Good times, bad times?

What must Europe's petrochemical producers do to ensure a sustainable future? Eight leading executives shared their thoughts at an ICIS-led CEO Roundtable in Brussels

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EUROPE'S PETROCHEMICAL producers have been enjoying an extended peak of profitability, driven by the combination of strong demand, tight supply and pricing power, backed by the surge in the oil price. But there are signs that economies around the world are slowing, and new capacities will soon lengthen the supply side of the equation.

How well are Europe's petrochemical producers positioned in this changing scenario, and what can they do to ensure the long-term sustainability of the European manufacturing base?

These and other questions were discussed at the recent ICIS and Booz Allen Hamilton CEO Roundtable in Brussels, Belgium, which was attended by eight of the region's top petrochemical executives (see page 32).

The consensus was that the next few years will inevitably be more difficult and challenging, given the wave of capacities coming

"Pressure is now increasing and clouds are coming"
Martin Kuzaj, Borealis

on stream in the feedstock-advantaged Middle East, although this is bound to affect some products more than others. But on the whole, there was confidence that the downturn would be manageable and relatively short, perhaps two to three years, commented both Benjamin Palomo-Sanz, managing director of chemicals at Spanish oil and gas company Repsol YPF, and Markus Wildi, European president of chemical giant Dow Chemical.

Certainly, there was no indication that there was any need for pessimism. One factor working in favor of damping any waves of investment past 2010 is the escalating costs involved in building new plants. This will raise the hurdle on investments and see less capacity planned after the current wave, described by one participant as "trophy plants," stimulated by the excess revenues from Middle East oil and gas and the need to create jobs in the region.

Factors that are really concerning the CEOs today center more on regional issues: security and cost of energy supplies; the cumulative effect of EU legislation, such as Reach and carbon trading, and energy policies; and the current volatility of raw materials pricing.

As Patrick Thomas, CEO of Bayer MaterialScience, the German polymer giant, pointed out, it is often not absolute cost levels that cause the pain, but their volatility. In many cases, products "are most profitable when high raw material costs flow through…. In certain products there has been high growth and pricing power has been relatively strong." But for some materials, "margins can swing dramatically quarter to quarter, even when selling prices are constant."

Improvements to the asset base in terms of cost, efficiency and integration; cash flow management; and supply chain performance generally emerged as the areas to focus on. Innovation and adding value were also emphasized as tools to stave off low-cost competitors.

"We should be more proactive in creating a better relationship with the authorities"
Boy Litjens, SABIC Europe

STRONG PERFORMANCE

Boy Litjens, CEO and chairman of SABIC Europe, and Anton de Vries, president of the polymers division of LyondellBasell Industries, both pointed to the markedly good performance over the past three to four years. The past two years, said Litjens, had been very good, providing the sector with a period of additional strong performance,

"It is very difficult to pass on these [energy] costs"
Kay Gugler, BorsodChem

given that a downturn had initially been expected in 2006. De Vries added that for probably the first time, the peak of the cycle had been extended, a welcome change from the rather more normal short peak and long trough suffered by petrochemical producers.

"This year should still be good – we are bullish in terms of sales holding up well," »

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FOCUS ON ASSET BASE AND REFINERY INTEGRATION

One of the themes at the Roundtable was the need to keep the European asset base up to scratch and to increase integration, especially with refinery operations.

Further focus on energy efficiency can also play its part here, noted Patrick Thomas, with high energy costs making more efficiency projects feasible.

With so much of the raw materials cost base being uncontrollable, noted Benjamin Palomo-Sanz, a key issue for Repsol YPF is how to optimize the value chain between the refinery and petrochemicals. Boy Litjens voiced the same concern at SABIC, where the emphasis is on getting all its European assets in good shape and within a low-cost, integrated platform.

On the refinery side, noted Francois Vleugels of UNIPETROL, the rapid increase in demand for diesel in Europe is leading to increased petrochemical production, as refiners crack closer to the bottom of the barrel. This means that more aromatics and C4s are coming out of the refinery today at marginal economics, and are available for processing by the petrochemical sector.

But Europe will have to come to terms with the fact that much of its production will, in global terms, slip into the second quartile of performance, given that the Middle East will shortly account for 25% of global petrochemical capacity, based on worldscale plants using the latest technology and operated at optimum efficiency standards.

commented de Vries. But, he warned, European players cannot compete on cost with the extra polymers coming out of the Middle East, based on cheap feedstocks. "If we do not position ourselves well, there will be difficult years ahead."

"The price advantage is so huge you can assume all the Middle East material will be sold out"

Francois Vleugels, UNIPETROL

To a great extent, noted Francois Vleugels, chairman and CEO of Czech Republic-based UNIPETROL, the impact of the new Middle East capacity on Europe hinges on what happens in Asia-Pacific, and especially China and India, and whether these continue growing at the rates predicted. "Even a small hiccup of 1–2% [off GDP growth rates] will make a significant difference in the supply-demand balance," he said.

Both he and Wildi believe that the present wave of new capacity differs from previous Middle East capacity waves, which came on stream largely on a level playing field with the rest of the world. "This time, Middle East investments are much more competitive given the cost efficiency of the feedstocks in a record-high oil price environment and the fact that all new plants are large, worldscale units," noted Wildi. And Vleugels commented: "The price advantage is so huge you can assume all the Middle East material will be sold out…. We need to be ready for it."

But, irrespective of whether Asian demand is as strong as expected, the prospect of vast amounts of polymers heading to Europe is not as certain as might at first be thought. Middle East producers are increasingly allied with those in Europe and they act in a responsive way. As Litjens pointed out, one-third of SABIC's turnover is now based in Europe and that requires a well-aligned approach.

"[Middle East] producers... will look at acquiring market share by buying competitors"

Benjamin Palomo-Sanz, Repsol YPF

Palomo-Sanz sees this trend developing further. "As the low-cost [Middle East] producers generate enormous amounts of cash and profits, they will look at acquiring market share by buying their competitors," he predicted. Again, the result will be more concern not to sour the European market.

CLOUDS ON THE WAY

But inevitably, the situation for Europe's producers will worsen. Indeed, the last quarter of 2007 showed definite signs of a decline in earnings. Martin Kuzaj, executive vice president of the base chemicals unit at Abu Dhabi and Austria's Borealis, noted, "pressure is now increasing and clouds are coming along…. We need to make the best of the situation and go with the flow." His advice is to ensure that the industry has the best assets and a good basis for production, and a strategy of value creation though innovation.

"Let's do our homework and stick with the strategy…. We know it will be difficult but it's all part of the business and we need to deal with it." He acknowledged that the sector has enjoyed good times and seen better than expected returns, but added that it was all too easy to talk yourself into a down cycle.

On a positive note, compared with earlier downturns, European players look better

SUPPLY CHAIN AND CASH FLOW ARE MAJOR ISSUES

A second major theme at the Roundtable was the supply chain and associated issues such as the customer interface and the order-to-cash cycle. Several participants noted the high cost of the supply chain in the bulk chemicals sector, with as much as one-third of value created being lost in delivering the product.

But several with recent experience in private equity firms or in privately owned companies noted just how much more producers can do to improve their performance in the cash flow area. There is not a lot of understanding of financial ratios, noted Bayer MaterialScience's Patrick Thomas, while Francois Vleugels, of UNIPETROL, added that working for private equity is like a crash course in this respect. "They are very good at cash generation and discipline."

But there have been positive developments. With product tight, and even sold out at some periods over the past few years, producers have been able to force changes on customers, targeting reduced complexity in stock, keeping units and variability in order terms and conditions.

The introduction of e-commerce and online ordering has also brought about further advances in low-cost service, and at the same time brought in new customers to producers that have gone down this route.

But there was evident concern that the growth in prices is beginning to have an effect on customers who are now reaching a limit on how much more they can absorb. LyondellBasell Industries' Anton de Vries noted that many are having difficulties passing on cost increases "and we are seeing increased financial stress – particularly in the packaging sector." This was seconded by Vleugels, who also noted that some customers were reaching their limits.

"Customers are cautious," added de Vries, "and are managing raw materials inventories carefully." Markus Wildi of Dow Europe pointed out that the whole cash flow area is a problem for customers and will be for the next couple of years. "If the euro stays where it is, customers will suffer," he said.

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"Margins can swing dramatically... even when selling prices are constant"

Patrick Thomas, Bayer MaterialScience

prepared this time. An extended period of restructuring through merger and acquisition (M&A) activity has resulted in fewer, but more-committed players. And there is increased integration from refinery to petrochemicals – generally viewed by the roundtable participants (see box) as essential for a sustainable future.

M&A has created a handful of major players by pulling together many businesses, often from the hands of less committed owners. LyondellBasell Industries, INEOS, SABIC Europe, Borealis, PKN Orlen/UNIPETROL and Total Petrochemicals are prime examples of this consolidation.

But what of more specific concerns? Many agreed with BorsodChem's CEO, Kay Gugler, when he pointed to the problems for the petrochemical sector from high energy and utility costs. For his company, electricity costs account for around 10% of turnover, compared with 5–6% just a few years ago. "It is very difficult to pass on these costs, especially in polyvinyl chloride (PVC)."

He added that the lack of an effective EU energy policy and the dependence on Russia's Gazprom creates difficulties, a view reinforced by Vleugels of fellow East European producer UNIPETROL. "Security of supply and the connection with Russia is a big issue for us." But, he added, the good news for the East European producers is the comparatively high growth rates being experienced in the region; polymers for instance, are seeing 8%/year advances on an increasingly sizeable base demand.

Wildi, too, commented on the energy issue, noting that it was not just the high level of energy pricing, but the volatility that is an issue, bringing quarter-on-quarter changes in company results.

ROUNDTABLE PARTICIPANTS

EXECUTIVES

Kay Gugler, CEO, BorsodChem
Martin Kuzaj, Executive vice president, base chemicals, Borealis
Boy Litjens, CEO and chairman, SABIC Europe
Benjamin Palomo-Sanz, managing director, chemicals, Repsol YPF
Patrick Thomas, CEO, Bayer MaterialScience
Francois Vleugels, CEO and chairman, UNIPETROL
Anton de Vries, president, polymers division, LyondellBasell Industries
Markus Wildi, president, Dow Europe

FROM BOOZ ALLEN HAMILTON

Joachim Rotering, senior vice president, chemicals
Sven Uwe Vallerien, vice president, chemicals
Richard Verity, senior vice president, chemicals and energy

FROM ICIS

John Baker, global editor, custom publishing

REGULATORY DANGERS

Increasing regulatory pressures were also picked up on by most of the participants. Reach and the EU's carbon trading plan were roundly seen as having a negative effect on the sector's competitiveness. But there are a number of other measures, and as Vleugels noted: "Lots of little things add up. It's really horrible, and something we need to do something about."

"Middle East investments are much more competitive this time given the cost-efficiency of the feedstocks in a record-high oil price environment"

Markus Wildi, Dow Europe

One issue, added Wildi, is that the EU looks at regulation on a vertical level and fails to see the cumulative effect on the industry of its various strands of legislation. "This may work as long as the economy is as strong as it has been in the last two years. However, if the economy weakens and the focus needs to be put on growth and employment, these various strands of legislation may turn out to be hindering rather than supportive." Thomas reinforced the point by suggesting that ongoing EU legislation would have a long-term impact on the European chemical industry, as a lot of manufacturing of products, such as personal computers and electronics, has shifted to China and India. "One day, the EU [legislators] will wake up and wonder what they have done… when all the chemical industry has gone."

"If we do not position ourselves well, there will be difficult years ahead"

Anton de Vries, LyondellBasell Industries

The advice from Litjens is that the industry needs to be much more positive in engaging the authorities in dialogue.

"We shouldn't complain – we should be more proactive in creating a better relationship with the authorities." The chemical industry, he explained, is still one of the leaders in Europe and represents a very big market. Also, on many issues such as energy and the environment, the industry is able to resolve problems, which is something it ought to be able to turn to its advantage. ■

ROUNDTABLE CONTACTS

The eight leading petrochemical company leaders met in Brussels, Belgium, on March 7 to discuss the issues facing petrochemical producers in Europe. John Baker of ICIS and Richard Verity of Booz Allen Hamilton co-chaired the discussion.

For copies of the briefing papers, please email **john.baker@icis.com**. Or contact Richard Verity at Booz Allen Hamilton: **verity_richard@bah.com**

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