



# CHINA'S COATINGS MARKET: A MID-YEAR UPDATE

The Chinese mid-market for coatings shows opportunities for growth. By Ed Barlow and Dr Kai Pflug.

**At its May 26 investor day, Sherwin Williams shared some data on the Asian coatings market. Comprising 41% of global revenues, the Asian market leads the world in all applications: architectural, OEM and specialty purpose. The company also shared a rather sober set of views on the regional market: growth in industrial, OEM and specialty purpose segments was indicated to be flat.**

**A** slower China is implicit in the analysis. As the world's largest coatings market, Chinese demand naturally forms a large part of the Asian picture. But China is as complex as it is large; it is growing at different speeds, and with the structural shifts in its economy, so too are changes (and opportunities) emerging in its paint and coatings sector.

## **SLOWING ECONOMY TO SHAKE OUT THE INDUSTRY**

The Chinese economy has always grown at different speeds, but lately these have changed from fast and very fast to moderate and, in some cases, slow. The structural shifts behind these divergent paths are beginning to impact the coatings industry. For starters, a wide gap has opened up between the consumer sector (including consumer driven investments, chief among which is property) and the industrial sector. Consider the real-estate and automotive markets. As of April year-to-date residential sales volumes have grown by nearly 40% year-on-year, while the automotive industry has accelerated by 7% year-on-year to 7.5 million cars sold to date. Retail sales are up by 10% and passenger aviation is up by 11%. This is where the growth is in China today and it's fundamentally healthy.

Consider too the industrial sector. Manufacturing PMI for May registered a contraction at 49.2 against 49.1 in April, according Caixin and Markit, which also stated that sector employment had fallen "markedly". Electricity product has fallen, freight rail is down by 5% and steelmaking, despite a rally in iron ore buying, is flat.

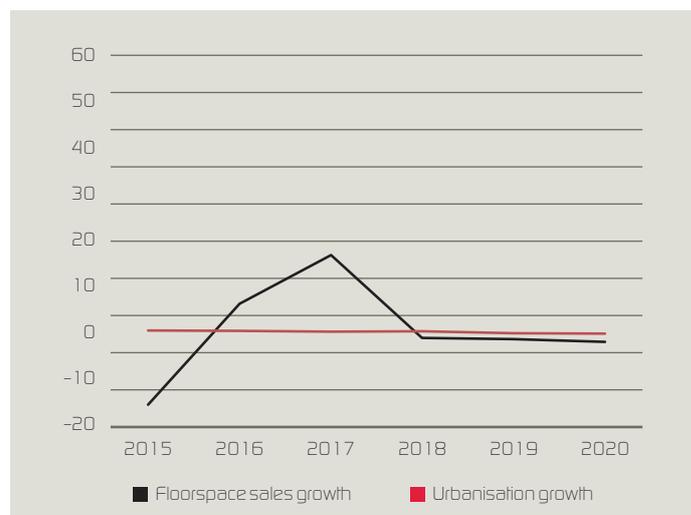
So far this has had a much greater impact on raw materials producers than it has on formulators. Part of the reason for this is the overcapacity in materials such as TiO<sub>2</sub> and aromatics like benzene, producers of which were unable to maintain prices when global commodities sank, while, on the other hand, formulators have been able to maintain prices. The slowdown has been felt by SMEs in the marine and container segment, who at a recent conference in Shanghai offered a variation on the Game of Thrones maxim: Winter is Coming. General industrial coatings formulators are also under pressure, reporting a contraction of orders in a survey we conducted over March and April.

There have been growing reports smaller coatings plants will close down or be acquired by larger rivals. Sankeshu, a large formulator of architectural, wood and OEM coatings is set to list on the Shenzhen stock market in 2016, stating it aims to raise EUR 45.75 million for expansion. The Chinese government supports consolidation, according to the China Coatings Association and appears to be encouraging it via stricter environmental compliance. For example, in Hebei province in 2015 many smaller formulators were told to cease production while larger producers have been offered assistance with relocation. As with Beijing's strategy across a number of industries, larger Chinese formulators are being nurtured to become the Chinese equivalent of PPG or Akzo Nobel.

Figure 1: China's coatings production volume 2012 - 2015 (in million tonnes).

Item	Production volumes			
	2012	2013	2014	2015
Architectural coatings	4.08	4.65	4.41	4.67
Automotive OEM coatings	0.47	0.46	0.55	0.57
Other OEM coatings	3.81	4.18	4.39	4.43
Specialty purpose & protective coatings	2.40	2.49	2.53	2.62

Figure 2: Growth in China floorspace demand and urbanisation 2015 - 2020 (in %).



**MID MARKETS: THE NEXT COMMERCIAL OPPORTUNITIES**

While the small and low-end of the market is being squeezed and the larger companies encouraged to grow, it is a very interesting time to be observing the Chinese mid-market for coatings. The mid-market is significant not just for its overall size but also the fact that it has been the fastest growing segment, suggesting there are relatively more commercial opportunities for growth.

In terms of definition, the mid-market is a product that sells for a 15%-20% discount to a premium coating by using lower cost raw materials. For example, in the architectural segment, a mid-market coating would use an alkyd resin, organic diluent (although in recent years, water has been substituted into the formulation to a degree where mid-market producers claim the product is waterborne but is actually a reduced organic solvent), locally sourced pigment and higher quality dispersants and additives.

A typical producer would have a nameplate capacity of between 10,000 and 20,000 tonnes per year of formulated product. Production equipment such as tanks, agitators and fluid handling devices are almost exclusively bought locally but some laboratory and process control equipment may be imported. Prices for its architectural paint would be in the EUR 0.95 -1.37 per kg range.

For foreign formulators looking to grow into the middle market, the acquisition of a Chinese company may be the fastest way to grow. Not only do local companies have physical capital but also a well-developed sales network. But successful deals are very challenging because valuations are not grounded in the same methods used in the West, and therefore potential suitors will need to be more flexible in terms of the mixture of cash, knowhow and market access they bring to the deal.

**TECHNICAL TRENDS: NOT A TREND SETTER (YET)**

While it is the world's largest coatings market, China still takes its technical cues from Europe, Japan and North America. R&D is still emerging as scientists are hired away from MNE firms and into local companies but the "R" is rarely seen in comparison to the "D". As industry participants know, there is a very big difference between reproducing a formulation and creating one anew. Sources at the coatings association say that the upcoming Five Year Plan will set some specific

targets for the coatings industry to this end. The Sankeshu IPO note also stated that the company will use the capital market to fund an R&D centre, which may well have been a requirement for approval as it has been for other materials companies.

Quality control is another area that is becoming increasingly important to mid-market formulators. Many preeminent Chinese formulators need to improve their industrial automation in lock step with better formulation chemistry. Opportunities exist for a PLC or DCS package supplier with experience in coatings. The Coatings Association states this is one of their most often heard requests.

**SUMMARY**

China's coatings industry is entering a new phase of development, characterised by the exit of small, homogenous producers that have been suppressing margins for the whole industry. Consolidation will see larger scale formulators undertaking a more customized approach to the middle market. Even in a slowing market opportunities exist everywhere. Specialist formulators and raw materials producers will need to re-examine their customer base in China, not only to manage the risk that a partner shuts down but also the risk of a partner growing rapidly to a size where it no longer needs them, or worse yet, becomes a competitor. ◀



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