



Strategic Rationale for Chemical Acquisitions in China

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Between 2015 and 2017, the number of Chinese chemical companies with annual sales above RMB20 million declined by 8%, and preliminary information for 2018 and 2019 indicates that this trend is continuing and even accelerating. In a recent paper also published in the China Chemical Reporter, we already discussed the main drivers leading to this consolidation. We also mentioned the two pathways for the reduction in numbers: either companies go out of business completely, or they merge with others. Most of these mergers are in fact acquisitions – one company buys another one.

We were interested in the strategic rationale behind such acquisitions in China's chemical industry. In order to get a better understanding, we therefore analyzed 130 chemical deals published in a database (Pitchbook) that were done in China between 2014 and 2018. For each deal, we examined the portfolio and situation of both

buyer and seller and then assigned the most likely rationale behind the deal. A few deals were excluded as no clear rationale could be assigned.

The analysis clearly demonstrated that there are a few recurring themes explaining these deals. The most important ones are:

- Domestic consolidation of the chemical industry (i.e., merger of companies with closely related businesses)
- Financial deal (e.g., private equity or venture capital participating in a chemical company)
- Expansion in China (by a foreign company acquiring a business in China)
- Diversification (a Chinese company buying a chemical company with limited or no overlap in business)
- Integration (a Chinese chemical company buying another one that allows for horizontal or vertical integration)
- Exit from China (foreign companies exit some chemical businesses in China)

• Going abroad (Chinese chemical companies acquiring chemical businesses outside of China)

Fig. 1 shows the relative distribution of these categories. As the underlying database is incomplete and assignment of deals into categories is not always straightforward, the percentages are to be used as approximate indicators only.

We will now describe some of the categories in more detail and give one or more typical examples for each category.

Domestic consolidation of the chemical industry

Though this is already the most important category, we expect that its importance will still increase substantially. Domestic consolidation is the most obvious way to improve the industry structure, and it is consequently strongly supported by the Chinese government. For highly fragmented



segments and those with overcapacity, domestic consolidation should be particularly relevant.

Chemical segments for which several such deals each have happened within our sample include titanium dioxide, pesticides and fertilizers, all segments which are indeed fragmented and should benefit from such consolidation. In some cases, the acquisition of another player complements the need for adding capacity, though in other cases (e.g., the acquisition of Dongming Qianhai by Sinostar Pec Holdings), the buyer still expands capacity (polypropylene in this example) on its own despite getting additional capacity from the acquisition

target.

An interesting example is the one of Private Equity (PAG) subsequently buying two industrial gases companies, presumably with the intention of merging them or at least leveraging synergies. This is known as a “Buy and Build” strategy.

Financial deals

These represent the second largest category in our sample. In terms of strategic rationale, these deals are somewhat less interesting as the targets are acquired by pure financial players, thus eliminating synergies with an existing chemical business

of the buyer. This category includes deals in which formerly publicly listed companies (such as Yongye, a fertilizer company) are being taken private, as well as a number of venture capital deals involving small, new and fairly innovative companies in segments as diverse as electronic chemicals, chemical databases, polymer additives and fullerenes.

Expansion in China

The third major category is that of foreign companies expanding their China presence by acquisition of a local player or the setup of a joint venture. A typical example is the PPG acquisition of coatings producer Futian Xinshi, in which the global paint producer bought the assets, customer lists and distribution channels of the local company. Though the buyers include big Western chemical companies such as BASF, Ecolab, Clariant and PPG, the majority were made by smaller firms that entered China relatively late. Generally speaking, the aim of the acquisitions and JVs seems to be to enhance the China presence in a chemical segment that is among the core areas of the Western player. For example, Elantas bought a Chinese wire enamels business (Changzhou Hongbo Paint), Ecolab bought Jianghai Environmental Protection and Israel

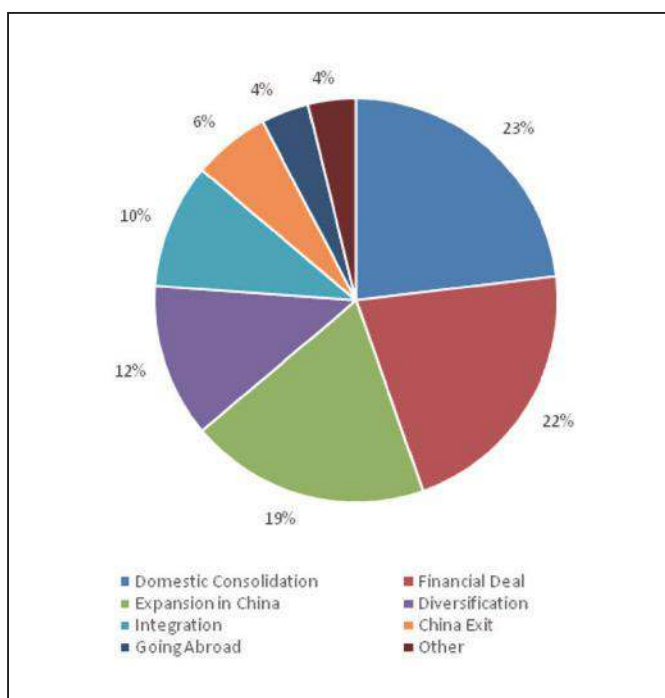


Fig. 1: Chinese M&A deals involving chemicals in the period of 2014 to 2018 by category



Chemical took a stake in fertilizer producer Yunnan Yuntianhua.

Diversification

Slightly more than 10% of the deals examined can best be described as diversification, i.e., the acquisition of a chemical business in which the buyer previously was not present. Particularly prominent are acquisitions of companies involved in lithium battery materials by more traditional companies active in, e.g., explosives, household goods or ceramics. Presumably this is regarded as an opportunity to enter a high-growth area. While this sounds attractive, this approach also sometimes fails as the buyer lacks the knowledge to be successful in the new segment.

Integration

Somewhat surprisingly given the high value Chinese chemical companies place on value chain integration, this is actually one of the lesser objectives of chemical M&A activity in China. Still, there are a number of deals which fall into this category, e.g., China Green Agriculture buying a number of distributors of agrochemicals or a producer of pharmaceuticals buying a producer of

pharma intermediates (vertical integration).

Exit from China

Perhaps somewhat surprisingly given the continuing growth of China's chemical industry and its concurrent increase in global importance, some recent deals actually are driven and initiated by Western companies exiting the Chinese market for specific chemical segments. Sometimes – but not always – this is part of a global exit of these segments.

There are multiple reasons for such exits. In some cases, companies see their China presence as too small to be competitive and prefer an exit to an expansion. Some Western chemical companies deliberately exit chemical segments that are commoditizing – often these are segments in which competition from Chinese competitors has recently increased, putting pressure on margins and capacity utilization. Other companies have decided to focus on specific regions in which they can have a leading market position – if China is not within these focus regions, they plan for an exit.

Companies that have exited China at least for part of their businesses between 2014 and 2018 include DSM, Total, Umicore, Dulux, BP, Evonik and Mitsubishi. However, in some cases the China exit was certainly driven by a

global strategy to exit from certain areas (such as carbon black for Evonik or Caprolactam for DSM). On the other hand, for some deals a relative weakness in China compared to other regions is explicitly indicated as rationale, e.g., Mitsubishi's sale of Chinese PTA assets.

Going abroad

Despite the Syngenta acquisition by ChemChina as a prominent example, the actual number of such overseas acquisitions by Chinese chemical companies has been quite small. Furthermore, several of these deals were acquisitions of raw materials such as phosphate and potash rather than proper chemicals. On the other hand, the size of these deals generally was large.

To conclude, most M&A deals in China's chemical industry have a strategic rationale rather than just being based on financial calculations. This means that the aim is to target synergies between the buyer and the target, thus allowing for a higher bid price. Of the different strategic objectives, industry consolidation was found to be the most important driver for domestic deals while the chance to quickly enter the Chinese market is likely to be the most important rationale behind foreign acquisitions of Chinese chemical companies. ■