemicals) set to close in mid-2015. US-based titanium dioxide (TiO_2) producer Tronox closed its \$1.64bn buyout of US-based FMC's soda ash business in April. US-based Albemarle closed its acquisition of Rockwood Hold-

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ings (lithium, surface treatment) for $6.2bn in January.

"We are still incredibly bullish on M&A activity. It's an exceptional seller's market and not a bad buyer's market because you can buy quality assets. We had been expecting some kind of M&A fallout from $50 oil but it's not showing up," said John Beagle, managing director and co-founder of investment bank Grace Matthews.

"Yet it's a time of many changing variables and often that results in a slowdown. With oil prices down and the strong US dollar, we expected more deal uncertainty," he added.

Main drivers for M&A activity include major transformation, portfolio adjustments, expansion of the core business, and the search for good values, said Karl Bartholomew, vice president, Americas at ICIS Consulting. However, the risk component from volatile oil prices could account for the current slowdown in deal activity, he said.

"A year ago, everyone tended to focus on what the market looked like – high oil prices and cheap US natural gas feedstock. But now there are a wide range of scenarios. What happens if oil stays at around $60/bbl for the next five years? What if it rises to over $100/bbl? The risk profile of an acquisition or investment changes," said Bartholomew.

Unexpected moves in the M&A market could happen as the market becomes saturated with the usual consolidation deals, noted Bernd Schneider, managing director and global head of chemicals at investment bank N+1.

"M&A has already come to a natural end in certain sectors where it is limited by antitrust. So forward or back integration, and moves into adjacencies will become more prevalent. It will be more difficult to predict who the buyers will be," said Schneider.

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Partner, The Valence Group

EUROPE IN FOCUS

Europe could play a greater role in global chemical M&A going forward, as optimism on a recovery takes hold, financing becomes exceptionally cheap and the euro weakens versus the US dollar. All these factors are being driven by the European Central Bank's quantitative easing (QE).

"This ECB injection is causing liquidity to pile up worldwide, and one consequence is that even laggard businesses are now saleable," said Schneider with N+1.

In March, Netherlands-based DSM agreed to sell a 65% stake in its caprolactam and acrylonitrile (ACN) business to private equity firm CVC Capital Partners representing a total enterprise value of €600m.

More buyers from emerging markets are also entering the European chemical and downstream landscape, evidenced by Mexichem's acquisition of Germany-based polyvinyl chloride (PVC) producer Vestolit in December 2014 for €219m, and ChemChina's bid in March 2015 to buy Italy-based tyre maker Pirelli, noted Schneider.

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LELAND HARRS
Managing director, Houlihan Lokey

"ChemChina is a big player in rubber chemicals and materials, and is now looking to downstream integration," he said.

And moves into adjacent markets could pick up steam. France-based industrial conglomerate Saint-Gobain is bidding to buy Switzerland-based construction chemicals and materials firm Sika in a heated battle with the latter's management and certain shareholders that oppose the deal.

"The trend of portfolio streamlining that began in the '90s in order to concentrate on core activities and avoid the 'conglomerate discount' is now drifting back as companies tend to broaden their scope and diversify risk," said N+1's Schneider.

"We see more portfolio restructuring and deals to come from Europe than the US. There could be better value there because growth has been subdued for years. Plus, the strong US dollar has made European targets more affordable," said The Valence Group's Zachariades.

"The spotlight is on Europe. Some US companies will revisit prior targets in Europe – they're now looking at the same euro valuation but with a stronger dollar," he added.

While the European target asset can be cheaper in absolute dollars, a Europe-based business will likely sell and book profit in euros as well. Thus, there isn't an advantage from an earnings standpoint, but the asset can simply be cheaper to acquire.

"People don't make long-term decisions to arbitrage currency. But at the margin it can give you an edge," said Houlihan Lokey's Harrs.

Yet an important advantage can come in the form of financing deals. Euro-denominated debt is simply much cheaper from a rate perspective than US debt, as many sovereign bonds yield less than 1% or even have negative yields in some instances.

US-based companies with significant European assets such as PPG Industries and Huntsman have recently raised euro-denominated debt at far cheaper rates.

Coatings giant PPG has been active in Europe on the M&A front lately. In April, the company completed its acquisition of France-based auto OEM adhesives and sealants (A&S) firm REVOCOAT – a company with annual sales of around $100m.

PPG is also is in discussions to buy France-based aerospace A&S firm LJF (Le Joint Francais), which is a licensee of its aerospace sealant technology. It expects to close the deal in the second half of 2015.

Europe's coatings market is far less consolidated than in the US with more independent country-oriented companies. Asia likewise has a fragmented market.

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BERND SCHNEIDER
Managing director, N+1

"Over time, we will see more deals outside the US," said PPG chairman and CEO Charles Bunch.

Within Europe, rumours have been swirling around a potential buyout of Switzerland-based Clariant by Germany-based Evonik.

In March, JP Morgan Cazenove analyst Ben Scarlett said Evonik is in an acquisition mood and Clariant would fit its aspirations quite perfectly, despite the "pricey" tag of Swiss francs (Swfr) 23 per share (total value of Swfr7.3bn) suggested by media reports.

"If you look at Clariant's businesses, there is some overlap – catalysts, for instance, which makes 20% of Clariant's EBITDA, as well as Clariant's surfactant technology, which it sells to the consumer sector. Another overlap could be plastics and coatings, where 40% of Clariant's EBITDA come from," said Scarlett.

REVERSE MORRIS TRUST (RMT) DEALS

The blockbuster deal signed thus far in 2015 is the merger of Dow Chemical's chlor-alkali and derivatives business with US-based player Olin in a $5bn Reverse Morris Trust (RMT) transaction.

This tax-advantaged deal will result in Dow shareholders receiving around 50.5% of the shares of the "new" Olin.

An RMT transaction can be an attractive option for a company aiming to sell off large assets with very low book value – this is typically the case where the assets have been built/owned for many years and thus have been depreciated down to near zero. Where a regular sale would trigger huge capital gains taxes, an RMT would be tax free while meeting certain stringent conditions.

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President, Young & Partners

"The RMT method is being considered by a number of chemical companies in the US. Since it is a US tax law centric structure, it will always involve a US company as the primary organizer," said Peter Young, president of investment bank Young & Partners.

"On the other hand, the number may not be very large this year and next because many potential candidate pairings will not meet the rules. Often there is an obstacle with regard to relative size, fit, etc," Young added.

Candidates that could engage in RMT deals include MeadWestvaco, which plans to spin-off its specialty chemicals business (activated carbon, pine resins, asphalt additives, etc), as well as Air Products, which has a long-standing chemicals business (electronic chemicals, epoxy curing agents, polyurethane additives, etc), according to The Valence Group's Zachariades.

"There will be more RMTs because it's a very powerful tool to mitigate tax leakage issues," he noted. "But you have to find a counterparty with the right size and portfolio of businesses which is never an easy task. That's why you don't see too many of them."

GOING PRIVATE?

One aspect of the chemical M&A market that has been scarce for several years is public companies going private. However, this type of activity could pick up going forward, noted KeyBanc's Toukan.

In April, private equity firm New Mountain Capital agreed to buy US publicly traded cleaning and maintenance chemicals company Zep for $692m, including the assumption of net debt. The purchase price of $20.05/share was a premium of 17% to Zep's prior closing price. KeyBanc advised New Mountain Capital on the deal.

"In chemicals, we haven't seen many 'go-privates' but the space is filled with small- to mid-cap companies that could have more flexibility under private ownership," said Toukan.

"We see more of these in the next 12-18 months as going private still makes sense. As a small cap company, you are restrained to some extent, without full access to capital markets," he added.

Small cap companies are those in the range of up to $2bn in market capitalisation.

"If you're a small cap public company of $1bn-2bn trying to figure out an end game, it's an uneasy situation. We might see some combinations of mid-size chemical companies," said Grace Matthew's Beagle.

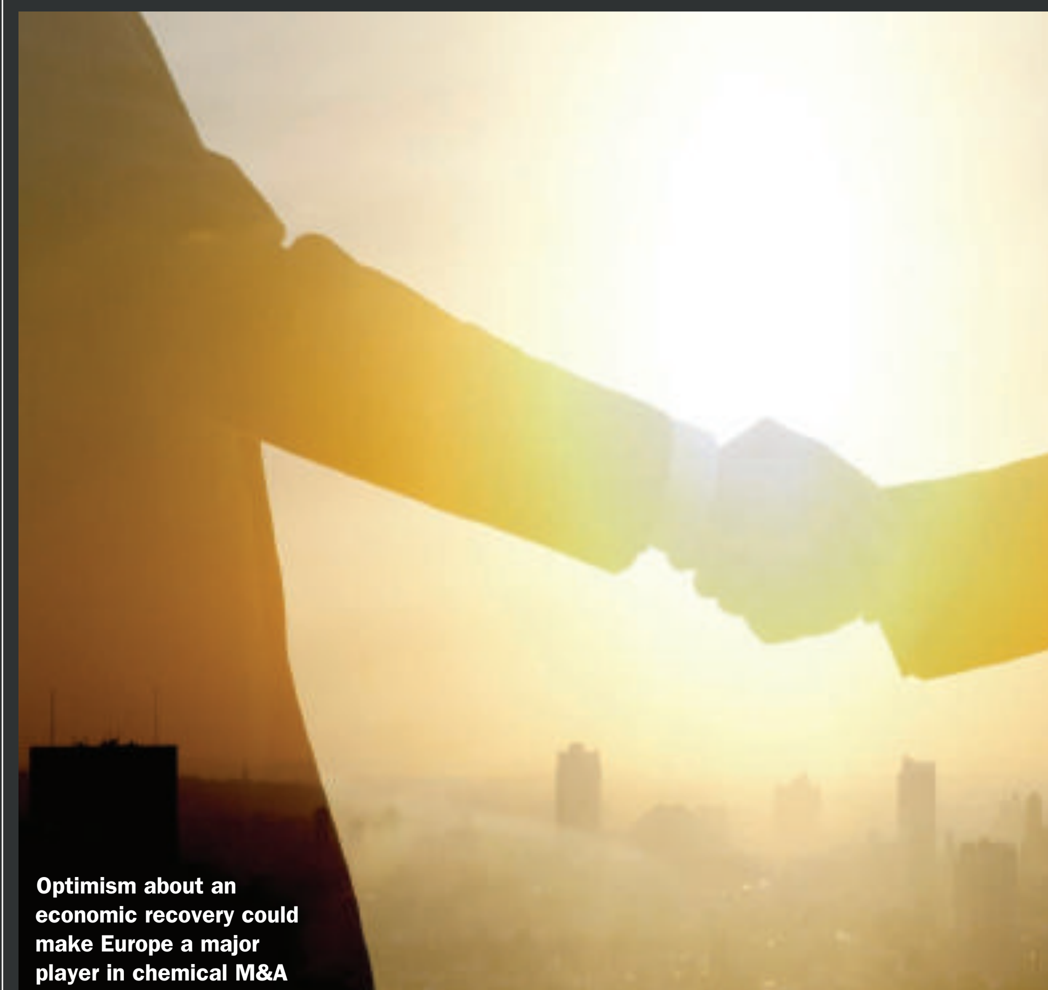
LEVERAGE AND VALUATIONS

In the meantime, private equity firms remain active and interested on the buy side.

"Private equity firms that are very focused on the chemical space are aggressively chasing all the assets becoming available," noted KeyBanc's Toukan.

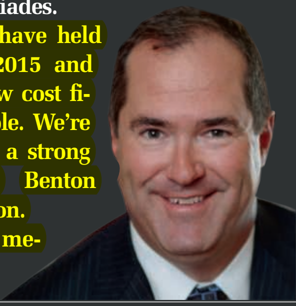
While the debt financing market is still strong, with leverage of 5-6x EBITDA possible, depending on the asset, "it has come down just a little bit – perhaps a quarter turn (0.25x)," he added.

"There's definitely been a slight cut in lever-



Optimism about an economic recovery could make Europe a major player in chemical M&A

age levels of a quarter or half turn (0.5x), driven by regulatory constraints on large banks. There is also some concern that interest rates will rise in the second half," said The Valence Group's Zachariades.



"Valuations have held up so far in 2015 and there is still low cost financing available. We're still looking at a strong market," said Benton with Scott-Macon.

In 2014, the median specialty chemical M&A multiple was 9.9 times EBITDA versus 9.5 times in 2013, Benton noted.

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Specialty chemical deals over $1bn in size commanded a premium at 11.0 times EBITDA in 2014 versus 9.6 times in 2013. For commodity chemicals, the median deal multiple in 2014 was 7.0 times EBITDA versus 6.9 times in 2013, the banker added.

"Valuations are high so it's a good time to look at strategic options on the sell side," said Beagle with Grace Matthews.

"However, the challenge for large public companies is that with public equity values also high, you must have a long-term strategic reason to sell. Yet we're also seeing that – companies selling off commodities and moving into more specialization," he added.

While potential sellers typically want to see high valuations, it can be a hindrance in a low yield environment when returns on the proceeds are negligible.

"Many would-be sellers could realise 10x EBITDA and beyond in a sale but if there is little return on the cash proceeds, they may rather stay on and run the business," said Schneider.

"With the lack of yield, some managements may be more inclined to continue on and neglect the risk inherent in their business models until it is too late," he added.

In the meantime, certain private equity firms will "play multiple arbitrage", selling off businesses earlier than their typical holding period of 3-5 years, he noted.

HOT SECTORS

Certain sectors appear ripe for consolidation and deal activity.

The Dow/Olin deal in chlor-alkali, along with the closing of the Solvay INEOS polyvinyl chloride (PVC) joint venture could pressure others to seek consolidation opportunities in this chain.

"There will continue to be deals in the chlor-alkali and PVC arenas because strategic players are voting to exit or partially exit or to get bigger, depending on their business positions and their view of the industry outlook, or the relative role of the businesses in their overall strategic portfolio," said Young of Young & Partners.

"The ingredients business – food, pharma, personal care – will be attractive going forward," said KeyBanc's Toukan.

"Construction is also an interesting area, as in the US, we still haven't seen a full recovery in the sector," he added.

A. Schulman's announced acquisition of Citadel Plastics Holdings for $800m in March highlighted the growing interest in thermoplastics and composites assets.

"For the plastics industry, the Schulman-Citadel deal represents how strategic players are trying to extend their product capabilities and how broad-based they are seeking to get," said KeyBanc's Toukan. KeyBanc advised Citadel on the sale.

Schulman gained exposure to new end markets such as healthcare, aerospace and defence, and oil and gas, he noted.

In 2014, Citadel Plastics had sales of around $525m and EBITDA of $75m. The $800m purchase price represents a healthy EBITDA multiple of 10.7 times.

Coatings, adhesives and sealants, and certain lubricants – formulated chemicals – offer acquisition opportunities which can lead to cost savings and growth, noted Beagle with Grace Matthews.

"For paints and coatings valuations, I don't see it getting any better. Public valuations at 14-15x EBITDA are at a 60% premium to historical values, and those are directly linear to M&A multiples," said Beagle.

Agricultural chemicals in particular are attracting attention on the M&A front, noted Benton from Scott-Macon.

In April, US-based FMC closed its acquisition of crop protection firm Cheminova from Denmark's Auriga Industries for around $1.8bn. Earlier in February, US-based Platform Specialty Products completed its $3.5bn buyout of Arysta LifeScience, also in crop protection, from private equity firm Permira. Platform in 2014 completed two deals in ag chemicals – US-based Chemtura AgroSolutions for $950m and 2m shares of Platform stock, and Belgium's Agriphar for €300m.

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KARL BARTHOLOMEW
Vice president, ICIS Consulting

As for the return of the mega deals of the pre-crisis 2000s, don't hold your breath, said Young of Young & Partners.

"With the exception of the Sigma-Aldrich/Merck KGaA deal, we do not expect the return of mega deals. The deal is somewhat unique as to the drivers. If any happen, they will likely be special situations, not driven by normal strategic considerations," said Young. ■

Additional reporting by Jonathan Lopez in London