

Adapting to a changing landscape Midyear outlook for the global chemical industry

The past year has been a defining one for the global chemical industry. The well-known struggles of the automotive and construction industries have translated into reduced demand, declining revenues, and diminishing profits for nearly every chemical company worldwide. Globally, production declined over 10% midway into 2009¹ resulting in companies being forced to rethink and adapt their strategies for the present as well as the future. To help better understand the forces moving the industry, Deloitte Touche Tohmatsu's (DTT) Global Manufacturing Industry Group turned to a global panel of chemical industry leaders, including Tim Hanley, Tom Marriott, Dr. Willem Vaessen, Kevin Gromley, Duane Dickson, Jim Manocchi, Dr. Barry Phillips, and Jim Guill, for perspectives on the state of the industry — and the difficult decisions companies in the sector must make in the short term that will determine who wins, who loses, and who survives in the future.

Q: How has the recession affected the global chemical industry?

Tim: The most obvious impact is the sudden and significant drop-off in demand from end user markets. Due to the chemical industry relying so heavily on the success and failures of the automotive and construction industry, it is unavoidable that the chemical industry is directly affected by the volatile state of those industries.

Barry: Tim, I agree that diminishing demand is a root cause of the many troubles global chemical companies are facing. Companies, especially those that are not managing cash well or are too highly leveraged, are taking drastic measures to quickly reduce costs. We are seeing plant closures, decrease in production units, and employee reductions to conserve cash.

Tom: Indeed, some companies are taking significant measures to survive, including divesting operations or filing for Chapter 11. Recently we have seen LyondellBasell, Tronox, and Chemtura file for bankruptcy, which is a direct result of a business condition characteristic of this recession². There are, however, some subsectors in the chemical industry that have not been as impacted by the recession including agriculture and nutrition.

Kevin: It has been interesting from my perspective to experience the recession while living and working in China

the past few years. The recession has been pervasive across the board in Asia with commodity producers affected more heavily. Export-oriented companies, especially those in Japan, have also been hit harder than those serving domestic markets, such as China and India.

Outlook at a glance

- Global demand for chemicals has contracted significantly, with the automotive and construction sectors bearing most of the responsibility.
- Given the unlikelihood of a return to pre-recession levels in demand in the near to intermediate term, consolidation will be a major trend, both within the chemical industry and in end user markets.
- Revising and redefining the corporate business model will be an important restructuring tactic to adapt to the new economic environment.



Q: In your view, what is the biggest challenge ahead for chemical companies in this unprecedented environment?

Jim Manocchi: Companies are struggling with how to effectively plan for the future given current marketplace uncertainty. Executives are wondering, will this recession be 'V', 'U', or 'W'- shaped and how long will it last? Some companies can only develop 45–60 day forecasts at best to balance supply and demand.

Willem: I agree with Jim but see some companies using a flexible planning strategy to deal with demand uncertainty. It does, however, take a more experienced company to execute this type of plan and effectively synchronize production with market forecasts. Those companies that are struggling and have challenges forecasting future demand are experiencing substantial destocking. Once they start restocking, we are going to see a stop-and-go phenomenon as pickup in demand resumes.

Duane: Certainly more precise planning is going to be a differentiator, but experimenting with new business models that look at new customers and suppliers may be required to position companies for successfully managing in these challenging times. Most of the chemical company business models that I see are very capital intensive and asset-centric. By looking at multiple scenarios for the future, it will help chemical executives evaluate a variety of possible outcomes, consider the variables, and prepare a flexible and profitable response.

Tom: I can see both sides my colleagues have described and do agree that an overhaul in business model strategy will help executives develop a new perspective on their companies and define what is needed for revival. In my opinion, research and development (R&D) is an important driver for any chemical company because it paves the way for future revenue growth opportunities. Most of the chemical companies I follow are aware they need to invest in R&D but they are concerned about the short term and the need to conserve cash. Government stimulus money may be a source of funding for R&D programs in this environment where liquidity concerns are forcing companies to curtail R&D budgets.

Q: Some are saying that this recession will force major restructuring in the global chemical industry, including drastic measures. Do you agree? What might this look like?

Jim Manocchi: The chemical industry is at a turning point. After this downturn, the world is going to look very different for chemical companies. The weaker players are going to be acquired and it will be interesting to see by whom. Will it be by the big players or will the industry continue to be fragmented?

“The chemical industry is at a turning point. After this downturn, the world is going to look very different for chemical companies.”

— Jim Manocchi,
Deloitte United States
(Deloitte Consulting LLP)

Duane: It is hard to predict. Over the next 18 months, I foresee many companies faced with the real danger of bankruptcy, which has the potential to change the face of the industry. Worldwide, I expect there will be fewer production facilities as they are going to be rationalized at an unprecedented pace.

Kevin: Although we may see fewer facilities, the geographic footprint of the industry will no doubt broaden, providing more global balance. Asia's importance to the industry will continue to increase, both from a demand and supply standpoint.

Jim Guill: This is an interesting scenario and we already see this happening within the petrochemical industry as more production migrates to the Middle East.

Q: What are chemical companies saying about demand coming out of the recession? Do they expect demand to return to pre-recessionary levels?

Jim Guill: There is still too much uncertainty within the chemical industry. Many executives do not believe that demand will return to pre-recession levels anytime soon. The possibility of a no or low growth scenario may trigger a situation where top line growth comes more from market share gains than a robust expanding market.

Jim Manocchi: To Jim's point, many of the executives that I talk to do not see the recovery bouncing back to the demand we saw a few years ago. They are anticipating that the location of demand will change, there will be a different mix of customers, and buying patterns will change significantly. These executives cannot predict what it will be like, but they have come to the conclusion that

“Part of the challenge is going to be separating real economic growth from the effects of economic stimulus packages.”

— Tom Marriott,
Deloitte United States
(Deloitte Consulting LLP)

2010—2012 will not look like 2007.

Tim: I agree that the recovery stage is going to be a slow and uncertain process, but we are starting to see signs of improvement from key indicators including the housing and automotive markets, durable goods, and even some of the recent labor statistics³. Additionally, we are starting to hear positive comments about the affects of the government stimulus packages on the manufacturing industry. Globally, governments have injected \$3.6 trillion in total stimulus packages worldwide with \$50 billion going to the ailing automotive industry⁴. Also, a good portion of the money in the U.S. and China is going to public service construction projects. It may take some time to make its way to the chemical industry, but we can anticipate the industry may benefit from the stimulus money.

Tom: As I mentioned earlier, government stimulus money is going to be a key factor helping companies to regain their momentum. Because of the large injection of stimulus in China and its indirect impact on the chemical industry, companies are also asking themselves if they should be placing even bigger bets on China and the Asia Pacific region.

Kevin: China is expecting a slow recovery with a few bounces. The Chinese economy is smaller than Japan's but its growth rate is higher. Asian executives believe that growth will start in China this year due first to \$586 billion in stimulus funding spending and then to the return of consumer confidence⁵. It is not clear when the recovery will happen in Japan. With the recent elections in India, a new government may mean new stimulus spending.

Q: What indicators do you think will signal a recovery? Are there end-use markets or regions we should be watching?

Willem: European companies are trying to look for positive economic indicators, which may result from government incentives. In Germany, for example, the government is encouraging new car sales through a €2500 subsidiary to trade-in old cars for more efficient new models. They have waved road taxes, exempted vehicle taxes for cars purchased before June 30, 2009, and opened a €100 loan guarantee for German carmakers⁶. Although encouraging for the consumer, it does make it difficult to get good recovery signals from the chemical sector.

Tom: Adding onto Willem's comments, part of the challenge is going to be separating real economic growth from the effects of economic stimulus packages. I think it is going to be a gradual recovery with certain geographies recovering faster than others. The winners will be those with the best “sense and respond” models for understanding economic activity by geography and end user sectors.

Duane: In addition, other indicators to watch are volume and pricing trends, and new capacity announcements. As companies regain capital and anticipate a rebound in their stock prices, we will see a pickup in merger and acquisition activity.

Barry: As I see it, a significant indicator in recovery is the spending confidence of the consumer. Although still on a downward slope, it is not as steep, which is encouraging. In the U.S. we have seen some growth through new

orders in the chemical industry in May⁷. This is again encouraging news!

Q: As we look toward recovery, what do you think will separate the winners from the losers?

Tim: Some companies are just too heavily leveraged or unable to refinance their debts. It is unfortunate, but many of these financially troubled companies will more than likely not survive. The companies that have taken the tough steps now to prepare for the other side of the recession will be better equipped to grow again. As a result, I expect to see many chemical companies engaged in consolidation transactions over the next two years.

Kevin: Adding on to Tim's point, not only will we see

companies consolidating but moving quickly to open up new facilities in low-cost regions.

Jim Manocchi: From what I am seeing, the real winners are going to be those who are truly adaptable. The way companies manage during a downturn is not the way they would manage for growth. They cannot cost-cut their way to prosperity and need to continue to innovate to create new products, develop new value propositions, and tap into new markets.

“The companies that have taken the tough steps now to prepare for the other side of the recession will be better equipped to grow again.”

— Tim Hanley,
Deloitte United States
(Deloitte & Touche LLP)

References

¹ American Chemistry Council, March and Provisional April 2009, Global Chemical Industry Production Index

² Chemical & Engineering News, “Chemtura’s Bankruptcy”, March 23, 2009

³ Deloitte Services LP, Strategy Research & Innovation, “Weekly Economic Update”, Week of June 8, 2009

⁴ Deloitte Touche Tohmatsu press release, “Deloitte says more is needed to revitalize ailing automotive industry”, March 2009

⁵ Deloitte Touche Tohmatsu press release, “Deloitte says more is needed to revitalize ailing automotive industry”, March 2009

⁶ Deloitte Touche Tohmatsu press release, “Deloitte says more is needed to revitalize ailing automotive industry”, March 2009

⁷ The Institute for Supply Chain Management, May 2009 *Manufacturing Report on Business*

About the panel

Thank you to the following who contributed comments:



Tim Hanley is a vice chairman, process and industrial products leader, Deloitte United States (Deloitte & Touche LLP).



Tom Marriott is a partner in consulting and serves as the process consulting leader for Deloitte United States (Deloitte Consulting LLP).



Dr. Willem Vaessen is a partner in Deloitte Netherlands and serves member firm clients in the chemical sector.



Kevin Gromley is a member of DTT's Global Manufacturing Industry Group executive team with specific responsibility as the DTT Global Manufacturing Consulting Leader.



Duane Dickson is a partner in consulting for Deloitte United States (Deloitte Consulting LLP) and serves member firm clients in the chemical sector.



Jim Manocchi is a director in consulting for Deloitte United States (Deloitte Consulting LLP) and serves member firm clients in the chemical sector.



Dr. Barry Phillips is a chemical industry specialist with Deloitte United States (Deloitte Consulting LLP) and specializes in providing corporate and competitive strategy advice to member firm clients in the chemical sector.



Jim Guill is a chemical industry specialist with Deloitte United States (Deloitte Services LP) and specializes in providing corporate and competitive strategy advice to member firm partners in the chemical sector.

Deloitte Touche Tohmatsu Global Manufacturing Industry Group

The Global Manufacturing Industry Group of the member firms of Deloitte Touche Tohmatsu is comprised of more than 750 partners and 12,000 industry professionals in over 45 countries. The group's deep industry knowledge, service line expertise and thought leadership allows them to solve complex business issues with member firm clients in every corner of the globe. Deloitte member firms attract, develop, and retain the very best professionals and instill a set of shared values centered on integrity, value to clients, commitment to each other and strength from diversity. Deloitte member firms provide professional services to more than 88% of the manufacturing companies in the Fortune Global 500®. For more information about the Global Manufacturing Industry Group, please visit www.deloitte.com/manufacturing.

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms.

Deloitte Global Profile

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in 140 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's 165,000 professionals are committed to becoming the standard of excellence.

Deloitte's professionals are unified by a collaborative culture that fosters integrity, outstanding value to markets and clients, commitment to each other, and strength from cultural diversity. They enjoy an environment of continuous learning, challenging experiences, and enriching career opportunities. Deloitte's professionals are dedicated to strengthening corporate responsibility, building public trust, and making a positive impact in their communities.

Disclaimer

This publication contains general information only, and none of Deloitte Touche Tohmatsu, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

None of Deloitte Touche Tohmatsu, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.