



2010 Chemicals Industry Perspective

The \$2 trillion chemicals industry continues to face challenges as it attempts to rebound from its worst year ever. The drop-off in demand appears to have bottomed out, but the damage has been done. Demand is rising, but off severely depressed levels – in some cases, demand had declined by 40 percent. Most new growth is in Asia; Middle Eastern producers continue to enjoy competitive advantages, while many assets in North America and Europe are severely impaired.

Do not be fooled into thinking that recent earnings announcements and the current reprieve from high raw material costs will outweigh the competitive pressure that continues to build. Below the surface, the chemicals industry is as competitive as it has ever been.

Simply put, there is far too much capacity to support viable margins. Making matters worse, new supply from cost-advantaged companies around the world continues to come online while global demand remains weak. The obvious response would be to initiate consolidation and dramatic cuts in capacity. So far, North American and European chemicals producers have made modest attempts to whittle back, but given the enormous gap between supply and demand, these efforts fall far short of what is necessary to restore the chemicals industry to sustainable economic health.

This lack of initiative may stem from some misperceptions about costs and demand. As an unanticipated consequence of the recession, a global oversupply of liquefied natural gas, coupled with new unconventional gas sources, has lowered U.S. prices for natural gas-based feedstock. The new technology that enables unconventional natural gas development has the potential to hold down the price for this essential raw material at \$3 to \$5 per MMBtu in the United States for the foreseeable future. Not surprising, ExxonMobil's chemicals unit, with its large U.S. presence in commodity chemicals, posted healthy profits in the third quarter. Usually a minor element in the energy giant's portfolio, the chemicals business contributed one-fifth of the company's earnings for that period.

Nonetheless, gas prices will not breathe new life into impaired assets throughout Europe, North America, and parts of Asia. Another false hope for these producers is that rising costs of labor and other inputs will erode the pricing power of producers in the Middle East and Asia. And they should also not continue to count on the drop in the value of the dollar, which has provided some support for North American and European companies that have put off the sharp capacity rationalization that needs to occur.

Another misperception is that demand will return suddenly in a V-shaped recovery. The reality is that this recession has triggered shifts in end-user behavior that will have a major, long-term impact on the chemicals sector. Shoppers trying to stretch each dollar are trading down, substituting premium labels for store brands. Sales of expensive durable goods are down even more than consumer products. Overall demand will lag until corporate and consumer spending increase to pre-recession levels. That will depend on growth in jobs and personal income – and unemployment is presently above 10 percent, with average personal income declining at a rate of 4 percent per year. Governments have stepped in with stimulus funding, but it is not at all clear whether this taxpayer investment will lead to sustainable economic growth, or simply generate a short-term boost.

Some emerging acquisition trends further point to underlying power shifts unfolding in the global chemicals industry. For example, the Abu Dhabi state-run company IPIC, having already taken over Nova Chemicals, is now in talks with Bayer Material Science. Likewise, India-based Reliance Industries is reported to be performing its due diligence on the bankrupt assets of LyondellBasell AF. We sense further support of this activity will come from private equity firms, which are stirring to make a play for some assets deemed non-strategic in developed economies.

Although the industry has largely failed to react to the impetus for change the recession provided, it is not too late to respond. We see a number of strategies for 2010.

Commodity producers need to drive industry leadership and adopt a back-to-basics approach. If you are competing in this market, you must first identify where you can win, then take a leadership position and ruthlessly push restructuring across the entire industry.

Chemicals firms can also apply advantaged business models across the industry's evolving sectors. Products that were once specialties have significantly commoditized. Producers with cost-advantaged operating models can target these newly commoditized markets in order to capture the spread between the semi-specialty price and their low operation costs.

In the last year or so we have seen companies such as Dow Chemical Company's Rohm and Haas and BASF's Ciba attempt to double down on specialties in search of better margins and the stable, high-quality earnings typical of this sector. In the current competitive environment, you need to be extremely cautious when turning to specialties as the answer to profit holes. Without the right disciplined business model this move can accelerate the commoditization process that is already destroying value in the specialty sector.

Specialty chemicals makers provide eloquent, high-value solutions to a number of niche segments. No single specialty market exists on a mass manufacturing scale. Furthermore, these niches are becoming increasingly scarce as more competitors chase a smaller market. Foreign producers that traditionally focused on commodities are having a disruptive influence in specialties as they actively try to enter these more profitable markets.

We have also observed chemicals companies offering specialty services and products to customers and markets that are willing to pay only commodity rates. Companies operating in Europe and North America exploring this option should be extremely careful in assessing or integrating target acquisitions with this strategy in mind. They must also resist trying to force acquisitions into existing business models. For players already operating in downstream markets, be mindful about future investments and carefully consider how best to serve these niche markets going forward.

Chemicals leaders need to step up and trigger the change necessary to lay the groundwork for future success; smaller firms do not have the force to initiate the change that needs to occur. The entire industry, it seems, is experiencing a collective mix of denial and excess optimism that has led to paralysis. Now more than ever, leading firms must aggressively take action to enhance those parts of their company capable of generating superior returns, and sell off or close down those that never will.

We hope these insights will help as you lead your firm forward in 2010.

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