

Challenges And Uncertainties

Chemical Distribution In 2009

Changing Picture – We witness now the realization of the most severe global crisis since sixty years. Initially centered on the housing and real estate markets, the downturn expanded into the banking and financial sectors before reaching the real economy and the chemical industry. Many analysis were done recently to understand the causes of the crisis, whereas now comes the sobering task to assess its consequences on chemical distributors and their suppliers. This article analyzes the new economic and financial sce-



Marc Henri Fermont
Districonsult

nario and specific challenges and opportunities faced by chemical distributors.

Last year, most chemical manufacturers experienced considerable decreases in raw material prices as well as significant drops in demand for their products. As most asset values busted, the disposable

incomes of various segments significantly decreased and are likely to remain deflated over a long period of time. In January, news of the bankruptcy of Tronox and of the U.S. arm of the third global chemical producer Lyondellbasell hit the whole industry. The Lyondellbasell bankruptcy represents a write off for the banks of over \$10 billion. Both companies were affected by demand and margin drops as well as by very high debt levels.

Simultaneously, the financial crisis and the decline in oil prices forced the collapse of the KDown joint venture concluded earlier between Dow and Kuwait Petrochemicals. This turnaround left Dow in quandary with limited resources to complete the generously valued Rohm and Haas acquisition. During the last few months, the Hexion, Huntsman, Lyondellbasell, Dow, Rohm and Haas demises marked the end of easy credit availability and leveraged buy outs.

Overall, the recession will lead to the restructuring of many industrial sectors, including the chemical industry. This will bring a new industrial outlook in industries where chemicals are used like paints and coatings, building, automotive, paper and polymer processing. It is now clear for distributors that dependence on a few large suppliers or on a few customers can be very precarious under the present circumstances. Finally, in relation to slow or negative industrial growth rates, producers and distributors will have to adapt their sales to shrinking industrial demand and declining markets.

Private Equity In Reflux

Private equity firms own most leading European chemical distributors. Their



Table 1: Overview of private equity owned distributors

Distributor	Owners	Transaction Amount (M€)	EBITDA Year of deal	EBITDA multiplier	Date of transaction	2007 global distribution sales (M€)
Azelis	3i	315	37	8.5	12.07 Tertiary	914
Brenntag	BC Partners	3500	360	9.7	07.06 Tertiary	6700
Druckchemie	3i	133	16	8.3	04.08 Secondary	70
IMCD	ABN Equity	320	38	8.6	06.05 Secondary	922
Neochimiki	Carlyle	749	83	9	06.08 LBO	400
Solvadis	Orlando SSP	NA	NA	NA	06.04 LBO	600
Quaron	Bencis	60	8	7.5	06.02 LBO	250
Safic Alcan	ING Parcom	115	13	9	12.07 Secondary	250
Unipex \$	AXA PE	155 (M\$)	18 (M\$)	8.6	04.08 LBO	220 M\$
Univar	CVC	1500	175	8.6	10.07 LBO	5.900
Warwick £	CFPE	129 (M£)	16	8.1	09.08 LBO	90 M€

Table 2: Impact of declining EBITDA multiples on private equity

	2007	2010 expectations at closing	2010 – a likely reality
Sales	600	800	700
Equity	78	270	42
Long term debts	210	210	210
Ebitda= 6% Sales	36	48	42
Multiple	8	10	6
Enterprise Value (EV=Ebitda X multiple)	288	480	252
Equity Value = EV minus debts	78	270	42

Table 3: Importers and Domestic Distributors' Characteristics

Domestic distributors	Importers capabilities
Relationships with EU producers	Relationships with overseas suppliers
Supplier partnership	Opportunistic buying
Reliable EU sourcing	Overseas sourcing networks
Short supply routes	Long supply chains
Defined pricing concepts	Buy "CIF", payments with Letters of credit
Shorter stock rotation	Hedging capability
Shorter payment terms	Pricing risks between shipment and delivery
Producers cover most Reach registration costs	Distributors cover most Reach registration costs
ERP/CRM in place, reporting functionalities	Specific IT systems to manage L/C's, shipments

inroads in the sector expanded significantly to reach last year an overall European industry market share above 30%. Private equity investments in chemical distribution have specific characteristics not evidenced in other sectors, namely: higher ownership rotation, shorter holding periods, only secondary or tertiary exits and increasing leverage levels. Secondary or tertiary placements entail a major drawback: namely the formation of a speculation bubble where the company values increase a lot and bear no relationship anymore with the financial reality. Since secondary placements are unlikely to be completed now and IPO's may not be on

the agenda before 2012 or 2013, we can only expect some M&A distressed opportunities to emerge soon.

This table illustrates well the new financial challenges faced by private equity, at times when acquisition multiples fall. It is considered that the equity value of a company is equal to its enterprise value (EV) minus its debts. The EV is assumed by private equity to be an Ebitda multiple. Most transactions were dealt in the recent past on the basis of multiples between eight and ten. In the future, they will be dealt on the basis of multiples between five and seven which will significantly penalize their equity values.

Consequently, the current strategy of most private equity owned distributors aims at trying to preserve the value of their equity investment by eventually growing sales and Ebitda to compensate the inevitable decline of acquisition multiples which is a challenging, if not unattainable goal.

The chemical distributor model remains a powerful engine of value creation in the supply chain between producers and end-users; however the conflicting interests of private equity, bankers and insurers faced with the decreasing performance of their investments, create many uncertainties in the sector.

Private equity faces new regulatory rules which impose that they assess annually the price of the companies they own, based on their market value and not anymore on the original cost of their investment. By some calculations, the actual losses created by goodwill impairments could exceed 30%. Therefore, private equity is now mostly sticking to what they have, trying to optimize the value of their investments, avoid equity injections and wait for better times.

Distributors' Challenges

Chemical distribution, even when confronted with a difficult environment, remains a flexible and entrepreneurial industry sector. This point is illustrated with innovative examples in the area of Reach implementation and information technology processes implementation.

2008 was the Reach implementation beginning year marked with the completion of the pre-registration process for higher volume products above 1000 mt/y and hazardous chemicals below 100 mt/y. The iterative registration process proved to be more costly and tedious than anticipated, since it includes comprehensive information about product handling, downstream uses and formulations. During the next two years, final registration within specific product consortia will take place.

Reach implementation is a bigger challenge for specialty chemical distributors who rely on overseas imports from USA, China and India. They often have to cover the registration costs on behalf of their overseas suppliers without being sure of recovering these investments on the market. Reach is now creating two types of European distributors based on distinct competencies, namely importers and domestic distributors.

Reach restricts domestic distributors to freely import buy chemicals from Asia. Consequently, there will be a small number of specialized companies able to manage increasingly complex import activities that

will purchase larger volumes, either for their own account or on behalf of other distributors or resellers.

Information Technology Inroads

Due to the sector complexities, information technology penetration into chemical distribution took more time than in other sectors. Initially, the adoption of

vendor managed inventories. Telemetry systems are used by bulk distributors to monitor their customers' stocks and this gives them some mutual benefits. Customers pay for what they consume and don't have to monitor their tank levels anymore. Distributors can also flexibly plan their customer shipments.

Distributors managing single sourcing contracts become purchasing agents

and simplify the management of used drums and pallets, returnable containers and spent chemicals. Information technology systems became process facilitators in the management of these complex and varied activities.

Chemical distribution is facing now major challenges and opportunities. Their most significant test lies in their ability to resolve complex financial and credit issues. Distributors with reduced indebtedness, strong balance sheets and a sound strategy are in a better position to benefit from the market recovery. It is safe to assume that the chemical distribution picture after the downturn will be different from what we observe now.

“Private equity firms own most leading European chemical distributors.”

adapted enterprise resource planning (ERP) systems by most distributors was driven by reporting, internal costs and margin management. Then it gradually moved into internal and external information exchanges. Impressive developments took place in the area of customer management processes like supply chain integration, procurement outsourcing and

for their customers. They provide a full range of chemicals and related services to their larger chemical users in the chemical and other related industries like paints and coatings, automotive or pharmaceuticals. As a result, chemical users decrease their purchasing costs by buying from a single source, reduce administration, lower inventory levels

► Kontakt:

Marc Henri Fermon

Districonsult

Leysin, Switzerland

Tel.: +41 24 49 42 380

Fax: +41 24 49 42 381

mfermont@districonsult.com

www.districonsult.com