Does Ownership Type Matter?

The growth of China's chemical market is primarily captured by private domestic companies

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Many multinational chemical companies feel that they are quite successful in China, and not a few careers of global chemical managers are based on achievements in China. However, while sales of multinational chemical companies in China certainly increased substantially in the last decade and China has indeed been a major driver of global sales growth for these companies, it is arguable whether this is really such a convincing success story.

The data gathered in by the National Bureau of Statistics in China and published in China´s Statistical Yearbook makes a strong case for a different perspective. Since 2005, industry specific data is given separately for state-owned enterprises, private domestic companies and foreign-owned ventures. The data for the industry segment "Manufacture of Raw Chemical Materials and Chemical Products" – available up to the year 2014 – shows a strong correlation between ownership and commercial success, as shown in Fig. 1.

Obviously, state-owned enterprises (SOEs) have been the companies with the slowest growth (almost 9% below the annual average CAGR), and they have lost profitability even in absolute terms. It is more surprising to see that foreign-owned companies have also lagged behind the market average, only somewhat with regard to sales growth (CAGR 18.4% vs. an average 19.7%) but substantially for profit growth (CAGR 13.2% vs. an average of 17.0%). Instead, private domestic companies have been the big winners of the last decade, reaching an annual sales growth of 28.6%, about 9% higher than the market average, and an even stronger annual profit growth of more than 33%.

Of course, the last decade is likely to be remembered as a period of exceptional growth for the chemical industry in China. More recent developments may already be different. Therefore, it is instructive to separately look at the situation for the last available year, covering the changes happening in 2014 (Fig. 2).

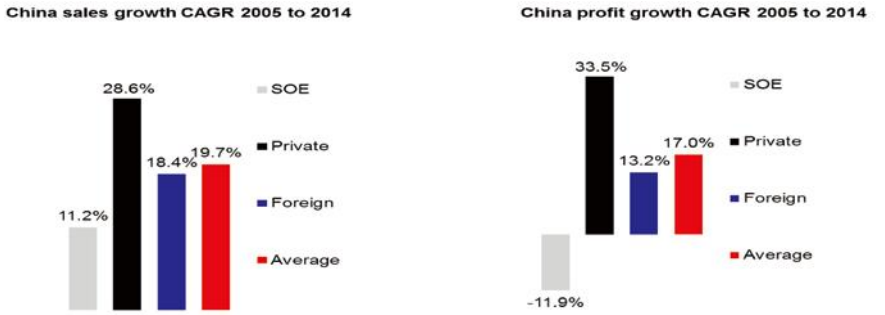

Fig. 1: Sales and Profit Growth CAGR of chemical companies in China by ownership type, 2005 to 2014

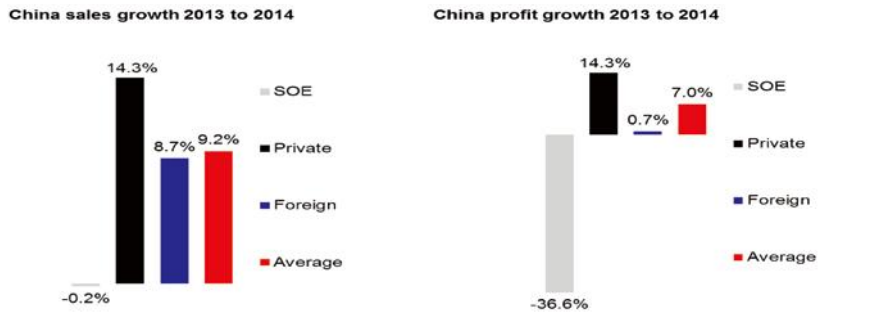

Fig. 2: Sales and Profit Growth CAGR of chemical companies in China by ownership type, 2013 to 2014

This most recent data shows that the growth of chemical production has slowed down substantially – from an annual 19.7% for the period of 2005 to 2014 to only 9.2% in 2014. However, the broad trend statements made for the longer period still hold true. SOEs see their sales grow at the slowest pace, private companies have the fastest growth, and foreign-owned companies perform slightly below market average.

The substantial difference in sales and profit growth of the different ownership types has cumulatively led to a significant shift in market shares, as shown in Fig. 3.

In this period, private companies almost doubled their market share from 25% to 48% at the expense primarily of the state-owned companies, which saw their share decline from 41% to 21%. The difference in the share of profit is even starker. While the SOEs essentially saw all their profits evaporate from 2005 to 2014, the profits of the private domestic companies more than tripled. Somewhat surprisingly, the profit share of foreign companies fell by much more than their market share. This makes it hard to believe that private Chinese companies only chase market share at the expense of profits, an argument sometimes heard from multinational companies.

Any explanation for the performance difference could either be sought in the ownership type itself, or in a factor only indirectly related to this. The latter certainly plays some part in the phenomenon described. For example, state-owned companies tend to be the largest and to focus on petrochemicals and basic chemicals, while private players are smaller and found

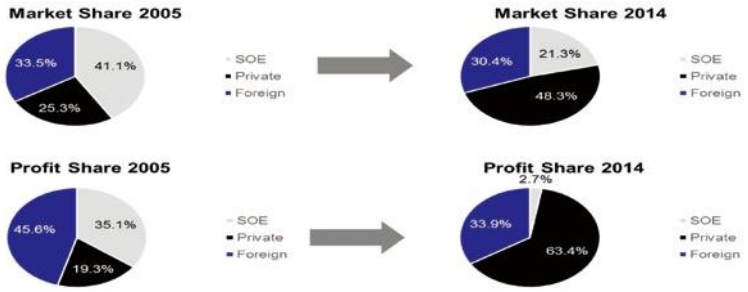

Fig. 3: Production value share of chemical companies by ownership type, 2005 and 2014

more in niche areas. However, overall it is tempting to see the different ownership type as at least partly a rationale for the performance difference.

What aspects of chemical companies are likely to be directly correlated to the ownership type? Table 1 provides some hypotheses based on the experience of the author.

Given the declining share of the SOEs, it seems likely that the profit motive is a strong driver of success. The lack of this as a strong motive is the main differentiator between SOEs and the other company types, though it in itself is linked to some of the other aspects such as attitude towards risk and reaction speed.

However, given the huge performance difference between private domestic and foreign companies, the profit motive alone does not seem to provide a sufficient explanation for the status quo. The higher reaction speed and greater flexibility of private domestic companies is likely to be a key reason for their outperformance compared to foreign-owned firms. This is an argument separate from that of local players having better market knowledge, which given that most field staff even of foreign companies are local Chinese does not sound very convincing anyway. However, local sales staff of foreign companies often complain about the slow decision making process in MNCs, which along with other delaying factors affecting MNCs (such as having to import some products from overseas) indeed leads to losses of sales. For most of the larger foreign companies, any larger investment has to be approved overseas in a process that can easily take a year or longer while decisions can be taken very quickly in private domestic companies if two or three key decision makers are in agreement.

The cost position of chemical companies also depends on their ownership type. Both state-owned entities and multinational companies have relatively high costs compared to privately owned enterprises. In the case of the SOEs, this is mostly because efficiency is only a limited concern for them as they also are to provide employment. Multinational companies have high overhead costs as corporate-wide global standards need to be maintained and managed. Thus, privately owned companies tend to have by far the best cost position of all three types, which is also indicated by their constantly and over proportionally increasing share of the profits of the chemical industry.

A separate argument can be derived from the status of the chemical industry as a fairly mature one. In such an industry, products and customer requirements are fairly stable, and constant innovation is not an absolute necessity. In fact, many foreign companies achieve a large share of their sales with fairly old and mature products. Given this stable environment, it is far easier and more efficient for a newcomer to approach the product quality level of the established players than it is for the latter to erect new barriers in the shape of innovative products. A negative proof for this hypothesis can be found in electronic chemicals, the segment for which China still relies the strongest on imports. Driven by advances in semiconductor technology, this segment is still highly innovative, allowing established foreign players to leverage their existing knowledge and R&D capabilities to out-innovate newcomers.

In terms of future actions, what does this mean for each of the three types of players? The situation seems toughest for SOEs – they seem ill equipped to really focus on profits, and such a focus would also make it hard to argue why they are necessary in the first place. As a broader group, it will be very hard for them to reverse the current declining trend.

Private chemical companies will probably further expand their market share, but will have to somewhat adapt their behavior to match a lower-growth and more regulated environment, probably by adopting some of the structures and processes of foreign companies. In doing so, they need to be careful not to erode their current cost advantages.

In contrast, multinationals seeking to avoid further market share losses will need to copy some of the positive characteristics of private companies, in particular the much faster reaction speed. Overall, this will mean localization not only of functions (such as production, R&D, etc.) but also of decision making power. They will also need to explore more options to maintain the cost structure of their local acquisitions, e.g., via owning only minority shares. ■

Tab. 1: Differences between chemical companies in China depending on ownership type

Aspect	SOE	Private Domestic	Foreign-owned
Key Company Objective	Provision of strategic state needs	Profit	Profit
Reaction Speed	Slow	Fast	Slow
Appetite for Risk	Low	High	Low to medium
Cost	Relatively high (low efficiency)	Relatively low (low overhead)	Relatively high (high overhead)
Level of Regulation	Medium to High	Low	High
Local Presence	High (all functions)	High (all functions)	Low (some functions still at HQ)
Product Variety	Low	High (local products)	High (global products)
R&D Efforts	Low	Low to high	High
Key Sales Argument	Price	Initially price, now increasingly quality	Quality, innovation