The Chemical Distribution Industry: An End to The Great Destocking and a Return to M&A?

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Chemical Distribution is a Critical Part of the Global Supply Chain

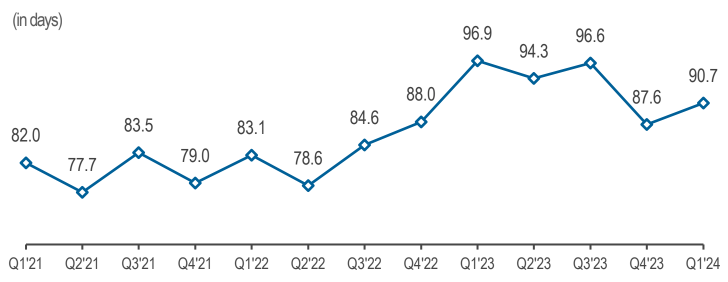
The $268 Billion[1] global chemical distribution industry is a critical part of the world's economy. The ingredients, materials, plastics, polymers and chemicals that flow through distributors ultimately find their way into products and applications that enhance our everyday lives. The chemical distribution industry has always been defined by its ability to adapt to the changes and shocks of its myriad end markets, and the perception of distributors by customers and manufacturers alike has evolved from "middlemen" to indispensable and critical supply chain partners. Distributors have been especially put to the test over the past five years due to crises, such as COVID-19 and the Ukraine war, and supply chain discontinuities, including the Texas "Deep Freeze" and the Suez Canal blockage, that have created both challenges and opportunities in the industry. The last two years have been especially volatile as "panic buying" by customers in 2021 and early 2022 as a reaction to COVID-19 shortages created excess inventory positions in 2023. This excess inventory in the supply chain led to a rapid turn in fortune for distributors as customer demand

dried up almost overnight in what has been called "The Great Destocking," leading to a compression of margins, valuations and M&A activity in the space. While the market has not returned to the post-pandemic highs of 2021, green shoots in volumes, selling prices and consumer demand are giving the market cautious optimism for H2 2024 and 2025 trading activity and, as a result, a return to robust M&A activity.

Post-COVID Panic Buying Leads to the Great Destocking of 2023

The global supply chain crises in 2020 and 2021 created an optimal environment for chemical distributors to capture value and grow market share as demand for inventory was out of balance with supply. Darren Birkelbach, CEO of Integrity Partners Group, a leading chemical distribution, blending, tolling and distillation group, commented, "*In 2021 [inventory availability] was constrained. Therefore, Average Selling Price and margin went through the roof. Margins were artificially inflated at [unsustainable levels].*" During this time, customers, fearful of production shutdowns due to insufficient stock, purchased large amounts of "safety stock" – in some cases 18-24 months worth. However, this dynamic could not continue in the face of global economic headwinds. Sean Tilley, CEO of Tilley Distribution, a leading distributor of ingredients and chemicals for specialty applications in food, nutrition, life sciences and industrials, commented, *"…June 2022 was peak COVID demand. Then demand just died in July. A hard stop. By July 2022, the 'Great Destocking' had begun."*

Days Inventory Outstanding (DIO) in S&P Materials Index [2]



As customers began engaging in destocking, overall demand plummeted, leaving excess inventory throughout the supply chain in 2023. The graph above illustrates this effect with average Days Inventory Outstanding (DIO) of large manufacturers increasing throughout 2022 and peaking by Q1 – Q3 of 2023. Vishal Goradia, CEO of Vinmar International, a leading, global distributor of plastics, polymers and specialty chemicals, commented, "*2023 still had residual impacts from 2022, namely, working through higher priced inventory and our customers operating at reduced rates ... [furthermore]… the Russian invasion of Ukraine and its ripple effects continued to depress European economic activity, and Chinese demand was weaker than expected*."

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>
> **Sean Tilley, CEO Tilley Distribution**

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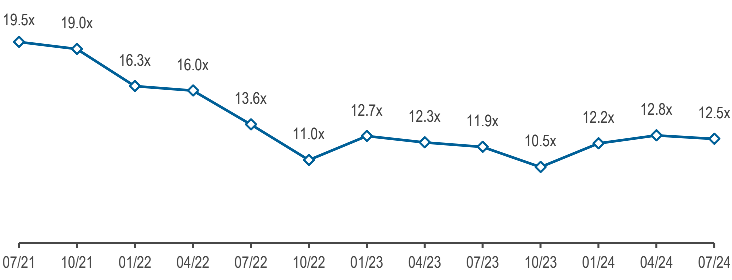
> **Vishal Goradia, CEO Vinmar International**

The Great Destocking depressed volumes, forced price competitiveness and sharply curtailed both M&A activity and valuations in the industry. As shown in the chart below, public valuations of chemical distributors had peaked at nearly 20x LTM EBITDA in 2021 before dropping almost by half to nearly 10x towards the end of 2023. A contributing factor for declining industry valuations and deal volume in 2023 was the lack of visibility on future volume and EBITDA sustainability. As a result, investors could not predict when or where the bottom would be hit.

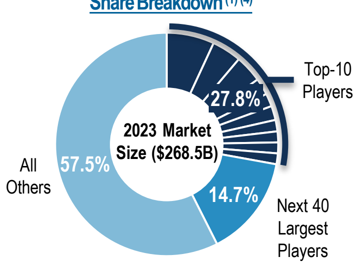
Average Enterprise Value / EBITDA Multiples for Public Chemical Distributors [3]



The good news is that promising trends appear to be developing for chemical distributors as excess inventory has largely burnt off and consumer demand is picking back up. Birkelbach commented *"…we weren't able to see increases in our volumes until mid-2023, and then had a nice increase for Q1 2024."* While average selling prices are yet to return to early 2022 levels, they are expected to gradually rise as customers return to predictable purchasing patterns. These positive developments are expected to influence future M&A activity.

High Industry Fragmentation Sustains an M&A Thesis

Chemical Distribution Market Share Breakdown [1] [4]

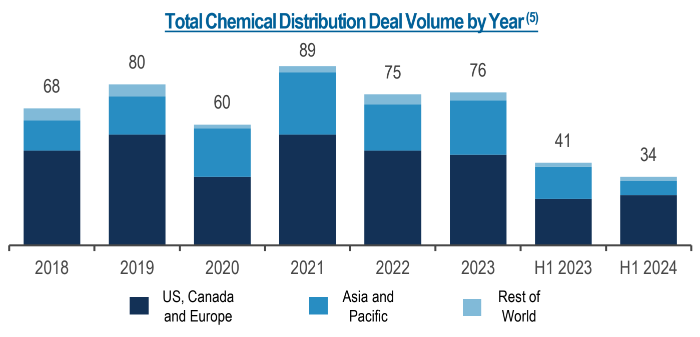


The chemical distribution industry is hallmarked by extreme fragmentation – some of the highest levels within the broader industrials sector. Consolidation in the industry has been led by large strategic players such as Brenntag, IMCD and Azelis, who each have completed dozens of transactions in the past five years. However, this M&A activity has not been limited to large strategics, as Private Equity has accelerated activity in the space, acquiring small "mom-and-pop" operators as well as global platforms such as the recent buyouts of privately-owned Manuchar by Lone Star and the go-private of publicly-traded Univar Solutions by Apollo Global. Despite this aggressive consolidation trend, the largest 10 players still only represent approximately a quarter of the industry with the largest company, Brenntag, holding less than a 7% market share. The next 40 players rounding out the top-50 hold less than a 15% stake combined, leaving nearly 60% of global revenues to hundreds of small and mid-sized participants – the majority private and founder-owned or operated.[4] The dynamics of this vast, unconsolidated family-owned universe continue to sustain fertile hunting grounds for consolidation activity, a trend that may accelerate as the founder generation seeks retirement. Sean Tilley commented, *"…having grown up in the business of chemical distribution and knowing lots of family-owned chemical distributors, there are hundreds who have no succession plan. There's a cliff somewhere here in the next 3-5 years where some of these businesses are going to be forced to sell – the consolidation of distribution has to continue."*

M&A Trends within the Specialty Chemicals Distribution Industry

From 2010 to 2018, the industry averaged approximately 37 chemical distribution transactions globally per year. However, a combination of Private Equity appetite, consolidation trends amongst large competitors and the margin and growth tailwinds of the post-COVID-19 world advanced global deal volume to an all-time high of 89 in 2021. During the Great Destocking however, M&A activity dropped sharply due to challenges bridging gaps between seller value expectations and buyer concerns about EBITDA sustainability. Still, many large players have remained active (since 2021, IMCD, Azelis and Brenntag have combined for over 85 acquisitions alone),[4] but overall deal volume, size and multiples have all fallen since the 2021 peak.

Total Chemical Distribution Deal Volume by Year [5]



Visibility into financial performance played a large role in the deceleration of M&A, as buyers centered their valuations on present negative trends (many looking at 2019 as a proxy of "normalized" levels of pricing and demand), while sellers were convinced of a return to 2021-2022 profitability levels. Now, after Q2 2024, specialty chemical distributors can provide stable financial performance for two consecutive quarters for the first time since 2019. Overall interest in selling has also increased, with Private Equity and strategic buyer anecdotes referencing increased outreach from sellers, with some re-engaging in M&A talks that were halted during the destocking period. Although global deal volume in H1 2024 is slightly lower than comparable 2023, North American and European deal volume is up year-on-year and is expected to pick up pace in H2 2024 due to increased visibility of earnings and volume. Ben Lyons, VP of Business Development and M&A for Univar Solutions, the world's 2nd largest chemical distributor, commented, *"…M&A for specialty chemical businesses is coming back because there is greater visibility. Our customers have greater visibility into demand and its normalizing. There's better predictability in earnings and … we've seen the margin profile start to normalize. We've also seen greater predictability in volumes which means we can start to get more comfortable with forecasting these businesses than we were 6 months ago."*

Furthermore, Private Equity, which holds over $2.62 trillion in dry powder [6], will remain a compelling exit for years to come – particularly for the masses of middle-market and family run businesses who will look to sell but prioritize preserving their unique company cultures. Lyons comments, *"…there is still a fairly robust Private Equity thesis in [the chemical distribution] space, because some [private/ family-owned] sellers don't want to sell directly to [strategics]. So, Private Equity / growth capital is still very attractive because they fill a valuable role in bridging the gap between founder-led businesses and a more professionalized management team."* As a result, industry participants broadly expect that the second half of 2024 will mark the beginning of a strong rebound in M&A activity that is supported by a wide range of factors.

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> **Ben Lyons, VP Business Development and M&A, Univar Solutions**

> "[in 2023] all sellers said 'there's no way [my performance] will fall to 2019 [levels]' thus killing deal discussions. However, now many of these same sellers are reaching out again to restart discussions after not selling in 2023 and saying, 'you were right'."
>
> **Darren Birkelbach, CEO Integrity Partners Group**

Conclusion

The chemical distribution industry will continue to serve as an invaluable link in the complex, global supply chain connecting manufacturers with consumers. However, distributors provide more than just chemicals and ingredients. Customers increasingly depend upon distributors for customer service, technical support, formulation guidance and logistical infrastructure. The past five years have presented the distribution industry with a rollercoaster of crises, challenges and opportunities. The Great Destocking has been the latest, and perhaps most extreme, of those challenges as the industry whipsawed from peak to valley in pricing, volume and profitability. Fortunately, it appears that the inventory levels across the industry have balanced out, and distributors are starting to see a return to visibility on demand and pricing. In an industry that is defined by its tremendous fragmentation, it is broadly expected that appetite for M&A will return. Whereas deal flow was stymied in 2023 because of a value gap between sellers looking backwards to unsustainable earnings, and buyers looking forward to uncertain market conditions, indications in 2024 are pointing to a closing of that gap as markets stabilize. Birkelbach of IPG summarized it best: *"[in 2023] all sellers said 'there's no way [my performance] will fall to 2019 [levels]' thus killing deal discussions. However, now many of these same sellers are reaching out again to restart discussions after not selling in 2023 and saying, 'you were right.'"*

TM CAPITAL'S SPECIALTY CHEMICALS & MATERIALS TEAM

TM Capital's Specialty Chemicals & Materials investment banking group has completed many complex, cross-border transactions in the consumer care, life science and performance chemicals, materials and ingredients sectors.

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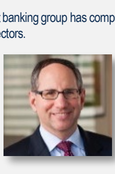

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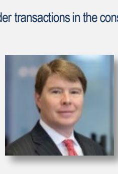

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Selected Specialty Chemicals & Materials Transactions

SK Capital HAS ACQUIRED Valtris Specialty Chemicals A PORTFOLIO COMPANY OF H.I.G. Capital

Fragrance Oils Ltd. HAS BEEN ACQUIRED BY Givaudan

NMC New Mountain Capital HAS ACQUIRED THE CHEMICAL BUSINESS OF Aceto

Leuna Tenside GmbH HAS ACQUIRED Vantage Specialty Chemicals A PORTFOLIO COMPANY OF H.I.G. Capital

I. Stern HAS BEEN ACQUIRED BY Ravago

Akcros Chemicals HAS ACQUIRED Valtris Specialty Chemicals A PORTFOLIO COMPANY OF H.I.G. Capital

Essential Ingredients HAS SOLD ITS ACTIVE INGREDIENTS PRODUCT LINE TO Vantage Specialty Chemicals A PORTFOLIO COMPANY OF The Jordan Company

PSL HAS BEEN ACQUIRED BY Arsenal Capital Partners

Warwick Chemicals A PORTFOLIO COMPANY OF cbpe A PORTFOLIO COMPANY OF Lubrizol

Inter'Actifs HAS BEEN ACQUIRED BY Aceto

(1) Grand View Research
(2) Capital IQ, S&P 500 Materials Index
(3) Pitchbook Data for Azelis Group NV (ENXTBR:AZE), Brenntag SE (XTRA:BNR), DKSH Holding AG (SWX:DKSH), Hawkins, Inc. (NASDAQGS:HWKN), IMCD N.V. (ENXTAM:IMCD)
(4) Independent Commodity Intelligence Services (ICIS) May 2024 Chemical Distributors Report
(5) Capital IQ Transaction Screens
(6) Preqin, S&P Global Market Intelligence