M&A The path ahead

Large-scale mergers and acquisitions (M&A) continue to transform industry. While the parade of multibillion dollar deals cannot go on forever, dealmakers expect the strong activity to continue for the foreseeable future.

Multibillion dollar M&A deals have captured attention in the chemical industry over the past several months, particularly in agricultural chemicals. DowDuPont Inc., China National Chemical Corp. and Syngenta AG, and the swirl of rumors around agchems consolidation—most notably Bayer AG's pursuit of Monsanto Co.—have made the biggest headlines. Air Liquide SA closed on its $13.4-billion acquisition of Airgas, Inc. in June, and Sherwin-Williams Co. announced plans to buy Valspar Corp. for $11.3 billion in the spring. Seven chemical transactions valued at $1 billion or more announced have been announced this year, according to *CW* research. This does not include DowDuPont, which was announced in December 2015.

"The second half [of this year] should be fairly strong like the first half, and that will likely continue into 2017," says Nadim Qureshi managing director with investment firm WL Ross & Co. LLC (New York, New York). While macro risks play out in the background, industry CEOs remain focused on carrying out their plans, bankers say. Those plans often involve M&A as companies aim to capture incremental growth, expand in targeted sectors, and generally improve portfolios. "Clearly, consolidation is going on, but I think today a successful CEO is a portfolio manager," says Kevin Yttre, managing director at investment bank Grace Matthews Inc. (Milwaukee, Wisconsin).

To peak or not to peak?

A high level of M&A activity has occurred this year. *CW* has counted 177 M&A transactions in the chemical industry and adjacent services, such as distribution and logistics, so far in 2016, with the total deal value approaching $80 billion; both figures are higher than last year. The large transactions that have dominated the headlines have been buttressed by a number of midsize and small deals, many of them divestitures and corporate carveouts. In some cases, these deals have been a direct consequence of the larger transactions, but mostly they represent an acceleration of the industry's normal portfolio reshuffling. Some recent transactions have involved EBITDA multiples well into the teens.

This trend would seem to indicate a peaking market—but not all M&A market watchers agree on this point. "In my view, there has been a fundamental shift," Yttre says. "Everyone has talked about low interest rates and low returns on fixed income. I think you have the private equity community willing to accept lower return, strategic [corporate] buyers willing to accept lower returns, and these translate into higher valuations and a longer market peak."

Bankers note both private equity firms and companies still have significant amounts of cash available. "Private equity firms have more money and the strategic buyers have more money and liquidity than they've ever had," says David Bradley, global head of chemicals and chairman of industrials with Jefferies LLC (New York). "This can sustain things for a while if the world economy holds up." Bradley also notes that valuation multiples are being inflated by agchem deals, which typically fetch higher valuations.

Some bankers see a peaking market but add activity and valuations could remain elevated for a while. "I think the market has peaked from a valuation perspective, and the question is what's the next phase," says Mario Toukan, managing director and head of chemicals with KeyBanc (Cleveland, Ohio). "I think ... the landing is going to be soft and prolonged." The dance is still going. "Two years ago, we were saying to people that this might not last for two more years," Yttre says. "I wish I could say how many more it will be now, but there is no indicator that it is slowing in the near term."

Focus, focus, focus

Three factors argue for sustainable M&A momentum: readily available deal financing, greater emphasis on portfolio management, and sluggish economic growth. All three work to increase the focus on and appeal of M&A transactions.

Financing markets paused in the first quarter of this year but have returned over the past few months. "In general, deal financing has picked up and gotten better," says Ryan Meany, managing partner with private equity firm Edgewater Capital Partners (Cleveland). "It was a little choppy earlier in the year, but it got better starting around late March."

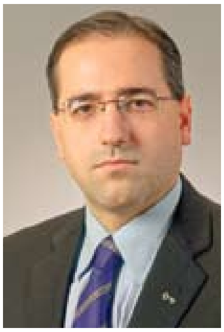
June's Brexit vote was a very brief hit to financing markets, but debt and equity markets have since shrugged it off. In the long term, Brexit's potential impact is difficult to gauge, bankers say.

Today, interest rates are slightly higher than in 2015 but still attractive by historical standards for borrowers, according to Bradley. He adds rates are moving down to 2015 levels. The slowdown earlier this year followed a sell-off in equity markets, and debt markets have rebounded along with equity markets, he adds.

Meanwhile, portfolio reshuffling—which has always underpinned chemicals deals—is taking on a new urgency in many cases. "It's no longer about empire-building; it's really about portfolio management," Yttre says. "If you can sell a division of your business for more than it's worth to you, you're probably going to sell it. In the past that may have been viewed as a sign of weakness, but that's not the mind-set anymore."

Indeed, many of Grace Matthews' recent transactions have been corporate divestitures or carveouts. "I'd say around half our business right now is corporate carveouts," Yttre says. "Two years ago, it was more privately held business and private equity deals."

BRADLEY: *Strong liquidity can sustain things.*



TOUKAN: *Activism happening in private.*

Large transactions, such as DowDuPont, are expected to drive even more divestitures, although probably not until 2017. "I think we will see more divestitures once they ... figure out what doesn't make sense in the portfolio," Toukan says. "We'll see some postclose housecleaning by corporates." Deal-driven regulatory pressure may also drive some divestitures. US antitrust authorities forced Air Liquide to sell some assets in conjunction with the Airgas deal and are extending their review of Sherwin-Williams' acquisition of Valspar.

Still, strategic considerations are likely to be the main driver. "People are trying to get more efficient, to hone and focus, so that means they will be trim some business units they view as ancillary ... as they get these massive deals done," Meany says.

Companies are also evaluating their portfolios more intensively, according to Qureshi. "The corporate strategy cycle for most chemical companies used to be around five years," he says. "Every five years companies would come around and think about their portfolios and what needed to change. But more recently there has been more urgency on corporate strategy." This was partly driven by shareholder activists, who have focused management teams around the idea of thinking like "internal activists," Qureshi says. But strategic position is an important part of it, as well. "Some companies have figured out core and noncore businesses," Qureshi says. "Core can be defined as where there is a competency fit, where there is a raw material fit, where there is an integration fit."

Shareholder activists themselves have been quieter this year than in 2015, but that does not mean they have gone away. Not all activism goes public, Toukan notes. "A lot of activism these days is private," he says. "They try to sort through some kind of arrangement with management teams."

Activism aside, sluggish global economic growth is arguably the biggest reason for the shift in corporate mind-set. "If you look at organic growth opportunities, they have slowed down for these companies," Qureshi says. This is partly due to fewer breakthrough molecules being discovered and largely to lagging market growth. Chinese growth has slowed and, at

Kind of a big deal*

(figures in millions of US$)

Target	Acquirer	Seller	Deal size	Target region	Target sector
Syngenta	ChemChina	Syngenta	43,000	Europe	Ag/fertilizers
Airgas	Air Liquide	Airgas	13,400	North America	Industrial gases
Valspar	Sherwin-Williams	Valspar	11,300	North America	Specialties
Axiall	Westlake Chemical	Axiall	3,800	North America	Basics
Air Products' performance materials business	Evonik Industries	Air Products	3,800	North America	Specialties
Chemetall	BASF	Albemarle	3,200	Europe	Specialties
Nexeo Solutions Holdings	WL Ross Holding	TPG Capital	1,670	North America	Distribution
Novacap	Eurazeo; Merieux Development	Ardian	784	Europe	Diversified
Nuplex Industries	Allnex; Advent International	Nuplex Industries	724	Asia	Specialties
BASF's industrial coatings business	AkzoNobel	BASF	531	Europe	Specialties

*Ten largest chemical M&A deals by value announced so far in 2016. Excludes some transactions involving nonchemical assets. Source: *IHS Chemical Week* research times, fallen short of expectations, and Europe remains mired in a years-long slump. Growth in the United States—which Qureshi views as the industry's best large market—has been mostly stable though hardly stellar.

CEOs are, by and large, confident enough to do deals but not particularly optimistic. "Globally ... there is not a lot of organic growth and that is helping drive more M&A. Buyers do not think the world is going to end, but they do fear that growth is stagnating," Bradley says.

Hollow in the middle

The lack of growth and lack of certainty has led companies to focus on core competencies—often to the exclusion of other areas. "Companies have realized that the diversified model may have to shift a little bit," Qureshi says. Many companies, including Ashland Inc., Air Products, FMC Corp., and PPG Industries Inc., have reshuffled assets to focus on a handful of core business lines and sometimes fewer than that. The DowDuPont deal will produce three new companies with more specific foci and less diversification. Even deals that may look like diversification plays often have an underlying commonality. For example, Albemarle Corp. saw similarities between lithium and bromine when acquiring Rockwood Holdings Inc.

This focus is particularly acute for diversified chemical manufacturers that are not in the industry's top revenue tier. "I do see some of the bigger-to-middle-tier companies getting a little smaller and a lot more concentrated," Meany says. "The tiers are going to spread out over time. So, you'd have fewer players at the top ... and a broad breadth of midtier players who will be more focused and concentrated. They will have one or two market segments."

"You end up going from three or four big silos [at diversified manufacturers] to more specialized chemical companies that are in ... downstream specialties or commodities or specific product sectors," Qureshi says.

This shift does not mean that large, diversified chemical manufacturers will go away. BASF, for example, does not appear to be interested in getting smaller; postspin-off Dow Chemical Co. will retain some degree of diversification. But diversified companies away from the very top tier are increasingly honing in on specific markets, and many bankers say such companies are unlikely to retain their present forms, at least in the medium-to-long term.

Interestingly, this does not necessarily mean that the industry will consolidate in the sense of there being fewer companies. "As we hear talk about consolidation in the industry, I'd argue that the companies we've lost due to acquisition have been offset by the ones we've created through spin-offs and carveouts," Bradley says. He notes Bayer is pursuing Monsanto but recently spun out Covestro AG. Ashland bought ISP Inc. and Hercules Inc. then sold what are now Nexeo Solutions LLC and Solenis LLC. Some sectors, such as distribution and coatings, are consolidating in the traditional sense, but the industry as a whole appears to be engaged in more of an extended reshuffle.

When the shuffling stops—or at least slows a bit—more focused chemical companies appear likely to emerge. "As these companies absorb each other and merge, there's quite a bit of opportunity for divestitures and spin-offs," Qureshi says. "This portfolio pruning will continue for quite some time." —VINCENT VALK