New reality for petchems

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A close look following the collapse of the global petrochemical industry reveals a major shift in behavior. Understanding this is critical when planning how to compete in the new landscape

Consultant's corner

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WHAT A difference a year makes. This time last year, the petrochemical industry was in a state of shock. After four boom years, the third quarter of 2008 saw a collapse in volumes and margins, and the financial sector was already in trauma. Few people had foreseen such a disaster.

Since then, the industry has had little time to reflect. First, a period of dramatic destocking unwound the inventory that had built up while the oil price rose during 2007 and the first half of 2008.

Some leading petrochemical companies, such as Dutch major LyondellBasell Industries, were forced into bankruptcy as a result. Many others, such as UK-based INEOS, had difficult discussions with their lenders as debt covenants had to be rewritten.

More recently, this nightmare experience has been replaced by a restocking sequence. Key industries such as housing, automotive and electronics have temporarily stabilized, helped by government stimulus packages – most notably, the scrapping plans in the auto sector.

Customers down the value chain have begun to order once again, although there is still a general lack of visibility about the underlying state of end-user demand.

HOW DID IT HAPPEN?

So now is a good moment to consider how the industry was so taken by surprise. How did demand end up in virtual free fall? And what will help us avoid making similar mistakes in the future? I suggest we were all living in a false utopia from 2003–2007:

- Central banks kept interest rates low to encourage consumption, in the belief that inflation was under control.

■ Individuals in Western countries were able to borrow money very easily, secured by the ever-rising price of their homes.

■ Emerging economies such as China lent vast sums of money to the West, to support manufacturing employment at home.

Much of the resulting boom was focused on areas such as housing and autos, where petrochemical demand is strongest. In turn, this led to a belief that demand was not only strong, but would remain so. Massive capacity increases seemed not only manageable, but essential, therefore.

These consensus beliefs were probably mistaken. Every mania has illusions, such as the belief during the 1630s that prices for Dutch tulips would always increase.

Ours focused on the seemingly unstoppable rise in housing prices in many Western countries. And it became more self-sustaining as more parts of the global economy came (knowingly or not) to be dependent on it.

Until, of course, the bubble began to burst. US consumers have since suffered a wealth loss of $15 trillion (€10 trillion), and global consumers a loss of "multiples of that figure," according to PIMCO, the world's largest bond fund managers. PIMCO correctly forecast the recession and now believes we are facing a "new normal" – for at least a generation – of "higher savings, lower consumption, and growth closer to 2% than the historical 3.5%."

ASKING THE AWKWARD QUESTIONS

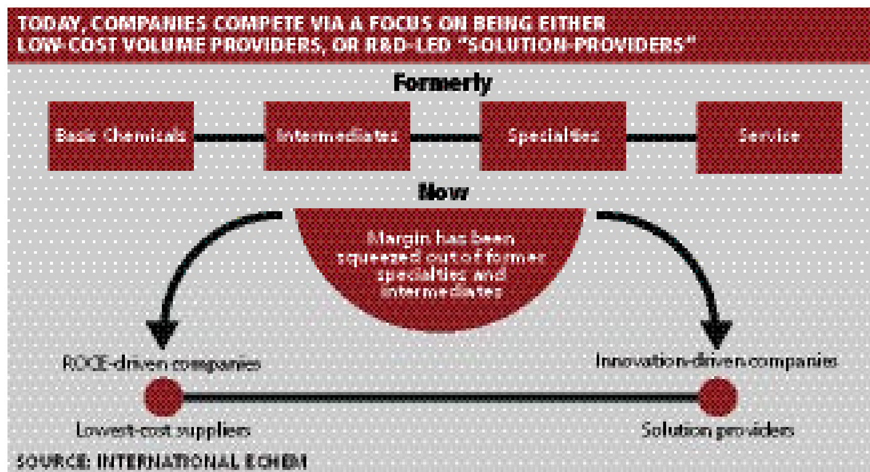
This is not a consensus view. But after the debacle last year, responsible CEOs and boards should consider a wider range of opinions when they come to developing strategy and budgets for the next few years.

They may still prefer to adopt a quick V-shaped recovery as their base case, but there could be major value from challenging this with a less conventional outlook.

Such a downside scenario might be based upon an assumption that recent levels of demand are unsustainable, and that we now face a prolonged downturn. The value of this approach, however unwelcome it might be, is that it asks the awkward questions:

■ What is the industry going to do about overcapacity? Will value chains survive in their current form? What new competencies might be required? Does demand for innovation die away, or will it refocus on areas such as climate change and carbon footprint?

■ Equally, what is likely to change upstream and downstream? Will oil and feedstock prices stay relatively high, due to the lack of investment in exploration and production during the boom period? If so, will our customers abandon the idea of global supply chains, and start to relocate their factories closer to demand in the West?



Each company can probably think of its own awkward questions – those that were brushed under the table when business was going well. If I could ask your board just one question, it would be: "Is your business robust enough to survive an extended period of low volumes and margins, against a background of tight credit markets, and continuing volatility in oil and currency markets?"

A MAJOR SHIFT

This suggests that a major change has been taking place, almost unnoticed, in the fabric of our industry. We still use words such as "specialty" and "commodity" to describe what we do, and how we compete. But do these words really represent what is happening?

When I joined the industry, some 30 years ago, it was true that most of the major companies focused on large-scale operations. And one of the key results of the 1980–1985 downturn was that portfolios were then streamlined. "Focus" became the catchphrase of the day.

As a result, a number of smaller companies were able to earn good profits by taking commodity products, and adding a touch of "magic" to them. This might be a specialty additive for use in a particular application, or the provision of competent technical resources to help their customer develop a new product or process.

But those opportunities came to their peak more than a decade ago. Since then, the internet has made it far easier to compare product prices. And more recently, the major retailers, such as US behemoth WalMart and the UK's Tesco, have been warning that consumers are increasingly focused on "needs" rather than "wants."

Today, "basic" and "value" products are increasingly being preferred, whereas before "new" and "improved" would drive a sales increase. And this change should lead companies to ask themselves:

■ If we consider ourselves a specialty company, do we provide genuine innovation to customers, or offer just a differentiated version of the same molecule or effect?

■ If we consider ourselves a commodity company, are we genuinely the lowest-cost producer? Or are we instead strong in some areas, but less competitive overall?

I suggest these potentially unwelcome questions because I believe we need to adjust our language to reflect a new reality. The retail industry is telling us consumers are becoming more frugal and less materialistic. So it is critical we determine how we plan to compete in this new landscape – whether by being genuinely low cost, or a solution provider.

Of course, there is nothing wrong in hoping for a quick V-shaped recovery next year. But my belief is that it would be prudent to also question whether the past year marks the start of a fundamental change in the outlook for the industry and a new reality. ■

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