



The Way to Go? M&A as Growth Path for Chinese Chemical Companies

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The growth of China's chemical industry is closely linked to China's GDP growth. As this growth slows down to the point where some observers already regard the government target of 7% as rather optimistic, individual companies also need to adapt their activities to this changed environment. However, many of them have grown used to much higher growth rates in the past and may prefer to change their growth strategies rather than to give up their growth ambitions altogether.

Most growth of China's chemical companies used to be organic – that is, companies invested in their own businesses, mostly by expanding production capacities. However, this has led to substantial overcapacities in many chemicals. In the past, there was always the hope that these overcapacities would either vanish soon due to the high market growth, or at least they could be used for export. However, lower domestic growth and a slowdown in export growth indicate that these are no longer viable options. In fact, some companies have already suffered serious consequences, such as Shaoxing Yuandong Petrochemical, a large PTA producer which had to file for liquidation in July 2015 as its capacity utilization was only about 60% in 2014 – even lower than that year industry average of 73%.

The alternative to organic growth is

inorganic growth – growth achieved via the acquisition of an existing business. A major advantage of this pathway (which is also often called M&A or mergers & acquisitions, though mergers are fairly rare) is that in contrast to organic growth, no additional capacities are being created. Instead, existing capacities change ownership, thus allowing the acquiring company to increase its production and sales while also consolidating the market and reaping economies of scale. Obviously this advantage is particularly relevant in segments with limited or no growth, a situation which will apply to more and more segments of the chemical industry in China. In fact, in mature chemical markets such as the US and Europe it is a major contributor to the growth of leading chemical companies.

Once acquisitions are under discussion as a potential growth driver, which options are available to companies? And what needs to be observed to be successful in pursuing this route towards growth?

Companies may either seek acquisition targets within their existing business area or outside of it. For example, Henan Billions recently merged with rival Chinese titanium dioxide producer Lomon. In this case, the acquirer stays within its existing business area, thus bringing a very good understanding of

the market, the opportunity for gaining economies of scale and also adding the benefit of a segment consolidation, which may lead to an improvement in profit margins. Clearly, for the segment as a whole (though not necessarily for its customers, nor for the buyer) this is preferable to Henan Billions expanding by increasing its own capacities. Of course, disadvantages of such an acquisition include the increased exposure to the given segment and the risk of overpaying for a competitor.

In contrast, when buying rubber additives producer Sinorgchem in 2012, Sinochem International moved into an area in which they previously had not been present (though the company's activities in natural rubber and the resulting synergy potential with rubber additives may have played a role in the acquisition). This acquisition therefore allowed Sinochem International to move the whole group into a slightly different strategic direction, that of a specialty chemicals producer. However, though no new capacities were created via the acquisition, there was also no industry consolidation, leaving the competitive landscape as before.

These two examples are for transactions within China. However, there is also a strong rationale for Chinese companies seeking targets overseas. The leading



chemical companies such as BASF, Dow and DuPont are all global companies with assets and subsidiaries on several continents. While Chinese companies may in the long run establish similar overseas assets themselves, this will take time. In addition, an acquisition particularly of a Western company will not only accelerate the speed of becoming a global player but may also benefit the domestic part of the business via the acquired technology, customer relationships, etc.

Wanhua certainly had this in mind when taking full control of Hungarian isocyanate producer Borsod, as evident from statements made by their CEO at the time: "The integration of BorsodChem into the Wanhua Group ... [turns] both companies from two regional players into one global company ... Wanhua will leverage BorsodChem on its path towards globalization."

In this case, the business acquired overseas was one that Wanhua has already invested in, leaving the globalization as main rationale (in fact the assets acquired by Wanhua in Europe were of substantially lower quality than its own in China). However, more frequently overseas acquisitions are used by Chinese companies to improve its own technology and market position. ChemChina has done a number of such acquisitions in the past decade, in areas including feed additives (Adisseo, 2005), silicones (Rhodia, 2007), agrochemicals (Makhteshim Agan, now Adama, 2011) and tires (Pirelli, 2015). Such deals allow the acquiring company to pursue both internationalization of the business and a strategic shift regarding the industry segment or value creation activity. In the situation of the chemical industry today, the latter mostly means a downstream move towards more specialty-type products. This is similar to the developments in the US and European chemical industry, where the leading chemical companies have sold

many of their commodity businesses while acquiring specialty chemicals companies, to the point that most industry leaders are no longer active in areas such as commodity plastics.

The above shows that growth via acquisitions – while obviously subject to more limitations than organic growth, as it requires the existence of suitable targets – still offers a huge scope for strategic decisions. In fact, acquiring a business is probably the most immediate way to change the overall direction of a company (along with selling a business, something that so far has not been done very frequently by Chinese companies but is a regular occurrence in the Western world). Other key reasons to consider an acquisition rather than organic growth are the move into a new geographical region (as it would take too long to establish a relevant market position via organic growth only), and the existence of substantial overcapacity, which limits the market share gains obtainable by organic growth unless the risk of a price war is deemed acceptable.

Once acquisitions are on the corporate agenda, it is recommended to establish a well-structured procedure at the start of the search for acquisition candidates, rather than opportunistically assessing individual target companies. Such a process should include at least the following components:

a) Clarification and prioritization of strategic targets of acquisitions (e.g., importance of sales growth versus profit growth; acquisition as a means of changing the existing business, e.g., to make it more international, more innovation driven or more service oriented)

b) Clarification of the overall boundaries of acquisitions (e.g., with regard to sales price, location of target company, industry segment of target company, etc.) – if available, some or most of these boundaries can be deduced from the overall company

strategy

c) Importance of synergies between current business and business of acquisition target (if synergies are important, this will limit the acquisition targets to certain industry segments, technologies or customer groups)

d) Assessment of current and potential strengths and weaknesses of own company (with a view on why the acquiring company would be better at running the acquisition target than competitors).

The actual target search should only be started once these preconditions have been defined. A suitable approach is to start with a broad long list of targets and use those parameters for which data is most easily accessible to quickly narrow down the list. Only then some important but less accessible parameters such as asset quality or growth perspective of the target should come into play. This limits the overall effort of the search, or alternatively, allows a broader search with the same amount of resources.

In today's lower growth chemical market, it will be harder and harder to achieve substantial organic growth. Chinese chemical companies with the intention to keep growing therefore need to seriously look at acquisitions as a pathway to growth. Apart from a change from a mostly technical to a more commercial mindset, this will also require establishing dedicated resources, in particular knowledge, processes and staff capable of starting and managing M&A processes. If M&A is to become a regular activity, the creation of a dedicated M&A team should be considered. Its mandate should include defining the objectives of acquisitions, the understanding the available cash resources, carrying out the target identification and validating the targets. Less experienced companies may substantially benefit from external help in establishing such a team. ■