2009: A Chemical Executive’s Worst-Case Scenario

Steps Required to Stabilize Equity Valuations

The harsh sell-off in chemicals and materials stocks during the second half of 2008, followed by what is likely to be a sharper and deeper recession than has been witnessed in decades, is creating the perfect storm for chemical industry executives.

Chemical stocks experienced such severe sell-offs that many are now categorized as “small-cap” stocks. These stocks face declining equity research coverage, reduced institutional investor interest, higher overall borrowing costs, and heightened hedge fund activity – which can push valuations even lower (see Figure 1 on next page).

While the initial decline in chemical industry equity valuations was largely a function of the global financial crisis, additional selling pressure is likely in the months ahead as investors recalibrate earnings estimates to account for rapidly deteriorating business conditions.

Chemical industry executives need to take immediate action to minimize additional declines in equity values, and avoid other financial challenges such as under-funded pension liabilities. Will your company’s stock be deemed a “winner” or “loser” in 2009? Will investors perceive your company’s stock to be a value at current levels or will they adopt the mantra “don’t catch a falling knife”? Will your company’s market capitalization experience a recovery in 2009, or will it shrink further? Could your company become the target of a “take-under”, an unsolicited takeover offer at an unacceptably low valuation?

Even in the best of times, there is a gap between investors’ and company executives’ perceptions of a company’s intrinsic value. Today, there must be heightened urgency to differentiate your company and its financial health in investors’ minds. Decisions that are made in the weeks ahead, and the way in which they are communicated to the financial community, will likely seal companies’ fates for many quarters into the future, if not permanently in the case of companies taken-over in the year ahead.

Factors that Undermine Equity Values

- Internal view lags reality
- Unrealistic earnings guidance
- Closely guarding bad news
- Adopting bunker mentality
- Only doing the obvious
- Eventual upturn unaddressed

With the chemical industry in crisis, what needs to be done? We believe that firms need to take three essential steps: (1) recalibrate internal expectations of business performance and future prospects given new external realities; (2) develop strategies to survive the near term without undermining longer-term growth objectives; and (3) ensure that business and investor relations strategies are tightly integrated and effectively communicated.
Recalibrating Internal Perceptions

While equity valuations might already seem extremely low, it is clear that the industry has yet to absorb the full impact of the economic downturn. In many key end-use markets for chemicals and materials, sales are plummeting in line with dramatic falls in consumer spending. For example, US new housing starts in September 2008 were 31% lower than a year earlier, and in the automotive sector, US light vehicle retail sales declined by 32% in October 2008 compared with the previous year. As a result, market projections for 2009 are looking far too optimistic, and current 2009 consensus earnings estimates must be markedly reduced to reflect economic realities.

Many chemicals and materials companies are confronting these economic realities from a position of weakness rather than from a position of strength. Despite some industry consolidation over the past decade, many chemical companies still lack sufficient critical mass. Industry spending on R&D has declined over the past five years resulting in fewer new product introductions - the lifeblood of any healthy organization. The severe escalation in feedstock and energy costs over the past year has squeezed margins, ultimately leading to reduced cash on company balance sheets. Many companies, unable to recover rising costs via higher selling prices over the past year, now face customers demanding lower selling prices as energy prices have declined.

However, there are major differences in companies’ past performance and current position. Some companies have focused on growing the bottom-line through cost reduction, and will need to balance further rounds of cost cutting with the impact on their longer-term competitive positions. Other companies have grown the top-line but without the levels of profitability that investors expect, and will need to confront the challenge of further margin compression.

There are similar differences in equity valuations. While equity valuations have dropped precipitously, not all companies have faced equal selling pressure. There are several reasons for variations in stock valuations, including the degree of hedge fund activity, individual balance sheet condition, raw material exposure, and perceived earnings vulnerability to a prolonged recession.

As a result, companies’ internal perceptions of their business performance and future prospects are likely to be out of alignment with external realities. To ensure that the right decisions are made moving forward, senior leadership needs an objective view of their room to maneuver through the dual lenses of...
Surviving Near-term, Succeeding Longer-term

Cost reduction is front-of-mind in any downturn, and opportunities to improve efficiency are likely to exist across the organization – from reworking product and service offerings, through running the operations more efficiently, to renegotiating supplier contracts, to optimizing company assets. As an example of the pressures on companies’ supply chains, the downturn is causing increasing numbers of customers to move to just-in-time inventory management.

Pricing also has a major impact on financial performance, particularly in a rapidly-changing competitive landscape. One of the greatest near-term risks will come from irrational competitors willing to reduce selling prices in an effort to keep operating rates high rather than shut down capacity. As the recession takes hold, offerings that are not sufficiently differentiated will be exposed. Figure 2 illustrates that price decreases not only compress margins; they lead to pressures for budget cuts in areas key to future growth.

Figure 2: Pricing Sensitivity in the Chemical Industry

For the average chemical company*...

- ...a 1% drop in average prices results in...
- ...a 9.6% drop in operating margin, equivalent to...
- ...a 14.3% drop in annual capital investment...
- ...or a 40.9% drop in R&D spending

* Average for Top 50 US chemical firms, 2007
Source: Kline and Company, company data

Nevertheless, companies need to take particular care to ensure that cost reductions do not result in customer defections. One chemical company is using “war gaming” to gauge how their competitors and customers might respond to the impact of proposed efficiency measures. Another firm has asked its sales force to reiterate to customers the company’s balance sheet strength, with the implication that some of its competitors may not survive. At the same time, companies need to ensure that they are aligned with customers likely to survive the downturn. One measure that can help is to modify sales forces’ incentive compensation to include a variable component tied to customer accounts receivable delinquencies.

Action needs to be taken at both the strategic and tactical levels. Companies must maintain pricing discipline, ensuring they are price-makers, rather than price-takers. They also need to identify vulnerable offerings and decide how to modify their price/service differentiation. In the current business climate, speed and pragmatism may be more important than detailed analyses of price waterfalls.

Another area that ought to be front-of-mind is acquisitions. Many companies have identified M&A targets that met their strategic objectives over the past few years,
only to find they were out of reach with rising acquisition multiples.

**With declining valuations and less competition from private equity firms, acquisition targets that seemed prohibitively expensive just a few months ago may be relative bargains when viewed over the longer-term investment cycle.**

While it is human nature to want to go into hibernation during such a crisis, this is precisely the time to be opportunistic. We do not advocate stretching balance sheets in a current climate that prizes cash, but now is the time to begin exploring creative business transactions and deal structures. By way of example, think about the long-term value J.P. Morgan Chase will ultimately create by having been willing to acquire Bear Steams at its darkest moment for pennies on the dollar.

It is critical for firms to respond effectively to the near-term crisis while at the same time ensuring they are positioned for longer-term success. Firms that get it right will benefit from a recovery in the stock market that will precede an economic recovery. Trillions of dollars of investor capital are temporarily sidelined in cash or short-term investment vehicles. When investors eventually begin to put these funds back to work in equity markets, there will be a powerful rebound. The biggest beneficiaries of the return of investor capital will be those chemicals and materials companies with the greatest prospects for rapid margin recovery in the next business cycle.

**Integrating Business and Investor Relations Strategies**

Business strategies and investor relations strategies are inextricably linked. After all, a properly executed business strategy ultimately leads to higher earnings that fuel share price appreciation at a given earnings multiple. In many instances, companies are rewarded with a higher valuation multiple on the higher earnings base, creating a powerful multiplier effect. However, there are specific reasons why the drastic changes that have taken place in the global economy give added urgency to integrating business and investor relations strategies.

Sophisticated investors not only value stocks based on expected future earnings and cash flow, they also base their analyses on their perceptions of a company’s product portfolio, management talent, and the credibility of a company’s business strategy. Investors are looking to companies to provide a compelling response to the current economic downturn. Working on a parallel path ensures that a company’s investor relations investment thesis for the financial community is grounded on a sound business strategy, which in turn is shaped by the equity valuation likely to result from successful strategy implementation (see Figure 3).

**Figure 3: Driving Change in Business Performance and Investor Perceptions**

Source: Kline and Company, StreetSmart Strategies
Our experience is that an integrated approach can materially influence a company’s equity valuation, sometimes years in advance of full implementation. In uncertain times such as these, there can also be a “first mover premium”, with investors rewarding companies that show leadership and clarity of purpose.

Another factor affecting valuations is the concern – frequently discussed among institutional investors on Wall Street – that companies’ Investor Relations Officers may not have “a seat at the table”, that they are too detached from the strategic planning process. This concern partially explains why many institutional investors demand meeting directly with company CEOs and CFOs instead of just the Investor Relations Officer. An integrated approach mitigates this concern. Furthermore, some of the best strategic ideas implemented by corporate management teams originated from institutional investor feedback initially received by company Investor Relations departments.

Finally, while hedge fund “short selling” activities are being more closely scrutinized for financial industry and related stocks, hedge funds continue to “short sell” chemicals and materials stocks, in essence “placing bets” on which chemical companies might go bankrupt – a process that can be self-fulfilling if enough hedge funds target a given company’s stock. A competent investor thesis – tied back to a company’s business strategy and effectively communicated – may reduce the risk of hedge funds attempting to “bet against management”.

About the Authors

Jonathan Goldhill is a Senior Vice President of Kline & Company. Responsible for Kline’s management consulting activities worldwide, he focuses on business strategy and innovation. Prior to joining Kline, he was CEO of Celestian LLC, a strategy consulting and technology firm acquired by Kline in 2005. He was formerly a Vice President at Arthur D Little, where he led ADL’s global chemicals practice. Contact: Jonathan.Goldhill@KlineGroup.com or +1 215 887 4257

Tim Gerdeman is President of StreetSmart Strategies. He has helped numerous corporations develop their financial messages and investment themes, fueling increased equity research coverage and materially higher equity valuations. He was formerly an Institutional Investor-ranked Specialty Chemicals Equity Research Analyst at Salomon Brothers, Citigroup, and Lehman Brothers. Prior to Wall Street, he worked for Kline and Valspar Corporation. Contact: tgerdeman@streetsmartstrategies.com or +1 312 320 3393

Eric Vogelsberg is a Senior Vice President of Kline & Company responsible for Kline’s global chemicals and materials practice. He works with leading chemical companies, investment banks and private equity firms to identify, evaluate and pursue organic and M&A growth and diversification opportunities. Early in his career, he worked for Hercules Inc. and Harshaw Chemicals, now part of Arkema. Contact: Eric.Vogelsberg@KlineGroup.com or +1 973 435 3466

Kline & Company and StreetSmart Strategies believe the chemicals and materials industries are confronted with some of the greatest commercial and financial challenges in living memory. If these challenges are unaddressed, or if companies’ business and investor relations strategies are misaligned, the impact on company performance and equity valuations will be severe. If you would like to explore these issues in more depth and understand how we can help, please contact us.

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