# What Is the Difference Between Acquiring a Chemical Company in China and in the Western World?

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Despite the recent slight slowdown of the Chinese economy and the effects of tightened environmental regulation, China is still widely regarded as the most important growth driver for the global chemical industry. According to CEFIC data, the country currently accounts for 37.2% of the global chemical market, which is substantially more than NAFTA (14.9%) and the EU (15.6%) combined. And CEFIC expects this share to grow to 49.9% by 2030. As for annual market growth, forecasts given by IHS are lower than for the last few years (5-7% per year for the next four years), but this is of course still much higher than for the EU or the US. BASF has just announced two massive investments in China, the logical consequence of BASF´s expectation that half of the global chemical industry growth will come from China. In conclusion, CEFIC states "Although competition in China's chemicals market is currently intensifying and demand growth is weaker than in the past, China still offers a huge and attractive market. In the mid-term, European chemical producers – due to their high technological capabilities and innovative products – are expected to benefit from a robust growth trend in China."

While some of this growth can be captured via exports to China, a more promising approach is investment in local production in China. If this is to happen within a short period of time, the best option is the acquisition of a local chemical company. Setting up production without such an acquisition certainly has its own advantages, but will definitely take more time and larger local resources.

However, acquiring a chemical company in China is not quite the same as doing such an acquisition in the Western world. To start with, China´s chemical industry has its own unique characteristics which include bigger government involvement, the current tightening of environmental regulation, the coexistence of different ownership types (e.g., state-owned entities), rapidly rising salaries, overcapacity for many chemicals, a high degree of industry fragmentation, the use of alternative raw materials such as coal, and the huge differences within China (for example, average per capita consumption of polypropylene in Gansu province is only about 25% of the consumption in Shanghai or Beijing). Getting a basic understanding of these characteristics is recommended before embarking on an acquisition.

Next, valuations of chemical companies in China are much higher than those of comparable companies in the US or Europe. Table 1, which is based on hundreds of stock-market listed companies in each region, shows this quite clearly.

The average EBITDA multiple is substantially higher for Chinese chemical companies, reaching about 15 for basic chemicals and 19 for specialty chemicals compared to 8-10 for basic chemical companies in Europe and the US and 13-14 for specialty chemical companies. While this number is for listed companies, private company owners are also aware of these multiples and adapt their sales price expectations accordingly. As a consequence, it will be very difficult to conclude a deal in China expecting to pay only Western multiples.

Another point to note in pursuing an acquisition in China´s chemical area is that the risks and selection criteria may differ somewhat from those typically recommended in the Western world.

This starts with the need for a more aggressive business plan in order to justify the higher multiples that likely have to be paid. Typically, this means not only assuming a continuation of the previous growth of the target but also adding some additional growth justified by the improved products or other synergies (e.g., in distribution) that go along with the change of ownership and the access to Western technology and products. Of course, making such growth assumptions is not without risk, particularly given the current uncertainty about China´s future economic development and global trade.

One aspect that certainly requires much more attention is the production location of the target. Is it in a chemical park or not? The latter will almost certainly require a relocation in the next few years. Even among chemical parks, not all are the same – some smaller ones (e.g., those on local rather than on provincial or national level) are much more likely to be closed down as well.

A well-known risk in buying a private chemical company is the threat of competition from the previous owner, who may have a competitive advantage due to his local knowledge and network. This is a risk that can be mitigated by a suitable deal structure. For

Tab. 1: EBITDA multiples of listed basic and specialty chemicals companies in different regions (source: Stern University database)

| | EV/EBITDA by Region | | |
|---|---|---|---|
| Chemical Segment | USA | Europe | China |
| Basic | 9.7 | 7.9 | 14.9 |
| Specialty | 13.9 | 13.1 | 18.6 |

example, Brenntag initially only bought 51% of a local chemical distributor, Zhong Yung. Forty-nine percent remained with the founder, who helped Brenntag to develop the business further. Brenntag had an agreement with the founder to acquire the remaining 49% after 5 years, with the acquisition price depending on certain targets. This gave the founder an incentive to support the entity and kept him from setting up a rival business. As stated, this issue is particularly relevant if market access depends strongly on the network or knowledge of the owner or key staff.

Generally, there is a preference for acquiring private chemical companies as it is unlikely that a state-owned entity will be sold to a foreign chemical player. As a consequence, any acquisition target list should probably focus on such private (or listed) companies that are to be found within the relevant chemical segment.

A concern sometimes stated by foreign companies shifting production to China is that once customers are aware of local production, they will immediately request lower prices. While this is indeed the case, there are ways to mitigate the consequences. For example, after an acquisition of a domestic producer, several companies (e.g., AkzoNobel in auto refinish and DSM in UHMWPE) have kept the local brand name alive. This allowed them to achieve economies of scale and at the same time to target a lower-end market segment without reducing the prices of their high-end brands.

Protection of intellectual property is a concern of multinational companies establishing production in China as local production likely requires some transfer of IP to China. However, recent cases in the chemical industry have shown that IP issues primarily arise from individual employees – regardless of their nationality or location - illegally selling their knowledge to competitors. And recent developments such as the establishment of an appeals court show that there is a trend towards better IP protection, driven without doubt by Chinese companies themselves now establishing valuable IP.

Finally, it is necessary to thoroughly examine a potential target for compliance in a number of areas – this is a time-consuming and difficult process. Areas to be examined include safety, environmental issues, employment policy, anti-bribery issues, past taxes etc. An approach worth mentioning is that of initially pursuing only a cooperation and acquiring the company only after sufficient trust and knowledge about the company has been gathered. For example, rather than buying local coatings producer Guangdong Yinfang immediately, BASF first utilized the company as a local toll producer and only later acquired it.

These are all issues already to be considered when selecting an acquisition target. However, once a suitable target has been firmly identified, additional issues may arise. This is another reason why acquisition attempts in China generally have a lower chance of success than in the West. In the case of acquiring private companies, the seller may be fairly unsophisticated, and may need to be educated by the seller before an agreement can be reached. Frequently, there are some influencers and friends in the background, obscuring the understanding of who the real decision makers are. And owners of private companies are typically very hands-on and hesitate to delegate even relatively minor tasks that are part of the M&A process, leading to frequent delays. Therefore, Western companies should not underestimate the resources required to collect and verify data for an acquisition target. Private chemical companies in China often do not have a consistent, centralized filing system, and there is a greater chance that data is misleading or plain wrong. So, an acquisition in China typically takes both longer time and more resources.

Listing these potential obstacles may make pursuing an acquisition quite daunting. However, there are good reasons why the next few years will offer particularly good acquisition opportunities for Western chemical companies. Currently there is enormous pressure on many smaller companies to upgrade their facilities and/or to relocate, requiring them to invest. Some of them simply may not have the resources for such investments, giving them an incentive to sell. At the same time, tightened environmental regulations have already led to the closure of many small competitors, resulting in better margins and giving Western chemical companies with environmentally friendly products and processes a competitive edge. Finally, chemical parks often prefer Western chemical companies as tenants, so a sale to a Western company may facilitate relocation for a local firm. All these factors combined make an acquisition in China well worth considering despite the obvious risks involved. ■