

Chemical Week

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The road ahead

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Accelerating Cost Synergies

–A key to a successful M&A

Within the last 5 years, over \$530B of Merger and Acquisition (M&A) transactions within the chemical industry have been announced or finalized including the mega merger of Dow Chemical with DuPont and Bayer's acquisition of Monsanto. This unprecedented level of M&A activity has increased the focus on both the process used for integration as well as the overall effectiveness and success of merger integration efforts.

For M&A integration to be successful, there are hundreds of activities that must be completed within a relatively short time period – ideally within two years of the merger closing date. These activities can be grouped into three distinct programs:

Key Activities

- Change Management and Communications – Employees from both companies will undoubtedly be impacted by the M&A transaction and it is essential that the human aspects of change be managed well. Communications and employee engagement in the integration effort is extremely important. In addition to employees, there are many other key stakeholders, customers, suppliers, local communities, investors and shareholders, who have needs that should be addressed, too.
- Work Process Integration – Work processes are defined as the way work is completed and will often be significantly different from company to company. Some examples of work processes are as follows: How capital planning is accomplished; How annual operating budgets are set; What engineering standards will be used and What Environmental, Health and Safety (EH&S) standards will be adhered to. The computer infrastructure that exists within each company will also define many of the company's work processes. The M&A integration must reconcile the differences between each company's work processes and aim to have a standardized set of work processes across the new enterprise, post-closing.
- Synergy Identification and Capture – Investors and shareholders are primarily interested in the financial value created when the two companies are combined. Revenue or Growth Synergies will only be fully realized after the integration efforts are completed and will typically extend beyond the 2 year integration period. On the other hand, Cost Synergies should be realized almost immediately after the close of the M&A transaction and are the key metric that investors and shareholders will be watching during the 2 year post-closing time period. This article will examine the type of Cost Synergies that are often seen with M&A transactions in the chemical industry and also a methodology to accelerate the capture of these Cost Synergies.

Cost Synergies

Cost Synergies will undoubtedly be found within both companies and across almost every functional and geographic area. Let's look at the typical cost synergy projects that can be found in Cost of Goods Sold (COGS), Selling,

General and Administrative (SG&A) and Research and Development (R&D).

- COGS – There are numerous areas where cost synergies can be found to positively impact COGS. Significant savings in Purchasing can be readily achieved since the combined companies will now have a larger "buy" after the closing. The purchase of raw materials, packaging materials and process equipment can all benefit from the larger volume discounts that will be available post-closing. In addition, supplier consolidation is also an additional benefit that will add to the cost synergies. Supply chain savings can be found through more efficient use of external warehouses, enhanced production planning and consolidated shipping modes.

If both companies have similar product lines, manufacturing plant closures are a distinct cost synergy opportunity area. In addition, the sharing of technology best practices across both companies can often improve raw material yields, reduce energy consumption and/or increase production output.

Headcount reductions through the consolidation of engineering departments and manufacturing leadership positions are cost synergy areas that should be evaluated.

- SG&A- Perhaps the greatest area for cost synergies on a percentage basis is SG&A. With the combined company post-closing, you do not need duplicate functional organizations such as IT, HR, EH&S, Public Affairs, Legal or Purchasing. Within the geographic areas, the sales organization can be optimized, and redundant country management can be eliminated. All of these headcount reductions will result in the need for less office space, hence the shutdown of some administrative buildings. It is also important to recognize that with all of the headcount reductions, cost synergies will result from less wages, less benefit costs, less employee purchased office supplies and less employee IT costs.

Corporate overhead will always be reduced with a M&A transaction since there is no need for two CEOs, two CFOs, two General Counsels, two COOs, etc.

- R&D – Within the R&D functional area, headcount reduction and facility closures or consolidations are the most common areas for cost synergies. Headcount reductions will occur where both companies have similar R&D projects in the pipeline. In addition, the M&A is an excellent time to re-evaluate the entire R&D project pipeline and in many instances, "pet" R&D projects that should have been eliminated many years earlier can be cut to now to garner additional cost synergies. Redundant facilities across both companies, such as analytical labs, are often able to be closed or have their footprint reduced. And finally, it goes without saying that you will not need two separate R&D organizations and can eliminate redundant leadership positions.



Speed and Accountability

It is absolutely critical that the M&A integration occur fast and efficiently. The employees potentially impacted by the transaction will be “paralyzed” until they know their own employment status. Questions such as these will need to be answered: Will I have a job? What is my salary? Will I need to relocate? Who is my new boss? How will my benefits be affected? Best practices show that no matter the size of the M&A transaction, these questions should be answered with 90 days of closing.

Cost synergies are another area where the investor community and shareholders will want to see results quickly. Every cost synergy project needs to have a project leader, a project plan with key milestones identified, the risks associated with the project and the identification of inter-dependencies with other projects. The project leaders need to be held accountable for their respective projects.

To manage the entire M&A integration, the establishment of a Program Management Office (PMO) is critical. The PMO will establish the overall time line for the integration starting with the merger announcement, through closing and then for 2 year time period post-closing. The PMO will routinely report to corporate leadership and will be responsible to obtain the necessary resources for a successful integration.

A cost synergy tracking system needs to be established to accurately record the expected cost synergy for each project and then to track the actual cost savings realized. It is also highly recommended that a series of “business rules” be established so that these cost synergy savings are being recorded in a consistent manner across the corporation.

Use of External Resources

The integration places a significant stress upon the organizations impacted by the M&A transaction. Most employees already have a full time job and a serious error is often made when leadership expects these employees also to handle integration projects and activities. There are a number of areas where the use of external resources can pay huge dividends.

- Its critical to start with Best Practices and checklists or in Argo’s case a proven Playbook that will help accelerate synergy cycle time. Look for external resources that bring these tools.
- Where possible get external resources engaged upfront to assess readiness of integration and help develop the synergy initiatives and initial implementation plans.
- Many companies have limited experience handling M&A integration. It has been proven that, at the very least, a good senior management cadence starting with a 2 to 3 hour introductory integration workshop given by an experienced M&A integration practitioner is very helpful.
- The establishment and initial staffing of the PMO. This will significantly jump start the integration and should occur immediately after the M&A announcement.
- During the period between the announcement and closing is an opportunity time to develop the overall integration plan. There are often business confidential, competitively sensitive information that can-

not be disclosed between the companies. The use of “Clean Teams” is a highly effective approach to identify cost synergy areas that can then be acted upon immediately after closing. The staffing of these “Clean Teams” will require the use of external resources.

- Site and Plant Assessments to identify opportunities to improve Cost, Reliability, EH&S and overall work processes.
- With a large M&A integration, it is reasonable to assume that you could have over 100 projects. Staffing these projects with only existing employees who are also doing their regular job will often result in missed deadlines and the failure to capture cost synergies in a timely manner. The use of external resources to augment the existing employees should be strongly considered.

Final Comments

The announcement of a M&A transaction is an exciting event but it can also be terrifying! The integration is typically a major endeavor and will probably touch most of the employees in both companies. Focus is required on employee communications and change management, work process integration, and the capture of both growth and cost synergies. Establishing a PMO structure and identifying cost synergy projects with project leaders accountable for their project success is absolutely critical. And finally, using external resources with M&A experience to augment your own employee efforts will pay huge dividends for the integration success.

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M&A

The road ahead

With megadeals such as Bayer-Monsanto and Linde-Praxair complete or headed toward close and the Dow-DuPont spin-offs in sight, M&A watchers turn their sights to what comes next.

Vincent Valk

It's plain that M&A has remade the top ranks of the chemical industry. DowDuPont is now second-largest chemical company in the world by sales, trailing only BASF, but the future Dow Chemical and the future DuPont will both be smaller. Monsanto, synonymous with agchemicals for past two decades, is now a part of Bayer. Linde and Praxair—which announced the largest parts of their required divestitures earlier this month—will soon be one company. Other major players, including PotashCorp, Agrium, Airgas and Valspar have merged or been acquired by larger companies.

Some large pieces do remain. LyondellBasell is, for the first time since emerging from

bankruptcy in 2010, making a big splash in M&A. The company announced plans to acquire plastics compounder A. Schulman for \$2.25 billion in February, moving downstream and expanding its compounding business. More significantly, LyondellBasell in June confirmed exclusive talks to acquire a majority stake in Braskem from Odebrecht, the Brazilian giant's troubled controlling shareholder. A deal would make LyondellBasell the world's largest producer of polypropylene (PP) and a top-five maker of polyethylene (PE), as well as a top-three player in chemicals, with nearly \$50 billion/year in sales. Braskem is valued at about \$12.2 billion, according to analysts quoted in the Brazilian media.

Coatings is another area where major

consolidation could still take place. While over a year has passed since PPG's hostile bid for AkzoNobel, and PPG executives say the company has moved on, a renewed bid once AkzoNobel finalizes the sale of its chemicals business is possible. Axalta, which AkzoNobel and Nippon Paint briefly made runs at last year, is still seen as a potential acquisition target. Meanwhile, private equity firms have been rolling up companies in some industrial coatings segments.

Despite LyondellBasell's newfound acquisitiveness and the potential for more coatings consolidation, the future of M&A in chemicals looks likely to be driven by portfolio restructuring, including fallout from the megadeals. Indeed, this is already starting. In an indication of asset shedding,

about 63% of year-to-date announced M&A deal value in 2018 is accounted for by divestitures (chart on next page).

Do the reshuffle

M&A often begets more M&A. Regulatory-driven divestitures are only a part of the puzzle. Often, acquirers will discover that parts of a business that was recently purchased do not fit in with longer-term strategy. **“We see that the trend has been around portfolio rebalancing for strategic fit,” says Chuck Deise, senior vice president with Argo Consulting (Chicago), a chemicals and energy consultancy. “That has driven some of the megamergers ... but in the next phase, we see companies that have gone through the mergers rebalance their portfolios and start to shed or acquire assets that fit with their business focus.”**

It’s not hard to find examples of this from past waves of consolidation. For example, Ashland sold its water treatment business—much of which was acquired from Hercules in 2008—to private equity firm Clayton, Dubilier & Rice (CD&R; New York) in 2014. Dow Chemical has sold off pieces of Rohm and Haas (R&H). Dow’s electronic materials business, most of which was inherited with R&H, will transfer to the planned DuPont specialty products spin off.

“Over the next two to four years, I think we

[strategically than the old companies], but arguably they still have a number of disparate businesses.”

The future DuPont, which will consist of four distinct businesses, has been the subject of speculation about further M&A and carve-outs. While the future DuPont’s diverse collection of businesses has performed well this year, the trend toward portfolio simplification could lead to a significant amount of reshuffling once the business is independent.



YTTRE: Bolt-ons and asset shedding coming.

Bankers say that the positioning of newly enlarged companies will be a key driver for asset shedding in the months and years to come. “Some of these mergers have absolutely led to overweighted markets or underweighted geographies,” says Kevin Yttre, president and managing director with Grace Matthews (Milwaukee). “You could see bolt-ons and asset shedding.” The businesses that will be sold are likely to be noncore, and lower-performing, but could be in any number of sectors. “It’s hard to nail this to specific end markets because each deal is different,” Yttre says. “But the idea with these megadeals is that with relatively low organic growth, when you put a business together, you can benefit from a strong manufacturing footprint and a good cost position ... [to the extent that] it doesn’t make sense for some businesses to be

parts of portfolios. “I think there is going to be increased scrutiny on the performance of the businesses,” says Paul Colone, partner and managing director with Alantra (Boston). “This could be for either legacy businesses or recently acquired businesses. ... I’d think there will be more asset shedding over the next year or so as companies digest these acquisitions, and think about which businesses are or are not meeting expectations. And companies that have been active on the M&A front and are happy with their acquired businesses might think about shedding more legacy assets, too.”

Performance and financial metrics will be the key to this process. “The businesses we see being reviewed [for divestiture] are ones that just aren’t meeting certain thresholds in terms of growth or profits,” Colone says. “They’re not necessarily loss-making or bad businesses, they’re just not meeting corporate expectations.”

The desire on the part of large public companies to move toward higher-value specialty chemical products will often frame thinking about what assets to divest. “The [companies] I’ve seen ... have really tried to present themselves to the market as turning a corner from commodity to specialty-oriented businesses,” Colone says. This, almost inevitably, entails some housekeeping in terms of portfolio. “In order to be considered a specialty business, there are expectations around growth, and the markets they serve, and their margins,” he adds. “So as they acquire businesses that are more specialty in nature, they are taking a look at their legacy assets.” Older assets with a more commodity-type profile often are the ones put on the divestiture block—although these businesses may not attract the highest valuations.

The drive to specialties can lead to reshuffles even at companies that were not involved in the recent spate of megamergers. Companies that have been looking at portfolio transformations—a group that often includes, but is not limited to, those involved in recent megadeals—are obvious candidates to sell certain assets, notes Alain Harfouche, director/chemicals investment banking at KeyBanc Capital Markets (Cleveland). “A lot of the transformations have been about moving away from more commodity-like assets toward specialties,” Harfouche says. “You have to look at who has been active in pruning their portfolio and transforming their business.” A number of diversified manufacturers below the

Shed it*

Target	Acquirer	Seller	Deal size in millions of USD	Target region	Target sector
AkzoNobel chemicals	Carlyle Group; GIC	AkzoNobel	\$12,600	Europe	Diversified
Most of Praxair’s Europe business	Taiyo Nippon Sanso	Praxair	5,900	Europe	Industrial gases
Merck consumer health	Procter & Gamble	Merck	4,200	Europe	Specialties
Linde businesses in the Americas	Messer; CVC Capital Partners	Linde	3,300	North America	Industrial gases
Century Portfolio	Nufarm	Adama	490	Middle East	Ag/Fertilizers

*Five largest divestitures announced in 2018.

Source: IHS Markit.

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will see continued M&A and portfolio optimization and spin-offs among the larger companies,” one industry banker says. “DowDuPont is a great example. They’re splitting into three companies, and I wouldn’t be surprised if one or two of those take more portfolio actions going forward. The new Dow and new DuPont are better aligned

together, you will see portfolio shedding.”

Yttre notes that paying down debt is often an impetus for divestitures as well. “After some of these megadeals happened, you’ve seen companies with very high debt, and that’s an indicator that you will [see] divestitures,” he says.

Divestitures could also come from legacy

Dow-DuPont tier have made moves toward more specialties-oriented businesses. These include Celanese, Lanxess, Solvay, and DSM.

“If the CEO is talking about being a technology-driven business or being focused on certain markets, and there is an asset within the company that is noncore, now is the time to sell,” Harfouche says. “[Private equity] is paying up for assets and even for carve-outs. Financing markets are still favorable.” Bankers say that M&A valuation multiples have remained high all year, and the strong financing markets mean that cash is readily available.

Shareholder views have been crucial to this portfolio management process. Obviously, a shareholder would prefer a company to be involved with higher-growth, higher-margin businesses. Beyond that, for years shareholders have been driving the trend for portfolio simplification. Corporate strategies, and M&A strategies, often explicitly focus “core” or “close to the core” businesses—and these cores, of course, vary depending on the company.

“What I hear is there are a lot of private discussion between shareholders and management teams, and some of those shareholders are activists,” an industry banker says. “In the past four or five years, management has better learned how to handle and accommodate activist demands.” These often include calls for portfolio simplification and divestitures, as well as looking at financial policies and dividends and buybacks for shareholders.

Traditional shareholders are having strategic discussions with management teams, too, however. “The advent of activism has forced traditional, institutional shareholders to be a bit more vocal,” the banker says. “But, there has been a fundamental shift in how management and boards act now that they know what the activist playbook looks like.” High stock market valuations are leading to “a focus on equities, which is forcing management and boards to be more open to discussion and preempting any [activist] activity,” the banker adds.

Equity markets have, in fact, come down somewhat this year—but they remain at elevated levels by historical standards. This has led to a dynamic where corporate executives feel pressure to make moves to justify those their stock prices. Executives have long seen M&A as a way to do that, by extracting synergies and generating economies of scale in areas like manufacturing and

purchasing. The ideal is to buy a higher-growth business to move the needle above the GDP-level growth that many chemical companies typically experience.

All of this means that executives view their businesses the way that shareholders, or even private equity firms, might in many cases. CEOs and other senior leaders often see themselves as “portfolio managers” for their own companies, bankers say, a view frequently echoed in statements by executives themselves.

Many buyers

Meanwhile, the universe of potential buyers has expanded. Private equity firms have long been interested in chemicals, and that interest has only grown over time. Not only do firms have massive chunks of cash to invest—by some measures in the trillions of US dollars—but they have grown more sophisticated and



HARFOUCHE: Corporate strategy emphasizes specialties.

multiple,” Cardinal says. Firms look for fragmented industries, such as adhesives or chemical distribution, that present opportunities for consolidation. “That’s a tried-and-true approach,” Cardinal adds.

Buyers from Asian countries, particularly China, have also become more active in the M&A market in the West.

ChemChina’s acquisition of Syngenta, which closed in 2017, is the highest-profile example of this. However, it is not the only example, and bankers say that Chinese firms are often involved in auction processes and are getting more competitive.

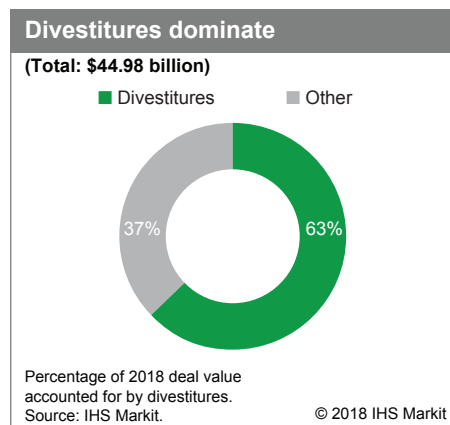
“We do continue to see more and more interest from Asian chemical companies in North American and European based businesses,” Yttre says. “Historically, it was an area that was less active, but they’ve gotten more aggressive.” Bankers say that Chinese buyers are regularly considered when pitching assets.

“A few years ago, the Chinese became much more apt to close deals,” Colone says. For some time, Chinese buyers were seen as “groups that will only pay a low price or never get to the finish line,” he adds. “There has been a change with the approach to valuation.”

Increasing competitiveness does not imply a wave of Chinese buyers for Western chemical assets, however. “There has been an increase on the China side, but it’s not been massive,” Harfouche say. Bankers across the board say that Chinese buyers have gotten more sophisticated and competitive, but while they are perhaps a more legitimate option today than they were in the past they are hardly driving the market.

One issue that could further hold back Chinese buyers in the future, especially with US-based targets, is a potential trade war. “With what is going on in trade policy, there has been a bit of caution for Chinese buyers of US assets,” Colone says.

Trade war generally is seen as a potential, but still-developing, threat. Bankers note that tariff announcements are still in very early stages, and industry executives have made similar statements. “It’s only starting to become known, and people are trying to figure out if and how it will impact their businesses,” Colone says. Trade flows could adjust to the new situation. “It’s a short-term disruption ... in the longer-term, the impact is more uncertain,” Harfouche says. ■



creative regarding their transaction strategies.

“There was a period when private equity investors were trying to figure out their formula for when valuations are in the double digits,” says Chris Cardinal, director/deal strategy with PriceWaterhouseCoopers (New York), a consultancy. “Paying that kind of multiple is not usually the domain of private equity. They’ve realized that multiples ... aren’t going [down], so they have to join the party.”

One strategy that has grown in prominence is to buy a so-called platform company, and then grow it through a string of acquisitions. “Private equity is finding they can buy a platform for a single-digit multiple, build up scale and scope, and then sell for a double-digit



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