Basic Chemicals in China - Different Issues for Multinationals and for Domestic Chemical Companies

Dr. Kai Pflug, CEO, Management Consulting - Chemicals (Ltd.),
Dr. Bernhard Hartmann, Managing Director, A.T. Kearney China

This paper now focuses on some aspects of basic chemicals.

Basic chemicals are chemicals that are produced at high volumes, and sold at a comparatively low price per kg. They thus account for a most of the chemical volume produced, but for only a small share of the total number of chemicals commercially available. They can be comprehensively described by their materials specification - in other words, the knowledge how to use the basic chemical lies with the customer, not with the producer. Most of the chemicals listed in the Import and Export statistics at the back pages of the China Chemical Reporter are basic chemicals.

For multinational companies, in some way selling basic chemicals in China used to be easier than elsewhere, though this is gradually changing:

* The quality of basic chemicals produced by multinationals used to be substantially higher and more consistent than that of domestic companies and therefore was easily preferred for high-end applications and exports. However, recently the quality of basic chemicals such as MDI produced by domestic companies is increasingly comparable to that of the multinationals, reducing their competitive advantage

* The prices of basic chemicals offered by multinationals (often imported) tended to be substantially higher than those of domestic product, often supported by a strong brand. However, recently domestic companies have successfully raised prices for some types of basic chemicals (e.g., specific types of titanium dioxide), thus approaching the price level of multinationals

* Multinationals used to primarily sell imported products, and customers had to accept the related issues of long lead times and insecure on-time delivery. As quality of domestically produced materials improves, these issues may be taken more seriously by customers.

Any company (both multinationals and domestic companies) trying to maximize profit from basic chemicals will need to differentiate their commodities. Given the very nature of basic chemicals, this is not an easy task. However, there are a number of options that may be considered to achieve such a differentiation:

* Certification by now is almost a given except for some very small domestic producers and thus has only limited value as a differentiator

* Delivery service can be a successful differentiator, particularly if the company can provide it at low (internal) costs

* Environmental care is taken as a given for multinationals but not necessarily for domestic companies. For large customers, this aspect will increase in importance

* Inventory management allows differentiation as it is not offered by all suppliers

* Lead time and on-time delivery may be used as differentiators by domestic companies if competing with imports

* Packaging - if customizable - may influence individual customers

* Payment terms are often a strong differentiator, with domestic producers often willing to offer much more flexibility

* Quality consistency still favors multinationals as they have a better long-term track record despite recent improvements of domestic players

* Safety in both production and transportation may still lead customers to prefer multinationals.

Overall, differentiation is probably more of an issue for multinational chemical producers than for domestic companies as multinationals tend to have higher prices and thus need a suitable rationale.

In contrast, there are also specific issues in basic chemicals that primarily apply to domestic companies. Clearly the most important one is the issue of persistent overcapacity, as indicated by low utilization rates that often are accompanied with further expansion plans by the current producers:

* Adipic acid had a utilization rate below 70% in 2009, at the same time, Hualu Hengsheng has plans for a new plant

* For calcium carbide, production and consumption in 2009 both were around 15 million tons while capacity was around 22 million tons, leading to a capacity utilization of only 68%. At the same time, approximately 10 companies in 2010 announced new capacity

* For caustic soda, capacity utilization in 2009 also was only around 68%. Nevertheless, in 2010 there were reports of approximately 20 companies adding capacity

* For methanol, capacity utilization in 2009 was only around 40% while e.g., Yanchang and BlueChemical started new capacity in 2010

* PVC capacity utilization for 2010 is estimated at 49%; during the same period, about 20 companies started or announced production expansions

From the viewpoint of a Western observer, this combination of high existing capacity, low capacity utilization and simultaneously announcements of further capacity expansions is perplexing, particularly as there is a perception that the Chinese government has a larger influence on industry activities than in Western countries. Clearly, the situation for some basic chemicals is not healthy, and it is likely to result in substantial financial loss for some of the companies involved. What is the reason for this phenomenon? The

answer will obviously to some extent be speculative. However, it seems justified to focus on two reasons.

First, domestic chemical companies in general tend to favor mass-produced, basic chemicals over more complex specialty and fine chemicals. This is probably due to their relatively short planning timeframe - obviously, for basic chemicals revenues can be obtained after a short construction period, while for fine and specialty chemicals a longer timeframe is required (to also include time for research, development, customer understanding and marketing instead of just for building production capacity).

The likely other main reason is that domestic chemical companies focus their future plans almost exclusively on current market conditions and forecasts, rather than on an evaluation of internal strengths. Therefore if a market for a specific chemical at any point seems attractive, many domestic chemical companies will move into this market. The problem with this approach is that the market may not be able to support all of the new production capacity. As a result, only some companies will be profitable in the market - those that have the best fit with the success factors of this market.

What does this mean for domestic companies considering entering the market for a basic chemical, or expanding their presence? In evaluating its plans, the company should focus not only on the external attractiveness of the market. More important is to assess how well the company can fulfill the success factors in that market. And this assessment needs to be done relative to the competitors - the key is to fulfill the requirements better than all or most of the competitors. Only then a company can realistically expect to gain from continued presence in the basic chemicals market. Furthermore, ideally such an assessment should not only be done when expanding in a market, but also when deciding whether to stay in a market. China's landscape of basic chemicals producers is notoriously fragmented. Only a small share of the current producers of many basic chemicals will survive in the long run. A company should therefore assess whether it has the necessary competitive advantages to be among these survivors. The consequence of such an assessment may well be to pull out of a market even though the company has already established a long-term presence - a decision that is sensible but difficult to take from an emotional point of view.

Only focusing on those businesses in which a company can be among the leading players is hardly a revolutionary thought. In fact, China's bookstores are full of books emphasizing this idea, which was initially propagated by Jack Welch of GE ("Be number one or two in your market or get out"). However, in China's basic chemicals industry, many companies have not accepted it yet. ■