A Year of Re-Orientation

Chemicals Outlook 2021: The Worst Is Over, but the Challenges Remain

The year 2020 was destined to be a year of transition for the chemical industry as a prelude to recovery. But then the COVID-19 pandemic struck and changed everything. The collapse of supply chains, production stops, closed borders, and week-long lockdowns led to a global economic slump and transformed 2020 into a crisis year of unprecedented dimensions.

Although the second wave of coronavirus is still ongoing, vaccines coming to market have raised hopes that the crisis will come to an end. However, the major issues preoccupying the chemical industry before COVID-19 have remained. And the pandemic has added new challenges the industry must tackle and finance. And so 2021 will be a year of re-orientation with business models being put to the test and adapted to the new environment.

Are We at the Beginning of a New Cycle?

After the global lockdown the market bottomed out in mid-2020. In the second half of the year, the rise of domestic demand in China marked the onset of the recovery phase. However, it has not been homogeneous, as some subsectors have fared better than others. For example, chemicals for electronic applications, specialty polymers, catalysts, and nutraceutical ingredients are currently experiencing above-average growth prospects in 2021, similar to segments that have already seen increased demand as a result of the healthcare crisis (e.g. packaging, Plexiglas, medical gases, etc.).

Geographically the recovery has also been uneven, with a strong recovery in China, a slower recovery in Europe, and the U.S. somewhere in between. In terms of prices, this was even more pronounced: Prices and margins bottomed out in the first half of the year due to inventory reductions and low utilization rates, as well as falling raw material prices, only to rebound sharply in the second half thanks to sequential recoveries, low inventory levels and restocking, and isolated capacity outages.

As vaccines should become more easily available during 2021 and infection rates start to decline, demand in chemical markets will continue to recover—in line with improved expectations for global GDP growth. However, the predictability of demand growth remains volatile.

Against this background, analysts see volume growth of 4%–6% for the sector, depending on the business and product mix. Those seem realistic at the moment. However, compared to Asia and the Americas, recovery of the chemical sector in Europe is most at risk in the coming months due to the strong Euro and the increasing infection rates, social restrictions and Brexit. Therefore, chances are 2021 will be another transition year for chemicals in Europe, with a slow start and a stronger second half.

Challenges in the New Normal

COVID-19 has accelerated some of the longer-term industry trends that already exist. The "new normal" will be different from before. The following issues will have a significant impact on the development of the chemical industry in 2021 and beyond:

1. The sustainability of China's recovery remains critical to global growth and industry profitability in 2021 and will determine the pace of recovery this year. China is the largest chemicals market—

accounting for about 40 percent of global chemical activity today—and will grow to about 50 percent by 2030. So far, China has recorded the strongest recovery from COVID-19 in the world. Domestic demand—particularly in the infrastructure, real estate, and automotive sectors—has increased significantly, driving up demand and prices for chemicals. Clear risks to recovery in China include trade tariffs and planned expansions of integrated production capacity.

2. Volume growth in subsectors varies significantly from end market to end market. Transportation markets such as autos, aerospace, and automotive aftermarkets, fuels, and broader industrial markets and personal care (cosmetics, fragrances, hair care) are best positioned for a strong recovery versus 2020. Momentum will be less pronounced in medical equipment, hygiene products, furniture, packaging, and do-it-yourself ("DIY"), which have already been on an elevated baseline since last year following a strong recovery in demand. In particular, the recovery of automotive demand in the EU has a key significance for the recovery of the chemical sector and will play an important role for various supplier sectors of specialty chemicals, such as paints and paints and coatings, specialty polymers, plastic additives, adhesives and sealants, and lubricants, and will support their growth disproportionately.

3. "De-globalization" was already in the agenda before the pandemic due to Brexit and trade tensions between the U.S. and China. The pandemic has highlighted the vulnerability of many international chemical supply chains and reinforced the need to strengthen local supply channels and production facilities. This will lead to an increase in local investment in chemical production facilities (near- and on-shoring) in 2021 as well as a broader distribution chain, particularly for critical raw materials used in industries such as agriculture, aerospace, pharmaceuticals, and semiconductors. This increases capital requirements for chemical companies for investment and for higher working capital ("working capital").

4. Due to acceleration of energy efficiency and "decarbonisation," many governments are promoting environmental policies requiring substantial investments in clean energy sources. Hydrogen, lightweight and electrification of cars, reduction of CO_2 emissions, and recycling are increasingly coming into focus, opening up additional business opportunities for chemical companies in the area of energy efficiency.

On the other hand, accelerated "decarbonization" will significantly increase the cost of doing business (higher prices for CO_2 emission rights) and will be a key driver for strategic investments in response to environmental regulations as well as the shift in demand towards "lower emission" end products. ESG performance will be valued as highly as operating cost and other productivity indicators in the future.

Most of these developments have implications for the future financial profile and capital structure of chemical companies and their competitiveness. This could pose existential problems, particularly for smaller to medium-sized companies that do not have the same liquidity buffers and financial flexibility as larger companies. Government stimulus programs and easily available financing have masked some of the structural problems already existing before COVID-19. As soon as the programs expire, liquidity problems may arise address challenges such as increasing competitive pressure, the need to grow and the capital requirements for investments, working capital, and debt repayment. In individual cases, this may well lead to corporate restructuring.

Continued Increase in M&A Activity in the Sector

After mergers and acquisitions in the chemical industry were interrupted with the onset of the COVID-19 pandemic, they increased significantly from last summer onwards. Mostly small and medium-sized transactions were carried out. Following the series of megadeals towards the end of the last decade, only a few very large companies are still available, so mergers and acquisitions will increasingly focus on small to medium-sized deals in the future.

Company valuations on the stock exchanges and in the M&A market have held up relatively well over the past year (as measured by EBITDA multiples). But we have also seen a certain "positive selection" on the M&A side as more successful companies or divisions came onto the market during the crisis. Businesses that were more severely affected by COVID-19 are still being held back and restructured internally.

The portfolio management approach, which was the norm in the industry before the pandemic—not least due to increasing pressure from activist investors—continues to gain ground as a result of pandemic-related cost pressures and the changing outlook for the future. Many companies are being forced to think carefully about what they really want to focus on. This will lead to portfolio shifts and divestments of non-core businesses as well as acquisitions to strengthen the core business.

The desire of many companies to enhance their growth prospects and improve ESG characteristics will further drive acquisition activity. As some transactions show, it is not unusual for companies to sell mature or cyclical businesses with low-growth prospects and high capital intensity and energy needs and reinvest the proceeds in specialty businesses with higher growth and higher more stable margins. The availability of private capital will also accelerate portfolio adjustments. Globally, private equity firms are sitting on nearly $1.5 trillion in funds which they are looking to invest profitably. As a result, financial sponsors are increasingly competing with strategic buyers. A number of sales processes are already in preparation or underway here, so we expect to see significant acquisition activity in the coming months.