CRA Insights

Charles River Associates

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Chemical Sector M&A: 'Back to Fundamentals'

The economic impact and ongoing uncertainty caused by COVID-19 has resulted in delays and cancelations of chemical mergers and acquisitions. However, it also set in motion the conditions that are likely to create attractive M&A opportunities as companies look to capitalize on, or reposition in, a changing business environment. Whether an investor group looking to buy underperforming assets or assets that they believe will benefit in a post-COVID world, or a chemical company seeking to reposition and focus its portfolio to create and enhance value, there are long-lasting structural changes for acquirers to consider in the M&A calculus.

The global health crisis is redefining the attractiveness of many end markets served by the chemical industry, raising the cost of doing business (e.g., to ensure public and employee health and safety), and altering global supply chains. Moreover, the drive for scale and greater portfolio focus will fuel the continued restructuring of the chemical industry. We believe these changes mean that more than ever operating companies and other investors need to focus on the fundamentals that will drive value and contribute to the success of M&A activity in this new environment.

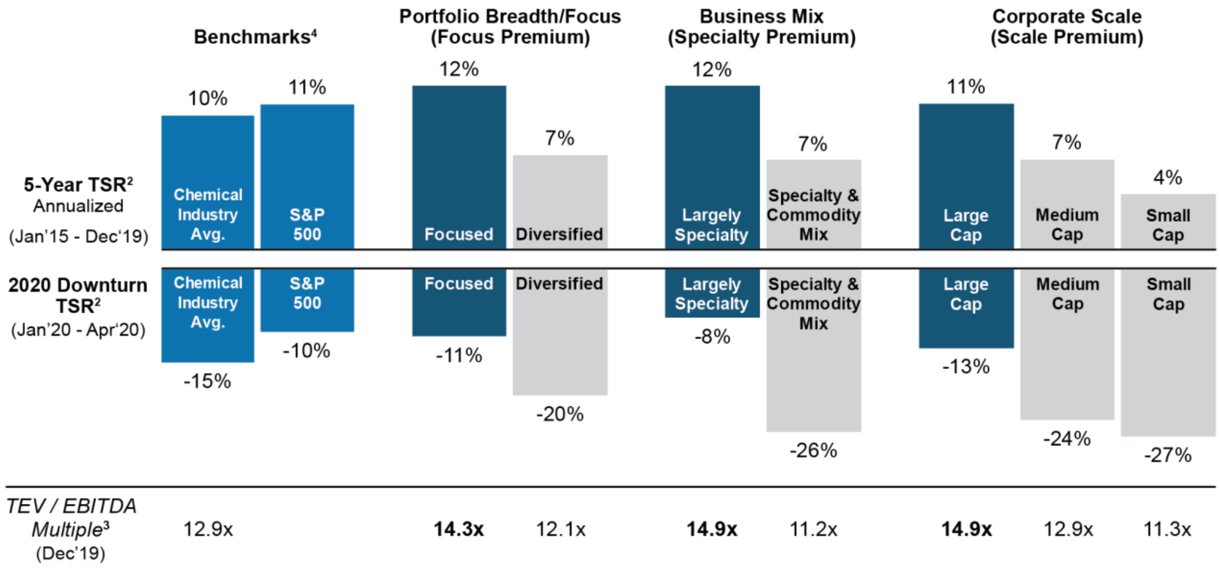
In this *Insights*, we discuss the factors that have contributed to leading performance in the sector, the impact of COVID-19 on the forces driving change in the chemical industry, and the implications for value-creating M&A strategies and programs.

Chemical company performance drivers

In the years leading up to the COVID-19 pandemic, the chemical sector experienced extensive restructuring. Three strategic themes have driven the industry reshaping: the pursuit of scale; shifting toward higher-value specialty businesses; and a move to create more focused and coherent corporate portfolios. Investors have rewarded companies that have followed these strategies with higher total shareholder returns (TSRs) and generally sizable EBITDA multiple premiums.

Our analysis of over 70 publicly traded chemical companies over the last five-year period of generally solid economic growth (2014–2019) reveals that leading companies delivered, on average, five percentage points higher annual TSRs and commanded 200 to 300 basis points higher EBITDA multiples (see Figure 1). Our analysis also reveals the large multiple premiums associated with portfolio focus—a specialty-oriented business mix and scale. Moreover, these same factors: portfolio focus, specialty mix, and scale allowed stronger performers to better weather the economic storm driven by the global pandemic, as measured by performance of the market during the difficult first four months of 2020.

Figure 1: Total shareholder return of chemical companies (past 5 years v. first 4 months 2020[1])



Notes:

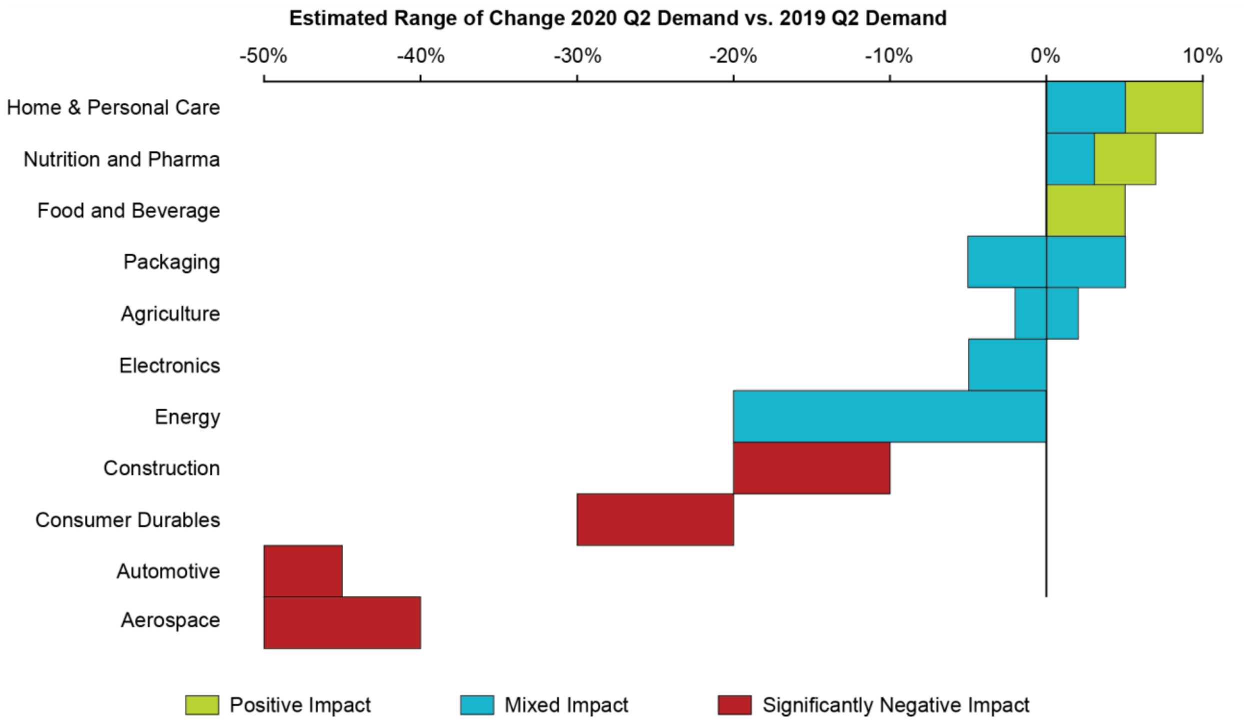
1. CRA segmented ~70 listed chemical companies in the US and Europe along three dimensions:
   - **Business mix** – defined by principal characteristics of a company's main lines of business; companies were classified as either largely specialty or specialty/commodity mix
   - **Portfolio breadth/focus** – defined by number of business segments and their degree of relatedness; companies were classified as either focused (i.e., few closely related businesses or one core business) or diversified (i.e., more than two major businesses with limited meaningful linkages between them, e.g., in market, technology, or manufacturing)
   - **Corporate scale** – defined by company's market capitalization; companies were categorized as large cap (greater than $10bn), mid cap (between $3bn and $10bn) and small cap (less than $3bn).
2. Total Shareholder Return (TSR) based on market capitalization weighted average of TSR of companies in each segment. 5-year TSR: 1/1/2015 - 12/31/2019; 2020 Downturn TSR: 1/1/2020 - 4/30/2020
3. Average TEV/EBITDA multiples of the segment; total enterprise value (TEV) as of 12/31/2019; company reported EBITDA of FY 2019
4. Net total return of S&P 500 (including reinvestment of dividends after the deduction of withholding tax)

Source: Capital IQ and CRA analysis

Chemical industry performance in the coronavirus era – So far

Being positioned in attractive markets is a critical underpinning of company strategy, a dynamic starkly illustrated in the COVID-19 era where end-market positioning was key in driving the relative performance of chemical producers. Companies like Ecolab and Stepan serve essential end markets such as cleaning and disinfecting, hygiene and sanitation. Packaging and pharmaceuticals, among others, have also fared well. Conversely, companies with a significant share of their business serving the auto, consumer durable, hospitality, or energy sectors have not weathered the downturn well and potentially face longer-lasting demand contraction. Published results from the second quarter 2020 reinforce the impact of portfolio positioning on revenue growth (Figure 2) and earnings performance.

Figure 2: Indicative performance of key chemical industry segments, Q2 20



Source: Chemical company Q2 earnings presentations

Regional positioning and mix have also played an important role in driving performance as the extent and timing of the impact and trajectory of the recovery from COVID-19 has varied considerably across regions. Companies with sizable positions in China tended to perform better in Q2 2020 than those with sales primarily in the US and Europe. Another important factor that has driven a company's relative resilience to a downturn has been balance sheet strength. In particular, the worst performers during the downturn have been small cap companies with high leverage; these averaged a 38% TSR reduction over the first four months of 2020.

Looking forward – the impact of COVID-19

For chemical industry M&A, COVID-19 is broadly changing the risk-reward balance across the sector. The crisis is changing what's attractive in the chemical industry, raising the cost of doing business and thereby the importance of business scale. The continued uncertain environment with the recent re-emergence of COVID-19 hot spots is raising risks and reinforcing the importance of end-market positioning. In evaluating M&A opportunities in the context of this changing business environment, we believe acquirers and sellers alike can consider the impact of COVID-19 in the following three categories:

1. **Established trends accelerated by COVID-19**. Established trends "turbo charged" by the pandemic are rapidly becoming part of the fabric of how we work, live, and spend our time. These include: "essential" and in-the-home/WFH-related end markets; the rapid growth of telemedicine; and the shift from global trade to a more regional paradigm. The focus on green/sustainable solutions is growing and are increasingly seen as central to business management.

2. **Major trends whose importance will be materially affected by the duration and severity of the pandemic**. Trends may be more enduring due to a longer lasting pandemic and/or where vaccine development and implementation is slow. Some of these trends include: the use of public transport; the growth and changed shape of travel and leisure; and a shift away from dense urban environments towards the suburbs. Evidence to date is mixed with the recent second wave of COVID-19 but with apparent progress on vaccine development.
3. **Temporary impacts expected to recover or 'return to normal' with an economic rebound**. Coronavirus-driven demand declines that will or are already beginning to bounce back, include: the increased demand for gasoline, the recovery of building and construction sectors, and growth in demand for consumer durables such as autos, furniture, and large appliances.

M&A strategy – 'Back to fundamentals'

As companies recalibrate their strategies and overall business portfolios to drive superior performance in this new environment, M&A is expected to become more active. For chemical producers, the foundation for successful M&A is having a clear strategy that defines the role of M&A and its principal priorities. Similarly, for private equity (PE) firms it is critical to have a well-defined and articulated value creation model at the center of acquisition/investment programs. As the macro and chemical industry environment changes and the deal environment improves, getting the fundamentals right will become even more important and the penalty for failing to do so may be high.

Our assessment of leading performers in the chemical sector provides insight into the fundamentals that will underpin the contribution of acquisitions to company performance and support attractive investments to PE firms. While the fundamentals will vary by business model, we believe the seven factors below should be at the center of the M&A calculus.

1. **Focus on attractive market structures** – A new higher risk environment means there will be a premium on quality. A quality business begins with an attractive market structure that supports strong margins and returns. In less attractive, more highly competitive markets it will be critical to determine a viable path to enhance performance. We expect to see substantial restructuring of chemical businesses serving the aerospace and energy industries as impacts related to COVID-19 have created enduring market headwinds.
2. **Market leadership position** – Leadership positions that are supported by measurable competitive advantages perform better through the cycle and are more valuable assets in today's environment. Since these types of businesses are less often for sale, determining whether there is a realistic opportunity to establish a leadership position or, at minimum, a position that can sustain healthy returns is essential.
3. **Technology / innovation intensity** – The value available from differentiated or specialty products varies considerably across businesses. In much of the chemical sector, differentiated product and/or market segments might represent only 20-30% of the total business. A focused innovation program to pursue existing differentiated products or to support product renewal/upgrading will be increasingly important to generate superior margins and underpin the ability to outgrow the market.
4. **The right cost structure –** In commodities, it is clear that having a low-cost feedstock and operating cost structure is the number one priority. In businesses with selected segments which have market, technology or product performance related differentiation, having a cost structure well aligned with the necessary requirements to support targeted differentiation is key. In specialty chemicals, getting the cost structure right is more challenging – it's about manufacturing and supply chain costs, aligning cost-to-serve with the value delivered to customers and targeted R&D / innovation spending.

5. **Scale –** As mentioned, the increasing costs of doing business driven by the coronavirus pandemic will make scale yet more important. Rising investment costs in technology and innovation, in facilities and infrastructure necessary to support competitive manufacturing costs plus the desire to provide solutions to the customer's most important issues, all point to rising scale requirements. Acquisitions that contribute to scaled (but not complex) business positions or achieved through roll-ups will become an increasingly important component of successful M&A.
6. **Growth dynamic** – The changing structure and outlook for many chemical end use sectors means positioning for growth will be more challenging. Having advantaged product offerings serving the more attractive segments including meeting the customer's demands for sustainability will be key to generating above average growth.
7. **Cycle resiliency** – The market's reward for performance stability has risen considerably over the past years and the pandemic has further raised the premium for cycle resiliency. Having a clear view on the underlying drivers of volumes, costs, prices, and margins is central to determining where an acquired company or business is in terms of the cycle, its expected performance profile, and the levers that might contribute to better performance through the cycle. Regional positioning can smooth cycles and can help insulate performance from temporary (e.g., COVID-19) or possible politically induced supply chain disruptions.

While the pandemic has led to an unprecedented and difficult environment for the chemical industry, the resulting structural changes present areas ripe for dealmaking for both strategic and financial buyers. M&A strategies and investment theses will need to adapt to the new environment – not just in the short term. Getting 'back to the fundamentals' outlined in this article is the order of the day.

How CRA can help

CRA provides a range of services to support M&A including acquisitive growth strategies, market and candidate screening, strategic and commercial due diligence, strategies for the combined businesses, antitrust and competition assessments as well as post-deal integration planning.

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