Mergers and Acquisitions: The Path to Value Creation

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Despite the level of consolidation already present in the North American paint and coatings value chain, merger and acquisition (M&A) activity continues, and in many cases, serves as a major path toward value creation. Several notable transactions announced at the end of 2012 were finalized in 2013. While deal-making seems to have slowed following this burst of activity, there is a general expectation among industry analysts that both coating formulators and raw material suppliers are pursuing additional opportunities to expand their product and technology portfolios and geographical presence through acquisitions. Therefore, they predict that the number of transactions will be on the increase again starting in the latter part of 2013 and on into 2014.

M&A volume has been lighter in the first half of 2013 than the market had expected, according to Ben Scharff, managing director of investment bank Grace Matthews, Inc. "Some of the reduction in activity is likely driven by continued uncertainty in the European markets, lower-than-expected growth rates in Asia, and political uncertainties in the U.S.," he says. Another contributing factor may be the number of major transactions consummated or announced in late 2012 that involved many of the large paint and coating players. Despite all of the pieces being in place for a highly active M&A environment, Scharff adds that 2013 has been largely a "digestion period" for bigger coatings buyers, with no significant transactions. There have been, however, a number of smaller, strategic deals by industry players focused on geographical and product line expansions.

The notable transactions announced at the end of 2012 included a mix of strategic purchases by large coating manufacturers. Examples include PPG Industries' acquisitions of AkzoNobel's North American Paint Stores business, Spraylat, and Deft Aerospace Coatings; Sherwin Williams' acquisition of the United States and Canadian pieces of Consorcio Comex, S.A. de C.V (the deal for the Mexican operations has since encountered a setback following its rejection by members of the Federal Economic Competition Commission); and some major purchases by private equity (Carlyle's acquisition of DuPont's Performance Coatings business—renamed Axalta; Advent International's acquisition of Cytec Coatings Resins—now Allnex).

PPG's $1.05 billion acquisition of AkzoNobel's North American Architectural Coatings business is of particular interest for the company and the coatings industry. It is one of the largest and most important acquisitions in PPG's history, and the second-largest in the company's history, according to PPG chairman and CEO Chuck Bunch. With this deal, the company extended its architectural coatings business in the United States, Canada, and the Caribbean in all three major business channels (home centers, independent paint dealers, and company-owned paint stores) and continued the accelerated pace of its business portfolio transformation to a company focused on the coatings industry. Specifically, this acquisition followed the separation of its commodity chemicals business and merger of its wholly-owned subsidiary, Eagle Spinco Inc., with a subsidiary of Georgia Gulf Corporation to form Axiall Corporation. This merger provided PPG with approximately $900 million in cash. The company is also divesting its 51% interest in Transitions Optical to Essilor International, which will bring in an addition $1.73 billion (pre-tax) in cash when the deal closes in the first half of 2014.

"As a result, we have now nearly completed our transformation to a company that is well positioned going forward to focus on our coatings portfolio with even more resources, strong organic growth, and a very strong balance sheet," Bunch says. He adds that PPG also has a balanced global portfolio, with a good mix geographically, and is well-positioned for strong organic growth in emerging regions like Eastern Europe, Asia Pacific, and Latin America. The transformation is quite apparent when looking at the product distribution of the company. In 2002, coatings accounted for just 55% of PPG's $8 billion in annual sales; today, paints and coatings contribute 90% (pro forma) of the company's $14 billion in annual sales.

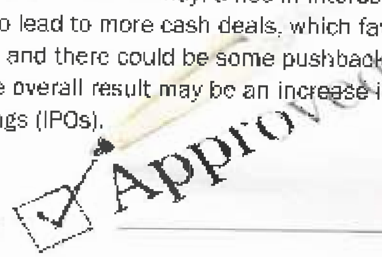
The impact of the acquisition of DuPont's Performance Coatings business by a private equity (PE) company could also be interesting, according to Michael D. Brown, president of consulting firm StrategyMark. "We now have, for the first time, a top coating formulator owned by a PE firm. PE firms manage companies differently because they are looking to turn around the business in a short time frame—typically five years or so—and therefore they are looking to make Axalta nimble and very competitive. Such a change will be good for Axalta, but may also affect other players in the market, and exactly how this scenario may play out remains to be seen," he explains.

As long as there is some degree of fragmentation in any segment of the paint and coatings industry, there will continue to be M&A activity, according to Daniel Murad, president and CEO of consulting firm The ChemQuest Group. "Strategic buyers like PPG and Sherwin Williams currently have cash flow and are upscaling in North America, as well as making moves to strengthen their positions in emerging markets," he notes. A good example of the latter, according to Scharff, is PPG's recent acquisition of Inver Group, an Italian industrial coatings manufacturer primarily serving the European market. "This deal provided PPG with an assortment of 'green' coatings technologies with a recognized brand and presence throughout Europe," he comments.

In addition, in the United States specifically, access to cheap natural gas as a result of shale gas development is creating expectations for a manufacturing renaissance in North America, according to Scharff. "Coupled with the continued weakness in Europe and lower-than-expected demand in Asia, much of the world is looking at the U.S. for investments in manufacturing and production assets," he remarks.

Even in the architectural coatings segment in the United States, where the top five companies account for just over 90% of the market, there are still several regional producers that could be targets. The same can be said for other fairly well-consolidated segments, including the automotive OEM, industrial wood, and can coating markets. Sectors that remain relatively fragmented and present greater opportunities for further consolidation include powder coatings; industrial maintenance coatings; and specialty/niche applications such as safety and security (e.g., blast mitigation), mold release, water remediation, and roof coatings, according to Murad.

"Activity in 2014 will, of course, depend on the health of the global economy and whether or not the recovery continues. If, for example, early signs of recovery in Europe develop further, then a pickup in activity by large strategic buyers can be expected. However, as the economy improves, raw material suppliers will raise their prices, which will negatively impact cash flows, and these buyers will likely be more selective in terms of what they consider to be good investments," Murad observes. Currently, according to Scharff, an aggressive lending environment is allowing private equity to continue to be competitive with strategic buyers for coatings assets. Brown notes, however, that while PE firms have been more active recently, a rise in interest rates would tend to lead to more cash deals, which favor strategic buyers, and there could be some pushback from PE firms. The overall result may be an increase in initial public offerings (IPOs).



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Regardless of the rate of economic recovery, though, companies that want to create value in a reasonable time frame do not have an alternative but to seek appropriate acquisitions, Murad says. "Organic growth adds value too slowly. In addition, innovation very seldom is achieved rapidly enough today, partly due to the significant reductions of R&D budgets in recent years. Furthermore, customers aren't generally willing to pay prices that will cover the full cost of innovation. As a result, acquisition in most cases is the best option for value creation." Scharff adds that because coatings players generally operate in low-growth environments, in order to meet growth expectations, many companies will look to acquire businesses that can supplement top- and bottom-line growth.

There is, in fact, interesting recent activity on the supplier side with respect to titanium dioxide (TiO_2), according to Brown. In mid-September 2013, Huntsman announced that it will purchase the titanium dioxide pigments business of Rockwood Holdings for $1.1 billion in cash. The deal is expected to close by June 2014 and will make Huntsman the second-largest TiO_2 producer, behind DuPont. Huntsman plans to retain a majority

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stake in the combined pigment business, but will spin off approximately 20% in an IPO, according to CEO Peter Huntsman. Rockwood has exited the TiO_2 and other businesses in order to focus on lithium for battery applications. DuPont, meanwhile, appears to be accelerating its plans to shed its TiO_2 and Performance Chemicals business (likely in response to increased pressure from activist board member Nelson Peltz) to focus on its agrochemical and life science portfolios. Analysts expect that, given DuPont's large size, the likely buyer of its pigment business will be a PE firm.

Also, on the raw material side, 2014 could possibly see the sale of Dow Chemical's epoxy resin business. Like DuPont, Dow is looking to emphasize its agrochemicals business and unload its low-cost, commodity-based activities. The company is considering all options, from forming a joint venture to complete divestiture, according to CEO Andrew Liveris.

"We expect to continue to see the larger players in the coatings value chain looking to divest mature, high-cash-generating businesses and redeploying those assets into higher-growth segments of the market," concludes Scharff.

The economic outlook for 2014 also seems to be favorable for additional M&A transactions. "With the Fed's recent announcement to continue its fairly aggressive economic stimulation, and the impact it will have on public markets, we expect that the trading multiples for companies across the coatings value chain will remain high well into 2014," observes Scharff. He further notes that, coupled with healthy balance sheets, this stimulation will allow industry buyers to aggressively pursue small- to medium-sized acquisitions and justify them as being highly accretive. "Given the high valuation environment, however, we believe that industry buyers will remain a bit cautious about overextending themselves," Scharff comments.

PPG is one of the industry buyers pursuing potential acquisition targets. Bunch believes that there is still a large portion of the global coatings industry in the hands of smaller, regional, and local companies. "There's still ample opportunity to pursue further consolidation, and I would expect that as we look forward over the next five to 10 years, we will see these consolidation trends continuing, with most of the opportunities in the $50 million to $500 million range," he says. He does agree, however, that not as many of the largest companies would be considered for sale. "We will need to get more aggressive in terms of realizing acquisitions in that space. There are a number of companies out there that we think would be suitable for PPG, though, particularly in Europe, Latin America, and Asia. In addition, while the North American market is more consolidated, there are still plenty of opportunities, but we will definitely have to move more aggressively."

In fact, a seller's market will continue into 2014, with strong interest from both industry and private equity buyers. "Given the availability of capital and the pressures for both industry and private equity buyers to grow and acquire, we are seeing a more systematic pursuit and mining of potential acquisitions. Most buyers are out aggressively looking for a proprietary deal flow vs. waiting for it to come to them. As such, we believe that these discussions will contribute to an acceleration of deal flow across the coatings market, from the raw material suppliers to the end formulators," Scharff asserts. He also notes that, with the help of investment banks, sellers are increasing their attractiveness by identifying and quantifying the strategic fit of their businesses with possible buyers. Down the road, Scharff expects to see PE firms turning their assets in response to pressure to sell and return capital to their limited partners.