Middle East petrochemicals companies aim to capture emerging markets

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Analysts say another global economic downturn is looming. For Middle East petrochemicals firms investing in new capacity, a rethink of their target markets could open up opportunities

Key fact

The global average for petrochemicals prices fell 5 per cent in September to $1,324 a tonne

Source: MEED

It briefly looked like 2011 could be the year the global petrochemicals industry finally bounced back. After the travails of the years following the global financial crisis, things were looking up. Demand was on the increase, producers were reporting record high sales and profits, and firms on the brink of ruin in 2008-09 had emerged stronger and more solvent than before.

Middle East petrochemicals firms were among the biggest winners in the first half of the year, racking up huge profits. Saudi Basic Industries Corporation (Sabic), the Middle East's largest listed company, is regarded as a traditional bellwether for the health of the regional petrochemicals industry. For the third quarter of 2011, it reported net revenues of SR49bn ($13.1bn) and profits of SR8.2bn, a 54s per cent jump on the same period in 2010 and a record for the company.

As the year draws to a close, the global economic outlook is much less certain.

Renewed gloom

Dark clouds are gathering over the North American and European financial sectors and demand in China is looking shaky. In light of this renewed gloom, analysts are expecting the industry to face a tough time during the rest of 2011 and much of 2012, as governments try to stave off another global recession.

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Paul Hodges, International Echem

Of more concern to many analysts and industry insiders than the prospect of more economic turmoil is what will happen afterwards. From 2013, the question is whether a 'new normal' is

likely to emerge, in which global demand is not driven by credit-happy consumers in the West, nor underpinned by rapacious growth in China. This scenario, if it plays out, would create many problems to the petrochemicals producers of the Middle East, but could also, if they get the strategy right, be their biggest opportunity to lead the global industry.

Paul Hodges, chairman of International Echem, is convinced another downturn in 2011-12 will prove the events of 2008 were not just about a banking crisis in the West. Hodges says the current environment is part of long-term changes to global consumption patterns related to a huge demographic shift in the world's biggest economies.

"There are two things going on at the moment," says Hodges. "The first is an economic recession brought on by high crude prices, which to me is a pretty simple cause-and-effect relationship." With European crude oil prices above $100 a barrel, it will be tough to create economic growth.

This, along with the sovereign debt crisis in Europe, is the central focus for many business leaders, policymakers and central bankers. The present environment for petrochemicals producers looks much like it did in 2008 as the crisis first broke, with buyers cutting stock in the summer and producers predicting lower operating rates and margins in the second half of the year.

In Europe, polyethylene and polypropylene producers are reportedly running their plants at 80 per cent capacity, with little buying or selling being done on markets. Where there is activity, buyers are targeting either static or lower prices on contracted volumes. Polypropylene prices in the US dropped 18 per cent cent during October contract negotiations, while prices and demand are also reportedly low in Asia.

On 5 October, London-headquartered market intelligence service Platts reported that the global average for petrochemicals prices fell 5 per cent in September to $1,324 a tonne from $1,387 a tonne in August. According to UK-based analysts Nexant Chemsystems, profit margins at petrochemicals producers fell 15 per cent in the third quarter of 2011, to their lowest levels in 18 months.

Petrochemicals demand was buoyed in 2008 by a huge expansion of credit in China, but Beijing has not responded the same way in 2011, because of concerns over inflation and the creation of a domestic credit bubble.

In a note to investors, Kunul Agrawal, an Asia energy analyst at French bank BNP Paribas, reported that petrochemicals inventories in China were up to about 70 days' supply, compared with a normal level of 50 days. Chinese consumers are placing orders 50-60 per cent lower than in 2010. Tighter domestic lending to small and medium-sized enterprises, meanwhile, has tightened the supply of credit.

Production capacity

"There are a lot of parallels with 2008," says Alan Eastwood, chief economic adviser to the UK's Chemical Industry Association. "It could get a lot worse before it gets better."

This is a particular worry for Middle East producers developing and bringing on stream new production capacity. According to Chemical Markets Associates International, now part of the US'

IHS Insight, Middle East ethylene capacity is set to grow from 25 million tonnes a year (t/y) in 2010 to 30 million t/y in 2030. It forecasts propylene capacity to increase to 11 million t/y from 8 million t/y over the same period.

Given the region's low-cost feedstock advantages, Hodges says it is likely to do well in terms of maintaining its market share. Some producers may even benefit from renewed turmoil, having gained traction in emerging economies during the 2008 crisis. "They are in a relatively favourable position," he says. "They will maintain market access, but there will be some considerable pricing pressure."

But these are short-term problems, he adds. "The second issue is the transition in the economic supercycle, the demographic time bomb which is going off," says Hodges. "One third of the population of the Western world is now over the age of 55, which is something that is unprecedented. If you are over 55 and the kids have left home, you just don't need to buy as much stuff. Everybody in business and policymaking is expecting everything to go back to [pre-2008] normal, but that just isn't happening."

Demographic changes

As early as 2005, analysts at the UK's McKinsey & Company were warning of the effects of demographic changes, pointing to Japan's experience over the previous 20 years. Japan has faced low birth rates and growing life expectancy since the 1980s. With 22.9 per cent of the population now aged 65 and over and an average age of 47.7 years, it has one of the oldest populations in the world, according to the US' Central Intelligence Agency.

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Alan Eastwood, Chemical Industry Association

The country's ageing population is leading to a fall in the rate of savings and the accumulation of the wealth. McKinsey says the wealth of the average Japanese household will decline by 0.2 per cent on average between 2003 and 2024, having grown 5.5 per cent a year over the previous three decades. This, in turn, has caused the country's economy to stagnate, with demand for goods and services, including major economic drivers such as home-building, effectively static. Japan's economic growth rate has been in long-term decline since 1998, according to the Washington-headquartered World Bank.

Western European countries, in particular, now face the same demographic and economic pressures, says Hodges. The huge economic growth of the previous 30 years was largely due to a combination of the growing income and associated spending power of the post-war 'baby-boomer' generation and a massive expansion of credit in the West. In the future, he says, Western consumers will spend less and, hence, consume less.

Eastwood, of the Chemical Industry Association, supports Hodges' view. "In Europe, and to a lesser extent, in the US, we have mature markets, as with Japan. We are largely past the place where people are investing in material-intensive goods. We spend our money on miniaturised goods and services."

In the West and Japan, the growth of the petrochemicals industry has largely moved in step with economic growth. Now, if producers want to sell more chemicals and plastics, they will have to look to new, emerging economies.

The growth markets of the future will not be the Western European and North American countries that were integral to the development of the petrochemicals industry over the past 100 years. They will be developing countries where growth and wealth are expanding rapidly. Much has been made of the Bric economies in recent years (Brazil, Russia, India, and China) as centres of future economic growth, with new middle-class consumers buoying demand.

The Organisation for Economic Cooperation and Development (OECD) estimates that 40 per cent of the world's middle-class consumers could be from Asia by 2020, compared with less than 25 per cent today. The UN, meanwhile, predicts that most population growth in the coming 65 years will be in Africa and West Asia.

Emerging economies

"The centre of economic gravity over the next 10-15 years will clearly be emerging markets," says Anil Gupta, chair of strategy and entrepreneurship at the University of Maryland's Robert H Smith School of Business in the US. "Demand from the Western economies will be low or flat; most growth will come from emerging economies."

While these emerging markets would appear to present huge opportunities, the new middle classes will not follow the same consumption patterns as their Western counterparts.

"Since 2008, people have been talking about the emerging markets, the new middle class, and China in particular as being the salvation of the petrochemicals industry," says one European petrochemicals trader and analyst. "But China has its own problems and a lot of the major petrochemicals producers in Europe and the US simply aren't [equipped] to provide for the kind of demand [coming from] poor countries getting a bit richer."

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Anil Gupta, Robert H Smith School of Business

A January study by the Asian Development Bank into the role of the middle class in the growth of developing countries drives this point home. The authors describe the middle class in developing countries as earning $2-10 a day, or about $500-5,000 a year. The median income of the average household in the US in 2010 was just under $50,000 a year, according to the US' Census Bureau. Even the top earners in the OECD's definition of middle classes in the developing world - those earning $10-100 a day - falls far short of the kind of income and spending power wielded by the baby boomers of the West.

"There is complete confusion over this middle class in emerging and developing markets," says Hodges. "The technical minimum wage in China is $6 a day, which is less than the minimum hourly rate in most developed countries. People's spending power and the kind of things they are going to be spending on will be completely different. There is going to be an enormous market of people leaving poverty for the first time, but the kind of things they are going to be buying will be completely different."

For petrochemicals, this means rethinking plans to develop advanced speciality chemicals aimed at Western consumers and a greater focus on high-volume, low-margin sales to developing-world consumers.

“It is all very well saying we can go to high value-added commodities, but Chinese and Indian producers will soon be able to make these goods,” says Eastwood. “What people need to do is try to take advantage of low-cost sales while investing abroad, putting plants on the ground in the Far East, for example.”

Balancing act

Gupta believes petrochemicals producers will have to be smart in the way they work, balancing the ongoing development of high-end speciality chemicals with the need to capture demand in fast-growing markets.

“The developed economies won’t fall off a cliff at the end of the world,” he says. “And even in emerging economies, there will be consumers who will have similar buying power to those in the West. You don’t want to ignore consumers who want high-end goods, but you will also have to concentrate on the ‘value’ segment of the emerging markets.”

The positive for Middle Eastern petrochemicals producers is they are well placed to benefit from the shifting consumption trends of the next decade. Geographically, they are positioned between Asia and Africa. Thanks to abundant energy supplies and existing petrochemicals trade links, their governments have good relations with emerging market giants, including China. They also have, for the moment at least, some of the cheapest feedstocks in the world, with ethane costing about $0.75 a million BTUs in Saudi Arabia, for example, compared with $3-4 a million BTUs on international markets.

Fortunately, the region’s producers are already taking note of the new trade winds. Announcing the $20bn Sadara Chemical Company joint venture of Saudi Aramco and the US’ Dow Chemical at Jubail in July, Dow chief executive officer Andrew Liveris made it clear which markets the partners were targeting.

“Sadara lies at the epicentre of our growth strategy, clearly situated to capture share in fast-growing end markets in emerging geographies,” he said.

The region’s other petrochemicals producers would do well to follow Sadara’s lead.