The right chemistry

YULE CATTO'S FINANCE DIRECTOR DAVID BLACKWOOD EXPLAINS TO **PETER WILLIAMS** HOW REPOSITIONING THE COMPANY HAS REVIVED ITS FINANCIAL FORTUNES.

Yule Catto is a company that has recovered its corporate mojo. The specialty chemicals manufacturer's fortunes have revived in recent years under chief executive Adrian Whitfield, and the company concluded 2010 with a successful £376m bid for German latex maker PolymerLatex. The group has continued to please the City more recently, with first quarter earnings strongly ahead of a year earlier, and rated a "buy" by all the analysts that cover it.

Group FD David Blackwood, formerly ICI group treasurer, has been with Yule Catto since September 2007. He has contributed to the revival of the company, which was founded by Andrew Yule in Calcutta back in 1863. Forty years ago rubber plantation holder Malay General bought shipping agent Yule Catto, and the move towards becoming a specialty chemicals producer began in 1981, with a takeover of industrial chemicals and paints group Revertex.

"The company's past activities have been quite varied and included plantations, car valeting and building products," says Blackwood, who is also a fellow of the ACT (the highest-level membership). "It rather lost its way for a while and while it's easy for me to say with the benefit of hindsight one or two of its acquisitions back in the Nineties perhaps weren't thought through sufficiently."

In 2006 Yule Catto lost its ranking in the FTSE 250. "The share price still had further to fall, though, as it remained unclear just what the business was really worth," Blackwood adds. "The company was still overvalued on chemical fundamentals when I joined the following year," due possibly in part to "a smallish group of fairly loyal investors". The turnover in the stock was very low. "The price may also have been supported by the extremely high dividend, which was clearly beyond the company's means."

Whitfield had come on board as chief executive designate just before the company's FTSE relegation, succeeding the incumbent, who had held the position for over 20 years. Among Whitfield's first actions was to review the product portfolio, which persuaded him to focus on the company's main strength, its core polymer chemicals.

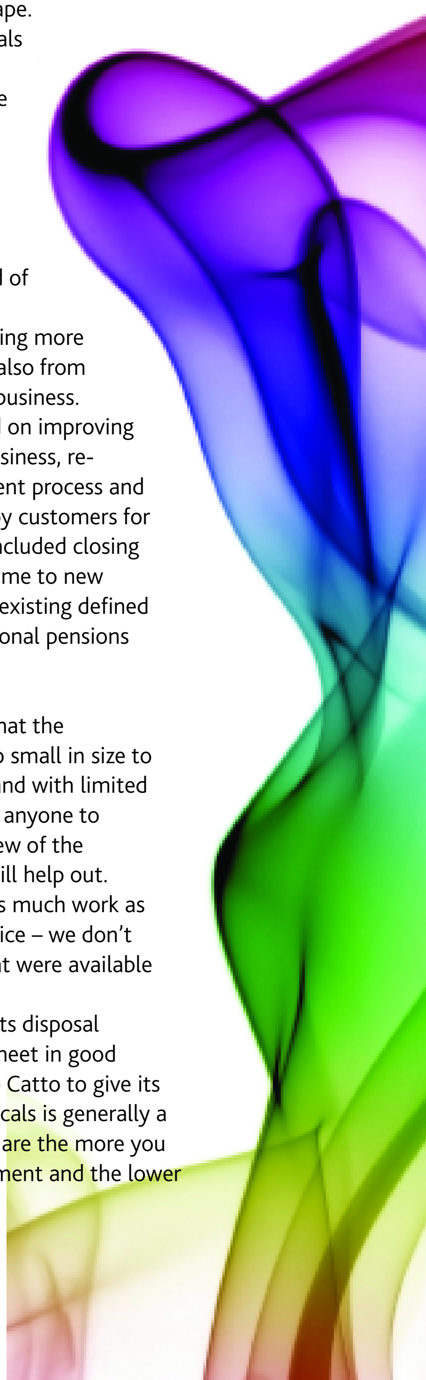
"We also have a small pharma business and we did have five small discrete businesses, which together were called our impact business," says Blackwood. "As with any other business, Adrian had decided the best strategy was to focus on what we were good at and get rid of secondary activities. The performance of the impact units was dire – so they were turned around, and ultimately put up for sale – and we managed to sell four of the five units such as photographic chemicals maker James Robinson prior to the financial crisis in late 2008."

The sale of these units was part of the plan to get the highly leveraged balance sheet back in shape. "Selling off the four impact chemicals units raised about £65m," says Blackwood. "We also suspended the dividend for 18 months – and did a lot of work on cash conservation – particularly working capital reduction. This helped us to reduce the debt by nearly two-thirds over three years, from £180m at the end of 2007 to £63m by the end of 2010."

By then Yule Catto was also making more money, mostly from polymers but also from pharma and the remaining impact business. Management was also very focused on improving the quality of the core polymers business, re-invigorating the product development process and looking to get paid the right price by customers for the value added. Other measures included closing the company's defined benefit scheme to new accrual, and transferring it and the existing defined contribution to a self-invested personal pensions (SIPPs) arrangement.

HARD WORK Blackwood admits that the disposals were hard work, being too small in size to attract any major banking names, and with limited buyer response. "It's difficult to get anyone to show much interest, other than a few of the smaller boutique-style firms that will help out. Small acquisitions require almost as much work as large ones. We run a small head office – we don't have the teams of professionals that were available at ICI – so everyone gets involved."

He says that, having completed its disposal programme and with the balance sheet in good shape, the timing was right for Yule Catto to give its core business greater scale. "Chemicals is generally a large-scale business: the larger you are the more you can leverage your product development and the lower your unit cash costs."



German company PolymerLatex offered an excellent strategic fit with the business. Owned by private equity group TowerBrook, it had already been looked over by Yule Catto three years earlier but the company could not have raised the funding at that time. In the intervening period Yule Catto had strengthened its credibility with investors, and management believed there would be support for a substantial equity lift. There was a "significant overlap" in activities between the two businesses and considerable potential for synergies. Indeed, the company had described its bid target to investors as "a German-headquartered Yule Catto".

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"For various reasons, TowerBrook had held onto the company for a long time, probably rather longer than envisaged as it was the last remaining asset in its fund," says Blackwood. "And as our industry's competitor base has been rationalised in recent years, there were only a limited number of possible trade buyers. For us, the acquisition ticked all the right boxes, plus we felt that we'd got it for a sensible price. We financed it by setting a debt limit, which we didn't want to leverage up to more than two times the EBITDA, and the balance came from the equity raise. Having spent two or three years getting the balance sheet sorted out, we didn't want to rush back to heavy debt levels."

The £376m purchase price was funded by a four-for-three rights issue that raised around £225m. A further £210m of debt was raised to cover the balance and provide working capital.

The FD adds that he has developed good relationships with several banks over the years, particularly Barclays and HSBC. "Both banks supported us when the company refinanced back in late 2008, when liquidity was unbelievably tight. Although we'd sorted it out by that point, trying to borrow at the time was dire. It was only a £30m facility, with £15m from each of them, but at the time hardly anyone could refinance and they came through for us.

"The share price fell to its all-time low in February 2009, two months after we refinanced. We kept telling investors that we'd refinanced, but if you're not in the FTSE 250 they don't need to own the stock – and there was massive risk aversion on any whiff of funding problems."

In early 2010, the company commenced a relationship with Commerzbank, helped by the fact that its biggest plant is in Germany. "So when the PolymerLatex acquisition came along they were keen to get involved with it. We told them that we wanted £210m, so it was a three-way deal with £70m each from Barclays, HSBC and Commerzbank."

THIN ON THE GROUND Yule Catto lacks a designated treasurer, and treasury duties are divided between the FD and his deputy. "We've always been fairly thin as regards staffing levels, so I undertake loan negotiations," explains Blackwood. "I also did all the modelling for the acquisition – in great detail!

"We have a couple of cash pools and we try to do everything to the best standard, but our size puts a limit on the perfect intellectual model that's also cost-efficient. So there are pragmatic approaches required in the way we do things."

So does this allow for, say, looking at the cash position on a daily basis? "Only in the pools – but not globally – though daily visibility is pretty pointless. In an effective capital structure you make sure you've got sufficient liquidity headroom to deal with all the daily ups and downs. So we look at cash monthly, and manage it effectively through a focus on EBITDA, working capital management and capital expenditure. Monthly cashflows are your typical business management cycle for reporting. So every month I review the working capital position and take action if that has deteriorated."

On joining the company Blackwood inherited a high level of fixed-rate debt, which has been running off; the remainder is floating rate, which he prefers. "The analysis is absolutely compelling – 90% of the time, looking backwards, you will find fixing the debt has cost you more than letting it float – it's intuitively obvious – as you are paying a risk premium. Fixed gives you cashflow certainty, which is fine, and some comfort on covenants if the interest cover test is challenging, but most of the important covenant is really net debt to EBITDA."

The company has two foreign exchange (FX) policies in force. "The first is the currency that we run our debt in. With a good chunk of business in Europe we used to run a small synthetic euro debt position swapped from sterling debt. With the acquisition all the new debt is in euros. It's about a 60% European business that we have bought – euro debt is the natural hedge. The second is we hedge out all sale/purchase commitments from date of order – a fairly standard policy – though I sometimes doubt its long-term value."

Yule Catto does not generally hedge its commodity purchases, although its key raw materials, monomers, are "close to the oil barrel". They can't be hedged. "Which is a good thing" says Blackwood, "as this ensures a level playing field with the competition, and avoids the temporary distortions arising from a successful or failed guess at future prices. Because our major raw materials are true commodities, we see a lot of volatility in the price, so this has to be dealt with via the sales force and ensuring we recover input cost increases. We have worked hard at improving our performance in this area too over recent years."

As finance director, is he also responsible for the company's risk management? "For financial risk, yes, and we have a joint process of looking at other risks and how we manage or insure them."

He adds that for a processor of chemicals the biggest operational risk is safety, health and the environment (SHE).

"Like many chemical companies, we have the potential if things go wrong to harm our employees and possibly our neighbours. SHE is therefore a major focus for us and all the various management teams around the world are heavily focused on it. It's the first thing on the agenda for all executive team meetings and the main board. Again, SHE is an area where we have made a great deal of progress in recent years, but it's an area where there is always more to do."

So how would Blackwood summarise the last few years?

"It's been hard work but very rewarding – and very different to the likes of ICI. Adrian has been great for the business, and the team he has created work together very well. We have taken the company back into the FTSE 250, and with the PolymerLatex acquisition we have doubled our scale and created a stronger group. The next phase is to get the combined group properly integrated and delivering, which will also be hard work and enjoyable. We will now have to focus on what comes after that."

Peter Williams is editor of The Treasurer.
editor@treasurers.org

Yule Catto is well known to ACT students. The company is used as an example by students at the MCT level. In Unit 1 of their studies, they look at strategy and governance and at financial risk. In Unit 2 they look more closely into the performance metrics, shareholder value management, dividend policy and more depth on strategy.