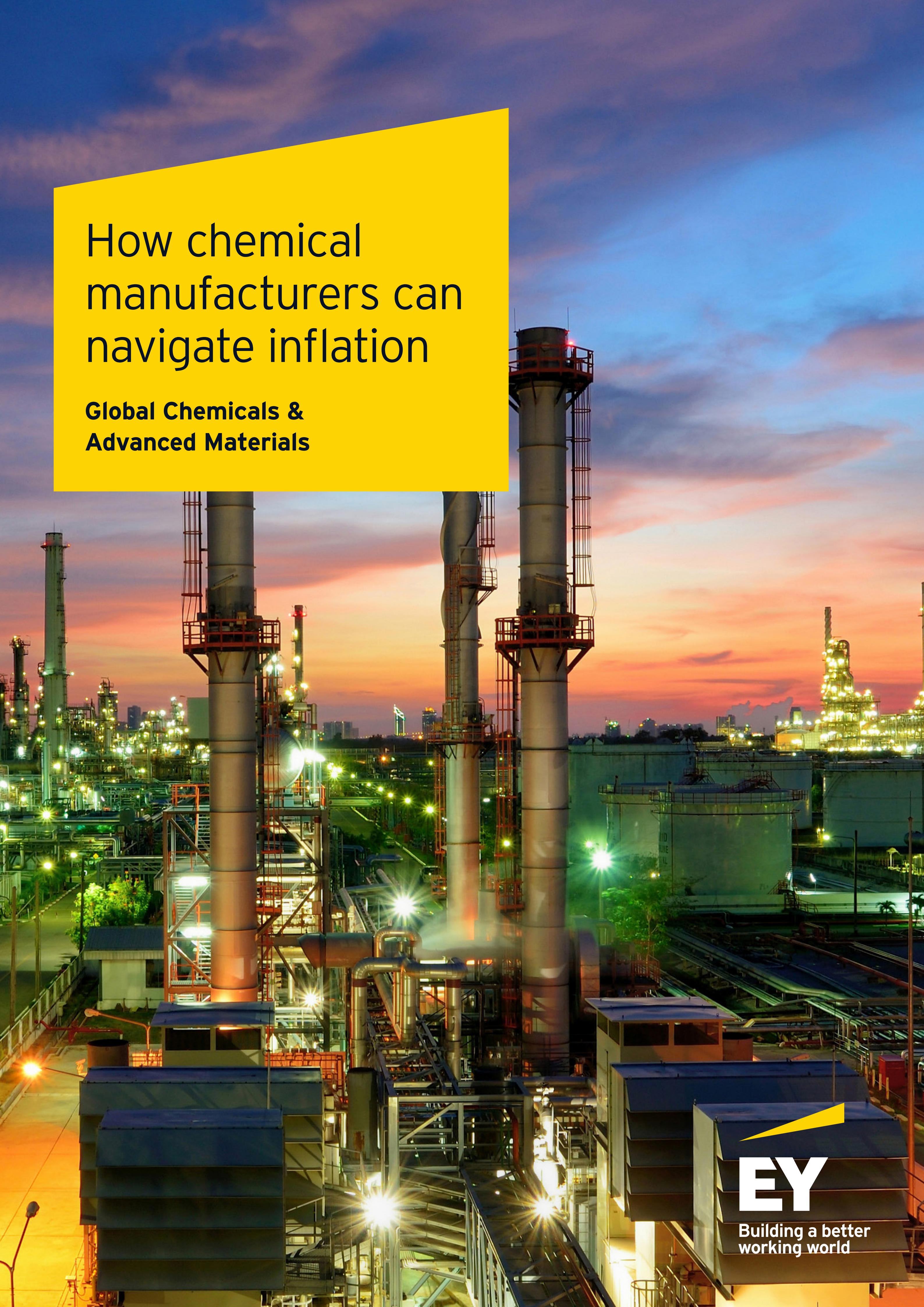
How chemical manufacturers can navigate inflation

Global Chemicals & Advanced Materials



Building a better working world

How chemical manufacturers can navigate inflation

2021 was a bounce back year for chemicals M&A after the challenges of COVID-19. Both deal value and volume returned to historical highs, surpassing pre-pandemic levels. Market valuation multiples also remain elevated.

This level of activity has continued so far in 2022, but there are storm clouds on the horizon beyond the war in Ukraine, including further geopolitical tensions, global supply chain disruption, and inflation levels not seen in over 40 years.

Almost all Q4 2021 chemical sector earnings calls included significant time discussing raw material, packaging, transportation, and wage rate cost inflation as well as pricing action to offset rising costs. It's a topic that is top of mind for most executives. Comparing earnings call transcripts for the top 32 chemical companies from Q1 2019 to Q4 2021, the mention of the word inflation increased roughly 300%. According to the EY 2022 CEO outlook survey, 87% of executives have seen significant increases in input prices.

So how will inflation affect the chemical M&A market going forward and what should executives do differently?

Winners, Losers and Due Diligence

Nearly all companies are experiencing input cost inflation. The winners will maintain and improve growth and profitability through a combination of dynamic pricing strategy and new productivity initiatives to mitigate cost pressure. While customers are generally receptive to price increases in this environment, strategic pricing is a skillset some companies must relearn. Some sales teams are hesitant to be bold or are restricted by competitive dynamics.

Even when customers are receptive to price increases, demand cannot be entirely inelastic to price. On the operational side, many are still struggling with labor scarcity and their innovation model in a post COVID-19 world, which is restricting productivity initiatives. The losers will see slower growth and compression in margin and cash flow.

On the M&A front, certain sub-sectors may need to consolidate or sell to survive, resulting in increased activity. On the other hand, potential sellers that have been temporarily dislocated by inflation may defer an exit until after they can successfully implement pricing and productivity initiatives to right the ship and improve resiliency in the long term. This is already happening in the market. For example, in March this year, Spanish energy company Cepsa announced that it has put a planned sale of its chemicals business on hold while it examines the potential impact of spiraling energy prices from the war in Ukraine.

In this new environment, buyers and sellers need to refine their approach to due diligence when evaluating a company and its prospects.

First, pricing must be considered. How successful is the company in increasing price? Is it wired into the DNA of the sales force or just a reactive process? Is pricing a value creation opportunity? Next, the cost stack should be assessed. A company's mix of fixed/variable and material/labor costs will significantly affect its exposure to inflation. Another major focus is critically evaluating the company's supply chain. As global supply chains continue to be affected by similar disruptions (many of which are simultaneously causing inflation), what are the supply chain risks and vulnerabilities? Is there sanctioned market exposure to suppliers and customers? Also in diligence, knowing the above exposures and history, the deal thesis should hinge on management's ability to manage through the exposure with productivity improvements. Does management have an established track record of implementing efficiency projects. What are their plans to manage cost inflation? Buyers should assess not only the action steps to improve long-term resiliency of the business, but also the cost of those initiatives.

Lastly, there is the question of cash flow. Often forgotten is the increased burden of working capital and both growth and maintenance capex in an inflationary environment, but these need to be factored into the forecast model. With increased capital investments required, maintaining margins alone will be dilutive to cash flow.

What is the Bigger Picture?

At the macroeconomic level, inflation will influence M&A through its impact on monetary policy and financial markets. Central banks have clearly moved past the rhetoric of positioning inflation as transitory. Monetary policy has tightened and will continue to do so, but the extent will vary across global markets. In the US market, where inflation is very broad based and there is very little labor slack, we expect aggressive tightening. In Western Europe, where energy is driving inflation and there is significant labor slack, the European Central Bank will likely take a softer approach. In Central and Eastern Europe, labor slack is much lower and inflationary pressure is much stronger. Regardless, we expect the persistence of inflation to lead to both interest rate increases and quantitative tightening of central bank bond portfolios. The U.S. Federal Reserve balance sheet exceeded US$9 trillion at its peak (compared with US$4 trillion at the end of the 2008 financial crisis), so we should expect some market volatility as quantitative tightening occurs.

These policies will both increase borrowing costs and slow economic growth or even induce a recession which would tame inflation. The impact will vary across the globe, but more cyclical parts of the chemical sector will likely see tempered demand. With the cost of debt and ultimately capital increasing, along with growth pressures, valuations will likely compress. If inflation persists or even accelerates well into the summer, we expect there will be increased pressure on central banks to accelerate their tightening of monetary policy.

In this setting, companies should reevaluate their capital structure to support their M&A outlook. It is important that they evaluate their fixed/floating mix in the context of current and future funding needs. In the short term, the outlook for access to funding still seems strong, but this should be monitored, and companies should prepare for lower and potentially negative growth. With capital markets' volatility and broader uncertainty, banks can become more tempered in their willingness to provide committed financing to support acquisitions.

Lastly, with significant dry powder in private equity and current access to cheap debt (essentially negative real cost while inflation remains high), valuations have remained high by historical standards. As inflation and cen-tral bank policy evolves, public and private valuations are likely to reset. We are already seeing that in the pub-lic markets. That uncertainty may create a valuation gap, which always challenges M&A broadly. However, this environment and dislocation should lead to opportunities for the bold.

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