Vintage Private Equity Deals: Apollo's Deal of a Lifetime with Bankrupt LyondellBasell

Introduction

Len Blavatnik, a Russian-born American billionaire who made his first fortune in post-Soviet Russia, is well known to many readers of financial news for his hugely profitable ownership of Warner Music [NASDAQ: WMG], which he took public in 2020, making a paper profit of as much as $7.5bn, according to estimates. One previous deal that also netted Blavatnik and his company Access Industries billions, which is less discussed today, is his involvement in piecing together the chemcials giant LyondellBasell [NYSE: LYB]. This deal was one with many ups and downs for Blavatnik, with the company going bankrupt during the financial crisis, only for Apollo [NYSE: APO] to take partial ownership of the company through buying some of LyondellBasell's debt. Ultimately, however, this deal became the most profitable private equity deal in history in terms of dollars of profits generated, meriting a deeper analysis by us in order to generate learnings that can be applied to any investment decisions investment professionals face in their day-to-day work.

Piecing together Lyondell and Basell

Len Blavatnik, as mentioned above, made his first fortune in post-soviet Russia, with his most significant investments including the oil company TNK-BP, a collaboration with British Petroleum, which Rosneft later acquired for $55bn, and Sual, an aluminium manufacturing company. Following these ventures, his focus shifted to chemical companies, where he saw consolidation opportunities. After being significantly impacted by the downturn that began in 2001, the chemical industry rebounded in 2004. Shipments of chemical products in the United States increased by 8.1% to $516.2bn in 2004, and robust growth was expected for the upcoming years.

In 2005, Access Industries, owned by Ukrainian-born American Len Blavatnik, completed the acquisitions of the Dutch company Basell Polyolefins. Basell, a leading manufacturer of plastics and chemicals, was acquired from its joint venture owners, BASF and Royal Dutch Shell, for a total of €4.4bn (approximately $5.7bn at the time). This acquisition was noteworthy for being the largest-ever leveraged buyout in the chemical industry at that time, and, in this case, Blavatnik put down $1.1bn to purchase Basell in a $5bn LBO.

In 2007, Basell, under the ownership of Access Industries, completed its acquisition of Houston-based firm Lyondell Chemical Company, which produced commodity chemicals for making plastics and had crude oil refining assets. Initially offering Lyndell $38 per share, executives at Access Industries were already worried about the economic viability of the deal since it would require a high level of debt for financing. Despite the concerns, in December 2007, Basell bought Lyondell for $48 per share (45% premium to market price) and a total of $12.2bn, with Blavatnik pushing through the deal despite concern from his associates. The deal created LyondellBasell, the world's third-biggest independent chemicals company.

Blavatnik's acquisition closed at the start of the global financial crisis, when the corporate sector experienced an unprecedented leveraged buyout boom. This period was characterized by abundant capital and loosening lending standards. It was also fueled by growth in collateralized debt obligations (CDOs) and other forms of securitization associated with lower spreads, weaker covenants, and greater use of bank debt in deal financing. Banks active in structured credit underwriting lent more for LBOs, allowing firms to finance large-scale acquisitions predominantly through debt. Due to the low-interest-rate environment, which reduced borrowing costs, The era saw some of the largest buyouts in history across various sectors.

The Financial Crisis & Bankruptcy

Access' timing of the deal could not have been worse. The financial crisis hit almost as soon as the deal closed in December 2007, and the combined firm, carrying $20bn in debt, struggled. From a cost perspective, oil prices increased dramatically in early 2008, reaching a record of $147/barrel due to surging demand and decreasing non-OPEC supply. The peak oil theory suggesting that easily extractable oil production would reach a peak and then inevitably decline also influenced market perceptions of future availability. However, by the end of the year, with the onset of the recession, prices fell to less than $45/barrel. Because of volatile oil prices, the company bought feedstock when the prices were high and was forced to sell its products with prices collapsing . Simultaneously, a crane collapsed in an accident at its Houston refinery, killing four employees, and hurricane Ike's activity in the southern US caused delays and shutdowns in its plants in Texas. At the same time, the economic crisis pressed reduced orders from major customers in the construction and automotive industry, and orders dropped significantly, resulting in a revenue decline from $15.6bn in Q1 to $8.2bn in Q4 of 2008 and a gross profit margin of -$1.4bn, without considering an extra $1bn in interest due Q4.

The situation worsened as the the company's borrowing base under the company's working capital facilities were directly linked to inventory valuation. With the downturn in oil prices and a consequent drop in the value of overall inventories, the borrowing base fell in value below the existing borrowed amounts. Because the inventory value was the security for the loans, an immediate need for repayment was triggered.

In December 2008, LyondellBasell failed to pay off debt and interest amounting to $281m million. Later, the company attempted to was denied access to a revolving credit line provided by Access Industries to cover this payment and was denied the claim that the firm was in default to cover this payment because it defaulted on the Credit Agreement. As the 30-day grace period for the debt expired, Lyondell Chemical (the company's American operating branch) declared bankruptcy on January 6, 2009, a little over a year post-deal, burdened by over $23bn billion in long-term debt and an additional $5bn billion in other liabilities.

Apollo's Entry

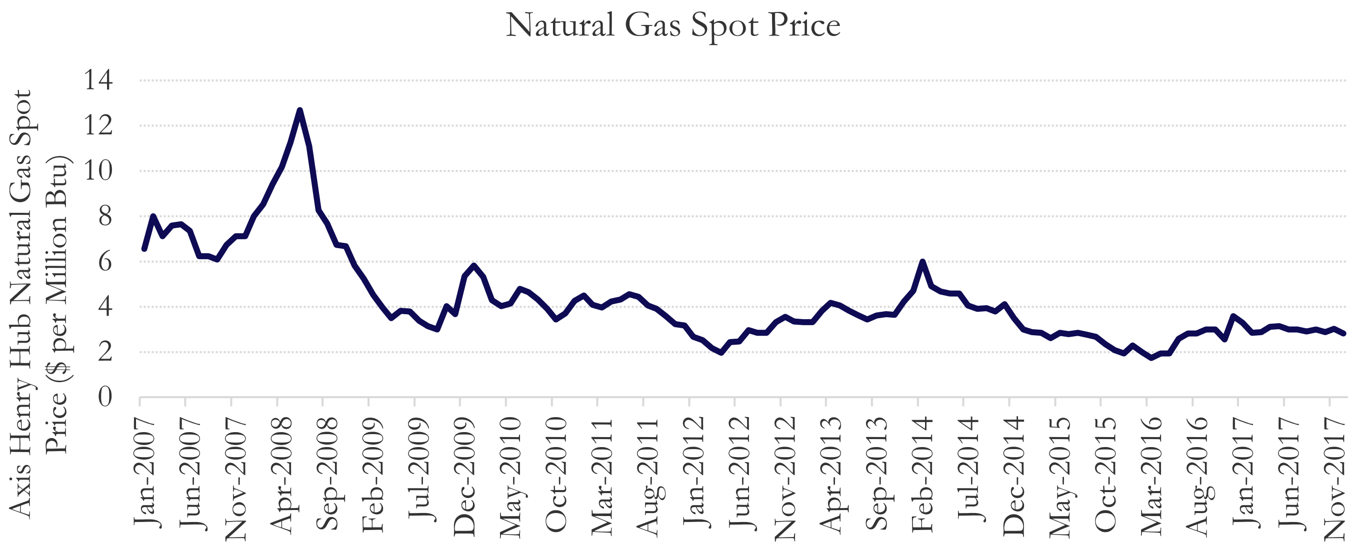
Apollo closely followed the developments at LyondellBasell. The private equity firm had already acquired Hexion Specialty Chemicals and Momentive Performance Materials prior to the financial crisis. Despite the global drop in demand for chemical products and rise in production costs, Apollo's co-founder Josh Harris decided to double down on the sector and acquired LyondellBasell term loans from Citigroup [NYSE: C], alongside Ares [NYSE: APO]. Prior to the financial crisis, Citigroup was a leading provider of loans for leveraged buyouts and was known for excessive risk-taking until the very end. Its then-CEO Charles Prince was infamously quoted in July 2007 "as long as the music is playing, you've got to get up and dance", when asked about continued commitment to leveraged buy-out deals. Once the music stopped, the lender was keen to exit its positions and accepted deep discounts. Ares and Apollo were not the only ones to take advantage of this, with emerging private credit platforms such as Blackstone's GSO [NYSE: BX] also picking up large amounts of leveraged loans from Citigroup.

When LyondellBasell was forced into bankruptcy, Apollo, Ares, and Len Blavatnik organized an $8bn debtor-in-possession restructuring financing. Re-financing the company was crucial for creditor recoveries, as the midpoint liquidation value was only $4.5bn versus the $23bn in net debt. Throughout this restructuring, Apollo continued to amass debt stakes, some for even as low as 20 cents on the dollar. In addition, Apollo, Ares, and Blavatnik backstopped a rights offering to provide cash to the firm. They also converted parts of their stakes into equity, resulting in 25% equity ownership for Apollo, and 7% for both Ares and Blavatnik when the firm later emerged from bankruptcy. The close ties between Ares and Apollo throughout this deal were not surprising, given Ares's founder Tony Ressler was previously a partner at Apollo and his sister was married to Apollo founder and then CEO Leon Black.

Throughout the 16-month bankruptcy process, LyondellBasell also underwent an operational restructuring. The firm finally achieved the synergies from the merger that originally brought Lyondell and Basell together, reducing fixed costs by $1bn per annum, and divesting bad contracts and underperforming assets, such as plants in Texas and Germany. This reduced the net debt load from $23bn to only $6bn, cutting annual interest payments by $1.7bn. They also managed to hire the seasoned oil executive Jim Gallogly, who previously headed Chevron Phillips Chemical, by offering him a very attractive share package. This allowed LyondellBasell to exit the bankruptcy process with a valuation of $15bn in 2010.

The Success Story Unfolds

The major tailwind that turned LyondellBasell into Apollo's most profitable investment was plummeting oil and gas prices in the U.S., a phenomenon attributed to the fracking boom. The shale revolution, driven by innovative techniques like hydraulic fracturing and horizontal drilling, unleashed a bounty of oil and natural gas reserves across the United States. The ensuing surge in domestic natural gas production precipitated a dramatic fall in prices, plummeting from highs of $13 per million British thermal units to a range of $3 to $4. This seismic shift proved to be a game-changer for industries reliant on petrochemicals, with LyondellBasell standing prominently among the beneficiaries. In contrast, investors betting on a rise in natural gas prices suffered. Most notably, the $45bn leverage buyout of Energy Future Holdings, led by KKR [NYSE: KKR] in 2007, ended in bankruptcy in 2014.



LyondellBasell's core competency lies in ethylene production, a key ingredient for plastics manufacturing. The company operates several ethylene-producing facilities, known as "crackers," both in the U.S. and Europe. Profits generated from ethylene and its derivatives constitute the bulk of LyondellBasell's earnings. Ethane, derived from natural gas, and naphtha, a crude oil derivative, serve as primary inputs for ethylene production. With the shale revolution, U.S. drillers discovered abundant natural gas reserves, leading to a substantial drop in ethane prices from 90 cents per gallon to 30 cents. This stark fall in prices bestowed a significant competitive advantage upon U.S.-based chemical producers, particularly LyondellBasell, compared to their counterparts in Europe and Asia, who were reliant on costlier oil-based naphtha.

To add to Apollo's fortune, some of LyondellBasell's facilities were strategically situated near natural gas pipelines. Almost overnight, these facilities underwent a metamorphosis, boasting profit margins of 32%, a stark juxtaposition to the barely profitable European naphtha-based ethylene.

Moreover, CEO Jim Gallogly proved the right bet from Apollo. Leveraging his expertise in the oil industry, Gallogly adeptly capitalized on the opportunities presented by the shale revolution, outpacing industry counterparts in both speed and efficiency. His astute leadership enabled the swift conversion of U.S. processing facilities to operate on natural gas 90% of the time. Diverging from the conventional approach adopted by competitors such as Huntsman [NYSE: HUN] or RPM International [NYSE: RPM], Gallogly pursued a strategy of incremental expansions at existing U.S. plants rather than substantial investments in new crackers. This facilitated rapid production expansion, a pivotal advantage in a cyclical market characterized by oligopolistic competition. It also saved Apollo a large amount of capital expenditure, which the firm could use to pay down debt.

Successful Exit

This shift towards ethane as a primary feedstock coupled with a reduction of $1bn in annual fixed costs resulted in $3.9bn in profits in 2013. The company's financial prowess was further underscored by its ability to return $8.4bn to shareholders from 2010 to 2013 through share repurchases and dividends. When Apollo eventually sold its stake in November 2013 for an average price of $62.65 a share, it netted a $9.6bn gain. The firm was able to leverage this deal as a poster child of their business model for its successful IPO in 2011 and for raising an $18.4bn fund in 2013, the largest since the financial crisis.

While Apollo sold, Len Blavatnik held on. This seemed initially successful, with shares rising further to hit a peak of $114 only a year later. However, in hindsight, we know the right play was to bet on rising gas prices — which Apollo did with its acquisition of gas properties from Encana and Energy Future Holdings. LyondellBasell currently trades at $97, still below its price in 2015. This deal embodies the principle of being greedy when others are fearful — and fearful when others are greedy.

Learnings

Given that this was an Apollo Management deal, which is known for looking at the hairiest deals that other private equity firms don't want to do and co-founder Joshua Harris saying that "if you propose a deal that is expensive, you do not belong at Apollo", the first learning from this deal is that it's very advantageous to enter deals at cheap valuations. Apollo bought into this deal during the height of the financial crisis when other market participants froze, as they were focused on extinguishing the various 'fires' in their existing portfolio instead of making new investments. Naturally, when there are few bids for an asset, you will arguably get a better deal, making it easier for you to generate your target returns. However, there are two important qualifications to the point of 'buying cheaply'. The first is that you must avoid tapping into the value trap, which is the idea that just because something is cheap it doesn't necessitate that it is a good buy. After all, the asset may be cheap for a good reason, such as key supplier risk, bad business fundamentals etc., and there may not necessarily be a catalyst that will improve the valuation of the business. Only if you have a view of the business not retaining its low valuation should you also buy a business at a low valuation. As Apollo specializes in buying struggling or misunderstood businesses at low prices and then getting rid of the complexities that deter other investors during their holding period, Apollo clearly understands how to avoid falling into the value trap. The second qualification to the point of buying cheap is that it is hard to do, as it requires you to be a very contrarian investor. When times are good, you will be most comfortable to do a deal and easily get the financing, but you will also pay the highest price. In bad times, you get lower prices but also have far more convincing to do of your investment committee and lenders, whilst you will also have to overcome the overall negative mood that will surround you, as was surely the case during Apollo's investment during the financial crisis. Nonetheless, we can see that investments done during crisis times are often some of the best.

The next learning that we can take from this deal is that, even though this insight might be trivial, it is essential to hire the best people. As mentioned above, Apollo had to give Jim Gallogy a generous and quite probably above-market stock options package, in order to take the position of LyondellBasell, which had just emerged out of bankruptcy and was therefore less safe than staying with the large oil company he was working for before. Even though this meant retaining less of the profits in the case of a good outcome, the probability of a good outcome was made far larger by taking on a strong CEO, who managed to successfully drive down costs, was smart about deploying capex, and understood the effect that fracking would have on the chemicals industry. Therefore, we can see here, as in many other deals, that having the right people running your company is the a to success.

Finally, the last learning we see in this deal is that it is important to not get greedy when a deal has gone well. Even though the quote 'no one has ever lost money by taking profits' sounds a bit flippant, there is some truth to it. After all, Apollo sold out of its investment by 2014, exiting its investment within the normal 3-5 year private equity holding period. Len Blavatnik, instead of doing the same, only continued buying more stock, which, judging by the firm's stock price over the last 10 years, was not a great investment. Hence, sometimes it is best to not get greedy and to simply take profits.

Conclusions

The past few years have had some parallels to the time before and around the financial crisis. You had a couple of years of ferocious private equity dealmaking, followed by a sharp decline, with some companies starting to struggle. Today, far fewer deals have gone bust than during the financial crisis, but as the effect of higher interest rates gradually feeds through the financial system, we may well see more distressed companies, leading to more opportunities for investors to buy into companies via distress-for-control deals. Given this dynamic potentially on the horizon, we felt that it would be useful to look at the most successful of these deals. We learnt that it is valuable to buy cheaply, as long as you have the prospect of returning the business to a strong valuation by, amongst other things, hiring the right people. Once you have done that, ensure that you exit the business once you've turned it around, as otherwise you may end up having your strong post-crisis recovery returns diluted, as Blavatnik did.

TAGS: Private Equity, Restructuring, Distress, Apollo, Len Blavatnik