Hope after the Covid-19 crisis

An update on chemicals deal activity and verticals called to emerge as winners from the crisis

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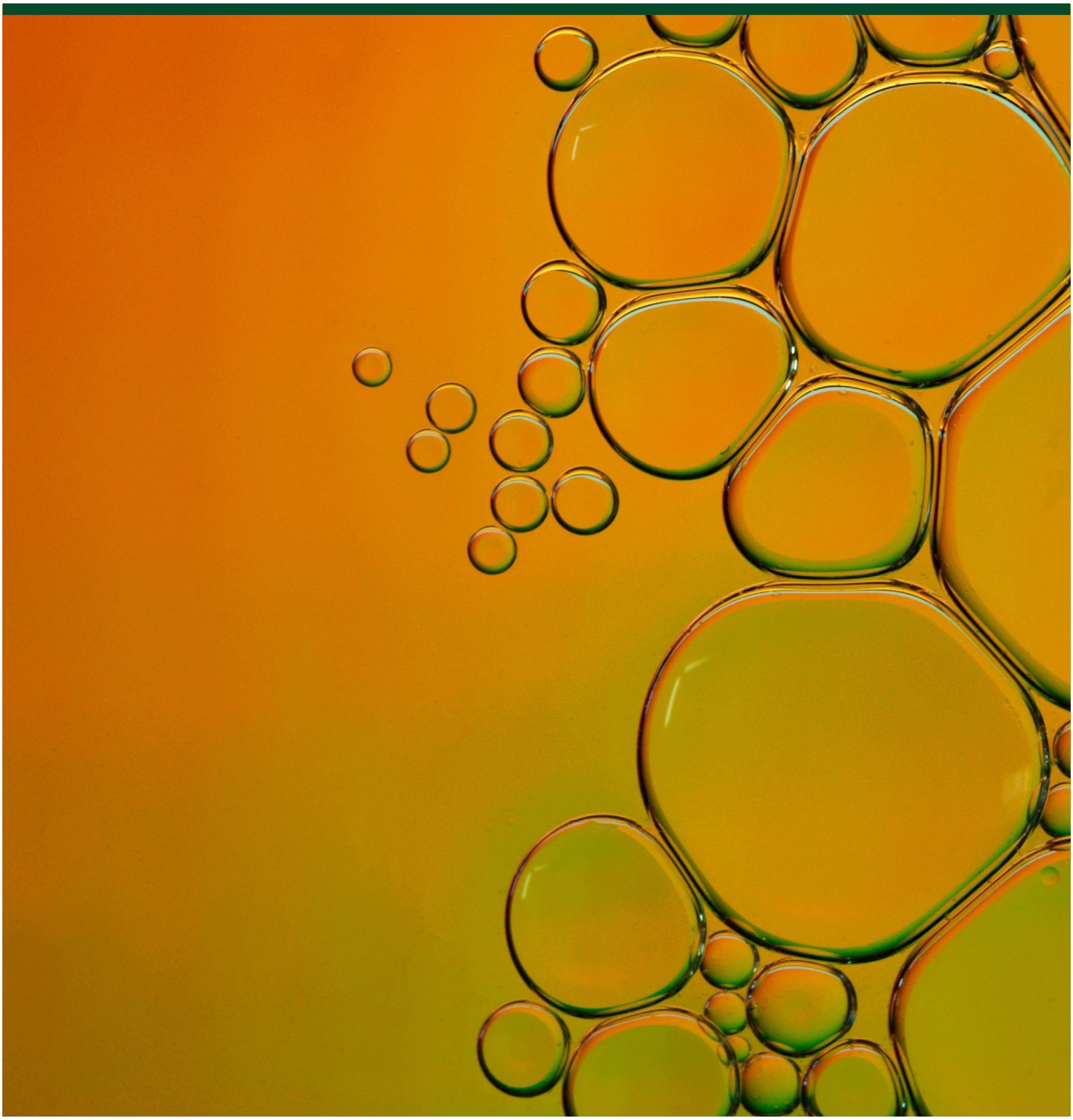

The impact of Covid-19 on Chemicals M&A transactions

The Covid-19 virus has also infected the chemical transaction market. Last year was characterized by fewer chemical transactions globally (553 versus 654 for the full year 2018 versus 639 for 2017; Source: MergerMarket) and only 91 deals were announced in the first quarter of 2020.
Lower deal volumes may have been caused by factors such as the expectation of an imminent recession after nearly a decade of positive business development, as well as rising tensions caused by tariff restrictions and geopolitical tensions.

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On the other hand, the Covid-19 crisis, which came to the fore at the end of the first quarter, came as a shock to market participants. Chemical companies, which are particularly dependent on the global network of value chains, are holding back on investments and acquisitions and are 'on sight'. Many companies are 'pulling the revolver', taking advantage of short-term credit lines and temporarily putting planned acquisitions on hold. The sharp fall in stock prices also lowers valuations for companies, and IPOs in this environment are much less attractive and more uncertain for issuers.

Based on recent news, we've seen that the electronic chemicals specialist Atotech, owned by financial investor Carlyle, has postponed its planned IPO in the US, and the Russian petrochemical company Sibur is another example of a postponed IPO. Even previously announced transactions, such as the US merger in the composites sector for the aircraft market Hexcel-Woodward, have already been cancelled due to Covid-19-related uncertainties regarding future business development.

Against this background, we believe it remains questionable when the sale of methacrylate activities announced by Arkema will actually start. Megadeals (those with corporate values greater than €1 billion) are likely to be particularly affected by the rigidity of market participants. Banks in particular are considered risk-averse, all the more so when it comes to providing high volumes of credit to, for example, financial investors and cyclical transactions.

A new metric best expresses this uncertainty, the EBITDAC – the result from ordinary business before interest, depreciation and the largely unknown Covid-19 effects ("Earnings before interest, taxes, depreciation, amortization and coronavirus").

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Chemicals industry

Verticals called to emerge as winners from the crisis

The situation facing other verticals in the chemical industry should be considered in a differentiated way. While the Corona crisis may partly exacerbate long-standing structural problems, chemicals for the internal combustion engine-focused car industry for example, other verticals have the chance to emerge as short-term and, above all, long-term winners from the crisis. Manufacturers of hygiene chemicals (disinfectants and so forth) as well as fine chemicals (such as API manufacturers and food ingredients) are examples here. The successful sale of Air Liquide's German subsidiary Schülke & Mayr to the Scandinavian financial investor EQT in the midst of the pandemic underlines the shortage of disinfectants in the crisis and the megatrend towards increasing hygiene awareness that can be observed worldwide. It remains to be seen what lessons are being drawn from the crisis about the increasing nationalization of value chains of 'critical' goods such as disinfectants or protective masks.

Nevertheless, as the 2009 financial crisis showed, transactions will continue to take place, in particular as the impact of the shock subsides. Of course, distressed sales will also increase in the short-term. However, the range of aid programmes announced by governments around the world will have an impact and provide massive further liquidity to the already spoiled markets, which are looking for investment opportunities in the low-interest-rate environment for the short and long-term. The number of minority deals could also increase, as specialist financial investors or family offices are able to meet temporary or permanent equity needs.

It can generally be assumed that, in the context of a crisis, the bargaining power of buyers increases as they want to pass on the risk associated with the future business development of the target company ('target') to the seller. As instruments, the earn-out mechanism (where payment of some of the purchase price is delayed and is dependent upon the future success of the target) and to mention the seller's shareholding, for example, by retaining a minority shareholding or a vendor note. The inclusion of a so-called 'MAC' clause in the transaction agreements is also being increasingly discussed. It grants the buyer the right to withdraw from an agreed transaction in the event of a material adverse change to the transaction or to the financial situation of the target company. Whether the Covid-19 crisis can be considered the trigger for a MAC case, however, is controversial amongst specialist lawyers.

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What's next

Outlook for 2020 in the chemical sector

Although Covid-19 has led to great uncertainty and reluctance amongst buyers and sellers, a gradual return to typical transactional activity is expected, particularly once some of the initial restrictions are relaxed or lifted, or a vaccination/therapy is available.

A number of factors will contribute to this. On the one hand, Covid-19 is not an industrial structural weakness but rather a temporary shock, the effect of which decreases significantly with a vaccination and increasing immunization. There are proven tools, such as short-time working, that enable companies to meet this challenge in the short-term. For many producers, the low price of oil dampens the negative effects of the crisis and often leads to a noticeable positive margin effect when volumes are smaller. On the other hand, liquidity is provided to markets to an unprecedented extent through aid programmes and interest rate cuts, which is looking for investment opportunities and, last but not least, should form a basis for the valuation of target companies. Financial investors, especially those with newly launched funds, have significant amounts of 'dry powder' and, so long as they are not distracted by current portfolio investments which might need to be restructured, they are under pressure to investment and are drawn to the attractive valuations of often operationally healthy companies from the buyer's point of view.

Strategic buyers from countries that have started to move into a different phase and start to put the Covid-19 crisis behind them (for example, South Korea and China) may also be increasingly tempted by attractive company valuations to go on a shopping spree in Europe and the USA; this will contribute to healthy competition for target companies. It is worth bearing in mind there is unlikely to be a nationwide sell-off of promising technology to Asia; transactions are often bound by the approval of a corresponding state authority and thus the latter can veto it.

Liquidity is provided to markets to an unprecedented extent through aid programmes and interest rate cuts, which is looking for investment opportunities and, last but not least, should support a solid floor to the valuation of target companies.

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Recent Transactions

Bridgepoint	Elkem	ELIX POLYMERS	ICG capiton
BUY-SIDE ADVISORY	BUY-SIDE ADVISORY	SELL-SIDE ADVISORY	SELL-SIDE ADVISORY
PharmaZell	POLYSIL SILICONE MATERIAL	SINOCHEM	prefere resins silverfleet capital

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