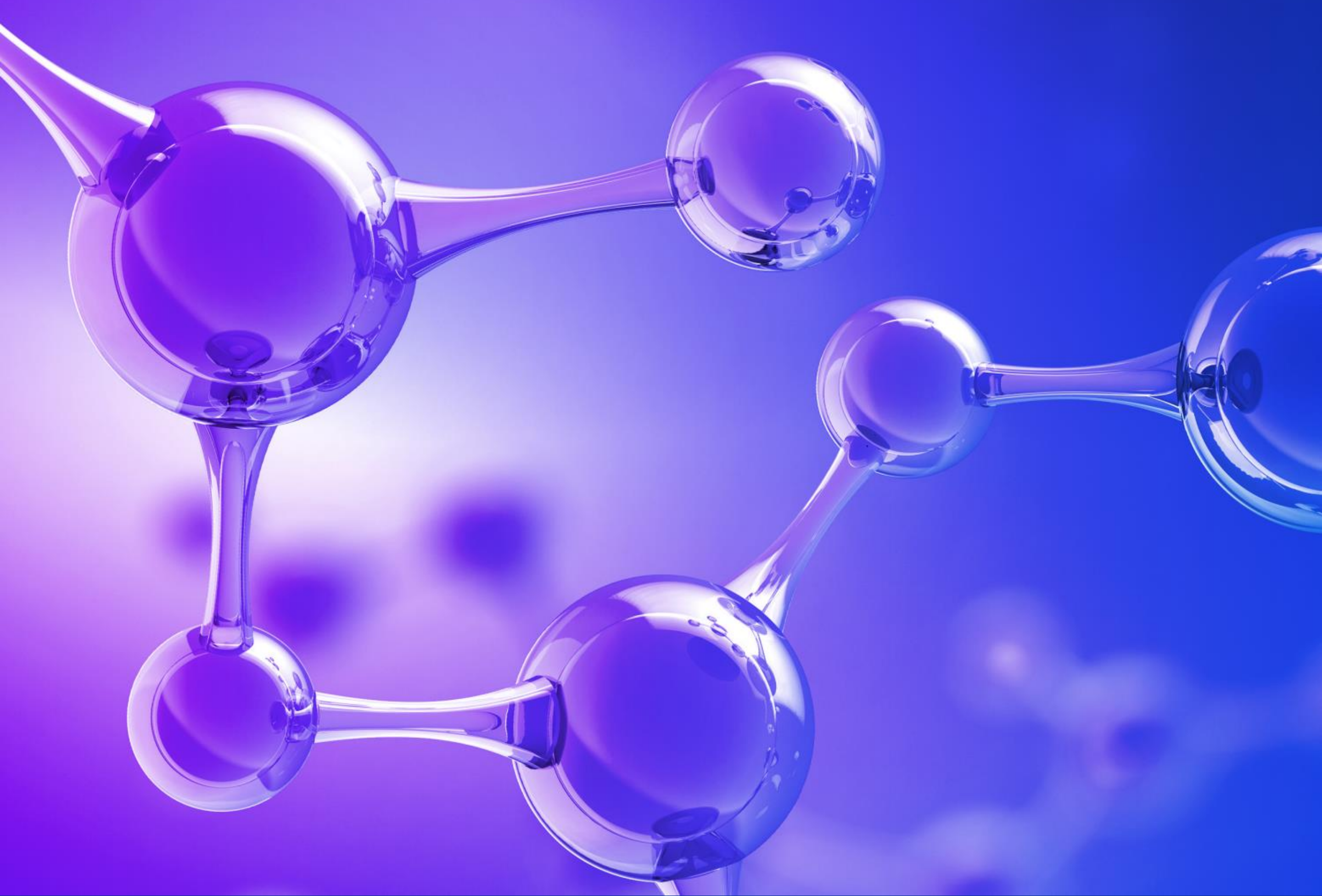
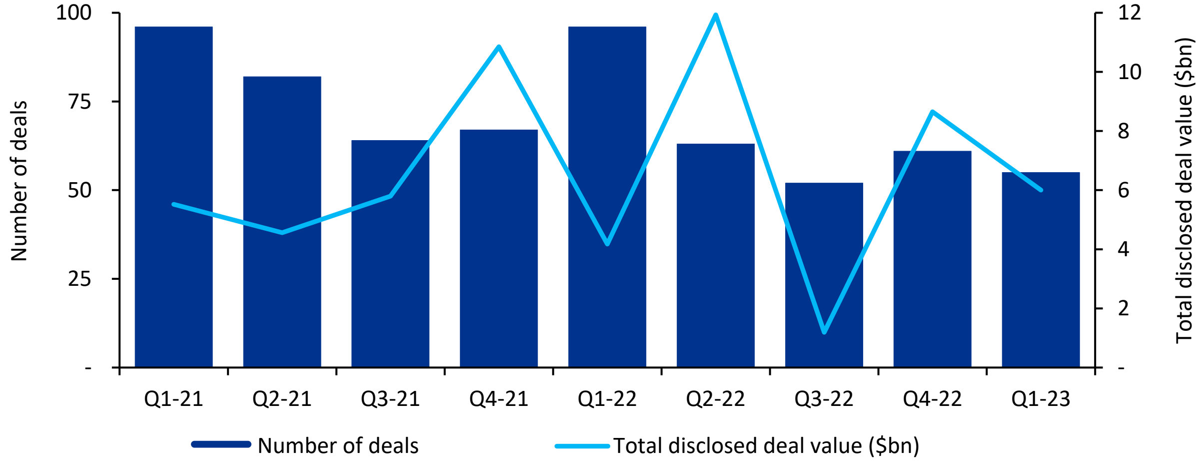
European Chemicals M&A 2024 outlook

Review of European chemicals activity

May 2023



Chemicals M&A activity in Europe



Source: Refinitiv, Capital IQ, Mergermarket and KPMG analysis

Following a record period of M&A activity in the European chemicals sector in 2021 – there was a sharp fall in deals in the second half of 2022 driven by rising borrowing costs and a deterioration in the macroeconomic environment.

While chemicals deal activity has continued in Q1 2023, it has largely comprised smaller deals – with participants either pruning their portfolios or investing in smaller "bolt-on" acquisitions.

KPMG has looked at several indicators to form a view on how chemicals deal activity is likely to develop in Europe in 2024.

We have looked at:

01

Debt markets: Borrowing costs and access to finance

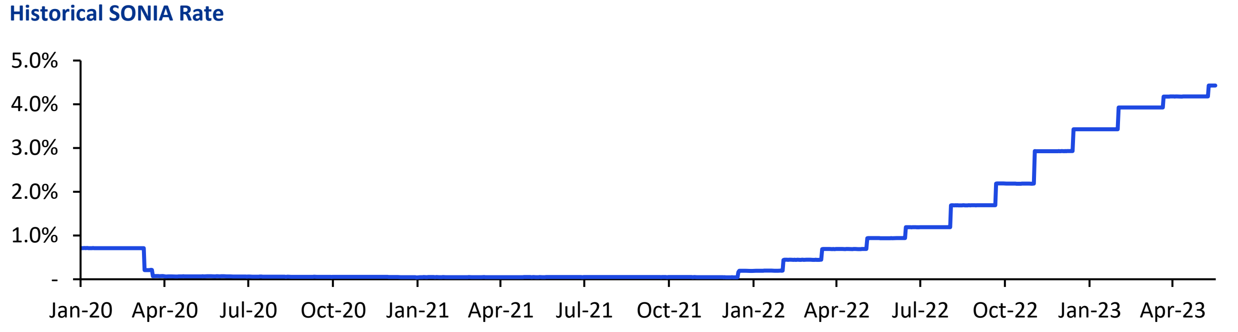
02

The role of Strategics and Private Equity in 2024 Chemicals M&A

03

The attractiveness of Europe for deploying capital

01 Debt markets: Borrowing costs and access to finance



Source: Bank of England (Daily Sterling overnight index average)

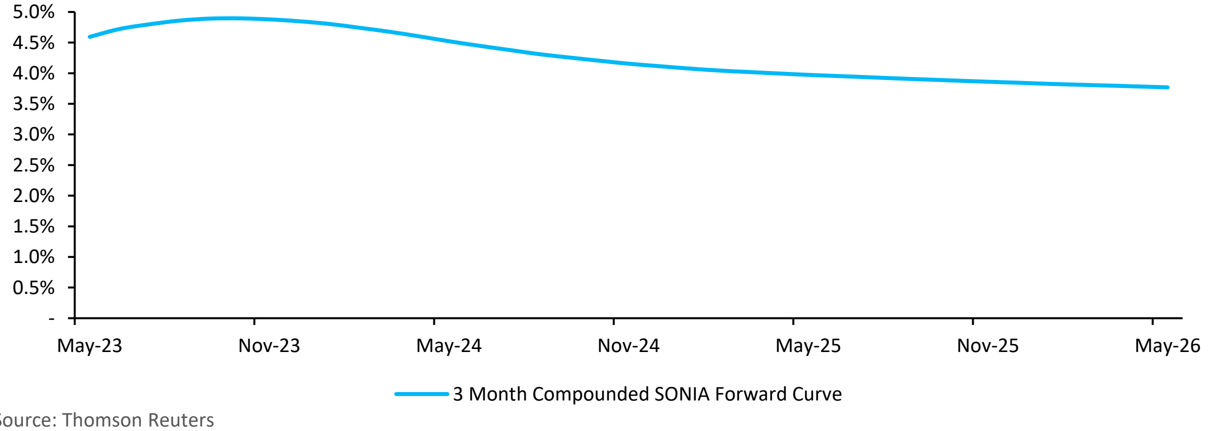
Although the cause of the sharp fall in M&A activity goes beyond the rise in borrowing costs and tighter supply of debt finance – this has clearly played a major role.

Central Bank rates have risen since the end of 2021 in an effort to curb soaring inflation. This follows a decade of loose money supply policies and government support measures through Covid-19. Rate hikes have directly impacted financing costs – putting pressure on debt serviceability for borrowers.

The Bank of England Base Rate for example is now at 4.50%, a rise of 4.40% since December 2021 and the highest level since 2008.

Events in the banking sector have also dominated news flows in recent months, though initial concerns have eased, with borrowers again able to access the debt markets albeit at higher pricing. But despite these events, Central Bank policy makers have continued to press ahead with rate rises – deeming the banking sector in overall good health.

SONIA Forward Curve



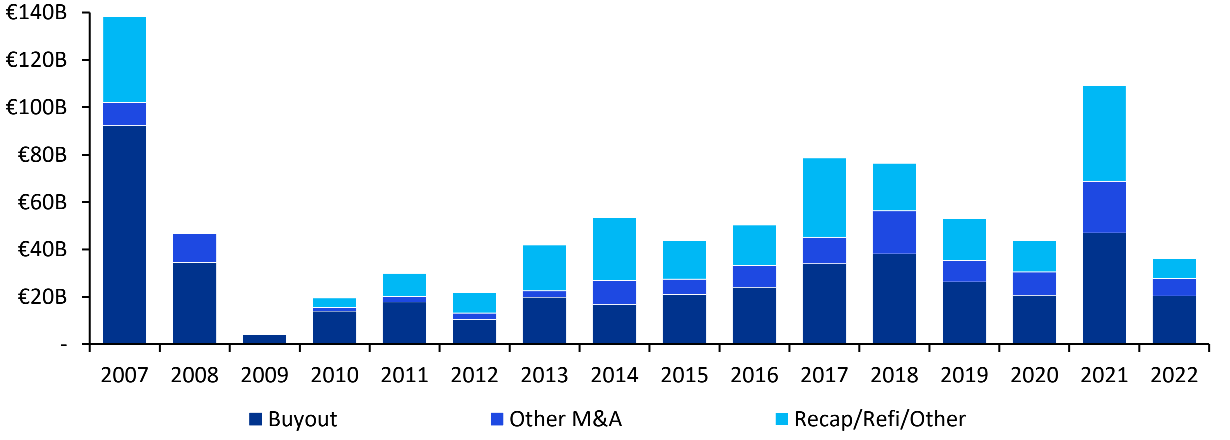
Source: Thomson Reuters

All-in borrowing costs over the last year have become more expensive but early signs of cooling inflation are providing a level of confidence to market participants.

Data from Thomson Reuters for example shows the SONIA 3-month forward peaking at 4.9% in October 2023 and then gradually easing.

> Although the cause of the sharp fall in M&A activity goes beyond the rise in borrowing costs and tighter supply of debt finance – they have clearly played a major role.

European Sponsor Backed Loan Volume



Source: LCD

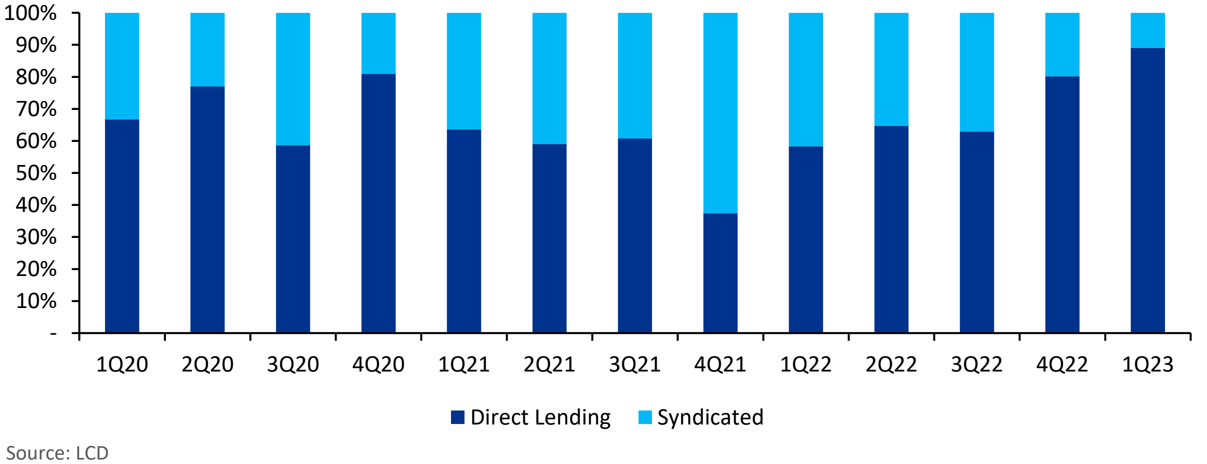
The European syndicated loan market which tracks new sponsor backed loans saw the lowest volumes in 10-years in 2022. However, 2023 is a very different scenario to 2009 when the market underwent a liquidity crisis – whereas, today's slowdown is largely driven by the higher cost of borrowing.

Although the syndicated loan market provides the most transparent and granular view of debt markets, it is representing a smaller proportion of buyout financing as sponsor backed borrowers are increasingly relying on private credit funds.

Private credit funds can offer a more dependable approach to capital deployment through periods of market volatility.

Private capital providers have to some extent filled any liquidity gaps as traditional bank lenders altered their credit policies or withdrew their balance sheets.

European LBOs financed via syndicated vs. direct lending

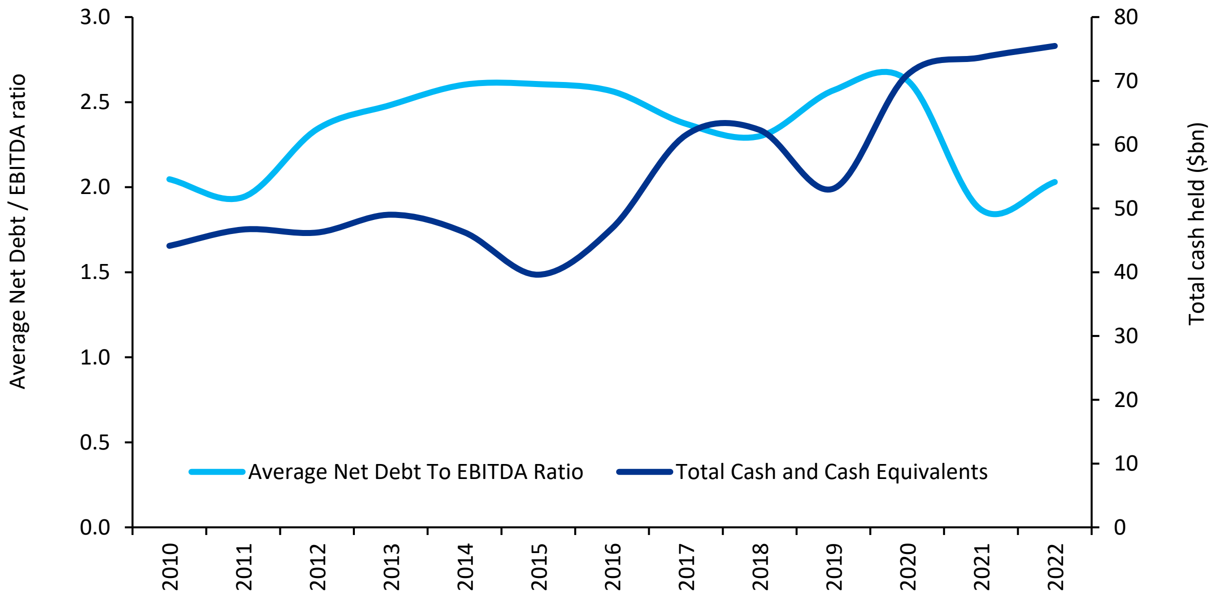


Source: LCD

A 'flight to quality' has been seen across all asset classes over the last 12 months but particularly evident in the debt markets as well as chemical assets. Certain segments of the chemicals sector are susceptible to supply and demand cyclicality and energy price volatility. **Lenders will therefore be mindful of "through the cycle" performance and their protections at the bottom of the cycle.** This will include more stringent and potentially additional covenants – which may reduce deal leverage.

To manage credit funds' typically binary view on assets, sponsors will need to demonstrate the resilient credit profile of the borrower. Therefore, financing requests will need to be carefully crafted to manage lender concerns – including more extensive due diligence. Debt serviceability and headroom in a rising rates environment will be a key credit metric for all lenders.

02 The role of strategics and PE in 2024 Chemicals M&A

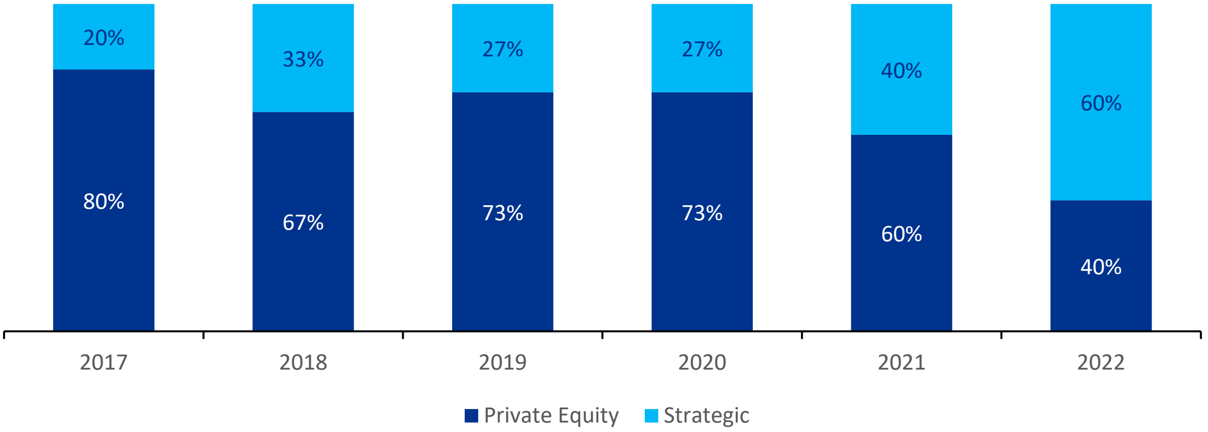


Source: Refinitiv; largest 100 chemicals company by market capitalisation

Despite the softening of European chemicals markets and in some cases the EBITDA of producers, the previously buoyant market conditions left many chemicals producers with strong balance sheets. **Based on the analysis of 100 publicly listed global chemicals companies, cash positions are at their highest level in more than ten years and debt to earnings ratios are near a ten-year low.**

The strong cash positions and lower relative debt levels means corporates are well-placed to make value enhancing acquisitions. This could be further helped by less intensely competitive auction processes with fewer PE bidders in 2023. Making strategic investors better placed than they have been for several years to grow core parts of their business through acquisitions.

Strategic vs PE activity of top 15 deals - by value (FY17-22)



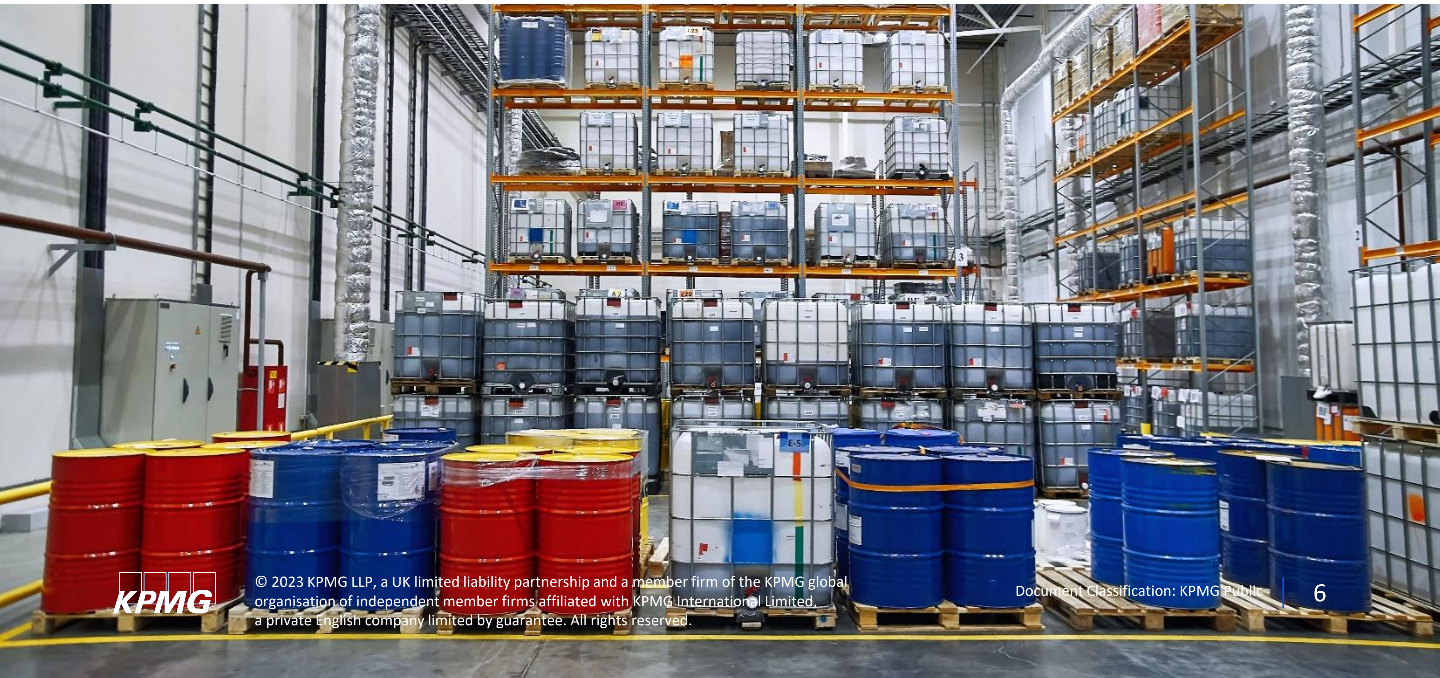
Source: Refinitiv, Capital IQ, Mergermarket and KPMG analysis

Last year, for the first time in several years – PE accounted for the majority of completed large M&A transactions, this was fueled by low-cost debt and huge firepower from recent fund-raising activity. These dynamics put strategic investors at a disadvantage – even when potential synergies were accounted for in their valuations. However, 2023 is likely to be different – with PE's share of Q4 2022 chemicals transactions already reducing to 25%. So, with their cash-rich balance sheets – strategic investors are likely to be better placed to compete for assets than they have been in recent years.

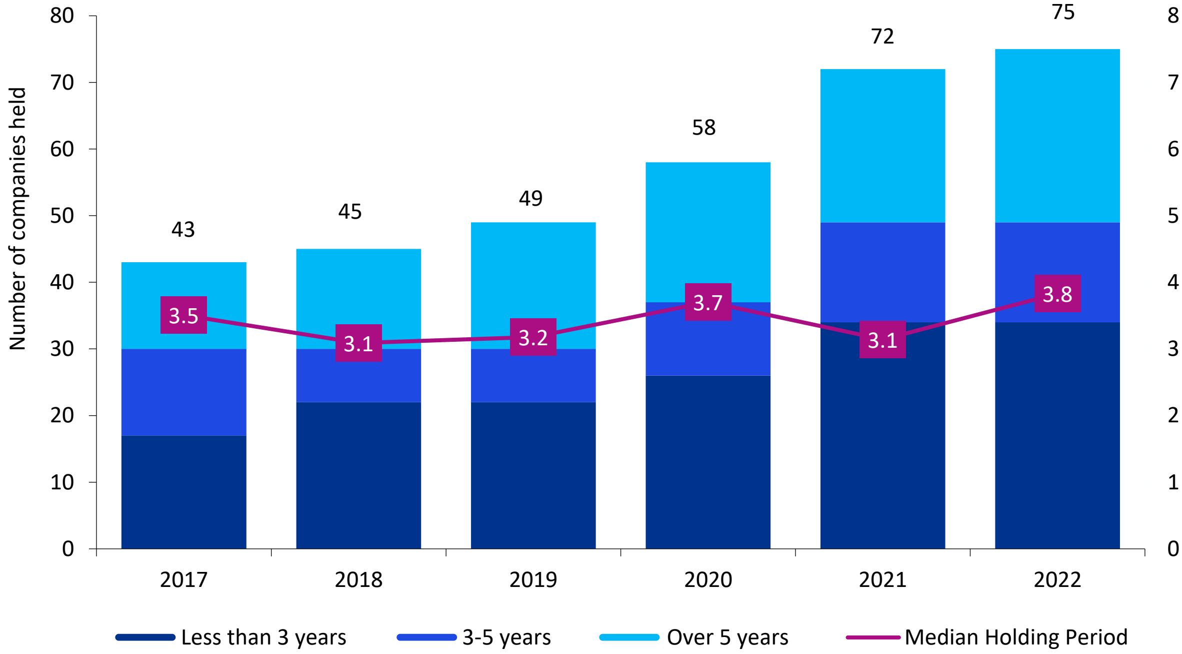
But as well as acquisitions – several European chemicals producers are undertaking major portfolio reorganisations. This will lead to significant carve-outs and asset sales. Such a strategy is already being undertaken by DSM, Solvay and Lanxess – and is likely to accelerate in 2024 once there is a track-record of successful transactions closing at reasonable valuation levels.

However, there are also several data points to suggest that once the financing market improves, we could see a sharp recovery in PE-led deal activity. **Private Equity is more invested in the European chemicals sector than ever before.** This demonstrates that financial investors see chemicals as an opportunity for value creation and a source of favourable investment returns.

As well as a record number of European chemicals assets in PE hands – the average holding period for these companies is reaching a historical peak**. More than a third of PE owned chemicals companies have now been in their owners' portfolios for more than 5 years.** Several PE-led sales processes which were launched prior to the deterioration in the M&A market have since stalled – suggesting several assets will need to come to market in the near-term.



Number of chemicals businesses held by PE Firms and the Average Holding Period (2017-2022)



Source: Company web sites, KPMG research

Private Equity has also raised a record amount of capital over the last 24 months (in excess of $2 trillion[1]) to make acquisitions.

We believe European chemicals will continue to be a focus for PE capital allocation – supported by the value of producers' technology, their solutions-based product portfolios and the proximity to end-markets. Chemicals assets also offer greater potential for portfolio and operational optimisation than some other sectors.

03 The attractiveness of Europe for deploying capital

However, a big question for investors (and should be for policy makers) – is where should this capital be allocated?

Both strategic and financial investors will need to choose where to invest – with North America, Europe and in some cases Asia, all competing for capital.

For some investors – North America could be favoured due to:

a) The typically lower cost curve position for chemicals production – supported by lower cost feedstock and energy prices. Firstly, because of North American shale-gas production and now exacerbated by the war in Ukraine and Europe's efforts to move away from lower-cost Russian gas.

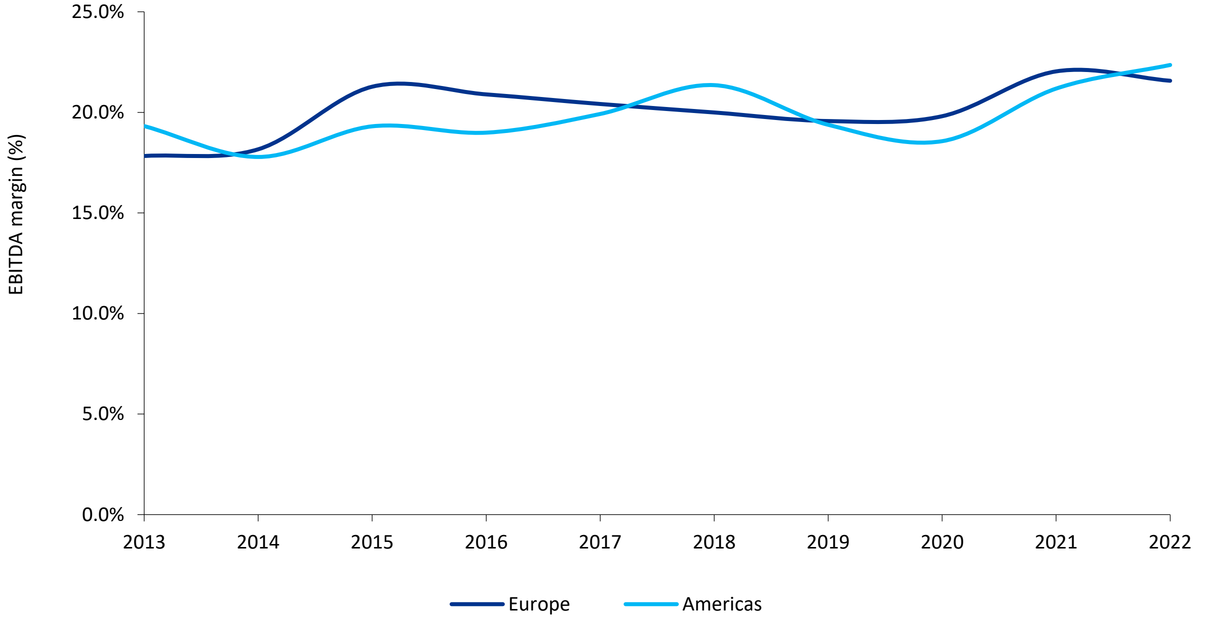
b) US government policy such as the Inflation Reduction Act ("IRA") which contains $500 billion in new spending and tax breaks aims to boost clean energy in the country. This has proved to be a major trigger for industrial investment and is supporting demand for several chemicals' segments in the US.

c) Latest economic forecasts also suggest higher economic growth (driving end-market demand) in the US versus the Eurozone – with GDP growth in North America averaging 3.8% between 2023 – 2028 versus 3.2% in the Eurozone for the same period[2].

[1] Source: Refinitiv; capital raised between Oct-21 and Mar-23

[2] Source: International Monetary Fund, World Economic Outlook Database, April 2023

EBITDA Margin (%) – North American vs. European chemicals companies (avg. of top 25 by market cap)



Source: [3] Refinitiv; top 25 US and European chemical companies by market cap. where comparative data is available

However, **many European chemicals assets are applications-focused and more oriented to "specialty" market segments – providing favourable margins and making them less exposed to commodity cycles.** European chemicals producers also offer strong technology/processing capabilities and benefit from their integrated supply chains. This is reflected in the comparable margins generated by European and US chemicals companies – despite the structurally higher cost structure of the European companies.

Conclusion

The higher cost and more stringent lending conditions have made financing acquisitions much harder. This along with the deterioration in the macroeconomic environment has reduced chemicals M&A activity since the second half of 2022.

However, there are reasons for optimism and there is the potential for a rebound in M&A activity in 2024 – supported by strong corporate balance sheets and private equity's significant exposure to chemicals assets.

We are also seeing early glimmers of improvement in the debt market and there is clearly a backlog of transactions. Both private equity and strategic players may therefore look to move quickly on long deliberated deals if an opening emerges in the debt market. With regards to resource allocation, the sentiment of many market participants suggests that European investment may suffer in the long term if nothing changes, however the speed and severity of such is still to be seen.

Contacts

Edward Middleton
Partner, KPMG

Energy & Natural Resources, Strategy

+44 7747 651 639
edward.middleton@kpmg.co.uk

David Hill
Partner, KPMG

Energy & Natural Resources, Deals Advisory

+44 7468 740783
david.hill2@kpmg.co.uk

James Cross
Associate Director, KPMG

Energy & Natural Resources, Deals Advisory

+44 7843 807 729
james.cross@kpmg.co.uk

Ryan Turner
Manager, KPMG

Debt Advisory

+44 7517 111 498
ryan.turner@kpmg.co.uk

Some or all of the services described herein may not be permissible for KPMG audited entities and their affiliates or related entities.

kpmg.com/uk

CREATE | CRT149075A | May 2023