Thriving in a competitive market

China offers enormous potential for international chemical companies. But its dynamic economy is constanly changing, and only a carefully thought-out strategy can make success more certain

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In 2005, Deutsche Bank issued a report on the prospects of the chemical market in China. It was perceived to be rather bullish, forecasting an annual growth of 10% over the next 10 years and resulting in a global chemical market share of 13%. As we now know, this was a vast underestimation of the prospects of China's chemical markets. In 2013, the global chemical market share of China already reached 33%, and the annual growth rate with which this was achieved was an amazing 23% in the period from 2005 to 2013.

At the same time, the Western underestimation of Chinese chemical market growth has also led to an exaggerated feeling of the successes of Western companies.

Sure, Western companies in China with annual sales growth of 10-20% impressed their owners – even though they actually underperformed the market. In fact, the market share of foreign-owned chemical companies in China has continuously declined in the last decade.

For example, according to Chinese statistical data, the market share of foreign-owned chemical companies declined from 27% to 23% from 2006 to 2012, while in the same period, private domestic companies increased their revenue share from 43% to 58% (the remainder is taken up by state-owned companies, which also lost market share).

Now that the overall economic Chinese growth is no longer in the double digits, this performance distinction between domestic and foreign-owned chemical companies becomes even more obvious. In the first 10 months of 2015, domestic privately owned chemical companies still managed to increase their sales by 5.6% while foreign-owned companies (excluding companies based in Taiwan, Hong Kong or Macao) saw a decline of 6.1%.

As China will have an estimated global market share of 40% by 2020 – and even at a GDP growth rate of 6-7%, it will still be the most important driver of global chemical demand growth. Therefore, it is not an option for multinational chemical companies to retreat from the Chinese market. The challenge is to understand the local market and to adapt to it.

KEY INDUSTRY DRIVERS

What are the key characteristics of the Chinese chemical industry, particularly when compared to the Western markets that multinational companies are more familiar with? Our analysis identifies 12 key differences, which will be discussed below.

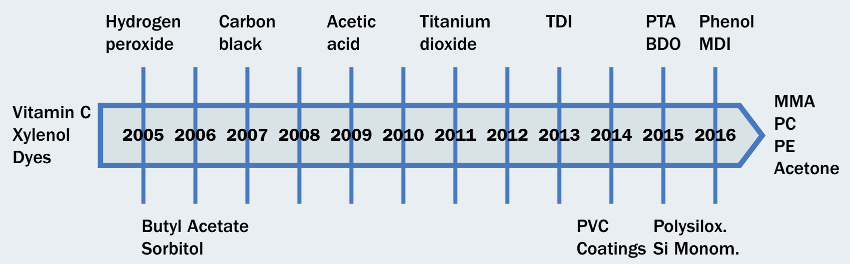
- **Government influence:** Despite the occasional statement assigning a greater role to the markets, the economy in China is under larger government control than in the West. This is reflected not only in the continuing presence of big state-owned chemical companies such as Sinopec, but also in the Five-Year Plan, sections of which are dedicated to the chemical industry. The 13th Five-Year Plan will come into force in 2016.
- **Tightening environmental regulation:** While tight and strictly implemented environmental regulation is a given for the chemical industry in the West, the situation in China is undergoing much greater changes. The actual implementation of existing regulation is of almost greater importance than the tightening of regulation itself. The emergence

CHARACTERISTICS OF CHINA CHEMICALS

	Characteristic	Implication for multinational chemical companies
1	Strong government influence	Need to understand effect on markets and competitors and incorporate into strategy planning
2	Tightening of environmental regulation	Application of Western standards from the start; problems and rising costs for some domestic players
3	Differences depending on province	Variations in products, marketing approach, pricing etc.
4	High industry fragmentation	Need for vast distribution network and market intelligence
5	Overcapacity for many chemicals	Avoidance of basic chemicals unless offering high entry barriers
6	Shift from import to export	Threat of low-cost competition from Chinese players abroad
7	Growing importance of specialty chemicals	Competition from local players in higher-end local markets; main area of growth
8	Competition among ownership types	Intense competition particularly from private domestic players
9	Localization of value creation	Cost control via localization, e.g., of production, sourcing etc.
10	Increasing salaries	Automation; good control of HR buildup
11	Use of coal as chemical raw material	Creation of new markets for chemicals used to facilitate coal conversion; additional competition for basic chemicals
12	Increasing Mid-level market	Exploration of mid market as target, e.g., via local acquisition or downgrading of existing products

HIGH-LEVEL ADVICE FOR MULTINATIONAL CHEMICAL COMPANIES IN CHINA

FIRST YEAR OF CHINA AS NET EXPORTER OF SPECIFIC CHEMICALS



SOURCE: CCR, MCC

of an urban middle class with a strong interest in their health and environment has given the government a strong incentive to push for environmental protection despite the resistance from local companies.

■ **Differences among provinces:** It is important to keep in mind that the average GDP per head in China's provinces varies by a factor of almost 10. As a consequence, there are very different end customer requirements for chemicals depending on the income level targeted by a specific chemical product. In particular, there still is a huge market for very low-end products.

■ **Industry fragmentation:** China has about 30,000 large chemical companies with annual sales of about €2m or above. In 2013, only 37% of the total market were accounted for by the biggest 500 chemical companies. This fragmentation of the market still exists on the level of individual chemicals. For example, in 2013, China had about 320 producers of calcium carbide.

■ **Overcapacity:** For many basic organic chemicals, China has massive overcapacities. For example, for BDO and for acetic acid the current utilisation is well below 50%. These overcapacities often coexist with substantial imports (for example, methanol) and surprisingly also with plans for massive further capacity expansions.

■ **Shift from imports to exports:** In the past, China had the global role of convenient outlet for excess chemical production elsewhere. However, as domestic companies have expanded their capacities and have often focused on products for which China used to depend on imports, China is now becoming a net exporter for more and more chemicals (see Fig. 1). Typically, once this tipping point has been reached, China remains a net exporter in the future.

■ **Growing importance of specialty chemicals:** While China's chemical industry is still more oriented towards basic chemicals than the Western chemical industry, growth rates for specialty chemicals are about 2-5% higher depending on specific segment. In particular, private domestic companies increasingly enter this area.

■ **Competition among ownership types:** There is a clearer distinction between different ownership types than in Western markets. While foreign-owned chemical companies tend to be technology leaders, state-owned entities focus mostly on bulk production of basic chemicals. Private companies are continuously expanding their activities and upgrading their technology. As hinted in the introduction, the type of ownership strongly correlates with market success, with private companies showing the highest growth.

■ **Localisation of value creation:** For multinationals, possibly the key measure to increase their local competitiveness is to localise their value chain. This not only covers aspects such as local production and local procurement, but also increasingly the setup of local research and development (R&D) in order to provide locally adapted products.

■ **Increasing salaries:** Average worker salaries in China have increased dramatically in the past decade or so, and are now easily higher than in many southeast Asian countries. While this has only a limited impact on the chemical industry, with its comparatively low labour intensity, there is a strong indirect impact as key customers of individual chemical segments such as textile manufacturers move production away from China.

■ **Use of coal as chemical raw material:** While most chemical production processes employed in China are similar to those in the West, the utilisation of coal as a chemical raw material represents a major exception. Driven by high availability of cheap domestic coal in relatively remote areas coupled with the government objective of reducing import dependence, the sector has grown dramatically in the past few years. Even though the current low oil prices make the economics of these projects questionable, in the future they are still likely to be supported politically.

■ **Growing mid-level market:** As in other industries, in the past many chemical markets showed a dichotomy between a smaller high-end segment primarily served by multinationals and a larger low-end segment primarily served by domestic producers. As income levels and regulatory requirements increase, a large share of the low-end segment is being pushed towards a higher quality level and thus also becomes potentially accessible to multinationals.

MULTINATIONALS IN CHINA

What do all these different characteristics mean for multinationals in China? The table gives an overview. Admittedly, these implications make for a rather complicated picture. Therefore, here are some higher-level pointers for multinationals aiming to thrive in China's chemical market, based on long-term industry experience in China:

■ Chinese chemical companies are generally good at producing (but not marketing) a limited number of high-volume products. To escape competition from these players, multinationals need to embrace complexity (of products, services, etc – even though this may sound strange coming from a management consultant.

■ As commodities generally suffer from overcapacity, they are to be avoided. Instead, focus on one or more of the still attractive specialty chemicals segments such as electronic chemicals, filter materials, functional coatings, membrane materials, nutrition, water treatment.

■ Be as local as possible, both with regard to your staff and your products. The model of serving the Chinese market with foreign staff and foreign products will not be successful.

■ Another way to avoid intense competition from local players is to focus on long-term opportunities. Most locals do not take up this perspective.

■ Do not overestimate the importance of government relationships. This is actually becoming less relevant as the Chinese bureaucracy becomes more and more rule-bound. If this was the most important success factor, the market would be dominated by the state-owned entities. ■

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