Consolidation in China's Chemical Industry – Is It Finally Happening?

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China's chemical industry has long been characterized by a high degree of fragmentation. In 2015, there were more than 25 000 chemical companies with annual sales above RMB20 million – and these are only those chemical companies classified "Manufacture of Raw Chemical Materials and Chemical Products" in the China Statistical Yearbook, i.e., excluding companies in related areas such as plastics and chemical fibers.

This is not surprising. Industries typically go through an industry life cycle that includes at least an introduction stage, a growth stage and a maturity stage, and only in the maturity stage consolidation really becomes relevant. In the past two decades of high growth of China's chemical industry, this maturity stage simply had not been reached yet.

However, there are some indications that consolidation has now started to occur in China's chemical industry, as shown in Fig. 1.

The statistical data first shows a strong increase in the number of chemical companies between 2006 and 2010, with the total number increasing by more than 40%. Unfortunately, the figures for 2010 and 2011 are not comparable as the definition of designated size was changed (from above RMB5 million annual sales to above RMB20 million of sales), resulting in a reduction of the number of chemical companies counted by the statistics. However, the development from 2011 to 2014/2015 still indicates an increase in the company number, though at a slower pace of only 2% to 5% per year. However, since 2015, the number of chemical companies has decreased – by 2.7% from 2015 to 2016 and by another 5.1% from 2016 to 2017. This decrease probably accelerated in 2018, as CPCIF reported a decline of 1 566 chemical companies for 1H 2018 alone.

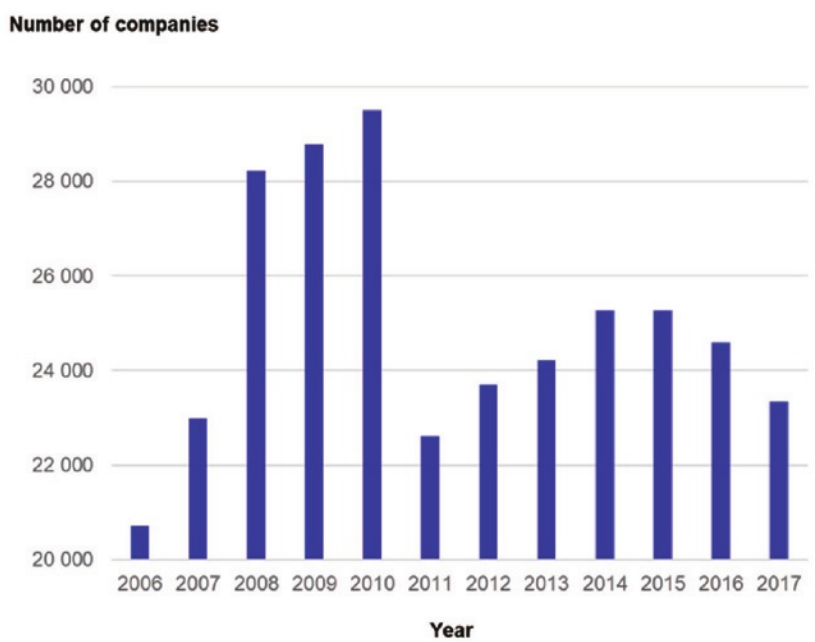

Fig. 1: Number of chemical companies in China above designated size (above RMB5 million of annual revenue until 2010, above RMB20 million from 2011)

Indeed, a number of drivers of industry consolidation have rapidly increased in importance in the most recent past, both economic and political ones.

Revenue growth of the Chinese chemical sector has slowed down dramatically. In the first four months of 2019, according to industry organization CPCIF, the increase was only 1% year on year. This is obviously a very different situation from the past annual double-digit sales growth.

Also, for many chemical materials, particularly those with commodity characteristics, China has low utilization rates of only around 60% - in other words, there is overcapacity. In contrast to past conditions of overcapacity, the slower demand growth makes it unlikely these overcapacities can quickly be absorbed by the market.

Tightened environmental regulation has increased production costs and in effect created higher barriers to chemical production, as additional investments in emission treatment, safety measures etc. are required.

Closely related is the central government goal to concentrate chemical production in dedicated chemical parks, which will force a large number of chemical companies to relocate in the near future. At the same time, chemical parks currently are inundated with inquiries from chemical companies wishing to relocate, which gives them the power to reject most of such inquiries or to impose high investment thresholds on companies wishing to enter a chemical park.

Some provinces have even started an active policy of reducing the number of chemical companies operating in their area. For example, Jiangsu province has pledged to reduce the number of chemical businesses in the province from 5 433 in 2017 to under 1 000 in 2022, particularly those with low safety standards and severe pollution issues. In 2018 alone, nearly 4 000 chemical production sites were closed down in Jiangsu and Shandong province, and a number of provinces including these two as well as Hebei and Henan banned the establishment of new chemical parks. Shandong province even aims to halve the number of chemical parks from the current 200 to no more than 100.

Environmental regulation also has indirectly led to some consolidation. For example, solvent-based coatings are increasingly being restricted, particularly in Eastern China, as the government favors the more environmentally friendly water-based alternatives. However, these alternatives require a higher level of technology and thus lead to the closure particularly of very small and low-end coatings producers. In fact, coatings is a sector particularly affected by tightened environmental regulation. Of China's 8 000 smaller coatings producers (i.e., with annual sales below RMB20 million), about 4 000-5 000 have reportedly closed down or suspended production in 2016-2017 as a result of tightened environmental regulation.

Finally, for some chemical segments, there is a specific government objective to consolidate the industry. For example, in 2016 the China Crop Protection Industry Association issued the 13th Five-Year Plan for China's Pesticide Industry. One of the stated goals is to have the top 20 companies account for 70% of total industry sales in 2020.

With these strong drivers for consolidation in place, it is very likely the number of chemical companies in China will decrease much more. As the examples above indicate, a substantial factor in this consolidation will be the complete closure of smaller chemical companies. However, an alternative pathway that is more typical for consolidation in maturing industries is likely to be of similar importance. This is consolidation via mergers and acquisitions. Essentially, a stronger industry player buys one or more weaker competitors.

This has several advantages for both sides. The acquired company still gets some money for their material and immaterial assets. The buyer can increase its production capacity without increasing the capacity of the overall market, which could easily depress the market price. In addition, the acquirer gains experienced staff, additional products and customers.

In the past, this pathway to consolidation was relatively rare in China as each company aimed to become market leader on its own, thus contributing to the current overcapacity issues. However, recently a number of chemical segments have experienced this type of consolidation. For example, in June 2019 Lomon Billions, a Chinese producer of titanium dioxide, announced the acquisition of 68.1% of equity of Yunnan Metallurgical Xinli Titanium Industry, a competitor in titanium dioxide. Similarly, Danhua Chemical Technology is planning to purchase 100% equity of Jiangsu Silbang Petrochemical via share issuance, thus combining two Chinese producers of ethylene glycol. And Chinese pesticide manufacturer Limin Chemical will acquire the pesticide business of ENN for RMB760 million, allowing ENN to achieve its strategic objective of exiting the pesticides business while increasing Limin's presence in pesticides. These mergers often also have political support. For example, Shanxi province – in an action plan for the chemical industry for 2019 - encourages companies to merge with other local or with central companies.

What do all these developments mean for individual companies participating in China's chemical industry?

First of all, with the Chinese chemical industry maturing and the overall China GDP growth rate slowing down, it is a safe assumption that consolidation in China's chemical industry will continue (though the speed of this consolidation will differ very much between chemical segments).

Second, each chemical company will have to consider its own future in a consolidating landscape. For small companies with limited resources, this may well mean actively trying to find a buyer and exiting the business before the own assets have become worthless. For larger players, the consolidation offers substantial opportunities to expand the range of products, customer segments and technologies without at the same time intensifying competition in the market.

Third, this may be the last chance for foreign companies to enter the Chinese market with a reasonable chance of success. Currently, market shares are still shifting and can be grabbed – this will likely be much more difficult in the future, more consolidated landscape.

Finally, consolidation should eventually be good news for all those companies surviving it. Consolidated industries typically have higher profit margins than fragmented ones. So, there is a strong incentive to stay in the industry and benefit from its consolidation. ■