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Guest Article: Chemical Makers Keep Drawing Buyers

Spin-offs of the proposed merger of Dow and DuPont and other mega mergers will create buying opportunities for PE firms that invest in coatings, adhesives and sealants

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The U.S. specialty chemicals sector remains an attractive sector for middle-market investors, despite modest global growth, the crude oil decline, the commodity capital cycle and the recent dip in public market valuations (as measured by a proprietary index that tracks the relative valuation of the specialty chemical sector), which may indicate lower multiples for acquisitions in the future. We expect deal flow over the next two to three years to continue to remain healthy, which, combined with an attractive investment thesis, could create substantial opportunity for private equity buyers.

The growth and earnings outlook over the next several years remains attractive for U.S. specialties. Growth in the U.S. is expected to be modest but stable, with favorable raw material tail wind from low-cost natural gas and crude oil, buoying the basic chemical feedstocks derived from them. The commodity capital cycle has featured new capacity additions for a series of basic chemical feedstocks in 2015 (ethylene, propylene, methanol, benzene, chlorine, and para-xylene) of 20 million metric tons (m.t.) with planned new capacity in 2016 of 25 million m.t. In addition, Chinese expansions represent approximately 14 million m.t. in 2015 and an estimated 8 million m.t. in 2016. We believe these capacity expansions will continue to exert pressure on basic chemicals prices, and given that they constitute raw materials for specialty chemicals, will continue to have a positive impact on specialty chemical earnings.

Deal flow in specialty chemicals will likely be bolstered due to unique dynamics in the marketplace. For example, the broader chemical industry is undergoing a significant shift in industry structure driven by shareholder value activism and board pressure to optimize portfolios in a bid to generate more value for shareholders. Large unprecedented mergers/spins-offs — e.g. the planned merger of Dow Chemical Co. and DuPont Co., with the planned spin-off of three independent publicly-traded entities in agriculture, material sciences and specialty products — could present buying opportunities for PE players, as a combined Dow-DuPont will likely need to divest select businesses to meet antitrust guidelines. Other large diversified players have been rumored to be looking to pursue merge and restructure strategies as well, and the resulting business platforms will likely divest specialty businesses that do not fit from a market or technology perspective.

While the specialty chemicals sector has consolidated modestly in recent years, there remains a plethora of small to mid-sized specialty chemical companies with a high degree of sales exposure to the U.S. market, with opportunities to consolidate further. Examples of segments that present consolidation opportunities include coatings, adhesives, sealants, elastomers and surfactants. These segments include a range of private companies that present opportunity for "roll-ups" to achieve greater economies of scale and scope, with a range of exit options.

Joseph Coote

For buyers, especially middle market PE firms attempting a roll-up strategy in the sector, mid-sized specialty chemical companies present a range of levers to capture value during their investment horizon:

Entry Valuation and Multiple Expansion — targeting middle market specialties which trade at a 2x EV/Ebitda discount to their large cap counterparts, a discount that may be even higher for privately held targets. A successful roll-up strategy typically leads to multiple expansions in the 2-4x range.

Pricing and Margin management — sub-optimized in a data starved decision-making environment typical in mid-market companies, and in our experience one of the most powerful levers to create value.

Acquisitive Growth — generally under-leveraged at mid-market companies due to limited resources and a conservative strategy. Mid-market companies can benefit from a PE-backed acquisitive growth / roll-up strategy.

Systematic Operating Management — middle market firms can benefit from a systematic and focused operations management and performance improvement effort, especially given the typical complexity in products, customers and assets. These efforts often lead to sizeable gains in operating cost productivity, and often capital deferment and cash release as well.

Management Upgrades — selectively bringing in managers with complementary skills and scale-up/exit experience can result in substantial upside capture from growth and performance improvement initiatives.

One good example of a widely reported "roll-up" in a specialty intermediate and derivative market is Taminco Corp., a producer of alkylamines and derivatives, key building blocks for the pharmaceutical, agrochemical, animal feed, and water treatment industries. The company was established in 2003, as a carve-out from the Belgian pharma company UCB, and purchased by Dutch private equity investor NIB Capital (renamed AlpInvest in 2004) for €115m. From its origin as a chemical intermediates supplier, Taminco developed its portfolio with products having strong niche specialty chemical positions. Its roll-up included acquiring the amines business of Air Products, nearly doubling the firm's size and firmly positioning itself geographically as the global market leader in methylamines, methylamine derivatives and higher amines. Other components of the roll-up included businesses acquired from Akzo Nobel and Arkema. CVC purchased the business in 2007 from AlpInvest for €0.8 billion (~ 7x Ebitda), adding value through operational performance improvement and commercial excellence. In 2011, CVC sold the business to Apollo for €1.1 billion (~7x Ebitda), which went on to IPO the company on the NYSE in 2013. Eastman Chemical Co. recently acquired the public entity for $2.8 billion, at a valuation of approximately 10.4x Ebitda, making it the second largest acquisition in the company's history, and a classic example of how value can be created at each step in the sale process ending with a sale to a strategic.

Pranav Garg

In summary, the U.S. specialty chemicals sector presents an attractive investment environment for the following reasons:

Stable Market Exposure — most of the mid-sized specialty chemical firms have significant exposure to the US market which presents a stable, modest growth outlook.

Resilient Earnings — U.S. specialty chemical companies have demonstrated stable earnings in recent years. The outlook remains attractive, with crude oil and commodity capital cycle effects providing a raw material tailwind in the near-term.

Attractive Valuation Potential — Middle market specialty chemicals firms trade at a discount to their large cap counterparts, offering potential value capture from multiple expansion during the holding period of the investment.

Many Levers to Create Value — aside from the upside from attractive valuation, middle market specialty chemical companies offer many value creation opportunities through acquisitive growth / roll-ups and enhanced operational and commercial management. There is a history of successful roll-ups in the industry.

Healthy Deal Flow — In addition to a plethora of small and medium sized private companies, we expect significant portfolio shaping and pruning among large diversified chemical companies, leading to a healthy deal flow in the sector.

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