

Grant Thornton Corporate Finance mergers & acquisitions

Grant Thornton 

Plastics Compounding Industry M&A Update

Content

- Summary
- Market overview
- Recent M&A activity
- Public company trading comparables
- Outlook

Grant Thornton Corporate Finance Mergers & Acquisitions

Stephen McGee

Director

P: (617) 848-4988

E: Stephen.McGee@gt.com

Arthur Dembro

Vice-President

P: (617) 848-4916

E: Arthur.Dembro@gt.com

Mark Shifrin

Associate

P: (617) 848-4909

E: Mark.Shifrin@gt.com

226 Causeway Street

Boston, MA 02114

www.GrantThornton.com

Summary

We expect merger & acquisition (M&A) activity in the compounding sector to accelerate in 2006 due to increased purchasing power for both strategic acquirers and private equity groups. Larger strategic buyers are benefiting from improved economic conditions and stock market valuations, while private equity groups have large un-invested funds. Deals will be driven by the search for innovative products, product portfolio re-alignments and the opportunity to purchase lower priced assets through distressed sales.

Market overview

Our report focuses on the \$17 billion compounding segment of the \$310 billion plastics industry. The North American plastics compounding market is showing signs of maturity. Annual growth rates have decelerated to 2 percent from higher levels of 4 to 6 percent in the late 1990s and gross margins have also decreased. Based on research undertaken by Grant Thornton Corporate Finance, we believe the key issues facing privately-held plastics compounders include:

- Many U.S. manufacturers have shifted operations to China and are using local suppliers. Although China is still a large net importer of plastics, Chinese domestic production doubled between 2002 and 2005. This trend has created opportunities for larger compounders to invest in off-shore operations, but has resulted in lost orders for smaller U.S. players who are now faced with excess capacity.
- Resin price increases driven by high oil prices and hurricane-related supply interruptions have increased input costs. The compounders' lack of pricing power over larger customers has caused gross margin compression. Margins are expected to recover somewhat during 2006 as increased input costs are passed through to customers on a selective basis.
- Margin compression is driving many compounders to develop proprietary products and technology. The requirement to invest in research and development or acquisitions at a time when margins are falling has caused some level of financial stress. As an alternative to investment some firms are considering selling to a market consolidator or private equity group.
- The market has suffered from decreased margins as a whole, but some suppliers serving certain end markets have suffered more than others. For example, firms serving the automotive industry have suffered larger margin decreases due to intense end user industry competition. By contrast, medical device and pharmaceutical suppliers have fared better due to lower price elasticity and higher regulation related switching costs.
- The commodity tolling business has come under heavy pressure as large players have brought volume in-house to fill excess capacity, which has increased pressure on smaller vendors.

Recent M&A activity

Recent M&A activity is being driven by product portfolio realignment, product innovation and the opportunity for financial buyers to purchase assets at lower prices through distressed sales. Table 1 below shows recent M&A activity.

Product portfolio realignment

Product portfolio realignment is being pursued by both the larger players and their smaller competitors. Firms are divesting non-core product lines and operations while at the same time making selective acquisitions in product areas where they are strong.

- Product portfolio realignment is demonstrated by the simultaneous buying and selling by three large players: BASF, Spartech and Polyone. The three companies are bulking up their core products and shedding weaker operations. Specifically, Spartech, the world's largest sheet extruder, purchased vinyl sheet extrusion specialist VPI, while disposing of their performance elastomer group and excess corrugated sheet capacity.
- Private acquirers that service smaller customers are pursuing a similar strategy. Each acquirer is consolidating

within their respective niche to gain scale economies in a difficult and maturing market place.

The plastics compounding segment is highly fragmented and experiencing overcapacity. As margins have contracted and more volume has been manufactured off-shore, smaller vendors are coming under financial pressure. Falling margins and fragmentation in a maturing industry are indicators that further consolidation is necessary.

Table 1 - Recent North American Compounding Market M&A Activity

Ann. Date	Target	Description	Acquirer	EV (\$mm)		
				Sales	EV/EBITDA	
12/12/2005	Color and Additive Technologies, Inc.	Color and additive concentrator	Americhem, Inc.	NA	NA	NA
12/8/2005	Lati USA, Engineering Plastics Operations	Plastic resin compounder	BASF AG	NA	NA	NA
12/07/2005	DSM North American polypropylene business	Producer of polypropylene compound	Fiberfil Engineered Plastics	NA	NA	NA
9/27/2005	PolyOne Engineered Films Inc.	Producer of thermoplastic elastomer films	Matrix Capital Markets Group, Inc.	27	0.2	NA
09/21/2005	Starfire Systems, Inc	Developer of nanotech plastic formulations	Clariant, AG	NA	NA	NA
9/2/2005	Spartech Corporation, Corrugated Sheet business	Corrugated sheet manufacturer	Coroplast Inc	6	0.7	NA
07/29/2005	Lynn Plastics Company, LLC	Plastic resin compounder	S&E Specialty Polymers LLC	NA	NA	NA
05/16/2005	Rodgers Engineering Corp.	Manufactures sheet molding compounds	Bulk Molding Compounds, Inc.	NA	NA	NA
5/13/2005	Novatec Plastics Corporation	Plastic resin compounder	Polyone Corp.	1	NA	NA
05/02/2005	Vincolit NV and Vyncolit North America Inc.	Plastic resin compounder	Sumitomo Bakelite Co. Ltd.	120	1.5	NA
4/25/2005	Cyro Industries	Producer of acrylic sheets, and extrusion compounds	Röhm GmbH & Co. KG	190	0.6	NA
03/04/2005	Thermoplastic Composite Designs	Develops thermoplastic composite materials	Envirokare Tech, Inc.	15	NA	NA
01/17/2005	Rutland Plastics Technologies	Manufacturer of plastisol compounds and polyurethanes	Laud Collier & Co.	30	0.6	NA
01/12/2005	New England Extrusion, Inc.	Manufacturer of multi-layered polyethylene films	Appleton Papers Inc.	69	1.4	NA
1/4/2005	Chem Polymer Corporation	Compounder of engineering thermoplastics	Teknor Apex Company	NA	NA	NA
12/13/2004	Gitto Global Corp.	Plastic resin compounder	Toner Plastics	9	0.3	NA
10/23/2004	NYCOA	Manufactures engineered grade nylon	Metapoint Partners	NA	NA	NA
09/21/2005	Starfire Systems, Inc	Developer of nanotech plastic formulations	Clariant, AG	NA	NA	NA
9/1/2004	VPI, LLC	Custom sheet extruder	Spartech Corp.	88	0.9	NA
07/19/2004	Total Compounding Solutions, Inc.	Plastic resin compounder	Matrixx Group	NA	NA	NA
7/6/2004	Hexion Specialty Chemicals, Inc.	Manufactures resins, inks, coating and adhesive resins	Apollo Advisors, L.P.	1,206	0.8	8.7
6/29/2004	Excel Polymers	Elastomers and performance additives business	ACI Capital	120	0.3	NA
04/05/2004	Unit of BASF AG	Producer of polystyrene compounds	Spartech Corp.	6	NA	NA
02/19/2004	Spaulding Composites, Inc.	Producer of polystyrene compounds	Metapoint Partners	NA	NA	NA

Innovation

Innovation acquisitions are driven by the search for higher margin products or technology transfers. Technology transfers create value by leveraging existing manufacturing and distribution systems to expand or dramatically improve product offerings. Target multiples are higher for innovation transactions, which generate returns from high margin growth.

- Clariant and Appleton Paper sought out acquisitions that integrate technologies into their existing product lines. Clariant purchased access to nanotech formulations that can be used to significantly lower product weights while Appleton Paper purchased access to plastics expertise that complements their paper coating technologies.
- Envirokare acquired Thermoplastic Flowform technology through its purchase of Thermoplastic Composite Designs specifically to leverage its manufacturing and distribution networks.

Financial buyers

Financial buyers focus on the relationship between acquisition costs and estimated future cash flows. Plastics companies provide solid cash flows and opportunities to cut costs that are attractive to private equity even when growth is slow. Recent trends among financial buyers include:

- Large financial buyers that specialize in distressed sales or underperforming

companies have been active. For example, Apollo Group, a distressed investment specialist, has acquired unwanted assets from Eastman, Borden and Shell to create Hexion, a \$3.6 billion specialty chemical manufacturer.

- Private equity investors were strong buyers of middle-market private companies in 2005, but were not so active in the area of compounders. Investors had difficulty analyzing earnings due to volatile resin prices. Resin prices are predicted to be more stable this year, which even at higher than normal levels, provide greater cash flow predictability and will drive more middle-market private equity transactions in 2006.

Public company trading comparables

The four major publicly traded compounders' valuations have increased significantly during the last 12 months. EBITDA multiples increased from a low point of 7.2x in Q1 2005 back to the five year average of 7.8x by Q1 2006. This multiple expansion reflects the following market and company improvements:

- The large plastics compounders have selectively been able to pass on price increases to their end customers, catching up with input cost increases incurred during 2005. Additionally, resin prices are more stable and have even fallen during the last three months as oil prices have eased and weather related supply shocks have been resolved.
- Investors have responded positively to divestitures of non-core product lines and strategic acquisitions that build on strengths. Renewed focus is welcomed after compounders took on significant debt to complete several large mergers in the late 1990s.
- Operational improvements have also been taking hold. The large plastics compounders have improved operating cash flow management and SG&A expense ratios.

Rising valuations provide currency to conduct acquisitions. The market leaders' ability to more effectively pass on price increases and lower operating costs will allow the larger compounders to profitably integrate smaller players.

Table 2 - Public Company Trading Valuation Multiples

Company Name	Market Cap. \$MM	Enterprise Value \$MM	TTM Sales \$MM	TTM EBITDA \$MM	EV/ TTM Sales	EV/TTM EBITDA	EBITDA Margin
A. Schulman, Inc.	\$725	\$693	\$1,467	\$86	0.5x	8.0x	5.88
Polyone Corp.	\$820	\$1,439	\$2,451	\$189	0.6x	7.6x	7.72
Spartech Corp.	\$763	\$1,131	\$1,436	\$122	0.8x	9.3x	8.50
Ferro Corporation*	\$805	\$1,298	\$1,775	\$175	0.7x	7.4x	9.85
				Median	0.7x	7.8x	8.1%

*Ferro last reported earnings in 2003

Source: Capital IQ; Stock Prices as of 3/22/06

Outlook

Market forces are aligned for a strong M&A environment in 2006. The key M&A market drivers are:

- Strategic consolidators and private equity buyers have purchasing power derived from higher stock prices and large un-invested funds respectively.
- Compounders are more attractive takeover candidates due to better earnings visibility and improved operational efficiency.
- Large and small vendors will continue realigning product portfolios by shedding non-core product groups and building on strengths through selective acquisitions.
- Falling margins and capital investment requirements will continue to drive consolidation as firms without large scale economies or strong niche products sell to private equity and larger strategic compounders.
- Larger firms with solid manufacturing and distribution systems will continue to acquire companies that make innovative high margin products.

The combination of strong buying power for acquirers and economic motivation for sellers should provide incentives for buyers and sellers to participate in industry consolidation. The best acquisition targets will have consistent earnings and products that can be leveraged across larger manufacturing and distribution systems. Global scale will become even more critical as pricing pressure heats up, and large customers demand to be serviced at their point of manufacture. Mid-market generalists will find the market increasingly difficult as pricing pressure and global supply chain requirements continue to intensify.



About Grant Thornton Corporate Finance LLC

Grant Thornton Corporate Finance provides boutique investment banking services to privately held middle-market businesses in the United States and around the world. As a recognized advisor on middle-market mergers and acquisitions, we offer a range of investment banking services including sell side advisory, buy side advisory, management buyouts, restructurings and capital raising. Grant Thornton LLP provides investment banking services through its wholly owned broker-dealer subsidiary Grant Thornton Corporate Finance LLC.

About Grant Thornton LLP

Grant Thornton LLP is the U.S. member firm of Grant Thornton International, one of the six global accounting, tax and business advisory organizations. Through member firms in 112 countries, including 50 offices in the United States, the partners and employees of Grant Thornton member firms provide personalized attention and the highest quality service to public and private clients around the globe. Visit Grant Thornton LLP at www.GrantThornton.com.

The factual statements contained herein are taken from sources believed to be reliable, but such statements are made without any representation as to accuracy or completeness or otherwise. Grant Thornton Corporate Finance LLC does not engage in the business of recommending or effecting transactions in securities. The above information is presented solely in connection with describing Grant Thornton Corporate Finance LLC's mergers and acquisitions services, and should not be considered as constituting a research report or as providing information reasonably sufficient upon which to base an investment decision.