Chemical distribution: What's next in 2010?

During recent conversations we held with the management of several distributors, we were told that the release of news items on www.districonsult.com was most interesting but what was more needed and appreciated were the industry sector analyses which are published on the site every quarter. To satisfy your need for analysis of the chemical and polymer distribution sectors, we invite you to read the following newsletter. We also welcome your comments.

Now that we are closing 2009 which was a rather hectic and eventful year, it is time to prepare ourselves for the likely 2010 scenario. For this purpose, it is important to recap the events which affected the distribution industry in 2009 and which define the trends that will shape the world of chemical distribution next year.

2009 started with a spat of dramatic financial news involving several chemical manufacturers like LyondellBasell, Tronox, Nova, Chemtura, Ineos or Dow Chemical. The credit crunch affected private equity firms which were faced with a decline in asset values and the threat of a global economic meltdown. The national economies in Western as well as in Central and Eastern Europe entered into a severe recession which drastically reduced the overall demand for chemicals and related services.

A spreading economic crisis in Central Europe became a major concern, but eventually did not materialize. Meanwhile one of the hottest topics for 2009 focused on financial regulations to cover banks, hedge funds, private equity, credit-rating agencies and tax-heavens. Lack of appropriate financial regulations was perceived to be a major contributor, if not the root cause of the crisis.

Collapse of M&A Activities

The main characteristic of 2009 for chemical distributors was the collapse of M&A activities. Some acquisition negotiations were rumored to take place, but were never completed. A transaction which was completed late December 2008 and announced early 2009 was the change in the ownership structure of the Kruse Group and the financial involvement of a former Brenntag top executive, alongside a majority shareholder belonging to the Kruse family. The new financial structure, which has not been disclosed, seems to have raised the company indebtedness. This transaction left the control of the German industrial chemicals distribution market firmly in German hands.

In May, came the announcement that JLM ranked the tenth largest US distributor with revenues above $330m went bankrupt. It appeared later that JLM was not a true distributor but mostly a chemical merchant involved in "back to back" transactions whose revenues published in industry statistics were grossly inflated by adding "back to back" transactions to its smaller distribution income. JLM was later bought by the Japanese trading house Marubeni. This story revealed the tendency for some distributors to inflate their declared or apparent sales revenues by adding their agency business or back to back transactions as sales and not only the resulting commission flows to their overall sales figures.

Some transactions still took place during the last months like the acquisition of 50% of Staub in Bavaria by Stockmeier AG, the acquisition of CH Chemicals in South Africa by Brenntag's JV partner Chemical Services Ltd. Meanwhile, the Neochimiki saga re-emerged during the summer when it was published in the Financial Times that Carlyle was considering suing the previous owner for lack of "accuracy of earnings data". Neochimiki was purchased by Carlyle for EUR 749 mn in June 2008. Recently published Neochimiki 2008 results were sales of EUR 210 mn and losses of EUR 55 mn. In October Lavrentis Lavrentiadis declared that he was ready to buy back his former company for EUR 84mn.

During the summer, several private equity owned distributors reportedly renegotiated their credit covenants with their willing bankers who applied the principle “extend and pretend” in order to postpone the pending issue of the total amount of debts to be repaid to a later time. Then in September, BC Partners who will have to pay back investors within the next year announced the planned IPO’s of Brenntag, Amadeus and Medica during the first half of 2010. They are encouraged by the solid results of Brenntag obtained in a particularly challenging context, an improved stock market performance and the perceived increase in investors’ appetite for new equity issues.

Stalled antitrust investigations

Since 2007, as a result of numerous pleas for clemency reportedly filed with the national competition authorities of Austria, Germany, France, Belgium and Holland, the chemical distribution sector is the target of long and tedious investigations. These took the form of dawn raids in April 2007 in France and Germany as well as numerous distributor employees and managers interviews in France and detailed questionnaires sent to over one hundred distributors this June in Germany.

So far, the only judgments published affecting chemical distributors were the verdict in March 2008 regarding an acetic acid cartel in Norway, a recent judgment in Austria against Brenntag and Donauchem where Brenntag was protected by its position as whistle blower. The same exemption was granted to Brenntag in a swimming pool chemicals cartel in Holland whose participants were collectively sentenced to fines for a total amount of EUR 3mn. Five companies controlled the Dutch swimming pool chemicals market which consisted mostly of installations run by municipalities.

The jury is still out for the pending commodity chemicals investigations which are rumored to be completed soon. It is too early to comment on what are still on-going investigations and deliberations. However, it is important to note at this stage that the various national competition agencies gained an in-depth detailed knowledge of the chemical distribution sector.

This is likely to have an impact on future M&A transactions. We already saw it happen when the UK Office of Fair Trading (OFT) blocked the acquisition by BOC of the Ineos packaged chlorine business or the merger of Nufarm with AH Marks. In both instances, the concept of pertinent markets was defended as well as the avoidance of the transformation of national oligopolies into duopoly or monopoly situations.

The National and European Competition Authorities will not disappear from the chemical distribution landscape anymore. Rather they will continue to be involved to avoid the recurrence of illegal cartel activities and to prevent monopolistic situations in the case of significant M&A transactions.

What’s up in 2010?

Chemical markets will be in better shape globally and overall demand levels will be higher than during the depressed period of October 2008 to June 2009 without reaching the peaks of 2007/2008. This will allow most chemical players to show improved results during the first half of 2010. Profits should improve but producers and distributors will not benefit from significant windfall profits anymore which came in 2009 as a result of lower value stock replenishments, payment terms reductions or restructuring benefits.

For what concerns a revival of the M&A market and sector consolidation, a lot is at stake with the planned Brenntag IPO. If it is successful and well subscribed, it will both reopen opportunities for acquisitions and pave the way for similar exits for companies like Univar, IMCD or Azelis. It will also allow for additional new funding to be made available to distributors to acquire targeted companies, while motivating new strategic players to consider investing in the sector.

The Brenntag IPO, as well as the chemical market environment, are very much dependent on the health and stability of financial markets which are now being shaken by the uncertainties around sovereign debts and risk of defaults in the Middle East and Southern Europe.

Chemical distribution which was marred by often imprecise data and sometimes wrong information, as was probably the case with JLM or Neochimiki, will be described in the future in a much more professional manner. The sector will be presented on the basis of accurate descriptions which will define the position of each company on pertinent markets.

Distributor markets are segmented as industrial chemicals split into direct deliveries, trading and warehouse businesses and specialty chemicals split by applications such as paints and coatings, adhesives and sealants, cosmetics, food and pharmaceuticals, agrochemicals and animal feed. Polymers are divided in turn into basic, engineering and technical product segments. Distributors' market shares will be consequently estimated within defined segments.Sales between distributors need to be identified separately as they often tend to significantly increase the reported market sizes. Investors are becoming more selective and will be attracted towards the sector if it is precisely described to them with detailed and reliable facts and figures.

It is now reported that direct deliveries from producers' sites to end customers, notoriously known in Germany as "Streckengeschaefte" are now managed by the distributors themselves and that rules about the information exchange between suppliers and distributors are better defined. Information about market trends and technical issues are acceptable but detailed information about customers and prices are not permitted anymore.

After all the difficulties faced by distributors in 2009, there can be no doubt that 2010 will be a better year and hopefully easier to manage. With this optimistic remark, the DistriConsult practice wishes you a Very Happy New Year and thanks you for your continuous support and our on-going fruitful dialogue.

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