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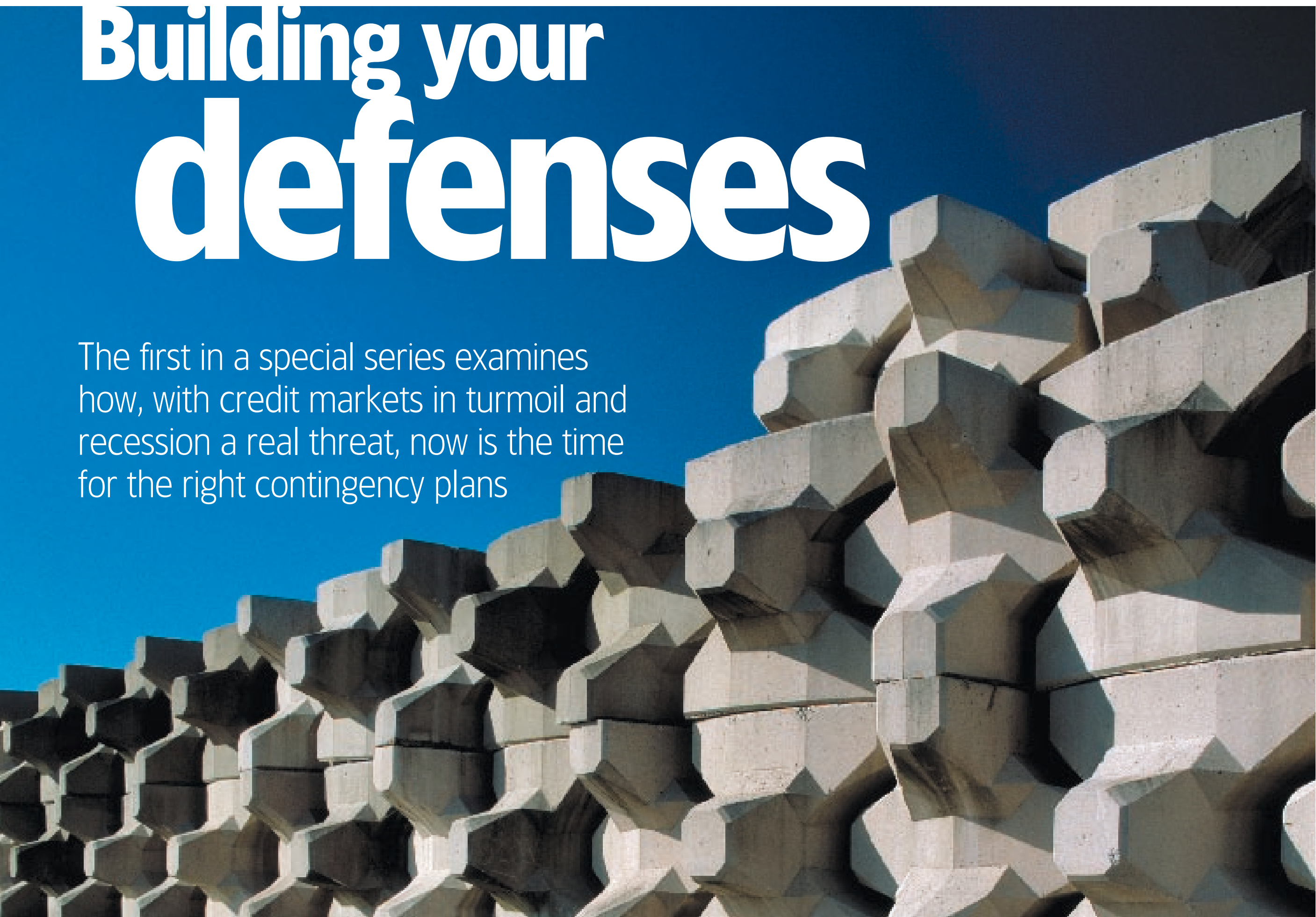


The first in a special series examines how, with credit markets in turmoil and recession a real threat, now is the time for the right contingency plans

ALAMY

Consultant's corner

PAUL HODGES
INTERNATIONAL ECHEM

IMAGINE THAT you had come into work this morning and learned that a major customer had gone bankrupt overnight. Unfortunately, according to your sales team, a new consignment had just been delivered yesterday to their warehouse. And when you call your credit manager to see what can be done, he tells you that the company was already three months late on payment.

Contingency planning has gone out of fashion in recent years, as executives have focused on meeting "stretch targets" for increased profits instead. Today, however, it may well be about to make a comeback. It is 16 years since the Western world last had a full-blown recession. And many managers have forgotten, or have never known, just how bad things can get.

Of course, some argue that things are different now, and that all-powerful central banks will ensure that the world avoids a serious downturn. Therefore, they argue, companies should still focus on meeting the stretch targets, and hope to take advantage of more cautious competitors.

I disagree. In my Chemicals & the Economy blog last August, I marveled as Citigroup's CEO announced that they were "still dancing" in spite of recent credit market problems. That CEO lost his job by the end of the year, after a $10bn (€6.4bn) fourth-quarter (Q4) loss. And since then, the problems in financial markets have been increasing.

Stock markets are also sending out warning signals.

Compare the rise in crude oil prices over the past six months to changes in share prices for major specialty and commodity companies such as Switzerland's Ciba, Dow Chemical of the US, Germany's BASF and Saudi Arabia's SABIC.

The oil price increased by 40% over the period, badly impacting some producers. Worst hit has been Ciba, whose share price is down over 30%. It recently reported that sales prices had only increased by 1% in 2007, while raw material costs had risen by 3%. This is clearly unsustainable, and the company said it is now being forced to "walk away from less profitable business."

More recently, Dow has also seen its share price slip. It reported in January that Q4 had seen the "highest-ever increase in purchased feedstock and energy costs." These were up $850m versus Q3, causing "margin-squeeze" in both performance and commodity businesses alike.

Unlike Dow, BASF has the prop of a major oil and gas business, which accounted for

50% of its Q4 profit. But its North American chemical business saw sales down by 11%, and profit down by 64%. The share price's earlier outperformance has disappeared, as investor concern has grown.

IGNORE AT YOUR PERIL

Investors in SABIC initially ignored signs of a downturn, pushing the share price up by nearly 70%. Clearly, they thought that SABIC's advantaged feedstock position in Saudi Arabia would compensate for any downturn. But this optimism didn't last, and the share price is now well below its highs, even after the recent rally. Investors have really been rather slow to spot the growing problems caused by higher oil prices. Based on data from the new ICIS pricing Weekly Margin service for European polyethylene (PE), it shows how the ethylene margin fell from nearly €600/tonne in early 2007 to around €100/tonne in December 2007 (see graph, right).

The high density polyethylene (HDPE) margin fell from €200/tonne to €125/tonne over the same period. Seasonal trends and slightly firmer prices have helped both margins to recover in recent weeks, but they are still well below 2007 levels.

Of course, the higher oil price is not the only problem being faced by the industry. Housing is an enormously important market, with the American Chemistry Council estimating that each new house uses $16,000 worth of chemicals. So the fact that US housing starts are now less than half their peak level in 2006 is very bad news for chemical demand.

In addition, the associated subprime crisis has now become what the Bank of England has called the "largest-ever peacetime liquidity crisis." Surveys of chemical company chief financial officers show that credit is already less available in the US and Europe.

So what can companies do to better position themselves in case the downturn continues or worsens? This is where contingency planning becomes so important. The first step is for senior management to review the outlook and take a view on the likely length and depth of the potential downturn. Experience of previous recessions in 1980–1983, and 1990–1992 suggests that it would be prudent to plan for it to extend to 2010, as a minimum.

In terms of depth, a range of scenarios might be developed, to include a mild and a more major downturn. Overcapacity is looming in most petrochemical products, due to new plants coming on stream in the Middle East and Asia.

The Ciba example shows that specialties and fine chemicals are also hit by higher oil prices. These act as a tax on consumers, causing demand to shrink. As a result, market share objectives often become paramount during major downturns, and profit suffers.

Once senior management has finalized its preferred scenarios, they then need to establish a task force to develop the necessary contingency plans. All main functions need to be represented, and proposals should be developed that cover commercial, technical and financial options. This needs to be done quickly, while line managers continue to operate the business on a day-to-day basis.

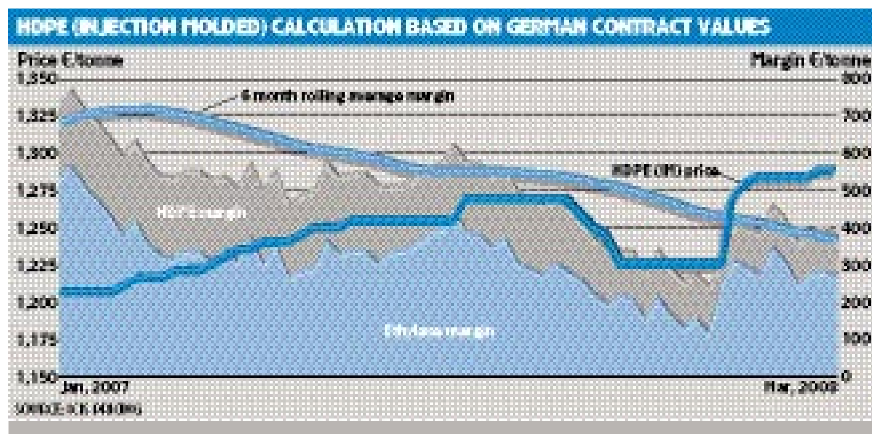
One of the benefits of the team approach is that it stimulates proactive financial management across the functional silos. Better management of working capital is one obvious example of a cost-saving measure. But credit managers can also provide regular reports to sales teams, for example, to highlight potential problem industry segments. In addition, they can develop special monitoring programs for individual customers.

LEVERAGE = RISK

The recent trend for highly leveraged private equity deals poses an exceptional level of risk for their suppliers. During a boom, a company with 90% debt would see its return on equity hit a fabulous 126%, if profits rose by 30%. But in a bad year, where profits fell by just 10%, the company would be bankrupt.

Equally, the team needs to see what internal actions can be taken. Cost reduction will inevitably be part of the program, but contingency planning should be more imaginative than a typical budget exercise. For example, managers also need to be quizzed on whether new products or plant processes can be fast-tracked to increase sales or reduce costs.

In a year, the optimists may have been proven right. Today's problems may appear as a minor hiccup. But if a serious downturn is now under way, then time will be of the essence in ensuring business survival. And those companies with robust contingency plans will find themselves with a major advantage.



> **Last month's US bankruptcy of Plastech seems likely to cause several major companies to lose money**

Unfortunately, the example with which I started this article is not hypothetical. Last month's US bankruptcy of Plastech Engineered Products seems likely to cause several major companies, and many smaller ones, to lose significant amounts of money. So time spent today on preparing contingency plans, before similar problems impact your company, may well prove to be the best investment you can make this year. ■

» Paul Hodges is chairman of International eChem **www.internationalechem.com**, commercial advisers to the global chemical industry. He writes the ICIS Chemicals & the Economyblog.