Challenges and Opportunities for Specialty Chemicals in China

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In the last few months, the developments in China's specialty chemicals segment have been somewhat confusing and partly contradictory.

On the one hand, global specialty chemicals players such as Clariant still strongly emphasize the importance of China – in September, the CEO of Clariant, Hariolf Kottmann, stated that China will remain the main growth engine and contribute about 60% of the absolute global growth in the chemical industry until 2020, concluding that "Clariant's future continues to be decided in China".

On the other hand, there are also voices that are much more critical about the future of chemicals in China. BASF has recently confirmed that its earlier target of achieving Euro 12 billion sales in China by 2020 will not be met, quoting lower than expected growth as a main reason. And specifically referring to specialty chemicals, several Indian financial analyst reports also are fairly negative, as these excerpts illustrate:

* "Our analysis of leading Chinese (chemical) manufacturers indicates increasing cost pressure in China. Factors such as appreciating currency, increasing cost of labor & power, and tightening pollution control norms have diluted the cost advantages enjoyed by Chinese manufacturers earlier".

* "The Chinese Ministry of Environmental Protection has enforced strict penalties with effect from January 2015. This has resulted in many plant shutdowns and softening of the China's chemical exports. According to industry experts, the cost of production of India's specialty chemicals works out to 10%-15% lower than that in China after investment in environmental protection".

* "Implementation of new environmental laws in China has already caused a decline in its chemicals exports and the trend is likely to accentuate in 2016-17".

Of course, a controversy like this is an ideal opportunity for a consultant to try and give his own analysis, while at the same time apologizing for the somewhat predictable and unappealing title of the paper. The focus will be on specialty chemicals, a segment less affected by the overcapacities plaguing many commodity chemicals in the Chinese market.

First of all, the "New Normal" will of course lead to a slowdown in growth rates not only for the economy in general but also for specialty chemicals. Depending on which forecast is used, GDP growth may slow down to a value as low as 4.3% in 2020 – the value given by the Economist Intelligence Unit. Obviously this is far below the growth rates achieved only a few years ago, which generally were above 10%. While the specialty chemicals segment may potentially grow somewhat faster than GDP due to the innovative nature of some of its products, overall it is unlikely to outpace GDP growth much, particularly now that China is gradually turning its focus from the secondary to the tertiary sector, from

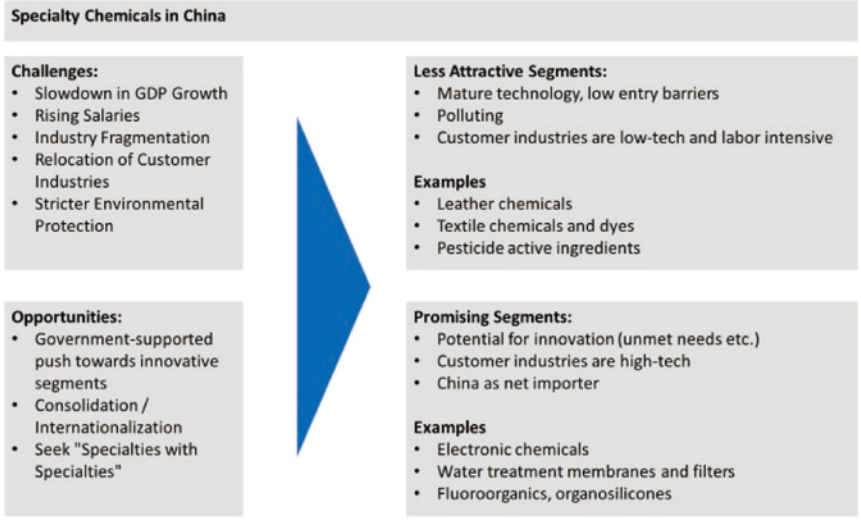

Fig. 1: Situation of specialty chemicals in China

industrial production to services. I recall that one consulting company forecast specialty chemicals growth rates of 9% just 18 months ago – in my own opinion, an annual growth rate in the range of 5%-7% is much more realistic for the next few years.

Secondly, the domestic specialty chemicals industry is still highly fragmented. This is true both within individual specialty chemicals segments and for the overall sector. So for example there are many small producers of water treatment chemicals, rather than a few strong leaders. And most of these companies are only active in water treatment, rather than following the example of global specialty chemicals companies of establishing a presence in several specialty chemicals segments. This could be a disadvantage for local players as they try to move towards more sophisticated, more innovative products. To justify the R&D to develop these products, they need to be marketed globally, which is much easier to do for a larger player with a broader range of activities.

Furthermore, China´s salaries have indeed been rising quickly. While it is true that labor cost matters somewhat less in chemicals than in many other industries, there is a strong indirect effect. Once labor-intensive industries such as textile lose competitiveness in China, this may also result in a loss of markets for the relevant chemicals (e.g., textile additives, dyes). The shift of the textile industry away from China has already started. For example, in December 2015 it was reported that major clothing producer TAL was to close a factory in Dongguan due to rising wages and had already begun transferring pants orders to its factory in Malaysia. And according to CCR, China's output volume of dyed/printed cloth in larger enterprises dropped by 5.1% in 2015 compared to 2014.

Another – possibly somewhat overrated – aspect is the increased environmental regulation (and implementation) in the recent past. Indeed, stricter environmental laws may affect players in some highly fragmented and polluting segments such as specific dyes. However, in the longer run this will lead to a shift of market share to larger players with better resources to invest in environmental protection equipment and technology. As a consequence, subsequent price rises (as reported from India, leading to improved profitability for local Indian players) are likely to be short-term rather than permanent, and the initial loss in profitability may well be compensated for by the healthier industry structure.

Of course, increased environmental protection is also a major aspect of the 13th Five-Year Plan (5YP), which covers the period from 2016 to 2020. Some of the specific aspects related to the chemical industry will also have an influence on production costs. For example, the 5YP mandates control of mercury pollution, air pollution, organic waste, VOC and hazardous waste disposal while encouraging waste gas recycling, recycling of other materials, and clean production technologies. The government also seems to be serious about implementing these regulations – for example, in September a guideline was published describing a pilot program to evaluate officials based on their performance in environmental protection. The 5YP also stresses the importance of chemical parks as the future center of chemical production, and many chemical companies (both local and foreign) have already had to move or have been told to move in the near future, which often requires substantial investment.

On the other hand, the 5YP also emphasizes the government goal of achieving strong positions in innovative specialty chemicals segments such as engineering plastics, organosilicones, fluoroorganics, and materials used in water treatment. A particular focus is on electronic chemicals, for which China currently strongly depends on imports. The government has set a target of lowering the import dependency in the IT sector, aiming to achieve 40% self-sufficiency by 2020 and 70% by 2025. As a consequence, specialty chemicals companies active in targeted segments can expect substantial support for establishing R&D and production.

In conclusion, the prospects for specialty chemicals in China still seem fairly bright, particularly in the more innovative segments, though some mature segments such as textile dyes or leather chemicals may indeed suffer. After all, specialty chemicals are an area which is strongly aligned with China´s overriding goal of moving from the world´s global workshop to a key center of global innovation. And while a growth rate of 5%-7% may seem low using China´s recent past as a benchmark, it is still very high compared to the growth rates in Western markets. This view is also reflected in BASF´s announcement to shift emphasis in Asia "from commodity chemicals in the oversupplied markets to focus on specialties catering for industries that include transportation, consumer products, electronics, construction, packaging, and agriculture".

It is also important to keep in mind that in each specialty chemicals segment, there is a range from chemicals that are almost commodities to those that are true specialties. While the first type suffers from many of the same issues as true commodities, the latter still allow for a high degree of innovation and differentiation and subsequent high margins. This is true even for mature segments such as textile chemicals, in which products such as low-volume, high-margin fashion dyes are still attractive. The realization of such distinctions has already led to a few overseas acquisitions of China´s specialty chemicals. For example, Transfar, a Chinese producer of textile chemicals, recently bought Dutch specialty chemicals producer Tanatex, presumably to get access to Tanatex´ portfolio of specialized textile auxiliaries. This move to "specialties within specialties" will probably continue and shape the portfolio of both domestic and foreign players. ■