

## The clouds part

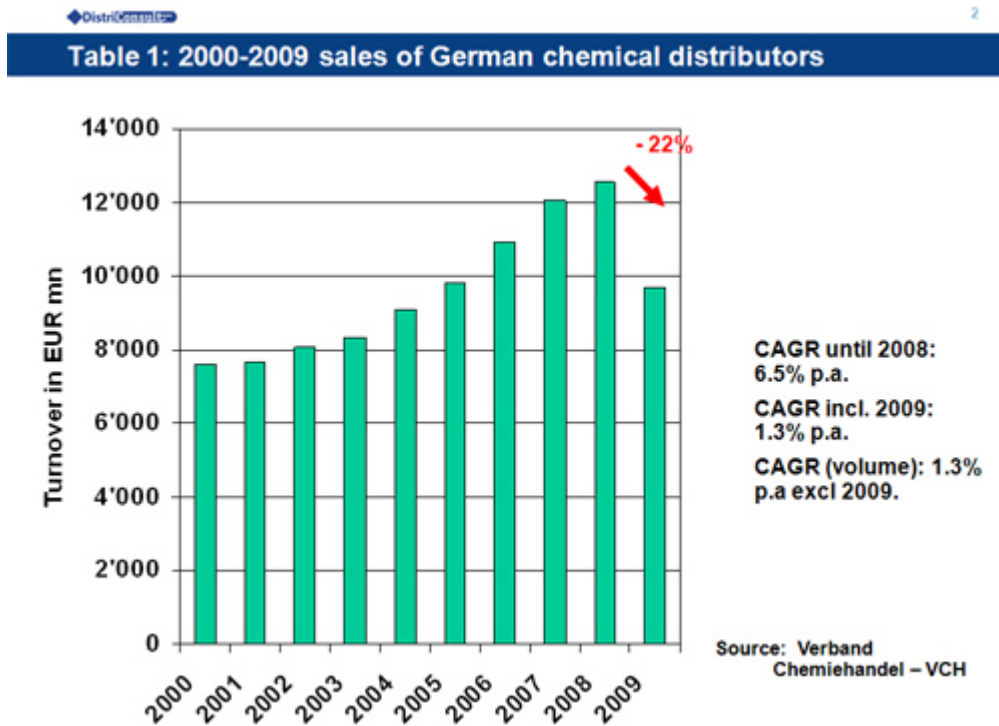
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After a tough year for the chemical industry and chemical distributors, 2010 is showing some glimpses of optimism. Demand for chemicals improved significantly in most countries, with above average growth rates in the emerging economies of Latin America and Asia. The Brenntag IPO is considered a success as the shares were well subscribed and the share price has stayed above the IPO price level. Finally, chemical distribution continues its evolution towards more efficiency and better performance. Two main topics are covered in this article, namely an evolving business environment for chemical distributors and the future of consolidation and M&A in the sector.

### Evolving business environment

The German Chemical Distributor Association recently published the overall 2009 figures for their members. German distributor sales reached EUR 9'696 mn, which represents a decrease of 22.8% versus 2008, while volumes dropped 12.9%. (see Table 1: German Distributor Sales 2000 - 2009).

This is historically the biggest drop in distributor revenues in a single year, From 2000 to 2008, the German distributor revenue CAGR was 6.5% p.a; when including 2009, it declines to 2.75% p.a. CAGR in volumes is reported to be at 1.3% p.a. until 2008; but when including 2009, volumes were overall flat. This reliable set of data constitutes to some extent a European industry benchmark, since the German market is the largest market for chemicals in Europe. It includes as well more chemical distributors than other countries and several industry leaders have their roots there. Other national distributor associations report similar results for their members. As much as 2008 was overall an exceptional vintage, 2009 appears to be a year to forget.



On April 20th 2010, the European Commission issued new block exemption rules “BER”, valid for the next twelve years. These rules exempt vertical agreements between suppliers and distributors of restrictions, provided they contain no competition hardcore infringements such as resale price maintenance. However,

agreements between companies which could contractually benefit from gaining or strengthening a market share exceeding 30% require specific authorizations from the national competition authorities.

Additionally, the regulation allows producers to implement an exclusive or selective distribution network and choose their distributors on the basis of pre-defined selection criteria. However, distributors are allowed to actively sell to other distributors throughout the internal market and to any end consumer. Any restriction of their freedom regarding where and to whom they sell would be considered as a hardcore restriction and is therefore prohibited.

By issuing these general rules, the EU Commission in effect also opens the discussion about chemical distributors' market share assessments and their corollary, namely the definition and size of the relevant markets on which they operate. Unless a market is defined and quantified, there can be no market share assessment. Recently, an effort of clarification was made in various publications, like in the Brenntag IPO prospectus, to better define the role of the actors involved in third party distribution.

In the chemical industry, we find traders who sell a limited product range to a small number of customers and agents who work for producers and receive a commission, while they do not take title to the products they sell. Both traders and agents' roles are defined by the specific services they offer to their suppliers and their customers. These are distinct and narrower from the broader service range offered by chemical distributors. Distributors take title of the chemicals they sell; they store, ship and sell them through a specialized sales force. Distributors offer a wide product portfolio and supply related services their customers require to transform the products they buy.

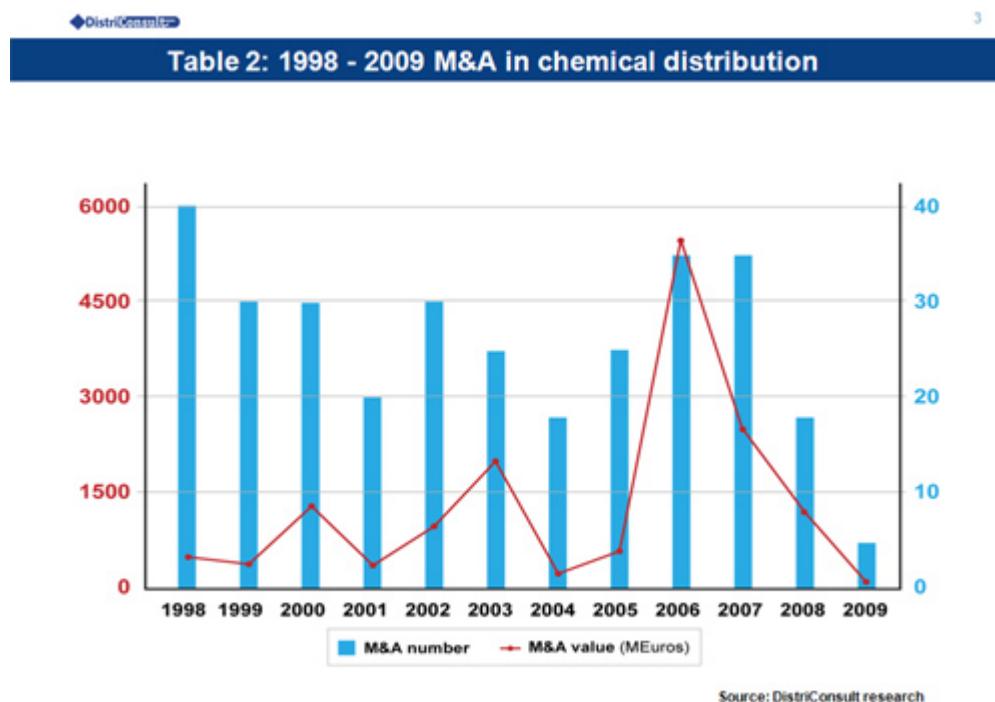
Traditionally, the chemical distribution market is split between the logistics intensive "commodity industrial chemicals" and "performance or specialty chemicals", generally marketed in the form of "factory packed chemicals". There is a relevant market for commodity industrial chemicals mostly sold by producers in bulk-loads and delivered either to the distributors' warehouses or directly to the distributors' customers (the notorious German term used here is "Streckengeschäft"). **Both the warehouse and the direct segments are relevant markets which are respectively used to assess the market share of the main players.** Brenntag owns and manages over 400 sites globally and has therefore a leading position on the commodity chemical warehouse market. Unlike specialty chemicals, industrial chemicals are produced employing well established generic processes and are available from a large group of suppliers. The number of players involved in commodity industrial chemicals with well equipped sites holding the necessary permits (called Seveso 1 or 2), is limited to a handful of companies on each national market, with the exception of Germany where there are more of them. In the industrial commodity chemicals segment, suppliers outnumber distributors.

Specialty chemicals, sold as so called "factory packed chemicals" in their original containers, are products with performance characteristics designed for specific applications in industries such as paints and coatings, adhesives, composite resins, food additives, cosmetics, pharmaceuticals or water treatment, to name but a few. **Each industry segment constitutes a relevant market which can be used to assess the market share of the various distributors serving those industries with factory packed chemicals. The quantitative evaluation of relevant markets is often challenging.** For specialty chemicals, we estimate that the top five distributors together hold a market share of up to 80% of the relevant national industry market, for each of the specific applications listed previously. **In summary, the chemical distributor market looks initially large, growing and fragmented, whilst when looking at it on a segment basis, the relevant markets are often small and served by a limited number of qualified distributors.**

### **The future of consolidation**

During the last ten years, the distributor market was consolidated particularly under the influence of private equity owned distributors. Since 1991, the four most acquisitive companies completed globally over 210 acquisitions, the leader being Brenntag with 93 acquisitions. Azelis made 45 acquisitions, IMCD 35 and

Univar 25. These acquisitions were part of well formulated “Buy & Build” strategies supported by the availability of leveraged financing and easily identifiable targets. (see Table 2)



Until 2008, 80% of all acquisitions were completed by private equity owned distributors. In 2009, the M&A market collapsed, with only five identified acquisitions. Previously, Brenntag dedicated each year on average EUR 100 mn for acquisitions, but only spent EUR 11 mn on acquisitions during 2009. Since 2008 on one hand, the well publicized credit crunch restricted the availability of funds to finance leveraged acquisitions. On the other hand, additional strategic and legal reasons added to the uncertainties surrounding the future of M&A in chemical distribution.

Several private equity owners are now more concerned about the future exits from their investments and are reluctant to further increase their exposure to the sector. Specialty distributors which have achieved critical mass in several industry sectors can't make new acquisitions as this would often create conflicts and overlaps with their existing suppliers. Finally and more specifically in the commodity industrial chemical sector, the National and European Competition Authorities are aware of the increasing concentration which happened on this segment and are prone to closely scrutinize further consolidation.

As it was highlighted at a recent FECC congress by a prominent competition lawyer, Dr Wessely of Freshfield Deringer Bruckhaus, who declared “there are no real problems when a merger of two companies does not create a new entity with a share above 25% of a relevant market”. **Presumption of dominance exists when a single company market share is above 50%”. In general, he said, “six companies in a relevant market is good, three are too few”.**

The Competition Authorities benefit now from the detailed knowledge of chemical distribution they acquired as a result of on-going antitrust investigations and recent judgments for some sub-segments issued in several countries. As the European and North American distributor markets are both consolidated and mature, we can eventually expect more M&A activity to take place on the faster growing and still fragmented markets of Asia and Latin America. In Europe, opportunities could still emerge for medium size specialty distributors to increase their franchise and coverage through well chosen and targeted M&A projects.

**As we could observe it over the last twenty years, chemical distribution is continuously restructured and reorganized under the influence of external and internal trends, which are essential to identify**

**and integrate into each company's strategy, in order to allow them maintain a competitive edge.**

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It has been a real pleasure for me to co-operate since 1990 first with European Chemical News and later ICIS Business News and to share with you my analysis of this significant sector of the chemical industry. As I am now retiring, my successor Gunther Eberhard, General Manager DistriConsult GmbH, will continue informing you of the on-going developments in the chemical distribution sector.