



Mid-market dynamics

Mergers and acquisitions within fine chemicals have more than tripled in recent years, with increasing interest coming from Indian manufacturers and private equity firms

Consultant's corner

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FINE CHEMICALS mergers and acquisitions (M&A) activity increased significantly at the beginning of 2005, and remains strong by historical standards in 2007. But what will be the impact of the emergence of India and private equity money be in this environment?

To put things in perspective, the table on page 21 illustrates fine chemicals M&A activity since 2000. From 2000 to 2004, there were approximately five announced fine chemicals M&A transactions per year. Our estimates track third-party merchant manufacturers, and exclude pharmaceutical firms that manufacture fine chemicals principally for internal consumption.

Beginning in 2005, the level of activity more than tripled. We have observed increased interest from private equity firms and, for the first time, we saw significant activity from Indian fine chemicals manufacturers acquiring Western firms.

What is driving this increased activity? There are a number of factors behind the trend. They include both general market conditions that are driving strong M&A activity, as well as developments among each major category of buyer.

A MID-MARKET INDUSTRY

When analysing general market trends in fine chemicals M&A activity, it is helpful to understand that fine chemicals is a mid-market industry. Most sources estimate that worldwide merchant market demand for fine chemicals is \$25bn–30bn (€18.8bn–22.5bn), at least two-thirds of which is produced for pharmaceuticals. That estimate excludes in-house manufacturing by pharmaceutical firms

for their own consumption.

The in-house, or captive, segment of the market is difficult to quantify but, by some estimates, it is twice as large as the merchant market. Over the past

five to 10 years, there has been a trend towards outsourcing by pharmaceutical firms, which has contributed to the growth of the merchant market.

Structurally, the fine chemical industry is highly fragmented and consists of medium-sized and smaller firms. There are 500–600 fine chemicals manufacturers, of which only about 10–12 have sales in excess of \$250m. The majority have sales under \$100m and are privately owned.

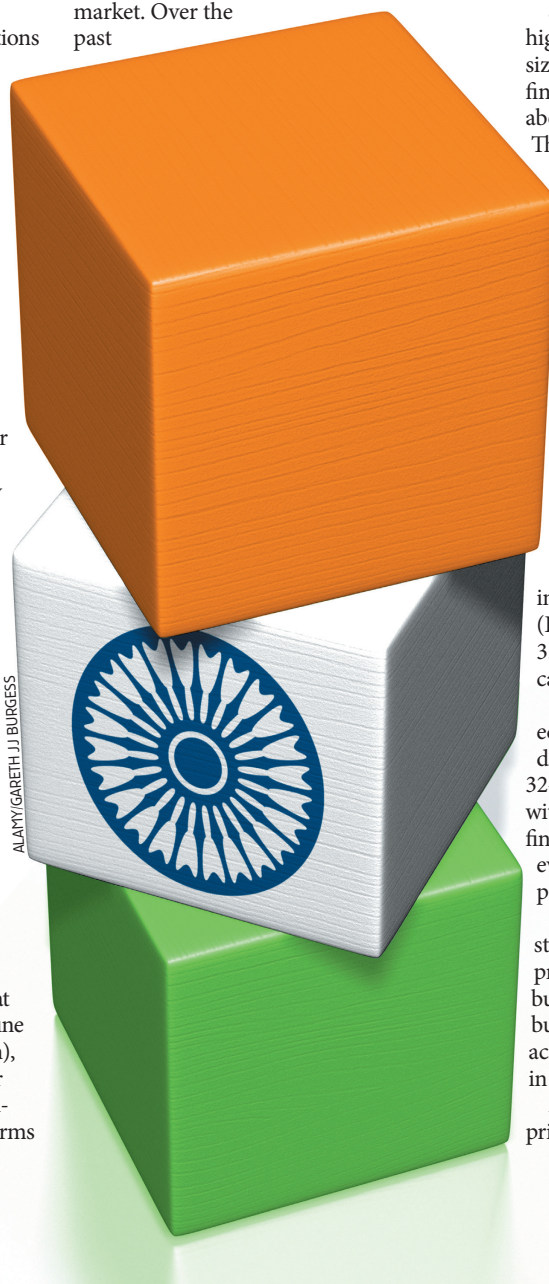
By our estimates, in 2005 and 2006, private equity firms were the acquirers in approximately one-third of fine chemicals M&A transactions. From a private equity standpoint, the fact that fine chemicals is a mid-market industry is significant because the mid-market, in general, is at, or near, peak activity, driven largely by the increased availability of acquisition debt over the past 24–36 months.

US mid-market M&A activity is up by more than 35% from its low point in 2002. Debt multiples for mid-market deals – less than \$50m of earnings before interest, tax, depreciation and amortisation (EBITDA) – are running at approximately 3.6 times EBITDA, and total debt multiples can exceed 5.0 times EBITDA.

At the same time, the amount of equity required to fund acquisitions has decreased, and is now in the range of 32–33% of total capitalisation, as compared with 40% in 2002. Although these are US financial market statistics, we have observed even more aggressive lending activity in parts of western Europe.

While other factors are at work, the strong debt market is a major reason why private equity firms have been more active buyers. We have seen similarly increased buying activity by private equity firms across all sectors of the mid-market, not just in chemicals and fine chemicals.

Across all sectors, the average purchase price multiple paid by private equity firms



in mid-market acquisitions rose to 8.1 times EBITDA in 2006, from 5.9 times in 2001. We are seeing no immediate signs of a slowdown, but some have predicted the market may cool at the end of 2007 or early 2008.

THE EMERGENCE OF INDIA

In 2005 and 2006, Indian firms went on a buying spree, accounting for approximately one-third of fine chemicals acquisitions.

Over at least the past five to 10 years, India has emerged as a major player in pharmaceuticals and a threat to Western fine chemical manufacturers. According to Indian fine chemicals manufacturer Hikal, in 2005, the Indian pharmaceutical industry was worth some \$8bn, representing the fourth-largest producer in terms of volume, and the 13th largest in terms of value.

Why is India a threat to Western manufacturers? There are several reasons. First, Indian firms can produce sophisticated fine chemicals at a lower cost and, increasingly, at comparable quality to Western manufacturers.

According to KPMG, pharmaceutical production costs are approximately 50% lower in India than in the West. India has a strong pool of chemists, and Hyderabad-based Divis Laboratories estimates that wages and salaries for chemists are 20% of those in the US. Second, environmental regulations are less stringent than in the West, resulting in a lower cost of compliance.

Finally, India has become much friendlier with respect to intellectual property rights compliance, having recently passed regulations that recognise international patent laws. As a result of these advantages, Indian firms continue to grow their international sales.

Given the cost advantages, why would an Indian firm wish to acquire a Western fine chemicals manufacturer? The answer is not because of technology, or the need for additional production capacity. Instead, Indian firms have been looking to gain a foothold in the West and access to customers. In an industry where customers rarely switch suppliers once a product is in advanced stages of development or is commercialised, it is much easier to acquire an existing business that already has customer relationships and contracts in place.

Many firms have been in a retrenchment mode and have sought to restructure

The question now is: will Indian buyers continue to seek acquisitions in the West, or have they already met their strategic goals with the acquisitions already made? Given the lack of significant announced acquisition activity by Indian firms in the first five months of 2007, evidence suggests that the wave of Indian buying activity may be subsiding.

STRATEGIC ACTIVITY AMONG WESTERN FIRMS

M&A activity among Western fine chemicals manufacturers has modestly increased, but not by the same proportion as activity among Indian and private equity firms. Western firms have been subject to considerable pressure in recent years by the rise of Indian manufacturers and a relatively weak new drug-development pipeline.

As a result, many firms have been in a retrenchment mode and have sought to restructure, close or sell their operations. Where they have made acquisitions, it has tended to be for very strategic reasons, such as adding a specific technology or establishing a presence in a new geography. Not all western firms have struggled. Those who have unique technologies or the right strategy tend to perform the best, and are the most highly sought-after acquisition candidates. We have observed at least three successful strategies, with firms often pursuing more than one simultaneously. These include the following:

- **Focus on Technology.** The most successful firms own technologies and capabilities that are in high demand and are difficult and/or

expensive for others to obtain. Areas such as energetics, hazardous chemistries, and chiral chemistries are examples of difficult or less-common technologies.

A growing area of investment, in response to trends in pharmaceuticals, has been high-potency chemicals, which are highly reactive and require exceptional precautions for handling and safety. The ability to sustain a technology or know-how advantage is one of the top determinants of success in the current environment.

- **Emphasise Service.** It is no longer sufficient to manufacture production-scale quantities. More firms have become involved in the development process by investing in lab-scale and pilot-scale capabilities. By working with customers in the early clinical trial phases, the goal is to develop an incumbent position as drugs are commercialised.

The ability to provide these services requires commitment of additional resources to business development, and therefore could provide an advantage to larger firms that can afford the investment.

- **Add Asian Manufacturing.** This could be achieved through direct investment, a strategic alliance or joint venture. The idea is to offer low-cost manufacturing for earlier-stage intermediates or products, where cost is a higher concern to customers, while also keeping western manufacturing where there are unique technological capabilities, or where customer service is critical.

What does the recent activity tell us about the state of fine chemicals M&A? For one thing, these are dynamic times. The competitive landscape, structure and growth opportunities look much different today from how they did just a few years ago, and they are likely to change significantly over the next few years.

In one sense, we are seeing the decoupling of many fine chemicals businesses from larger Western corporations, into the hands of smaller Indian companies and independent private equity firms. Whether a full-scale industry consolidation will follow remains to be seen, but the level of transaction activity suggests that the trend will continue. ■



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FINE CHEMICALS M&A TRANSACTIONS			
	Strategic Buyer	Private Equity	Strategic Indian Buyer
2000	3	0	0
2001	5	3	0
2002	3	2	0
2003	2	1	0
2004	5	1	0
2005	7	5	5
2006	4	7	6
YTD May-07	5	3	0
TOTAL	34	22	11

SOURCE: CAPITAL IQ AND LINCOLN INTERNATIONAL.